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million was included in other assets, net at December 31, 2006.

Allowance for Doubtful Accounts

VMware maintains an allowance for doubtful accounts for estimated probable losses on uncollectible accounts receivable. The allowance is based upon the creditworthiness of VMware's customers, historical experience, the age of the receivable and current market and economic conditions. Uncollectible amounts are charged against the allowance account.

Furniture, Fixtures and Equipment

Furniture, fixtures and equipment are recorded at cost. Depreciation commences upon placing the asset in service and is recognized on a straight-line basis over the estimated useful lives of the assets, as follows:

Furniture and fixtures	5 years
Equipment	2 to 5 years
Leasehold improvements	Shorter of lease term or useful life

Upon retirement or disposition, the asset cost and related accumulated depreciation are removed with any gain or loss recognized in the income statement. Repair and maintenance costs, including planned maintenance, are expensed as incurred.

Research and Development and Capitalized Software Development Costs

Costs incurred in the research and development of new software products are expensed as incurred until technological feasibility is established. Technological feasibility is defined as the earlier of the completion of a detail program design or a working model. Such costs include salaries and benefits, including stock-based compensation, consultants, facilities-related costs, equipment costs, and depreciation. Software development costs incurred subsequent to establishing technological feasibility through the general release of the software products are capitalized. Capitalized costs are amortized over periods ranging from 18 to 24 months, which represent the products' estimated useful lives. Unamortized software development costs were \$46.1 million (unaudited), \$46.5 million and \$25.8 million at March 31, 2007 and December 31, 2006 and 2005, respectively, and are included in other assets, net. Amortization expense was \$8.0 million (unaudited), \$2.8 million (unaudited), \$22.3 million, \$6.2 million and \$1.3 million for the three months ended March 31, 2007 and 2006, and for the years ended December 31, 2006, 2005 and 2004, respectively. Amounts capitalized were \$7.6 million (unaudited), \$17.7 million (unaudited), \$43.0 million, \$25.1 million and \$8.2 million for the three months ended March 31, 2007 and 2006, and for the years ended December 31, 2006, 2005 and 2004, respectively.

Long-lived Assets

Purchased intangible assets, other than goodwill, are amortized over their estimated useful lives which range from three to nine years. Goodwill is carried at its historical cost.

VMware periodically reviews long-lived assets for impairment in accordance with SFAS No. 144 Accounting for Impairment or Disposal of Long-Lived Assets. VMware initiates reviews for impairment

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value of the asset. If impairment is indicated, the asset is written down to its estimated fair value.

VMware tests goodwill for impairment in accordance with SFAS No. 142 Goodwill and other Intangible Assets, in the fourth quarter of each year or more frequently if events or changes in circumstances indicate that the asset might be impaired.

Advertising

Advertising production costs are expensed as incurred. Advertising expense was \$1.6 million, \$0.9 million and \$0.3 million in 2006, 2005 and 2004, respectively.

Income Taxes

Income taxes as presented herein are calculated on a separate tax return basis, although VMware is included in the consolidated tax return of EMC. Deferred tax liabilities and assets are recognized for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the difference between the tax basis of assets and liabilities and their reported amounts using enacted tax rates in effect for the year in which the differences are expected to reverse. Tax credits are generally recognized as reductions of income tax provisions in the year in which the credits arise. The measurement of deferred tax assets is reduced by a valuation allowance if, based upon available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

VMware does not provide for a U.S. income tax liability on undistributed earnings of VMware's foreign subsidiaries. The earnings of non-U.S. subsidiaries, which reflect full provision for non-U.S. income taxes, are currently indefinitely reinvested in non-U.S. operations or will be remitted substantially free of additional tax.

The difference between the income taxes payable that is calculated on a separate return basis and the amount actually paid to EMC pursuant to VMware's tax sharing agreement is presented as a component of additional paid-in capital.

Sales Taxes

Sales and other taxes collected from customers and subsequently remitted to government authorities are recorded as accounts receivable with a corresponding offset to sales tax payable. The balances are removed from the consolidated balance sheet as cash is collected from the customer and as remitted to the tax authority.

Earnings Per Share

Through March 31, 2007, VMware had 32.5 million shares of Class A common stock and 300.0 million shares of Class B common stock outstanding. There is no difference between basic and diluted earnings per share because there were no outstanding options to purchase shares of VMware common stock or other potentially dilutive securities outstanding. For purposes of calculating earnings per share, the Company uses the two-class method. Because both classes share the same rights in dividends, basic and diluted earnings per share was the same for both classes. In connection with the IPO, eligible employees will be offered the right to exchange equity instruments held in EMC's common stock for equity instruments of VMware's common stock, and certain employees will be awarded stock option grants to purchase shares of VMware's common stock.

Unaudited pro forma per share data gives effect, in the weighted average shares used in the calculation, to the additional 26.4 million shares, which, when multiplied by the assumed offering price of \$28.00 per share (the midpoint of the range set forth on the cover page of the prospectus relating to the initial public offering of

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VMware Class A common stock), and after giving effect to a pro rata allocation of offering costs, would have been required to be issued to generate proceeds sufficient to pay the portion of the \$800.0 million dividend declared in April 2007 (see Note M) that exceeded the most recent twelve months' earnings.

Comprehensive Income

Comprehensive income is equal to net income.

Concentrations of Risks

Financial instruments which potentially subject VMware to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and are maintained with financial institutions of reputable credit and therefore bear minimal credit risk. VMware places cash and cash equivalents in money market funds and limit the amount of investment with any one issuer.

VMware provides credit to distributors, resellers and certain end-user customers in the normal course of business. Credit is generally extended to new customers based upon industry reputation or a credit evaluation. Credit is extended to existing customers based on ongoing credit evaluations, prior payment history and demonstrated financial stability.

Two distributors accounted for 28% and 11%, respectively, of VMware's accounts receivable balance as of December 31, 2006. Two distributors accounted for 30% and 11%, respectively, of VMware's accounts receivable balance as of December 31, 2005. One of these distributors accounted for 29%, 30% and 27% of revenues in 2006, 2005 and 2004, respectively.

Accounting for Stock-Based Compensation

VMware employees have been granted stock options for and restricted stock awards of EMC's common stock. On January 1, 2006, FAS No. 123R became effective. The standard requires recognizing compensation costs for all share-based payment awards made to employees based upon the awards' estimated grant date fair value. The standard covers employee stock options, restricted stock and employee stock purchases related to employee stock purchase plans. Additionally, VMware applied the provisions of the SEC's Staff Accounting Bulletin No. 107 on Share-Based Payment to VMware's adoption of FAS No. 123R. Previously, VMware elected to account for these share-based payment awards under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Although the equity awards have been made for grants in EMC's common stock, for purposes of presentation within these financial statements, the compensation related to these equity grants has been included as a component of stockholder's equity.

FAS No. 123R was adopted using the modified prospective transition method which does not result in the restatement of results from prior periods, and, accordingly, the results of operations for the year ended December 31, 2006 and future periods will not be comparable to the historical results of operations of VMware.

Under the modified prospective transition method, FAS No. 123R applies to new equity awards and to equity awards modified, repurchased or canceled after the adoption date. Additionally, compensation cost for the portion of awards granted prior to the adoption date for which the requisite service has not been rendered as of the adoption date is recognized as the requisite service is rendered. The compensation cost for that portion of awards is based on the grant-date fair value of those awards as calculated in the prior period pro forma disclosures under FAS No. 123, Accounting for Stock-Based Compensation (FAS No. 123) as reported by EMC. The compensation cost for those earlier awards is attributed to periods beginning on or after the adoption date using the attribution method that was used under FAS No. 123, which was the straight-line method. Instead of recognizing forfeitures only as they occur, VMware now estimates an expected forfeiture rate which is utilized to determine VMware's expense. Deferred compensation which related to those earlier awards has been eliminated against additional paid-in capital in conjunction with the adoption of FAS No. 123R.

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For stock options, VMware has utilized the Black-Scholes option-pricing model to determine the fair value of VMware's stock option awards. For stock options and restricted stock, VMware recognizes compensation cost on a straight-line basis over the awards' vesting periods for those awards which contain only a service vesting feature.

In connection with the IPO, VMware and EMC are conducting an exchange offer enabling eligible VMware employees to exchange their options to acquire EMC common stock for options to acquire VMware common stock and to exchange restricted stock awards of EMC's common stock for restricted stock awards of VMware's common stock based on a formulaic exchange ratio which will be determined by dividing the two-day volume-weighted average price of EMC's common stock for the last two full days of the exchange offer by the initial public offering price of VMware's Class A common stock. The Company expects the exchange offer will expire on the date of the pricing of the initial public offering of VMware Class A common stock. The exchange offer is structured to generally retain the intrinsic value of the tendered EMC securities. The number of VMware options received in exchange for EMC options will be determined by multiplying the number of tendered EMC options by the exchange ratio. The exercise price of the VMware options received in exchange will be the exercise price of the tendered EMC options divided by the exchange ratio. The number of shares of VMware restricted stock received in exchange for EMC restricted stock will be determined by multiplying the number of tendered EMC restricted shares by the exchange ratio. The exchange offer will likely result in a reduction in diluted earnings per share due to the future inclusion of the potential VMware common shares.

Revision of Financial Statement Presentation

The Company has revised its prior presentation of the cumulative effect of adopting the provisions of FAS No. 123R to now present the impact of recording the pro forma balance sheet amounts related to capitalized software costs as a credit to additional paid-in capital at January 1, 2006 as opposed to as a cumulative effect of accounting change that impacted net income. The effect of this change was immaterial to the consolidated financial statements and reduced net income for the full year 2006 and the three-months ended March 31, 2006 by \$1,060,000 and increased additional paid-in capital at January 1, 2006 by the same amount. This change had no impact on the previously reported income before cumulative effect of a change in accounting principle or on cash flows from operating, financing or investing activities.

New Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FAS No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50 percent likelihood of being realized upon ultimate settlement. VMware adopted FIN No. 48 on January 1, 2007, and it did not have a material impact on our financial statements.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements (FAS No. 157), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles. FAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and should be applied prospectively, except in the case of a limited number of financial instruments that require retrospective application. VMware is currently evaluating the potential impact of FAS No. 157 on VMware's financial position and results of operations.

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In February 2007, the FASB issued FAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FAS 115 (FAS No. 159)". The new statement allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item's fair value in subsequent reporting periods must be recognized in current earnings. FAS No. 159 is effective for fiscal years beginning after November 15, 2007. VMware is currently evaluating the potential impact of FAS No. 159 on VMware's financial position and results of operations.

B. Business Acquisitions, Goodwill and Intangible Assets

In June 2006, VMware acquired all of the outstanding capital stock of Akimbi Systems, Inc. (Akimbi), a developer of software that builds upon and leverages virtualization technology to improve the efficiency and effectiveness of enterprise application development operations and the IT organizations that support them. Through the acquisition of Akimbi, VMware's capabilities for virtualizing information by providing virtualization solutions to the development and test environments have been enhanced.

The purchase price, net of cash received, was \$47.3 million, which consisted of \$45.9 million of cash, \$0.7 million in fair value of EMC's stock options and \$0.7 million of transaction costs, which primarily consisted of fees incurred by VMware for financial advisory, legal and accounting services. The fair value of EMC's stock options issued to employees of Akimbi was estimated using a Black-Scholes option-pricing model. The fair value of the stock options was estimated assuming no expected dividends and the following weighted-average assumptions:

Expected life (in years)	2.5
Expected volatility	35.0%
Risk-free interest rate	5.0%

The consolidated financial statements include the results of Akimbi from the date of acquisition. The purchase price has been allocated to the tangible and identifiable intangible assets acquired and the liabilities assumed based on estimated fair values as of the acquisition date.

The following represents the allocation of the purchase price (table in thousands):

Current assets	\$ 410
Furniture, fixtures and equipment	527
Other long-term assets	24
Intangible assets:	
Goodwill	34,254
Developed technology (weighted-average useful life of 5.0 years)	9,300
IPR&D	3,700
Total intangible assets	47,254
Current liabilities	(546)
Deferred income tax liability	(380)
Total purchase price	\$ 47,289

In determining the purchase price allocation, VMware considered, among other factors, VMware's intention to use the acquired assets and historical and estimated future demand of Akimbi's products. The fair value of intangible assets was primarily based upon the income approach. The rate used to discount the net cash flows to

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their present values was based upon a weighted average cost of capital of 25%. The discount rate was determined after consideration of market rates of return on debt and equity capital, the weighted average return on invested capital and the risk associated with achieving forecasted sales related to the technology and assets acquired from Akimbi.

The amortization period for the developed technology is 5.0 years. The developed technology is being amortized based upon the pattern in which the economic benefits of the asset is being utilized, which in general reflects the cash flows generated from the asset. None of the goodwill is deductible for income tax purposes.

The IPR&D of \$3.7 million was written off at the date of acquisition because it was determined that the IPR&D had no alternative uses and had not reached technological feasibility. The value assigned to IPR&D was determined utilizing the income approach by determining cash flow projections relating to the identified IPR&D project. The stage of completion for the in-process project was estimated to determine the discount rates to be applied to the valuation of the in-process technology. Based upon the level of completion and the risk associated with in-process technology, VMware applied a discount rate of 35% to value the project.

Intangible Assets

Intangible assets, excluding goodwill as of December 31, 2006 and 2005, consist of (tables in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Book Value
2006 Category			
Purchased technology	\$ 102,910	\$ (70,684)	\$ 32,226
Trademarks and tradenames	7,580	(3,200)	4,380
Customer relationships and customer lists	5,290	(1,774)	3,516
Other	5,660	(2,267)	3,393
Total intangible assets, excluding goodwill	\$ 121,440	\$ (77,925)	\$ 43,515

	Gross Carrying Amount	Accumulated Amortization	Net Book Value
2005 Category			
Purchased technology	\$ 93,610	\$ (48,845)	\$ 44,765
Trademarks and tradenames	7,580	(1,736)	5,844
Customer relationships and customer lists	5,290	(809)	4,481
Other	5,660	(1,013)	4,647
Total intangible assets, excluding goodwill	\$ 112,140	\$ (52,403)	\$ 59,737

Amortization expense on intangibles was \$25.5 million, \$26.1 million and \$26.3 million in 2006, 2005 and 2004, respectively. As of December 31, 2006, amortization expense on intangible assets for the next five years is expected to be as follows (table in thousands):

2007	\$ 25,150
2008	12,344
2009	3,465

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2010	1,807
2011	397
Total	\$ 43,163

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Changes in the carrying amount of goodwill for the years ended December 31, 2006 and 2005 consist of the following (table in thousands):

	2006	2005
Balance, beginning of the year	\$ 526,252	\$ 525,479
Goodwill acquired	34,258	4,644
Finalization of purchase price allocations	(28)	(3,871)
Balance, end of the year	\$ 560,482	\$ 526,252

C. Other Current Assets

Other current assets consists of (table in thousands):

	March 31, 2007 (unaudited)	December 31, 2006	December 31, 2005
Restricted cash	\$ 10,002	\$ 10,173	\$ 2,515
Prepaid expenses	6,975	7,337	2,522
Other receivables	4,232	4,950	492
Other	187	226	444
	\$ 21,396	\$ 22,686	\$ 5,973

D. Furniture, Fixtures and Equipment

Furniture, fixtures and equipment consists of (table in thousands):

	March 31, 2007 (unaudited)	December 31, 2006	December 31, 2005
Furniture and fixtures	\$ 5,139	\$ 1,338	\$ 99
Equipment	71,256	57,321	23,677
Improvements	16,721	11,456	2,758
Construction in progress	3,602	9,942	5,660
	96,718	80,057	32,194
Accumulated depreciation	(38,240)	(31,382)	(12,853)
	\$ 58,478	\$ 48,675	\$ 19,341

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Depreciation expense was \$6.9 million (unaudited), \$3.5 million (unaudited), \$18.7 million, \$7.2 million and \$2.6 million for the three months ended March 31, 2007 and 2006, and the years ended December 31, 2006, 2005 and 2004, respectively.

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Accrued expenses consist of (table in thousands):

	March 31, 2007 (unaudited)	December 31, 2006	December 31, 2005
Salaries and benefits	\$ 42,256	\$ 45,576	\$ 20,720
Accrued rebates	31,365	28,655	7,891
Other	30,660	29,090	13,806
	\$ 104,281	\$ 103,321	\$ 42,417

F. Income Taxes

VMware's provision for income taxes consists of (table in thousands):

	Year Ended December 31,	Year Ended December 31,	Period from January 9, 2004 to December 31,
	2006	2005	2004
Federal:			
Current	\$ 53,101	\$ 47,088	\$ 11,021
Deferred	(20,083)	(20,840)	5,957
	33,018	26,248	16,978
State:			
Current	3,096	2,942	(214)
Deferred	(2,184)	(1,653)	1,058
	912	1,289	844
Foreign:			
Current	2,902	1,028	547
Deferred	(2,902)	(1,028)	(547)
	2,902	1,028	547
Total provision for income taxes	\$ 36,832	\$ 28,565	\$ 18,369

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A reconciliation of VMware's income tax provision to the statutory federal tax rate is as follows:

	Year Ended December 31,		Period from January 9, 2004 to December 31,
	2006	2005	2004
Statutory federal tax rate	35.0%	35.0%	35.0%
State taxes, net of federal benefit	0.7%	1.4%	2.4%
Tax rate differential for international jurisdictions	(21.0)%	(16.7)%	(12.4)%
U.S. tax credits	(4.9)%	(3.9)%	(8.0)%
Permanent items, including Subpart F Income, non-deductible stock-based compensation expenses and IPR&D charges	20.8%	16.1%	38.7%
Other	(0.5)%	(1.9)%	(3.4)%
Effective tax rate	30.1%	30.0%	52.3%

The components of the current and non-current deferred tax assets are as follows (table in thousands):

	December 31, 2006		December 31, 2005	
	Deferred Tax Asset	Deferred Tax Liability	Deferred Tax Asset	Deferred Tax Liability
Current:				
Accounts receivable	\$ 630	\$	\$ 604	\$
Accrued expenses	9,402		3,460	
Deferred revenue	16,778		16,740	
Net operating loss carryforwards	846		63	
Total current	27,656		20,867	
Non-current:				
Property, plant and equipment, net	2,749		1,007	
Intangible and other assets, net		(30,579)		(31,150)
Deferred revenue	15,698		5,400	
Credit carryforwards	612			
Net operating loss carryforwards	1,876			
Total non-current	20,935	(30,579)	6,407	(31,150)
Total deferred tax assets and liabilities	\$ 48,591	\$ (30,579)	\$ 27,274	\$ (31,150)

VMware has federal net operating loss carryforwards of \$7.0 million from acquisitions in 2005 and 2006. These carryforwards expire at different periods through 2026. Portions of these carryforwards are subject to annual limitations, including Section 382 of the Internal Revenue Code of 1986, as amended (the Code), for U.S. tax purposes. VMware expects to be able to fully use these net operating losses against future income.

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Deferred income taxes have not been provided on basis differences related to investments in foreign subsidiaries. These basis differences were approximately \$12.9 million and \$0.5 million at December 31, 2006 and 2005, respectively, and consisted of undistributed earnings permanently invested in these entities. The unrecognized deferred tax liability associated with these unremitted earnings is approximately \$4.4 million and \$0.1 million as of December 31, 2006 and 2005, respectively. Income before income taxes from foreign operations for 2006, 2005 and 2004 was \$82.0 million, \$48.5 million and \$14.0 million, respectively.

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The difference between the income taxes payable that is calculated on a separate return basis and the amount actually paid to EMC pursuant to VMware's tax sharing agreement is presented as a component of additional paid-in capital. These differences resulted in an increase of additional paid-in capital of \$3.8 million in 2004 and a decrease in additional paid-in capital of \$13.8 million and \$32.3 million in 2005 and 2006, respectively.

VMware adopted FASB Interpretation 48, Accounting for Uncertainty in Income Taxes (FIN No. 48), at the beginning of fiscal year 2007. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FAS No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50 percent likelihood of being realized upon ultimate settlement. VMware had no changes to the amount of its income tax payable as a result of implementing FIN No. 48. Prior to the adoption of FIN No. 48, VMware's policy was to classify accruals for uncertain positions as a current liability unless it was highly probable that there would not be a payment or settlement for such identified risks for a period of at least a year. VMware reclassified \$4.5 million of income tax liabilities from current to non-current liabilities because a cash settlement of these liabilities is not anticipated within one year of the balance sheet date.

As of January 1, 2007, we had \$4.4 million of unrecognized tax benefits; if recognized, all of this amount would be recognized as a reduction of income tax expense impacting the effective income tax rate. This amount did not change significantly during the three months ended March 31, 2007. We are subject to U.S. federal income tax and various state, local and international income taxes in numerous jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we file.

We have substantially concluded all U.S. federal income tax matters for years through 2004. The U.S. federal income tax audit for 2005 and 2006 is scheduled to commence in June 2007, and we have income tax audits in progress in numerous state, local and international jurisdictions in which we operate. In our international jurisdictions that comprise a significant portion of our operations, the years that may be examined vary, with the earliest year being 2003. Based on the outcome of examinations of VMware, the result of the expiration of statutes of limitations for specific jurisdictions or the result of ruling requests from taxing authorities, it is reasonably possible that the related unrecognized tax benefits could change from those recorded in our statement of financial position. It is possible that one or more of these audits may be finalized within the next 12 months. However, based on the status of examinations, and the protocol of finalizing audits, it is not possible to estimate the impact of such changes, if any, to our previously recorded uncertain tax positions.

We recognize interest expense and penalties related to income tax matters in income tax expense. In addition to the unrecognized tax benefits noted above, we had accrued \$0.1 million of interest as of January 1, 2007. The amount did not change significantly during the three months ended March 31, 2007.

G. 401(k) Plan

VMware employees participate in EMC's 401(k) plan. VMware matches pre-tax employee contributions up to 6% of eligible compensation during each pay period (subject to the \$750 maximum match each quarter). Matching contributions are immediately 100% vested. VMware contributions for employees were \$3.1 million in 2006, \$2.0 million in 2005 and \$0.9 million in 2004.

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Employees may elect to invest their contributions in a variety of funds, including an EMC stock fund. The 401(k) plan limits an employee's maximum investment allocation in the EMC stock fund to 30% of his or her total contribution. The matching contribution mirrors the investment allocation of the employee's contribution.

H. Commitments and Contingencies***Operating Lease Commitments***

VMware leases office facilities and equipment under various operating leases. Facility leases generally include renewal options. Rent expense for 2006, 2005 and 2004 was \$14.0 million, \$5.8 million and \$3.8 million, respectively.

VMware's future lease commitments are as follows (table in thousands):

2007	\$ 13,562
2008	8,966
2009	7,864
2010	7,617
2011	6,632
Thereafter	253,442
Total minimum lease payments	\$ 298,083

Outstanding Obligations

At December 31, 2006 VMware had outstanding purchase orders aggregating \$46.7 million. While the purchase orders are generally cancelable without penalty, certain vendor agreements provide for percentage-based cancellation fees or minimum restocking charges based on the nature of the product or service. In addition, VMware had outstanding construction contracts for VMware's new headquarter facilities aggregating \$77.6 million at December 31, 2006. EMC currently reimburses VMware for the costs VMware incurs under these contracts and will continue to do so through the date of VMware's initial public offering, at which time VMware will purchase the facilities from EMC. Total costs incurred through December 31, 2006 were \$63.5 million. There will be additional costs incurred through the initial public offering date.

Guarantees and Indemnification Obligations

VMware enters into agreements in the ordinary course of business with, among others, customers, distributors, resellers, x86 system vendors and systems integrators. Most of these agreements require VMware to indemnify the other party against third-party claims alleging that a VMware product infringes or misappropriates a patent, copyright, trademark, trade secret and/or other intellectual property right. Certain of these agreements require VMware to indemnify the other party against certain claims relating to property damage, personal injury or the acts or omissions of VMware, its employees, agents or representatives.

VMware has agreements with certain vendors, financial institutions, lessors and service providers pursuant to which VMware has agreed to indemnify the other party for specified matters, such as acts and omissions of VMware, its employees, agents or representatives.

VMware has procurement or license agreements with respect to technology that is used in VMware's products and agreements in which VMware obtains rights to a product from an x86 system vendor. Under some of these agreements, VMware has agreed to indemnify the supplier for certain claims that may be brought against such party with respect to VMware's acts or omissions relating to the supplied products or technologies.

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VMware has agreed to indemnify the directors and officers of VMware and VMware's subsidiaries, to the extent legally permissible, against all liabilities reasonably incurred in connection with any action in which such individual may be involved by reason of such individual being or having been a director or officer.

In connection with certain acquisitions, VMware has agreed to indemnify the current and former directors, officers and employees of the acquired company in accordance with the acquired company's by-laws and charter in effect immediately prior to the acquisition or in accordance with indemnification or similar agreements entered into by the acquired company and such persons. VMware has maintained the acquired company's directors' and officers' insurance, which should enable VMware to recover a portion of any future amounts paid.

Based upon VMware's historical experience and information known as of December 31, 2006, VMware believes liability on the above guarantees and indemnities at December 31, 2006 is insignificant.

Litigation

VMware is a party to various legal proceedings which VMware considers routine and incidental to VMware's business. Management does not expect the results of any of these proceedings to have a material adverse effect on VMware's business, results of operations or financial condition.

I. Stockholder's Equity

Common Stock

Following the initial public offering of VMware Class A common stock, VMware will have two classes of authorized common stock: Class A common stock and Class B common stock.

Dividend Rights

Subject to preferences that may apply to shares of preferred stock outstanding at the time, the holders of outstanding shares of VMware's Class A common stock and Class B common stock are entitled to receive dividends, out of assets legally available, sharing equally in all such dividends on a per share basis, at the times and in the amounts that VMware's board of directors may determine from time to time.

Conversion Rights

Each share of Class B common stock is convertible while held by EMC or its successor-in-interest at the option of EMC or its successor-in-interest into one share of Class A common stock. If VMware's Class B common stock is distributed to security holders of EMC in a transaction (including any distribution in exchange for shares of EMC's or its successor-in-interest's common stock or other securities) intended to qualify as a distribution under Section 355 of the Code, or any corresponding provision of any successor statute, shares of VMware's Class B common stock will no longer be convertible into shares of Class A common stock. Prior to any such distribution, all shares of Class B common stock will automatically be converted into shares of Class A common stock upon the transfer of such shares of Class B common stock by EMC other than to any of EMC's successors or any of its subsidiaries (excluding VMware). If such a distribution has not occurred, each share of Class B common stock will also automatically convert at such time as the number of shares of common stock owned by EMC or its successor-in-interest falls below 20% of the outstanding shares of VMware's common stock. Following any such distribution, VMware may submit to its stockholders a proposal to convert all outstanding shares of Class B common stock into shares of Class A common stock, provided that VMware has received a favorable private letter ruling from the Internal Revenue Service satisfactory to EMC to the effect that

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the conversion will not affect the intended tax treatment of the distribution. In a meeting of VMware stockholders called for this purpose, the holders of VMware Class A common stock and VMware Class B common stock will be entitled to one vote per share and, subject to applicable law, will vote together as a single class and neither class of common stock will be entitled to a separate class vote. All conversions will be effected on a share-for-share basis.

Voting Rights

Except that holders of Class A common stock are entitled to one vote per share while holders of Class B common stock are entitled to 10 votes per share on all matters to be voted on by VMware's stockholders and except with respect to the election of directors, conversion, certain actions that require the consent of holders of Class B common stock and other protective provisions as set forth in this prospectus offer to exchange relating to the exchange offer, the holders of Class A common stock and Class B common stock have identical rights. The holders of VMware Class B common stock, voting separately as a class, are entitled to elect 80% of the total number of directors on VMware's board of directors which it would have if there were no vacancies on the board of directors at the time. Subject to any rights of any series of preferred stock to elect directors, the holders of VMware Class A common stock and the holders of VMware Class B common stock, voting together as a single class, are entitled to elect the remaining directors, which at no time will be less than one director. In any such election, the holders of Class A common stock and the holders of Class B common stock are entitled to one vote per share. In the event that the rights of any series of preferred stock would preclude the holders of VMware Class A common stock and the holders of VMware Class B common stock, voting together as a single class, from electing at least one director, the board of directors will increase the number of directors prior to the issuance of that preferred stock to the extent necessary to allow these stockholders to elect at least one director. Generally, all other matters to be voted on by stockholders must be approved by a majority of the votes entitled to be cast at a meeting by all shares of Class A common stock and Class B common stock present in person or represented by proxy, voting together as a single class, subject to any voting rights granted to holders of any preferred stock. Additionally, following a distribution of VMware Class B common stock to security holders of EMC, any person or group that beneficially owns 10% or more of the Class B common stock will not have any right to vote their shares of Class B common stock in the election of directors unless that person or group of persons also beneficially owns at least an equivalent percentage of VMware Class A common stock with two exceptions:

where such person or group obtains the consent of VMware's board of directors prior to acquiring beneficial ownership of at least 5% of VMware's common stock; or

where such person or group acquires beneficial ownership of at least 5% of VMware's common stock solely as a result of a distribution of Class B common stock to EMC stockholders and, prior to acquiring one additional share of Class B common stock, such person or group obtains the consent of VMware's board of directors.

No Preemptive or Redemption Rights

VMware's Class A common stock and Class B common stock are not entitled to preemptive rights and are not subject to redemption or sinking fund provisions.

Right to Receive Liquidation Distributions

Upon VMware's liquidation, dissolution or winding-up, the holders of VMware's Class A common stock and Class B common stock are entitled to share equally in all of VMware's assets remaining after payment of all liabilities and the liquidation preferences of any outstanding preferred stock.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Approval Rights of Holders of Class B Common Stock

In addition to any other vote required by law or by VMware's certificate of incorporation, until the first date on which EMC ceases to beneficially own 20% or more of the outstanding shares of VMware's common stock, the prior affirmative vote or written consent of EMC as the holder of the Class B common stock is required (subject in each case to certain exceptions) in order to authorize VMware to:

consolidate or merge with any other entity;

acquire the stock or assets of another entity in excess of \$100 million;

issue any stock or securities except to VMware's subsidiaries or pursuant to the initial public offering of VMware Class A common stock or VMware's employee benefit plans;

dissolve, liquidate or wind VMware up;

declare dividends on VMware's stock;

enter into any exclusive or exclusionary arrangement with a third party involving, in whole or in part, products or services that are similar to EMC's; and

amend, terminate or adopt any provision inconsistent with certain provisions of VMware's certificate of incorporation or bylaws.

Preferred Stock

Subject to the approval of the Class B stockholders, and subject to any requirements of the New York Stock Exchange, or any applicable national securities exchange, VMware's series preferred stock may be issued from time to time in one or more series, with such terms as VMware's board of directors may determine.

Equity Plans

VMware employees participate in the EMC Corporation 2003 Stock Plan (the 2003 Plan) which provides for the grant of stock options, stock appreciation rights, restricted stock and restricted stock units. The exercise price for a stock option shall not be less than 100% of the fair market value of EMC's common stock on the date of grant. Options generally become exercisable in annual installments over a period of three to five years after the date of grant and expire ten years after the date of grant. Incentive stock options will expire no later than ten years after the date of grant. Restricted stock is common stock that is subject to a risk of forfeiture or other restrictions that will lapse upon satisfaction of specified conditions. Awards of restricted stock that vest only by the passage of time will not vest fully in less than three years after the date of grant.

In addition to the 2003 Plan, VMware employees have participated in EMC's three employee stock option plans (the 1985 Plan, the 1993 Plan and the 2001 Plan). Under the terms of each of the three plans, the exercise price of incentive stock options issued must be equal to at least the fair market value of EMC's common stock on the date of grant. In the event that non-qualified stock options are granted under the 1985 Plan, the

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exercise price may be less than the fair market value at the time of grant, but in the case of employees not subject to Section 16 of the Securities Exchange Act of 1934, not less than par value (which is \$0.01 per share), and in the case of employees subject to Section 16, not less than 50% of the fair market value on the date of grant. In the event that non-qualified stock options are granted under the 1993 Plan or the 2001 Plan, the exercise price may be less than the fair market value at the time of grant but not less than par value.

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Employee Stock Purchase Plan***

Under EMC's 1989 Employee Stock Purchase Plan (the "1989 Plan"), eligible VMware employees may purchase shares of EMC's common stock through payroll deductions at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. Options to purchase shares are granted twice yearly, on January 1 and July 1, and are exercisable on the succeeding June 30 or December 31. In 2006, 2005 and 2004, 1.0 million shares, 0.5 million shares and 0.3 million shares, respectively, were purchased under the 1989 Plan by VMware employees at a weighted-average purchase price per share of \$9.32, \$11.61 and \$9.58, respectively. Total cash proceeds to EMC from the purchase of shares under the 1989 Plan by VMware employees in 2006, 2005 and 2004 were \$9.0 million, \$5.3 million and \$3.2 million, respectively.

Stock Options

The following tables summarize option activity for VMware employees in EMC stock options (shares in thousands):

	Number of Shares	Wtd. Avg. Exercise Price
VMware options exchanged for EMC options at January 8, 2004 (see Note A)	6,311	\$ 1.59
Options relating to employees transferred from EMC	122	24.10
Granted	4,917	11.69
Forfeited	(469)	6.46
Expired	(39)	13.08
Exercised	(1,467)	1.22
Outstanding, December 31, 2004	9,375	6.95
Options relating to employees transferred from EMC	128	22.04
Granted	3,442	13.84
Forfeited	(1,021)	9.26
Expired	(11)	9.42
Exercised	(1,328)	3.41
Outstanding, December 31, 2005	10,585	9.59
Options relating to employees transferred from EMC	293	23.59
Options exchanged in a business acquisition	265	0.40
Granted	4,941	12.51
Forfeited	(847)	12.22
Expired	(114)	14.80
Exercised	(1,298)	2.35
Outstanding, December 31, 2006	13,825	11.23
Options relating to employees transferred from EMC (unaudited)	354	25.22
Granted (unaudited)	879	13.91
Forfeited (unaudited)	(207)	12.71
Expired (unaudited)	(14)	13.06
Exercised (unaudited)	(291)	3.79
Outstanding, March 31, 2007 (unaudited)	14,546	11.86

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The total pre-tax intrinsic values of options exercised for the three months ended March 31, 2007 and 2006, and the years ended December 31, 2006, 2005 and 2004 were \$3.0 million (unaudited), \$3.6 million (unaudited), \$13.2 million, \$13.6 million and \$17.3 million, respectively. Cash proceeds from the exercise of stock options

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

paid to EMC were \$1.1 million (unaudited), \$1.0 million (unaudited), \$3.0 million, \$4.5 million and \$1.8 million for the three months ended March 31, 2007 and 2006, and the years ended December 31, 2006, 2005 and 2004, respectively.

Summarized information about stock options outstanding that are expected to vest and stock options exercisable at March 31, 2007 (unaudited) is as follows (shares and intrinsic values in thousands):

Range of Exercise Price	Options Outstanding and Expected to Vest				Options Exercisable			
	Number of Options	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Aggregate Intrinsic Value	Number of Options	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Aggregate Intrinsic Value
\$ 0.01 - \$ 5.00	1,887	5.90	\$ 1.29	\$ 23,699	1,724	5.68	\$ 1.37	\$ 21,514
\$ 5.01 - \$10.00	932	8.63	9.22	4,313	159	4.81	6.47	1,172
\$10.01 - \$15.00	9,112	8.33	12.98	8,852	2,197	7.35	12.55	3,104
\$15.01 - \$20.00	61	4.42	16.73		61	4.42	16.73	
\$20.01 - \$30.00	25	2.38	27.49		25	2.38	27.49	
\$30.01 - \$50.00	139	3.25	34.77		139	3.25	34.77	
\$50.01 - \$70.00	72	3.01	60.61		72	3.01	60.61	
\$70.01 - \$90.00	49	3.49	82.91		49	3.49	82.91	
	12,277	7.84	11.75	\$ 36,864	4,426	6.30	10.37	\$ 25,790
Expected forfeitures	2,269							
Total options outstanding	14,546							

The aggregate intrinsic values in the preceding table represent the total pre-tax intrinsic values based on EMC's closing stock price of \$13.85 as of March 31, 2007 which would have been received by the option holders had all in-the-money options been exercised as of that date.

Summarized information about stock options outstanding that are expected to vest and stock options exercisable at December 31, 2006 is as follows (shares and intrinsic values in thousands):

Range of Exercise Price	Options Outstanding and Expected to Vest				Options Exercisable			
	Number of Options	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Aggregate Intrinsic Value	Number of Options	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Aggregate Intrinsic Value
\$ 0.01 - \$ 5.00	2,100	6.00	\$ 1.29	\$ 25,021	1,913	5.77	\$ 1.37	\$ 22,641
\$ 5.01 - \$10.00	893	9.17	9.34	3,451	136	4.87	6.56	902

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\$10.01 - \$15.00	8,700	8.48	12.89	5,368	2,026	7.58	12.45	2,081
\$15.01 - \$20.00	39	5.01	16.46		38	4.61	16.57	
\$20.01 - \$30.00	25	2.63	27.49		25	2.63	27.49	
\$30.01 - \$50.00	68	3.58	35.52		68	3.58	35.52	
\$50.01 - \$70.00	12	3.17	59.59		12	3.17	59.59	
\$70.01 - \$90.00	45	3.71	83.85		45	3.71	83.85	
	11,882	8.02	11.06	\$ 33,840	4,263	6.51	8.67	\$ 25,624
Expected forfeitures	1,943							
Total options outstanding	13,825							

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The aggregate intrinsic values in the preceding table represent the total pre-tax intrinsic values based on EMC's closing stock price of \$13.20 as of December 31, 2006 which would have been received by the option holders had all in-the-money options been exercised as of that date.

Restricted Stock

The following tables summarize restricted stock activity for grants to VMware employees of EMC restricted stock in 2006, 2005 and 2004 (shares in thousands):

	Number of Shares	Weighted Average Grant Date Fair Value
Restricted stock at January 8th, 2004		\$
Granted	978	12.33
Outstanding, December 31, 2004	978	12.33
Granted	7,718	14.04
Vested	(622)	12.76
Forfeited	(172)	13.40
Outstanding, December 31, 2005	7,902	13.94
Granted	3,303	12.19
Vested	(1,967)	13.70
Forfeited	(425)	13.94
Restricted stock at December 31, 2006	8,813	13.34
Granted (unaudited)	48	13.93
Vested (unaudited)	(1,901)	14.01
Forfeited (unaudited)	(59)	13.16
Restricted stock at March 31, 2007 (unaudited)	6,901	13.16

The total fair values of EMC restricted stock that vested in the three months ended March 31, 2007 and 2006, and the years ended December 31, 2006 and 2005 were \$26.6 million (unaudited), \$8.7 million (unaudited), \$26.9 million and \$7.9 million, respectively.

The EMC restricted stock awards have various vesting terms, including pro rata vesting over three years and cliff vesting at the end of five years from the date of grant with acceleration in each of the first three or four years for achieving specified performance criteria.

As of December 31, 2006, 8.8 million shares of EMC restricted stock were outstanding and unvested, with an aggregate intrinsic value of \$117.6 million and a weighted average remaining contractual life of approximately 3.7 years. These shares are scheduled to vest through 2011. As of March 31, 2007, 6.9 million (unaudited) shares of EMC restricted stock were outstanding and unvested, with an aggregate intrinsic value of \$90.8 million (unaudited) and a weighted average remaining contractual life of approximately 3.6 years (unaudited). These shares are scheduled to vest through 2011.

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Impact of Adopting FAS No. 123R***

The following table summarizes the components of total stock-based compensation expense included in VMware's consolidated income statement for the three months ended March 31, 2007 (table in thousands):

	Three Months Ended March 31, 2007 (unaudited)		
	Stock Options	Restricted Stock	Total Stock-Based Compensation
Cost of license sales	\$ 25	\$ 11	\$ 36
Cost of services revenues	260	234	494
Research and development	1,274	5,118	6,392
Sales and marketing	1,259	1,685	2,944
General and administrative	435	1,343	1,778
Stock-based compensation expense before income taxes	3,253	8,391	11,644
Income tax benefit	1,062	1,862	2,924
Total stock-based compensation, net of tax	\$ 2,191	\$ 6,529	\$ 8,720

Stock option expense includes \$0.7 million (unaudited) of expense associated with the EMC employee stock purchase plan.

The following table summarizes the components of total stock-based compensation expense included in VMware's consolidated income statement in 2006 (table in thousands):

	Year Ended December 31, 2006		
	Stock Options	Restricted Stock	Total Stock-Based Compensation
Cost of license sales	\$ 80	\$ 19	\$ 99
Cost of services revenues	1,248	1,136	2,384
Research and development	4,095	22,247	26,342
Sales and marketing	4,704	7,316	12,020
General and administrative	2,500	7,881	10,381
Stock-based compensation expense before income taxes	12,627	38,599	51,226
Income tax benefit	2,327	9,902	12,229
Total stock-based compensation, net of tax	\$ 10,300	\$ 28,697	\$ 38,997

Stock option expense includes \$2.5 million of expense associated with the EMC employee stock purchase plan.

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In connection with the adoption of FAS No. 123R, VMware recorded to the income statement, a cumulative effect adjustment, net of taxes, of \$0.2 million to record an amount for the reversal of the previously recognized compensation expense related to outstanding restricted stock awards that are not expected to vest based on an estimate of forfeitures as of the date of adoption of FAS No. 123R. Additionally, VMware recorded to stockholder's equity, a cumulative effect adjustment, net of taxes, of \$1.1 million to capitalize amounts associated with software development costs that were previously capitalized in VMware's pro forma compensation disclosures.

For the three months ended March 31, 2007 and 2006, and for the years ended December 31, 2006 and December 31, 2005 VMware capitalized \$0.9 million (unaudited), \$5.3 million (unaudited), \$8.8 million and

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$3.5 million, respectively, of equity-based compensation expense associated with capitalized software development. For the three months ended March 31, 2007, VMware capitalized \$0.3 million (unaudited) of equity-based compensation expense associated with software developed for internal use.

As of December 31, 2006, the total unrecognized after-tax compensation cost for stock options, restricted stock and options under the employee stock purchase plan was \$97.6 million. This non-cash expense will be recognized through 2011 with a weighted average remaining period of 1.4 years.

As a result of adopting FAS No. 123R, VMware's income before taxes and net income in 2006 were \$4.9 million and \$1.5 million lower, respectively, than if VMware had continued to account for share-based compensation under APB No. 25. Basic and diluted earnings per share in 2006 would have been \$0.01 higher if VMware had not adopted FAS No. 123R.

For the periods prior to 2006, VMware elected to apply APB No. 25 and related interpretations in accounting for VMware's stock-based compensation plans. For the acquisition of VMware by EMC, VMware exchanged the options held by VMware employees for EMC options as of the acquisition date. In accordance with APB No. 25, VMware recognized the fair value of the exchanged options as part of the purchase price. VMware also recorded the intrinsic value of the unvested options as compensation expense over the remaining service period subsequent to the acquisition.

For purposes of determining the pro forma impact of FAS No. 123 for 2005 and 2004, the Company's policy was to record the amount by which the fair value of the vested and unvested EMC stock awards exceeded the value of the acquiree's options that were being exchanged. The difference in the fair value of the EMC options exchanged as compared to the fair value of the options held by VMware's employees was insignificant.

The following is a reconciliation of net income per weighted average share had VMware adopted the fair value recognition provisions of FAS No. 123 in 2005 and 2004 (table in thousands, except per share amounts):

	For the Year Ended December 31, 2005	For the Period from January 9, 2004 to December 31, 2004
Net income	\$ 66,775	\$ 16,781
Add back: Stock compensation costs, net of tax, on stock-based awards	21,423	16,458
Less: Stock compensation costs, net of taxes, had stock compensation expense been measured at fair value	(15,133)	(3,645)
Adjusted stock compensation expense per FAS No. 123, net of taxes	6,290	12,813
Adjusted net income	\$ 73,065	\$ 29,594
Net income per weighted average share, basic and diluted as reported	\$ 0.20	\$ 0.05
Adjusted net income per weighted average share, basic and diluted	\$ 0.22	\$ 0.09

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The fair value of each option granted during the three months ended March 31, 2007, and for the years ended December 31, 2006, 2005 and 2004 is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended March 31,	For the Year Ended December 31,		For the Period from January 9, 2004 to December 31, 2004
	2007 (unaudited)	2006	2005	
<i>Stock Options</i>				
Dividend yield	None	None	None	None
Expected volatility	30.1%	34.4%	40.8%	52.8%
Risk-free interest rate	4.7%	4.8%	4.0%	3.6%
Expected life (in years)	4.2	4.0	4.0	4.8
Weighted-average fair value at grant date	\$ 4.45	\$ 4.28	\$ 5.22	\$ 5.71

	Three Months Ended March 31,	For the Year Ended December 31,		For the Period from January 9, 2004 to December 31, 2004
	2007 (unaudited)	2006	2005	
<i>Employee Stock Purchase Plan</i>				
Dividend yield	None	None	None	None
Expected volatility	25.2%	27.6%	42.1%	49.5%
Risk-free interest rate	5.04%	4.9%	3.0%	1.4%
Expected life (in years)	0.5	0.5	0.5	0.5
Weighted-average fair value at grant date	\$ 3.03	\$ 2.86	\$ 3.95	\$ 3.48

Expected volatilities are based on historical and implied volatilities from traded options in EMC's stock. VMware uses EMC historical data to estimate the expected term of options granted within the valuation model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

J. Related Party Transactions

For the three months ended March 31, 2007 and the year ended December 31, 2006, VMware recognized professional service revenue of \$4.1 million (unaudited), and \$1.4 million for services provided to EMC pursuant to contractual agreements with EMC.

For the three months ended March 31, 2007 and 2006, and the years ended December 31, 2006 and 2005, VMware purchased \$0.6 million (unaudited), \$0.7 million (unaudited), \$2.9 million and \$0.6 million, respectively, of storage systems from EMC. The purchase amounts represent EMC's cost.

The financial statements include expense allocations for certain corporate functions provided by EMC, including accounting, treasury, tax, legal and human resources. These allocations were based on estimates of the level of effort or resources incurred on VMware's behalf. The total costs allocated from EMC were \$2.3 million (unaudited) and \$1.3 million (unaudited) for the three months ended March 31, 2007 and 2006, respectively and \$5.1 million in 2006, \$5.3 million in 2005 and \$4.5 million in 2004. Additionally, certain other costs incurred by EMC for VMware's direct benefit, such as rent, salaries and benefits have been included as expenses in

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

VMware's financial statements. The total of these other costs were \$20.2 million (unaudited) and \$10.5 million (unaudited) for the three months ended March 31, 2007 and 2006, respectively, and \$63.7 million in 2006, \$27.1 million in 2005 and \$7.3 million in 2004. As part of VMware's tax sharing arrangement, VMware paid EMC income taxes of \$63.1 million and \$6.6 million in 2006 and 2005, respectively, which differed from the amounts owed on a separate return basis. The difference between these amounts is presented as a component of stockholder's equity. VMware earned interest income on VMware's intercompany balance from EMC in the amount of \$1.3 million (unaudited), \$0.8 million and \$2.6 million for the three months ended March 31, 2007 and the years ended December 31, 2006 and 2005, respectively. For the three months ended March 31, 2006, VMware incurred interest expense on VMware's intercompany balance to EMC in the amount of \$0.1 million (unaudited). VMware's interest income and VMware's expenses as a separate, stand-alone company may be higher or lower than the amounts reflected in the financial statements.

K. Risks and Uncertainties

VMware's future results of operations involve a number of risks and uncertainties. Factors that could affect VMware's future operating results and cause actual results to vary materially from expectations include, but are not limited to: uncertainty in the potential market for VMware's products; increasing competition; the need for cooperation of operating system and hardware vendors; restrictions imposed upon VMware by EMC; reliance on distributors, resellers, x86 system vendors and systems integrators, dependence on VMware's existing management and key personnel; and protection of VMware's intellectual property rights.

L. Segment Information

VMware operates in one reportable segment in accordance with the provisions of SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information. 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. The chief operating decision maker is the President and Chief Executive Officer. VMware operates in one segment, therefore all financial segment information required by SFAS No. 131 can be found in the condensed consolidated financial statements.

Revenues by geographic area are as follows (table in thousands):

	Three Months Ended March 31,		Year Ended December 31,		For the Period from January 9, 2004 to December 31, 2004
	2007 (unaudited)	2006	2006	2005	
United States	\$ 136,443	\$ 66,683	\$ 391,614	\$ 209,600	\$ 119,304
International	122,252	62,394	312,290	177,474	99,452
Total	\$ 258,695	\$ 129,077	\$ 703,904	\$ 387,074	\$ 218,756

Long-lived assets, excluding financial instruments and deferred tax assets in the United States were \$685.5 million (unaudited) at March 31, 2007, \$694.0 million at December 31, 2006 and \$628.9 million at December 31, 2005. No country other than the United States accounted for 10% or more of these assets at March 31, 2007, December 31, 2006 or 2005. Long-lived assets, excluding financial instruments and deferred tax assets, internationally were \$18.8 million (unaudited) at March 31, 2007, \$5.5 million at December 31, 2006 and \$1.0 million at December 31, 2005.

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Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

VMware groups its products into portfolios that are categorized into the following classes:

Virtualization Platforms Products. The Company's virtualization platforms include a hypervisor for system partitioning that provides the capability to safely, securely and efficiently run multiple operating systems simultaneously on the same physical machine. The platforms products include VMware Player, VMware Workstation, VMware Server, VMware ESX Server, VMware Virtual SMP, and VMware VMFS products.

Virtual Infrastructure Management and Automation Products. The Company's virtual infrastructure management and automation products utilize the unique benefits of its virtualization platforms to automate system infrastructure services, such as resource management, availability, mobility and security, manage a virtualized environment and automate the interaction between various IT constituencies and the virtual infrastructure for a specific set of point solutions. They include VMware ACE, VMware VCB, VMware HA, VMware DRS, VMware VMotion, VMware VirtualCenter, VMware Lab Manager, VMware VDI, VMware Converter, VMware Capacity Planner.

Revenues by class of products or services were as follows:

	Year Ended December 31,		For the
	2006	2005	Period from January 9, 2004 to December 31, 2004
Virtualization platform products	\$ 281,336	\$ 204,697	\$ 147,960
Virtual infrastructure automation and management products	210,566	82,309	30,913
License revenues	491,902	287,006	178,873
Services revenues	212,002	100,068	39,883
Total	\$ 703,904	\$ 387,074	\$ 218,756

One distributor accounted for 23% (unaudited), 28% (unaudited), 29%, 30%, and 27% of revenues in the three months ended March 31, 2007 and 2006, and the years ended December 31, 2006, 2005, and 2004, respectively. One channel partner accounted for 11% (unaudited) of revenue in the three months ended March 31, 2007.

M. Subsequent Events

In April 2007, VMware acquired all of the capital stock of a privately-held company for \$24.2 million. Through the acquisition VMware advanced VMware's desktop virtualization efforts. The acquired company provides software that connects users to their desktop deployed on VMware Infrastructure.

In April 2007, VMware declared an \$800.0 million dividend to EMC. The dividend was paid in the form of a note. The note matures in April 2012 and bears an interest rate of the 90-day LIBOR plus 55 basis points, with interest payable quarterly in arrears commencing June 30, 2007. The note may be repaid, without penalty, at any time commencing July 2007. This dividend has been given retroactive effect as of December 31, 2006 in the accompanying consolidated balance sheet. The dividend was first applied against retained earnings until that was reduced to zero, then applied against additional paid-in-capital until that was reduced to zero, with the remainder then allocated using a reduction of retained earnings.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In April 2007, VMware entered into an agreement to acquire all of the capital stock of a privately-held offshore software development company for aggregate cash consideration of less than \$10 million. VMware entered into the acquisition as part of its efforts to expand its software development operations.

In June 2007, VMware adopted the 2007 Equity and Incentive Plan. Awards under the 2007 Plan may be in the form of stock options or other stock-based awards including awards of restricted stock. The maximum number of shares of the VMware's Class A common stock reserved for the grant or settlement of awards under the 2007 Plan is 80 million. The exercise price for a stock option awarded under the 2007 Plan shall not be less than 100% of the fair market value of our common stock on the date of the grant. Most options granted under the 2007 Plan vest 25% after the first year and then monthly thereafter over the following three years. In June and July 2007, VMware's Compensation and Corporate Governance Committee made broad-based grants of these options to purchase 35,679,411 shares of Class A common stock with an exercise price of \$23.00 per share and, in July 2007, made grants of these options to purchase 365,740 shares of Class A common stock with an exercise price of \$25.00 per share. Certain options that may be granted to non-employee directors under the 2007 Plan are exercisable immediately, terminate if not exercised within one year and vest one-third on the first three anniversaries of the grant. In June 2007, VMware's Compensation and Corporate Governance Committee made grants of these options to purchase 120,000 shares of Class A common stock with an exercise price of \$23.00 per share. All options expire six years from the date of grant. VMware's Compensation and Corporate Governance Committee also issued 537,676 restricted stock units under the 2007 Plan, 433,216 of which have terms that provide for 3-year cliff vesting, with performance acceleration in each of the first three years following achievement of certain performance goals, and 85,000 of which will vest (or not vest) based upon VMware's achievement of certain performance goals. The remaining restricted stock units will vest ratably over four years from the date of the grant. The fair value of these awards is approximately \$263.5 million which will be recognized over the awards' vesting periods.

VMware performed a contemporaneous valuation each time an equity grant of common stock was made. In determining the fair value of the equity, VMware analyzed general market data, including economic, governmental and environmental factors; considered its historic, current and future state of its operations; analyzed its operating and financial results; analyzed its forecasts; gathered and analyzed available financial data for publicly traded companies engaged in the same or similar lines of business to develop appropriate valuation multiples and operating comparisons, and analyzed other facts and data considered pertinent to the valuation to arrive at an estimated fair value.

VMware utilized both the income approach and the market approach in estimating the value of the equity. The market approach estimates the fair value of a company by applying to the company's historical and/or projected financial metrics market multiples of the corresponding financial metrics of publicly traded firms in similar lines of business. The use of the market approach requires judgments regarding the comparability of companies that are similar to VMware. If different comparable companies had been used, the market multiples and resulting estimates of the fair value of our stock also would have been different. The income approach involves applying appropriate risk-adjusted discount rates to estimated debt-free cash flows, based on forecasted revenue and costs. The projections used in connection with this valuation were based on our expected operating performance over the forecast period. There is inherent uncertainty in these estimates. If different discount rates or other assumptions had been used, the resulting estimates of the fair value of our stock would have been different. Due to the prospect of an imminent public offering, VMware did not apply a marketability discount in carrying out either approach. Further, VMware did not apply a minority interest discount in concluding on fair value.

In reaching its estimated valuation range, VMware considered the indicated values derived from each valuation approach in relation to the relative merits of each approach, the suitability of the information used, and

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the uncertainties involved. The results of the approaches overlapped, with the income approach results falling within a narrower range, which VMware ultimately relied on in its concluding estimate of value.

In addition to the aforementioned analysis, with respect to grants of options to purchase Class A common stock with a per share exercise price of \$23.00, the Company believes that the fair value of its equity at that time was further substantiated by the arm's-length transaction with Intel Capital (described below) whereby Intel agreed to purchase 9.5 million shares of VMware's Class A common stock at \$23.00 per share, subject to adjustment if the price in the offering is below \$23.00 per share. VMware believes that the fair value of its equity at the time of the grant of options at \$25.00 per share was substantiated by the contemporaneous arm's-length transaction whereby Cisco (described below) agreed to purchase 6.0 million shares of VMware's Class A common stock from EMC at \$25.00 per share.

The fair value of each VMware option granted at \$23.00 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Risk-free interest rate	5.0%
Expected dividend yield	0%
Expected life	3.4 years
Expected volatility	39.2%

The fair value of each VMware option granted at \$25.00 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Risk-free interest rate	4.8%
Expected dividend yield	0%
Expected life	3.4 years
Expected volatility	38.2%

The computation of expected volatility was based on the historical and implied volatility of comparable companies, considering factors such as industry, stage of life cycle, size and financial leverage. The expected term was calculated based on the historical experience of VMware employees have had with EMC stock option grants, as well as the expected term of similar grants of comparable companies. The risk free interest rate was based on a treasury instrument whose term is consistent with the expected life of the stock options.

In July 2007, VMware entered into a stock purchase agreement with Intel Capital, pursuant to which Intel Capital has agreed to purchase 9.5 million shares of our Class A common stock at \$23.00 per share for an aggregate offering price of \$218.5 million, subject to the expiration of the applicable waiting period under the HSR Act and the satisfaction of other customary closing conditions, including the absence of a material adverse change. If VMware does not complete an underwritten public offering with an aggregate price to the public of at least \$250.0 million on or before December 31, 2007, Intel Capital will have the right to exchange its Class A common stock for shares of Series A redeemable preferred stock, the terms of which will be designated prior to the closing of the Intel Capital investment. VMware has also entered into an investor rights agreement with Intel Capital pursuant to which Intel will have certain registration and other rights as a holder of VMware's Class A common stock.

In July 2007, VMware was a party to into a stock purchase agreement with Cisco and EMC, pursuant to which Cisco has agreed to purchase 6.0 million shares of our Class A common stock from EMC at \$25.00 per share for an aggregate offering price of \$150.0 million, subject to the expiration of the applicable waiting period under the HSR Act, the completion of the initial public offering of VMware's Class A common stock and the satisfaction of other customary closing conditions. If the closing conditions are not satisfied before December 31, 2007, Cisco and EMC will each have the right to terminate this stock purchase agreement. We will receive no proceeds from this transaction. VMware has also entered into an investor rights agreement with Cisco pursuant to which Cisco will have certain registration rights as a holder of VMware's Class A common stock. VMware has also agreed to consider the appointment of a Cisco executive to our board of directors at a future date.

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(in thousands)

	Balance at Beginning of Period	Allowance for Bad Debts Charged to Selling, General and Administrative Expenses	Charged to Other Accounts	Bad Debts Write-Offs	Balance at End of Period
Allowance for Bad Debts					
Year ended December 31, 2006 allowance for doubtful accounts	\$ 1,589	\$ 763	\$	\$ (213)	\$ 2,139
Year ended December 31, 2005 allowance for doubtful accounts	1,477	202		(90)	1,589
Period from January 9, 2004 to December 31, 2004 allowance for doubtful accounts	355	1,224		(102)	1,477

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