VMWARE, INC.
Form 10-Q
August 08, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 001-33622

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
As of July 31, 2016, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 424,408,248 of which 124,408,248 shares were Class A common stock and 300,000,000 were Class B common stock.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Revenues:				
License	$644	$ 638	$1,216	$1,214
Services	1,049	959	2,066	1,894
GSA settlement	—	(76)	—	(76)
Total revenues	1,693	1,521	3,282	3,032
Operating expenses[1]:				
Cost of license revenues	40	46	81	96
Cost of services revenues	221	204	432	397
Research and development	363	322	720	627
Sales and marketing	580	565	1,144	1,100
General and administrative	167	180	338	367
Realignment charges	(1)	(2)	52	21
Operating income	323	206	515	424
Investment income	19	13	35	25
Interest expense with EMC	(7)	(7)	(13)	(13)
Other income (expense), net	2	1	—	—
Income before income taxes	337	213	537	436
Income tax provision	72	41	111	68
Net income	$265	$ 172	$426	$368
Net income per weighted-average share, basic for Class A and Class B	$0.62	$ 0.41	$1.00	$0.86
Net income per weighted-average share, diluted for Class A and Class B	$0.62	$ 0.40	$1.00	$0.86
Weighted-average shares, basic for Class A and Class B	425,107	424,169	424,169	426,055
Weighted-average shares, diluted for Class A and Class B	427,102	426,797	425,729	428,772

(1) Includes stock-based compensation as follows:

Cost of license revenues	$—	$ —	$1	$1
Cost of services revenues	13	10	25	22
Research and development	74	53	144	107
Sales and marketing	47	43	95	81
General and administrative	18	17	36	31

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income	$265	$172	$426	$368
Other comprehensive income (loss):				
Changes in market value of available-for-sale securities:				
Unrealized gains (losses), net of taxes of $6, $(4), $15 and $0	10	(5)	24	1
Reclassification of (gains) losses realized during the period, net of taxes of $0, $0, $2 and $0	—	—	3	—
Net change in market value of available-for-sale securities	10	(5)	27	1
Changes in market value of effective foreign currency forward contracts:				
Unrealized gains (losses), net of taxes of $0 for all periods	(3)	5	—	(3)
Reclassification of (gains) losses realized during the period, net of taxes of $0 for all periods	1	(2)	1	—
Net change in market value of effective foreign currency forward contracts	(2)	3	1	(3)
Total other comprehensive income (loss)	8	(2)	28	(2)
Total comprehensive income (loss), net of taxes	$273	$170	$454	$366

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

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

	June 30, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$2,991	$2,493
Short-term investments	5,674	5,016
Accounts receivable, net of allowance for doubtful accounts of $2 and $2	1,215	1,633
Due from related parties, net	96	74
Other current assets	167	144
Total current assets	10,143	9,360
Property and equipment, net	1,073	1,128
Other assets	218	193
Deferred tax assets	442	456
Intangible assets, net	577	616
Goodwill	4,031	3,993
Total assets	$16,484	$15,746
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$115	$138
Accrued expenses and other	735	746
Unearned revenues	3,276	3,245
Total current liabilities	4,126	4,129
Notes payable to EMC	1,500	1,500
Unearned revenues	1,846	1,831
Other liabilities	376	363
Total liabilities	7,848	7,823
Contingencies (refer to Note I)		
Stockholders' equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 125,792 and 121,947 shares	1	1
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3
Additional paid-in capital	2,991	2,728
Accumulated other comprehensive income (loss)	20	(8)
Retained earnings	5,621	5,195
Total VMware, Inc.'s stockholders' equity	8,636	7,919
Non-controlling interests	—	4
Total stockholders' equity	8,636	7,923
Total liabilities and stockholders' equity	$16,484	$15,746

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

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

	Six Months Ended June 30,	
	2016	2015
Operating activities:		
Net income	$426	$368
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	174	159
Stock-based compensation	301	242
Excess tax benefits from stock-based compensation	(1)	(26)
Deferred income taxes, net	(5)	(22)
Impairment of strategic investments	5	—
Gain on sales of strategic investments	(1)	(1)
Other	5	—
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	417	305
Other assets	(23)	(13)
Due to/from related parties, net	(18)	63
Accounts payable	(10)	(33)
Accrued expenses	18	27
Income taxes payable	(36)	(49)
Unearned revenues	45	(21)
Net cash provided by operating activities	1,297	999
Investing activities:		
Additions to property and equipment	(79)	(184)
Purchases of available-for-sale securities	(2,211)	(2,095)
Sales of available-for-sale securities	979	1,373
Maturities of available-for-sale securities	619	524
Proceeds from disposal of assets	3	—
Purchases of strategic investments	(27)	(4)
Sales of strategic investments	1	2
Business acquisitions, net of cash acquired	(59)	(21)
Decrease (increase) in restricted cash	(2)	1
Net cash used in investing activities	(776)	(404)
Financing activities:		
Proceeds from issuance of common stock	52	69
Proceeds from non-controlling interests	—	4
Payment to acquire non-controlling interests	(4)	—
Repurchase of common stock	—	(850)
Excess tax benefits from stock-based compensation	1	26
Shares repurchased for tax withholdings on vesting of restricted stock	(72)	(124)
Net cash provided by (used in) financing activities	(23)	(875)
Net increase (decrease) in cash and cash equivalents	498	(280)
Cash and cash equivalents at beginning of the period	2,493	2,071
Cash and cash equivalents at end of the period	$2,991	$1,791

Supplemental disclosures of cash flow information:		
Cash paid for interest	$14	$14
Cash paid for taxes, net	135	136
Non-cash items:		
Changes in capital additions, accrued but not paid	$(19)	$(22)

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

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

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is a leader in virtualization and cloud infrastructure solutions that enable businesses to transform the way they build, deliver and consume information technology (“IT”) resources in a manner that is based on their specific needs. VMware’s virtualization infrastructure solutions, which include a suite of products and services designed to deliver a software-defined data center, run on industry-standard desktop computers, servers and mobile devices and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2016. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2015 Annual Report on Form 10-K.

As of June 30, 2016, EMC Corporation (“EMC”) held 80.6% of VMware’s outstanding common stock and 97.4% of the combined voting power of VMware’s outstanding common stock, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements. On October 12, 2015, Dell Inc. (“Dell”), Denali Holding Inc. (“Denali”) and EMC entered into a definitive merger agreement under which Denali has agreed to acquire EMC (the “Dell Acquisition”). On July 19, 2016, EMC shareholders approved the Dell Acquisition. The closing of the transaction remains subject to certain regulatory approvals.

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

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. Non-controlling interests are presented as a separate component within total stockholders’ equity and represent the equity and cumulative pro-rata share of the results of operations attributable to the non-controlling interests. The portion of results of operations attributable to the non-controlling interests is eliminated in other income (expense), net on the condensed consolidated statements of income and is not presented separately as the amount was not material for the periods presented. During the second quarter of 2016, VMware acquired all of the non-controlling interests previously presented as a separate component within total stockholders’ equity. Refer to Note B for further discussion. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with EMC and its subsidiaries are generally settled in cash and are classified on the condensed consolidated statements of cash flows based upon the nature of the underlying transaction.

Use of Accounting Estimates

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

New Accounting Pronouncements

During March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Compensation—Stock Compensation (Topic 718), which impacts the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The updated standard is effective for interim and annual periods beginning after December 15, 2016 and permits early adoption in any interim or annual period. The Company is currently evaluating the effect that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

During February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires a lessee to recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. This ASU also requires additional disclosure regarding leasing arrangements. The updated lease standard is effective for interim and annual periods beginning after December 15, 2018 and requires a modified retrospective adoption, with early adoption permitted. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures, and expects that most of its lease commitments will be subject to the updated standard and recognized as lease liabilities and right-of-use assets upon adoption of ASU 2016-02.

During May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. In 2016, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12, which provide interpretive clarifications on the new guidance in Topic 606. The updates are effective for the Company in the first quarter of 2018 and permit the use of either the retrospective or cumulative effect transition method. Early adoption is permitted, but not earlier than the first quarter of 2017. The Company has not selected a transition method and is currently evaluating the effect that the updates will have on its consolidated financial statements and related disclosures.

B. Business Combination, Definite-Lived Intangible Assets, Net, Goodwill and Joint Venture

Business Combination

On June 21, 2016, VMware acquired all of the outstanding shares of Arkin Net, Inc. ("Arkin") for approximately $67 million of cash, net of liabilities assumed. VMware acquired Arkin, a provider of software-defined data center security and operations, as part of a strategy to accelerate customers' adoption of VMware NSX and software-defined data centers. The pro forma financial information assuming the acquisition had occurred as of the beginning of the calendar year prior to the year of acquisition, as well as the revenues and earnings generated during the current year, were not material for disclosure purposes.

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

Cash	$7
Intangible assets	26
Goodwill	38
Deferred tax assets	5
Other acquired assets	1
Total assets acquired	77
Deferred tax liabilities	(10)
Total liabilities assumed	(10)
Fair value of assets acquired and liabilities assumed	$67

The identifiable intangible assets acquired were primarily related to purchased technology with estimated useful lives of four to five years. Goodwill is not expected to be deductible for U.S. income tax purposes.
Prior to the closing of the acquisition on June 21, 2016, EMC owned approximately 16% of the outstanding shares of Arkin. As a result of the acquisition, cash paid to EMC was approximately $13 million.

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

Definite-Lived Intangible Assets, Net

As of June 30, 2016 and December 31, 2015, definite-lived intangible assets consisted of the following (amounts in tables in millions):

	June 30, 2016			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	$ 672	$ (345)	$ 327
Leasehold interest	34.9	149	(22)	127
Customer relationships and customer lists	8.3	135	(56)	79
Trademarks and tradenames	8.6	61	(20)	41
Other	5.4	5	(2)	3
Total definite-lived intangible assets		$ 1,022	$ (445)	$ 577

	December 31, 2015			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	$ 648	$ (298)	$ 350
Leasehold interest	34.9	149	(20)	129
Customer relationships and customer lists	8.4	148	(62)	86
Trademarks and tradenames	8.6	61	(16)	45
Other	2.9	20	(14)	6
Total definite-lived intangible assets		$ 1,026	$ (410)	$ 616

Amortization expense on definite-lived intangible assets was $32 million and $65 million during the three and six months ended June 30, 2016, respectively, and $37 million and $74 million during the three and six months ended June 30, 2015, respectively.

Based on intangible assets recorded as of June 30, 2016 and assuming no subsequent additions or impairment of underlying assets, the remaining estimated annual amortization expense is expected to be as follows (table in millions):

Remainder of 2016	$ 66
2017	127
2018	115
2019	93
2020	43
Thereafter	133
Total	$ 577

Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the six months ended June 30, 2016 (table in millions):

Balance, January 1, 2016	3,993
Increase in goodwill related to a business combination	38
Balance, June 30, 2016	$ 4,031

Joint Venture

During the year ended December 31, 2014, VMware established a joint venture intended to expand VMware vCloud Air services in Japan. At December 31, 2015, VMware had a controlling interest in the joint venture and approximately 51% of the ownership. Accordingly, VMware consolidated the financial results of the joint venture. During the second quarter of 2016, VMware acquired all of the remaining non-controlling interests in the joint venture for $4 million.

C. Realignment Charges

On January 22, 2016, VMware approved a plan to streamline its operations, with plans to reinvest the associated savings in field, technical and support resources associated with growth products. As a result of these actions, approximately 800 positions were eliminated during the six months ended June 30, 2016. VMware recognized $49 million of severance-related realignment charges during the six months ended June 30, 2016 on the condensed consolidated statements of income. Additionally, VMware is in the process of consolidating certain facilities as part of this plan, which resulted in the recognition of $3 million of related charges during the six months ended June 30, 2016 on the condensed consolidated statements of income. As of June 30, 2016, $5 million remained in accrued expenses and other on the condensed consolidated balance sheets, which is generally expected to be paid during 2016. Actions associated with the plan were substantially completed by June 30, 2016.

During the first quarter of 2015, VMware eliminated approximately 350 positions across all major functional groups and geographies to streamline its operations. As a result of these actions, $21 million of realignment charges were recognized during the six months ended June 30, 2015, which consisted of severance-related costs. An immaterial credit was recognized during the three months ended June 30, 2015.

The following table summarizes the activity for the accrued realignment charges for the six months ended June 30, 2016 and June 30, 2015 (tables in millions):

	For the Six Months Ended June 30, 2016			
	Balance as of January 1, 2016	Realignment Charges	Utilization	Balance as of June 30, 2016
Severance-related costs	$3	$ 49	$ (50)	$ 2
Costs to exit facilities	—	3	—	3
Total	$3	$ 52	$ (50)	$ 5

	For the Six Months Ended June 30, 2015			
	Balance as of January 1, 2015	Realignment Charges	Utilization	Balance as of June 30, 2015
Severance-related costs	$8	21	(27)	$ 2

D. Net Income per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include unvested restricted stock units, including performance stock units, and stock options, including 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 net income per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

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

The following table sets forth the computations of basic and diluted net income per share during the three and six months ended June 30, 2016 and 2015 (net income in millions, shares in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income	$265	$ 172	$426	$ 368
Weighted-average shares, basic for Class A and Class B	425,107	424,169	424,169	426,055
Effect of dilutive securities	1,995	2,628	1,560	2,717
Weighted-average shares, diluted for Class A and Class B	427,102	426,797	425,729	428,772
Net income per weighted-average share, basic for Class A and Class B	$0.62	$ 0.41	$1.00	$ 0.86
Net income per weighted-average share, diluted for Class A and Class B	$0.62	$ 0.40	$1.00	$ 0.86

The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted net income per share calculations during the three and six months ended June 30, 2016 and 2015, because their effect would have been anti-dilutive (shares in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Anti-dilutive securities:				
Employee stock options	2,065	2,100	2,207	2,206
Restricted stock units	3,315	90	9,512	399
Total	5,380	2,190	11,719	2,605

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

E. Cash, Cash Equivalents and Investments
Cash, cash equivalents and investments as of June 30, 2016 and December 31, 2015 consisted of the following (tables in millions):

	June 30, 2016			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	$542	$ —	$ —	$ 542
Cash equivalents:				
Money-market funds	$2,374	$ —	$ —	$ 2,374
Time deposits	13	—	—	13
Municipal obligations	62	—	—	62
Total cash equivalents	$2,449	$ —	$ —	$ 2,449
Short-term investments:				
U.S. Government and agency obligations	$956	$ 5	$ —	$ 961
U.S. and foreign corporate debt securities	3,936	24	(1)	3,959
Foreign governments and multi-national agency obligations	29	—	—	29
Municipal obligations	500	—	—	500
Asset-backed securities	8	—	—	8
Mortgage-backed securities	216	1	—	217
Total short-term investments	$5,645	$ 30	$ (1)	$ 5,674
Other assets:				
Marketable available-for-sale equity securities	$15	$ 2	$ —	$ 17

	December 31, 2015			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	$725	$ —	$ —	$ 725
Cash equivalents:				
Money-market funds	$1,763	$ —	$ —	$ 1,763
Time deposits	5	—	—	5
Total cash equivalents	$1,768	$ —	$ —	$ 1,768
Short-term investments:				
Time deposits	$12	$ —	$ —	$ 12
U.S. Government and agency obligations	753	—	(3)	750
U.S. and foreign corporate debt securities	3,263	1	(12)	3,252
Foreign governments and multi-national agency obligations	35	—	—	35
Municipal obligations	705	1	—	706
Asset-backed securities	20	—	—	20
Mortgage-backed securities	243	—	(2)	241
Total short-term investments	$5,031	$ 2	$ (17)	$ 5,016
Other assets:				
Marketable available-for-sale equity securities	$15	$ 3	$ —	$ 18

Refer to Note F for further information regarding the fair value of VMware’s cash equivalents and investments.

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

VMware evaluated its available-for-sale investments as of June 30, 2016 and December 31, 2015 to determine whether or not any security had experienced an other-than-temporary decline in fair value. As of June 30, 2016 and December 31, 2015, VMware did not consider any of its available-for-sale investments to be other-than-temporarily impaired. The realized gains and losses on investments during the three and six months ended June 30, 2016 and 2015 were not material.

Unrealized losses on cash equivalents and available-for-sale investments as of June 30, 2016 and December 31, 2015, which have been in a net loss position for less than twelve months, were classified by asset class as follows (table in millions):

	June 30, 2016		December 31, 2015	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	$24	$ —	$657	$ (3)
U.S. and foreign corporate debt securities	385	(1)	2,564	(11)
Mortgage-backed securities	67	—	171	(1)
Total	$476	$ (1)	$3,392	$ (15)

As of June 30, 2016 and December 31, 2015, unrealized losses on cash equivalents and available-for-sale investments in the other investment categories, which have been in a net loss position for less than twelve months, were not material. Unrealized losses on cash equivalents and available-for-sale investments, which have been in a net loss position for twelve months or greater, were not material as of June 30, 2016 and December 31, 2015.

Contractual Maturities

The contractual maturities of short-term investments held at June 30, 2016 consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	$ 1,947	$ 1,947
Due after 1 year through 5 years	3,427	3,453
Due after 5 years through 10 years	109	111
Due after 10 years	162	163
Total short-term investments	$ 5,645	$ 5,674

F. Fair Value Measurements

Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis

Certain financial assets and liabilities are measured at fair value on a recurring basis. VMware determines fair value using the following hierarchy:

- Level 1 - Quoted prices in active markets for identical assets or liabilities
- Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are noted active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

VMware's fixed income securities are primarily classified as Level 2, with the exception of some of the U.S. Government and agency obligations which are classified as Level 1. Additionally, VMware's Level 2 classification includes forward contracts and notes payable to EMC. At June 30, 2016 and December 31, 2015, VMware's Level 2 securities were generally priced using non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques.

VMware did not have any material assets or liabilities that fell into Level 3 of the fair value hierarchy as of June 30, 2016 and December 31, 2015, and there have been no transfers between fair value measurement levels during the three and six months ended June 30, 2016 and 2015.

The following tables set forth the fair value hierarchy of VMware’s cash equivalents, available-for-sale securities, and forward contracts that were required to be measured at fair value as of June 30, 2016 and December 31, 2015 (tables in millions):

	June 30, 2016		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	$2,374	$—	$2,374
Time deposits	—	13	13
Municipal obligations	—	62	62
Total cash equivalents	$2,374	$75	$2,449
Short-term investments:			
U.S. Government and agency obligations	$667	$294	$961
U.S. and foreign corporate debt securities	—	3,959	3,959
Foreign governments and multi-national agency obligations	—	29	29
Municipal obligations	—	500	500
Asset-backed securities	—	8	8
Mortgage-backed securities	—	217	217
Total short-term investments	$667	$5,007	$5,674
Other assets:			
Marketable available-for-sale equity securities	$17	$—	$17
Other current assets:			
Forward contracts	$—	$2	$2

	December 31, 2015		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	$1,763	$—	$1,763
Time deposits	—	5	5
Total cash equivalents	$1,763	$5	$1,768
Short-term investments:			
Time deposits	$—	$12	$12
U.S. Government and agency obligations	543	207	750
U.S. and foreign corporate debt securities	—	3,252	3,252
Foreign governments and multi-national agency obligations	—	35	35
Municipal obligations	—	706	706
Asset-backed securities	—	20	20
Mortgage-backed securities	—	241	241
Total short-term investments	$543	$4,473	$5,016
Other assets:			
Marketable available-for-sale equity securities	$18	$—	$18
Accrued expenses and other:			
Forward contracts	$—	$(1)	$(1)

VMware has elected not to record its notes payable to EMC at fair value, but has measured the notes at fair value for disclosure purposes. As of June 30, 2016, the fair value of the notes payable to EMC approximated its carrying value due to the minimal difference between the fair market interest rate as of June 30, 2016 and the fixed interest rate for the notes payable to

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EMC. As of December 31, 2015, the fair value of the notes payable to EMC was approximately $1,474 million. Fair value was estimated primarily based on observable market interest rates (Level 2 inputs).
VMware offers a deferred compensation plan for eligible employees that allows participants to defer payment for part or all of their compensation. The net impact to the condensed consolidated statements of income is not material since changes in the fair value of the assets substantially offset changes in the fair value of the liabilities. As such, assets and liabilities associated with this plan have not been included in the above tables. Assets and liabilities associated with this plan were both approximately $27 million and $20 million as of June 30, 2016 and December 31, 2015, respectively, and are included in other assets and other liabilities on the condensed consolidated balance sheets.

Assets Measured and Recorded at Fair Value on a Non-Recurring Basis

VMware has strategic investments in its portfolio accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. VMware evaluates these investments to assess whether any of its strategic investments were other-than-temporarily impaired. VMware uses Level 3 inputs as part of its impairment analysis, including, pre- and post-money valuations of recent financing events and the impact of those on its fully diluted ownership percentages, as well as other available information regarding the issuer's historical and forecasted performance. The estimated fair value of these investments is considered in VMware's impairment review if any events or changes in circumstances occur that might have a significant adverse effect on their value. If VMware determines that an other-than-temporary impairment has occurred, VMware writes down the investments to their fair value.
During the six months ended June 30, 2016, VMware recognized charges of approximately $5 million, as a result of determining that certain strategic investments were considered to be other-than-temporarily impaired. There was no impairment charge during the three months ended June 30, 2016 and the three and six months ended June 30, 2015. All other realized gains and losses on investments during the three and six months ended June 30, 2016 and 2015 were not material. Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware's strategic investments accounted for under the cost method was $125 million and $103 million as of June 30, 2016 and December 31, 2015, respectively.

G. Derivatives and Hedging Activities

VMware conducts business on a global basis in multiple foreign currencies, subjecting the Company to foreign currency risk. To mitigate this risk, VMware utilizes hedging contracts as described below, which potentially expose the Company to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. VMware manages counterparty risk by seeking counterparties of high credit quality, by monitoring credit ratings and credit spreads of, and other relevant public information about its counterparties. VMware does not, and does not intend to, use derivative instruments for trading or speculative purposes.

Cash Flow Hedges

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware enters into forward contracts. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation have 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 (loss) on the condensed consolidated balance sheets and is subsequently reclassified to the related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. During the three and six months ended June 30, 2016 and 2015, the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not material. Interest charges or "forward points" on VMware's forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other income (expense), net on the condensed consolidated statements of income as incurred.
VMware enters into forward contracts annually, which have maturities of twelve months or less. As of June 30, 2016 and December 31, 2015, VMware had forward contracts designated as cash flow hedges with a total notional value of $109 million and $213 million, respectively. The notional value represents the gross amount of foreign currency that

will be bought or sold upon maturity of the forward contract.
During the three and six months ended June 30, 2016 and 2015, all cash flow hedges were considered effective.
Forward Contracts Not Designated as Hedges
VMware has established a program that utilizes forward contracts to offset the foreign currency risk associated with net outstanding monetary asset and liability positions. These forward contracts are not designated as hedging instruments under

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applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are reported in other income (expense), net on the condensed consolidated statements of income.

VMware enters into forward contracts on a monthly basis, which typically have a contractual term of one month. As of June 30, 2016 and December 31, 2015, VMware had outstanding forward contracts with a total notional value of $641 million and $721 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

During the three and six months ended June 30, 2016, VMware recognized a gain of $11 million and a loss of $12 million, respectively, relating to the settlement of forward contracts. During the three and six months ended June 30, 2015, VMware recognized a loss of $20 million and a gain of $21 million, respectively. Gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

The combined gains and losses derived from the settlement of forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of $1 million and $3 million, respectively, during the three and six months ended June 30, 2016. The combined gains and losses derived from the settlement of forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of $3 million and $9 million during the three and six months ended June 30, 2015, respectively. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

H. Unearned Revenues

Unearned revenues as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	June 30, 2016	December 31, 2015
Unearned license revenues	$ 455	$ 428
Unearned software maintenance revenues	4,189	4,174
Unearned professional services revenues	478	474
Total unearned revenues	$ 5,122	$ 5,076

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

Unearned software maintenance revenues are attributable to VMware's maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at June 30, 2016 was approximately two years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

Unearned license and software maintenance revenues will fluctuate based upon a variety of factors including sales volume, the timing of both product promotion offers and delivery of the future products offered, and the amount of arrangements sold with ratable revenue recognition. Additionally, the amount of unearned revenues derived from transactions denominated in a foreign currency is impacted by fluctuations in the foreign currencies in which VMware invoices.

I. Contingencies

Litigation

On March 27, 2015, Phoenix Technologies ("Phoenix") filed a complaint against VMware in the U.S. District Court for the Northern District of California asserting claims for copyright infringement and breach of contract relating to a version of Phoenix's BIOS software that VMware licensed from Phoenix. In the lawsuit, Phoenix is seeking injunctive relief and monetary damages. Trial is currently scheduled for November 2016. VMware believes that it has meritorious defenses in connection with this lawsuit, and currently a reasonably possible loss or range of loss cannot be estimated.

On March 4, 2015, Christoph Hellwig, a software developer who alleges that software code he wrote is used in a component of the Company's vSphere product, filed a lawsuit against VMware in the Hamburg Regional Court in Germany

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alleging copyright infringement for failing to comply with the terms of an open source General Public License v.2 (“GPL v.2”) and seeking an order requiring VMware to comply with the GPL v.2 or cease distribution of any affected code within Germany. On July 8, 2016, the German court issued a written decision dismissing Mr. Hellwig’s lawsuit because he failed to show that his protectable software code had been used in VMware’s product.

While VMware believes that it has valid defenses against each of the above legal matters, given the unpredictable nature of legal proceedings, an unfavorable resolution of one or more legal proceedings, claims, or investigations could have a material adverse effect on VMware’s condensed consolidated financial statements.

On November 17, 2015, Francis M. Ford, a VMware Class A stockholder, filed an action in the Delaware Chancery Court against certain current and former VMware directors, among others, alleging that the directors breached their fiduciary duties in connection with the Dell Acquisition, and the proposed issuance of tracking stock that is intended to track the performance of VMware. The plaintiff does not assert claims directly against VMware, but purports to bring class claims on behalf of other VMware Class A stockholders and derivative claims on behalf of VMware. In addition, on November 10, 2015, David Jacobs, also a VMware stockholder, filed an action in Massachusetts Superior Court against, among others, EMC and four directors who serve on both the EMC board and the VMware board, setting forth similar allegations to those in the Ford matter. While VMware does not believe that the cases represent material adverse exposures, no assurances can be given that the litigation will not have any adverse consequences for the company or the directors named in the suits.

VMware accrues for a liability when a determination has been made that a loss is both probable and the amount of the loss can be reasonably estimated. If only a range can be estimated and no amount within the range is a better estimate than any other amount, an accrual is recorded for the minimum amount in the range. Significant judgment is required in both the determination that the occurrence of a loss is probable and is reasonably estimable. In making such judgments, VMware considers the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal costs are generally recognized as expense when incurred.

VMware is also subject to other legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business or in connection with business mergers and acquisitions, including claims with respect to commercial, contracting and sales practices, product liability, intellectual property, employment, corporate and securities law, class action, whistleblower and other matters. From time to time, VMware also receives inquiries from and has discussions with government entities and stockholders on various matters. As of June 30, 2016, amounts accrued relating to these other matters arising as part of the ordinary course of business were not considered material. VMware does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on its condensed consolidated financial statements.

J. Stockholders’ Equity

VMware Stock Repurchases

During April 2016, VMware’s board of directors authorized the repurchase of up to an aggregate of $1,200 million of VMware’s Class A common stock through the end of 2016. The aggregate authorized stock repurchase amount of $1,200 million includes the amount remaining from VMware’s previous stock repurchase authorization announced on January 27, 2015, which was $835 million as of June 30, 2016. Stock will be purchased from time to time, in the open market or through private transactions, subject to market conditions. 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, legal and regulatory requirements and other market and economic conditions. VMware is not obligated to purchase any shares under its stock repurchase programs. Purchases can be discontinued at any time VMware believes additional purchases are not warranted. All shares repurchased under VMware’s stock repurchase programs are retired.

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There were no repurchases of our Class A common stock during the three and six months ended June 30, 2016. The following table summarizes stock repurchase activity during the three and six months ended June 30, 2015 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended June 30, 2015	Six Months Ended June 30, 2015
Aggregate purchase price	$ 412	$ 850
Class A common shares repurchased	4,750	10,116
Weighted-average price per share	$ 86.71	$ 84.02

The aggregate purchase price of repurchased shares includes commissions and is classified as a reduction to additional paid-in capital.

VMware Stock Options

Stock option activity was not material during the six months ended June 30, 2016. As of June 30, 2016, there were 2.6 million stock options outstanding. The stock options outstanding as of June 30, 2016 had an aggregate intrinsic value of $37 million based on VMware's closing stock price as of June 30, 2016.

VMware Restricted Stock

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

VMware's restricted stock also includes performance stock unit ("PSU") awards, which have been granted to certain of VMware's executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based vesting component. Upon vesting, each PSU award will convert into VMware's Class A common stock at various ratios ranging from 0.5 to 2.0 shares per PSU, depending upon the degree of achievement of the performance target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued.

The following table summarizes restricted stock activity since January 1, 2016 (units in thousands):

	Number of Units	Weighted-Average Grant Date Fair Value (per unit)
Outstanding, January 1, 2016	18,693	$ 77.29
Granted	9,974	56.28
Vested	(3,719)	80.94
Forfeited	(2,310)	79.31
Outstanding, June 30, 2016	22,638	67.22

The total fair value of VMware restricted stock that vested during the six months ended June 30, 2016 was $113 million. As of June 30, 2016, restricted stock representing 22.6 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of $1,295 million based on VMware's closing stock price as of June 30, 2016.

As of June 30, 2016, the total unrecognized compensation cost for stock options and restricted stock was $1,197 million and will be recognized through 2020 with a weighted-average remaining period of 1.5 years.

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Accumulated Other Comprehensive Income (Loss)
The changes in components of accumulated other comprehensive income (loss) during the six months ended June 30, 2016 and 2015 were as follows (tables in millions):

	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, January 1, 2016	$ (7)	$ (1)	$ (8)
Unrealized gains (losses), net of taxes of $15, $0 and $15	24	—	24
Amounts reclassified from accumulated other comprehensive income (loss) to the consolidated statement of income, net of taxes of $2, $0 and $2	3	1	4
Balance, June 30, 2016	$ 20	$ —	$ 20

	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, January 1, 2015	$ —	$ (1)	$ (1)
Unrealized gains (losses), net of taxes of $0	1	(3)	(2)
Balance, June 30, 2015	$ 1	$ (4)	$ (3)

Unrealized gains on VMware's available-for-sale securities are reclassified to investment income on the condensed consolidated statements of income in the period that such gains are realized.
The effective portion of gains (losses) resulting from changes in the fair value of forward contracts designated as cash flow hedging instruments are reclassified to its related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. The amounts recorded to their related operating expense functional line items on the condensed consolidated statements of income during the three and six months ended June 30, 2016 and 2015 were not material to the individual functional line items.
K. Related Parties
The information provided below includes a summary of the transactions entered into with EMC and EMC's consolidated subsidiaries (collectively "EMC").
Transactions with EMC
VMware and EMC engaged in the following ongoing intercompany transactions, which resulted in revenues and receipts and unearned revenues for VMware:

- Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end users.
- EMC purchases products and services from VMware for internal use.
- VMware provides professional services to end users based upon contractual agreements with EMC.
- Pursuant to an ongoing distribution agreement, VMware acts as the selling agent for certain products and services of Pivotal Software, Inc. ("Pivotal"), a subsidiary of EMC, in exchange for an agency fee. Under this agreement, cash is collected from the end user by VMware and remitted to Pivotal, net of the contractual agency fee.
- VMware provides various services to Pivotal. Support costs incurred by VMware are reimbursed to VMware and are recorded as a reduction to the costs incurred by VMware.

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Information about VMware's revenues and receipts from such arrangements during the three and six months ended June 30, 2016 and 2015 and unearned revenues from such arrangements as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	Revenues and Receipts				Unearned Revenues	
	Three Months Ended		Six Months Ended		As of	As of
	June 30,		June 30,		June 30,	December 31,
	2016	2015	2016	2015	2016	2015
Reseller revenues	$85	$ 69	$163	$131	$313	$ 292
Internal-use revenues	14	6	19	9	18	11
Professional services revenues	26	24	51	48	—	3
Agency fee revenues	1	3	2	4	—	—
Reimbursement for services to Pivotal	—	1	1	2	n/a	n/a

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

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

Information about VMware's costs from such arrangements for the three and six months ended June 30, 2016 and 2015 consisted of the following (table in millions):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
Purchases and leases of products and purchases of services	$17	$ 12	$34	$ 31
Collaborative technology project costs	—	1	—	3
EMC subsidiary support and administrative costs	21	26	44	54

VMware also purchases EMC products through EMC's channel partners. Purchases of EMC products through EMC's channel partners were not material during the three and six months ended June 30, 2016. Purchases of EMC products through EMC's channel partners were $18 million and $26 million during the three and six months ended June 30, 2015, respectively.

Tax Sharing Agreement with EMC

VMware has made payments to EMC pursuant to a tax sharing agreement. The following table summarizes the payments made during the three and six months ended June 30, 2016 and 2015 (table in millions):

	Three Months Ended June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Payments from VMware to EMC	$54	$43	$95	$92

Payments from VMware to EMC under the tax sharing agreement relate to VMware’s portion of federal income taxes on EMC’s consolidated tax return as well as the state payments for combined states. The amounts that VMware pays to EMC for its portion of federal income taxes on EMC's consolidated tax return differ from the amounts VMware would owe on a separate return basis and the difference is presented as a component of stockholders' equity. During the three and six months ended June 30, 2016, the difference between the amount of tax calculated on a separate return basis and the amount of tax calculated per the tax sharing agreement was $14 million and $15 million, respectively. During the three and six months ended June 30, 2015, the difference was not material.

Due To/From Related Parties, Net

As a result of the related party transactions with EMC described above, amounts due to and from related parties, net as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	June 30, 2016	December 31, 2015
Due (to) related parties	$(49)	$ (68)
Due from related parties	145	142
Due (to) from related parties, net	$96	$ 74
Income tax due (to) from related parties	$10	$ (18)

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

Notes Payable to EMC

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

The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: $680 million due May 1, 2018, $550 million due May 1, 2020 and $270 million due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and six months ended June 30, 2016, $7 million and $13 million, respectively, of interest expense was recognized. During the three and six months ended June 30, 2015, $7 million and $13 million, respectively, of interest expense was recognized.

Pivotal

During 2013, VMware transferred certain assets and liabilities to Pivotal in exchange for preferred equity interests in Pivotal's outstanding shares. As of December 31, 2015, VMware's ownership interest in Pivotal was 28%.

In April 2016, VMware contributed $20 million in cash to Pivotal in exchange for additional preferred equity interests in Pivotal. As of June 30, 2016, VMware's ownership interest in Pivotal was 17% and continued to be accounted for under the cost method. The decrease in VMware's ownership interest was a result of investments made by other investors.

L. Segment Information

VMware operates in one reportable operating segment, thus all required financial segment information can be found on the condensed consolidated financial statements. Operating segments are defined as components of an enterprise for 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.

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Revenues by geographic area for the three and six months ended June 30, 2016 and 2015 were as follows (table in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
United States	$870	$742	$1,671	$1,504
International	823	779	1,611	1,528
Total	$1,693	$1,521	$3,282	$3,032

Revenues by geographic area are based on the ship-to addresses of VMware's customers. No individual country other than the United States accounted for 10% or more of revenues for the three and six months ended June 30, 2016 and 2015.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of June 30, 2016 and December 31, 2015 were as follows (table in millions):

	June 30, 2016	December 31, 2015
United States	$ 817	$ 831
International	134	148
Total	$ 951	$ 979

No individual country other than the United States accounted for 10% or more of these assets as of June 30, 2016 and December 31, 2015, respectively.

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

The following management's discussion and analysis ("MD&A") is provided in addition to the accompanying condensed consolidated financial statements and notes to assist in understanding our results of operations and financial condition. Financial information as of June 30, 2016 should be read in conjunction with our consolidated financial statements for the year ended December 31, 2015 contained in our Form 10-K filed on February 25, 2016.

Period-over-period changes are calculated based upon the respective underlying, non-rounded data. Unless the context requires otherwise, we are referring to VMware, Inc. and its consolidated subsidiaries when we use the terms "VMware," the "Company," "we," "our" or "us."

Overview

The information technology ("IT") industry is transforming, moving from a hardware-based traditional model to one of a software-defined infrastructure. We are a leader in virtualization and cloud infrastructure solutions utilized by organizations to help transform the way they build, deliver and consume IT resources. We develop and market our product and service offerings within three main product groups, which are discussed in more detail below and allow organizations to leverage synergies and manage IT resources across complex multi-cloud, multi-device environments. Our three main product groups are:

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

We sell our solutions using enterprise agreements ("EAs") or as part of our non-EA, or transactional, business. EAs are comprehensive volume license offerings, offered both directly by us and through certain channel partners that also provide for multi-year maintenance and support.

SDDC or Software-Defined Data Center

Our SDDC technologies are the basis for the private cloud environment and provide the capabilities for our customers to extend their private cloud to the public cloud and to help them run, manage, secure and connect all their applications across all clouds and devices. Historically, the majority of our license sales have been from VMware vSphere, which is included in our compute product category within our SDDC product group. However, the market for our compute products is reaching maturity, and VMware vSphere license sales have been declining. As the transformation of the IT industry continues, we expect that our growth of license sales within the SDDC product group will be increasingly derived from sales of our newer products and services solutions across our SDDC portfolio. We have experienced continued growth in sales volume of VMware NSX ("NSX"), our network virtualization solution, through the first half of 2016. We also continue to see growth in sales volume of our Virtual SAN ("VSAN") products as well as other newer offerings.

Hybrid Cloud Computing

Our cloud strategy has three components: (i) continue to expand beyond compute virtualization in the private cloud, (ii) extend the private cloud into the public cloud, and (iii) connect and secure endpoints across a range of public clouds.

Hybrid cloud computing is comprised of VMware vCloud Air Network ("vCAN") Service Providers Program and VMware vCloud Air ("vCloud Air") offerings. Revenues derived from vCAN continued to grow during the second quarter of 2016. We have narrowed the focus of vCloud Air to provide specialized cloud software and services unique to VMware that are distinct from those offered by other cloud providers.

End-User Computing

End-user computing includes VMware Workspace ONE, which consists primarily of VMware AirWatch ("AirWatch") and Horizon desktop and application virtualization ("Horizon"). Our AirWatch business model includes an on-premise solution that we offer through the sale of perpetual licenses and an off-premise solution that we offer as software-as-a-service ("SaaS"). AirWatch products and services continued to contribute to the growth of our end-user computing product group during the three and six months ended June 30, 2016.

Business Realignment Plan

On January 22, 2016, we approved a plan to streamline our operations with plans to reinvest the associated savings in field, technical and support resources associated with growth products. We eliminated approximately 800 positions and personnel and recognized $52 million of realignment charges during the six months ended June 30, 2016. Actions associated with this plan were substantially completed as of June 30, 2016.

Dell and EMC Merger

We are a majority-owned and controlled subsidiary of EMC Corporation ("EMC"). As of June 30, 2016, EMC held 80.6% of our outstanding common stock and 97.4% of the combined voting power of our outstanding common stock, including 43 million shares of our Class A common stock and all of our Class B common stock.

On October 12, 2015, Dell Inc. ("Dell"), Denali Holding Inc. ("Denali") and EMC entered into a definitive merger agreement under which Denali has agreed to acquire EMC (the "Dell Acquisition"). Under the terms of the agreement, we will continue to operate as a publicly traded company. Upon closing of the transaction, a portion of the merger consideration that EMC shareholders will receive will include shares of Class V common stock that will be registered with the Securities and Exchange Commission and issued by Denali. Pursuant to the terms of the agreement, it is expected that approximately 0.111 shares of Class V common stock will be issued by Denali for each EMC share. Denali has also disclosed that the Class V common stock will be a publicly traded tracking stock that, upon issuance, is intended to track the performance of an approximately 53% economic interest in our business. On July 19, 2016, EMC shareholders approved the Dell Acquisition. The closing of the transaction remains subject to certain regulatory approvals.

Results of Operations

Approximately 70% of our sales are denominated in the U.S. dollar, however, we also invoice and collect in the euro, the British pound, the Japanese yen, the Australian dollar and the Chinese renminbi in their respective regions. In addition, we incur and pay operating expenses in currencies other than the U.S. dollar. As a result, our financial statements, including our revenues, operating expenses, unearned revenues, and the resulting cash flows derived from the U.S. dollar equivalent of foreign currency transactions are impacted by foreign exchange fluctuations.

Revenues

Our revenues during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,		$ Change	% Change		Six Months Ended June 30,		$ Change	% Change	
	2016	2015	Actual	Actual	Constant Currency	2016	2015	Actual	Actual	Constant Currency
Revenues:										
License	$644	$638	$ 6	1 %	1 %	$1,216	$1,214	$ 2	— %	1 %
Services:										
Software maintenance	915	829	86	10		1,806	1,641	165	10	
Professional services	134	130	4	3		260	253	8	3	
Total services	1,049	959	91	9		2,066	1,894	173	9	
GSA settlement	—	(76)	76	(100)		—	(76)	76	(100)	
Total revenues	$1,693	$1,521	$ 172	11	11	$3,282	$3,032	$ 250	8	9
Revenues:										
United States	$870	$742	$ 128	17 %		$1,671	$1,504	$ 167	11 %	
International	823	779	44	6		1,611	1,528	84	5	
Total revenues	$1,693	$1,521	$ 172	11	11	$3,282	$3,032	$ 250	8	9

In order to provide a comparable framework for assessing how our business performed, adjusted for the impact of foreign currency fluctuations, management analyzed year-over-year license and total revenue growth on a constant currency basis. License and total revenue growth in constant currency are non-GAAP financial measures that are calculated by converting license and total revenues recognized during the current period derived from non-U.S. dollar based transactions into U.S. dollars using the exchange rates that were effective in the comparable prior year period. The calculated current period license and total revenues, adjusted for foreign currency fluctuations, is compared to the license and total revenues of the comparable prior year period, as reported, in calculating license and total revenue growth in constant currency. We believe this information is useful to investors to facilitate comparisons of operating results and better identify trends in our business. These constant currency performance measures should be viewed in addition to, and not in lieu of or superior to, our operating performance measures calculated in accordance with GAAP.

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Hybrid cloud, including vCAN and vCloud Air, and our SaaS offerings, including our AirWatch mobile solutions, increased to approximately 8% of our total revenues during the three and six months ended June 30, 2016. vCAN revenues are generally included in license revenues and our SaaS revenues, including vCloud Air and our AirWatch mobile solutions, are included in both license and services revenues.

While we are seeing strong growth across our portfolio of emerging products, our compute products are reaching maturity and the sales of these products are expected to represent a decreasing percentage of our total business going forward. Taking this into account, we expect our total revenue growth in 2016 to slow as sales transition to our emerging products.

License Revenues

Overall license revenues during the three and six months ended June 30, 2016 increased slightly when compared with the same periods in 2015. While we experienced increased sales in our emerging products, including NSX and VSAN, as well as our vCAN offering, our license revenue growth rate was negatively impacted by certain factors, including lower license sales of our core compute products and increased growth derived from our hybrid cloud and SaaS offerings. Perpetual license revenues that are part of a multi-year arrangement are generally recognized upon delivery of the underlying license using the residual method, whereas revenues derived from our hybrid cloud and SaaS offerings are recognized over a period of time.

During 2016, we expect sales of our emerging products to continue to increase as a percentage of total revenues, and we expect overall license revenue growth in 2016 to be flat when compared with 2015.

Services Revenues

During the three and six months ended June 30, 2016, software maintenance revenues benefited from renewals of our software maintenance contracts sold in previous periods and additional maintenance contracts sold in conjunction with new software license sales. In each period presented, customers bought, on a weighted-average basis, more than 24 months of support and maintenance with each new license purchased.

Professional services revenues increased slightly during the three and six months ended June 30, 2016 when compared to the same period in 2015. As we continue to invest in our partners and expand our ecosystem of third-party professionals with expertise in our offerings to independently provide professional services to our customers, our professional services revenues will vary based on the delivery channels used in any given period as well as the timing of engagements.

GSA Settlement

During June 2015, we reached an agreement with the Department of Justice (“DOJ”) and the General Services Administration (“GSA”) to pay $76 million to resolve allegations that our government sales practices between 2006 and 2013 had violated the federal False Claims Act. The settlement was paid and recorded as a reduction of our total revenues during the three months ended June 30, 2015.

Unearned Revenues

Our unearned revenues as of June 30, 2016 and December 31, 2015 were as follows (table in millions):

	June 30, 2016	December 31, 2015
Unearned license revenues	$ 455	$ 428
Unearned software maintenance revenues	4,189	4,174
Unearned professional services revenues	478	474
Total unearned revenues	$ 5,122	$ 5,076

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

Unearned software maintenance revenues are attributable to our maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at June 30, 2016 was approximately two years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

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Unearned license and software maintenance revenues will fluctuate based upon a variety of factors including sales volume, the timing of both product promotion offers and delivery of the future products offered, and the amount of arrangements sold with ratable revenue recognition. Additionally, the amount of unearned revenues derived from transactions denominated in a foreign currency is impacted by fluctuations in the foreign currencies in which we invoice.

Cost of License Revenues, Cost of Services Revenues and Operating Expenses

Our cost of services revenues and operating expenses were primarily impacted by increasing employee-related expenses including salaries, bonuses, commissions and stock-based compensation across most of our income statement expense categories, net of realignment activities, when compared to the same period in 2015. We expect this trend to continue. As part of the realignment plan approved in January 2016, we expect to reinvest the associated savings primarily in research and development as well as sales and marketing.

In calculating the impact of foreign currency fluctuations on cost of license revenues, cost of services revenues and operating expenses, we converted expenses recognized during the current period derived from non-U.S. dollar based transactions into U.S. dollars using the exchange rates that were effective in the comparable prior year period and compared the calculated amount to the amount, as reported, in the comparable prior year period.

Cost of License Revenues

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

Our cost of license revenues during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	$ Change	% Change	2016	2015	$ Change	% Change
Cost of license revenues	$40	$46	$ (6)	(13)%	$80	$95	$ (16)	(17)%
Stock-based compensation	—	—	—	4	1	1	—	5
Total expenses	$40	$46	$ (6)	(12)	$81	$96	$ (16)	(16)
% of License revenues	6 %	7 %			7 %	8 %		

Cost of license revenues decreased during the three and six months ended June 30, 2016 compared to the same periods in 2015 primarily due to a decrease in royalty costs of $3 million and $9 million, respectively. In addition, amortization of intangible assets decreased by $3 million and $5 million during the three and six months ended June 30, 2016, respectively.

Cost of Services Revenues

Our cost of services revenues primarily includes the costs of personnel and related overhead to physically and electronically deliver technical support for our products and to provide professional services. Additionally, our cost of services revenues includes depreciation on equipment supporting our service offerings.

Our cost of services revenues during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	$ Change	% Change	2016	2015	$ Change	% Change
Cost of services revenues	$208	$194	$ 15	8 %	$407	$375	$ 31	8 %
Stock-based compensation	13	10	2	21	25	22	3	15

Total expenses	$221	$204	$ 17	8	$432	$397	$ 34	9
% of Services revenues	21 %	21 %			21 %	21 %		

Cost of services revenues increased during the three and six months ended June 30, 2016 compared to the same periods in 2015. The increase was primarily due to growth in cash-based employee-related expenses of $11 million and $29 million during the three and six months ended June 30, 2016, respectively. Additionally, during the six months ended June 30, 2016,

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equipment and depreciation increased by $9 million. These increases were partially offset by the favorable impact of $6 million during the six months ended June 30, 2016 resulting from fluctuations in the exchange rates between the U.S. dollar and the foreign currencies in which we incur expenses.

Research and Development Expenses

Our research and development expenses include the personnel and related overhead associated with the development of our product software and service offerings.

Our research and development expenses during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	$ Change	% Change	2016	2015	$ Change	% Change
Research and development	$289	$269	$ 20	7 %	$576	$520	$ 56	11 %
Stock-based compensation	74	53	21	39	144	107	37	35
Total expenses	$363	$322	$ 41	13	$720	$627	$ 93	15
% of Total revenues	21 %	21 %			22 %	21 %		

Research and development expenses increased during the three and six months ended June 30, 2016 compared to the same periods in 2015. These increases were primarily driven by growth in cash-based employee-related expenses of $21 million and $48 million during the three and six months ended June 30, 2016, respectively. In addition, stock-based compensation increased by $21 million and $37 million during the three and six months ended June 30, 2016, respectively, primarily driven by an increase in restricted stock awards granted to existing employees. Equipment and depreciation costs also increased by $7 million during the six months ended June 30, 2016.

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.

Our sales and marketing expenses during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	$ Change	% Change	2016	2015	$ Change	% Change
Sales and marketing	$533	$522	$ 10	2 %	$1,049	$1,019	$ 30	3 %
Stock-based compensation	47	43	5	12	95	81	14	17
Total expenses	$580	$565	$ 15	3	$1,144	$1,100	$ 44	4
% of Total revenues	34 %	37 %			35 %	36 %		

Sales and marketing expenses increased during the three and six months ended June 30, 2016 compared to the same periods in 2015. These increases were primarily driven by growth in cash-based employee-related expenses of $24 million and $57 million during the three and six months ended June 30, 2016, respectively, due primarily to higher commission expense resulting from increased sales volume. In addition, stock-based compensation increased by $14 million during the six months ended June 30, 2016 primarily driven by an increase in restricted stock awards granted to existing employees. These increases were partially offset by the favorable impact of $4 million and $17 million during the three and six months ended June 30, 2016, respectively, resulting from fluctuations in the exchange rates between the U.S. dollar and the foreign currencies in which we incur expenses, as well as decreases in costs incurred for marketing programs and related initiatives of $4 million and $12 million during the three and six months ended June 30, 2016, respectively. Equipment, depreciation and facilities-related costs also decreased by $4 million during the three months ended June 30, 2016.

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General and Administrative Expenses

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

Our general and administrative expenses during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	$ Change	% Change	2016	2015	$ Change	% Change
General and administrative	$149	$163	$ (14)	(8)%	$302	$336	$ (33)	(10)%
Stock-based compensation	18	17	—	2	36	31	5	16
Total expenses	$167	$180	$ (13)	(7)	$338	$367	$ (28)	(8)
% of Total revenues	10 %							