VMWARE, INC.
Form 10-Q
May 07, 2009
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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 March 31, 2009

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For transition period from ______ to ______

Commission File Number 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

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

(650) 427-5000

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

As of April 30, 2009, the number of shares of common stock, par value $.01 per share, of the registrant outstanding was 391,957,931, of which 91,957,931 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.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	March 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,031,482	$ 1,840,812
Accounts receivable, less allowance for doubtful accounts of $1,415 and $1,690	264,033	338,014
Deferred tax asset, current portion	47,628	44,573
Income taxes receivable from EMC	111,050	111,050
Other current assets	46,427	55,639
Total current assets	2,500,620	2,390,088
Property and equipment, net	415,978	418,212
Other assets, net	160,030	134,553
Deferred tax asset, net of current portion	72,305	68,280
Intangible assets, net	53,675	56,984
Goodwill	771,088	771,088
Total assets	$ 3,973,696	$ 3,839,205
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 63,803	$ 88,647
Accrued expenses	180,146	197,580
Due to EMC, net	18,023	33,407
Income taxes payable	33,897	15,761
Deferred revenue, current portion	576,657	544,355
Total current liabilities	872,526	879,750
Note payable to EMC	450,000	450,000
Deferred revenue, net of current portion	340,541	325,634
Deferred tax liability	48,631	47,825
Other liabilities	73,536	65,929
Total liabilities	1,785,234	1,769,138
Commitments and contingencies (see Note J)		
Stockholders equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 91,103 and 90,448 shares	911	904

Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000
Additional paid-in capital	1,891,763	1,836,513
Retained earnings	292,788	229,650
Total stockholders equity	2,188,462	2,070,067
Total liabilities and stockholders equity	$ 3,973,696	$ 3,839,205

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

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VMware, Inc.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended March 31, 2009	For the Three Months Ended March 31, 2008
Revenues:		
License	$ 257,003	$ 293,980
Services	213,307	144,195
	470,310	438,175
Operating expenses:		
Cost of license revenues	20,359	22,859
Cost of services revenues	54,644	54,311
Research and development	105,401	119,255
Sales and marketing	154,144	149,257
General and administrative	48,859	44,102
Operating income	86,903	48,391
Investment income	3,062	8,004
Interest expense with EMC, net	(2,674)	(5,819)
Other income (expense), net	(1,824)	454
Income before income taxes	85,467	51,030
Income tax provision	15,532	7,975
Net income	$ 69,935	$ 43,055
Net income per weighted-average share, basic for Class A and Class B	$ 0.18	$ 0.11
Net income per weighted-average share, diluted for Class A and Class B	$ 0.18	$ 0.11
Weighted-average shares, basic for Class A and Class B	389,857	381,026
Weighted-average shares, diluted for Class A and Class B	391,111	398,063

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

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VMware, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Three Months Ended March 31, 2009	2008
Cash flows from operating activities:		
Net income	$ 69,935	$ 43,055
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	41,383	37,434
Stock-based compensation, excluding amounts capitalized	49,815	42,161
Excess tax benefits from stock-based compensation	(230)	(22,692)
Other adjustments	493	1,336
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	74,161	846
Other assets	10,209	(8,594)
Due to/from EMC, net	(15,384)	17,246
Accounts payable	(17,222)	7,472
Accrued expenses	(14,663)	(15,305)
Income taxes payable	20,377	(21,596)
Deferred income taxes, net	(6,844)	(36,344)
Deferred revenue	47,209	88,161
Net cash provided by operating activities	259,239	133,180
Cash flows from investing activities:		
Additions to property and equipment	(35,825)	(49,022)
Capitalized software development costs	(29,935)	(4,164)
Purchase of investment	(745)	
Business acquisitions, net of cash acquired		(33,289)
Decrease (increase) in restricted cash		896
Net cash used in investing activities	(66,505)	(85,579)
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,503	23,669
Excess tax benefits from stock-based compensation	230	22,692
Shares repurchased for tax withholdings on vesting of restricted stock	(6,797)	(19,119)
Net cash (used in) provided by financing activities	(2,064)	27,242
Net increase in cash and cash equivalents	190,670	74,843
Cash and cash equivalents at beginning of the period	1,840,812	1,231,168
Cash and cash equivalents at end of the period	$ 2,031,482	$ 1,306,011

Non-cash items:				
Changes in capital additions, accrued but not paid	$	(9,957)	$	19,110

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

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (VMware or the Company) is the leading provider of virtualization infrastructure software solutions from the desktop to the data center. VMware s virtualization infrastructure software solutions run on industry-standard desktops and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated financial statements are unaudited and, in the opinion of management, include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware s consolidated financial condition, results of operations 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 2009. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware s 2008 Annual Report on Form 10-K.

VMware historically has received, and continues to receive, certain administrative services from EMC Corporation (EMC), and VMware and EMC engage in certain intercompany transactions. Costs incurred by EMC for the direct benefit of VMware, such as rent, salaries and benefits, plus a mark-up intended to approximate third-party costs, have been charged by EMC and included in VMware s financial statements. Management believes the assumptions underlying the financial statements are reasonable. However, given that these intercompany transactions did not arise from transactions negotiated at arm s-length with an unrelated third party, 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, or cash flows will be in the future if and when VMware contracts at arm s-length with independent third parties for services the Company has received and currently receives from EMC.

Principles of Consolidation

The consolidated financial statements include the accounts of VMware and its subsidiaries. All intercompany transactions and balances between VMware and its subsidiaries have been eliminated. All intercompany transactions with EMC in the consolidated statements of cash flows will be settled in cash, and changes in the intercompany balances are presented as a component of cash flows from operating activities.

Use of Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent assets and liabilities at the date of the financial statements. Estimates are used for, but not limited to, capitalized software development costs, receivable valuation, certain accrued liabilities, useful lives of fixed assets, valuation of acquired intangibles, revenue reserves, income taxes, stock-based compensation, and contingencies. Actual results could differ from those estimates.

New Accounting Pronouncements

In December 2007, the FASB issued FAS No. 141 (revised 2007), Business Combinations (FAS No. 141R). This statement establishes principles and requirements for how the acquirer in a business combination (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. On January 1, 2009, VMware adopted FAS No. 141R. FAS No. 141R will impact acquisitions closed on or after January 1, 2009. Adoption did not have a material impact on the Company s financial position and results of operations for the three months ended March 31, 2009.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

In December 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (FAS No. 160). The objective of this statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and therefore deconsolidation of a subsidiary. On January 1, 2009, VMware adopted FAS No. 160. FAS No. 160 will impact acquisitions closed on or after January 1, 2009. Adoption did not have a material impact on the Company s financial position and results of operations for the three months ended March 31, 2009.

In April 2008, the FASB issued a new position on FAS No. 142-3 titled Determination of the Useful Life of Intangible Assets (FSP No. 142-3). It amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS No. 142, Goodwill and Other Intangible Assets. The intent is to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141R, and other U.S. generally accepted accounting principles. This position is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. On January 1, 2009, VMware adopted FSP No. 142-3. Adoption did not have a material impact on the Company s financial position and results of operations for the three months ended March 31, 2009.

In November 2008, the FASB ratified EITF Issue No. 08-7, Accounting for Defensive Intangible Assets (EITF 08-7). EITF 08-7 applies to defensive intangible assets, which are acquired intangible assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting. Defensive intangible assets must be recognized at fair value in accordance with FAS No. 141R and FAS No. 157. On January 1, 2009, VMware adopted EITF 08-07. EITF 08-07 will impact acquisitions closed on or after January 1, 2009. Adoption did not have a material impact on the Company s financial position and results of operations for the three months ended March 31, 2009.

B. Significant Accounting Policies

Revenue Recognition

VMware derives revenues from the licensing of software and related services. VMware recognizes revenues for software products and related services in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended. VMware recognizes revenues when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectibility is probable.

The following summarizes the major terms of VMware s contractual relationships with customers and the manner in which VMware accounts for sales transactions.

License revenues

VMware recognizes revenues from the sale of software when risk of loss transfers, which is generally upon electronic shipment.

VMware licenses its software under perpetual licenses through its channel of distributors, resellers, x86 system vendors, and systems integrators and through its direct sales force. VMware defers revenues relating to products that have shipped into its channel until its products are sold through the channel. VMware obtains sell-through information from distributors and certain resellers on a monthly basis. For VMware s channel partners who do not report sell-through data, VMware determines sell-through based on payment of such distributors and certain resellers accounts receivable balances and other relevant factors. For software sold by x86 system vendors that is bundled with their hardware, unless the Company has a separate license agreement with the end user, revenue is recognized in arrears upon the receipt of binding royalty reports.

For all sales, VMware uses one of the following to constitute evidence of an arrangement:

- a purchase order or equivalent;
- a license agreement and a purchase order or equivalent;
- a license agreement which includes language that the agreement also serves as the purchase order; or
- a master agreement and a binding royalty report.

Sales through distributors and resellers are evidenced by a master distribution agreement, together with purchase orders or equivalent, on a transaction-by-transaction basis.

With the exception of one of VMware s desktop products, VMware s return policy does not allow end users to return products for a refund. Certain distributors and resellers may rotate stock when new versions of a product are released. VMware estimates future product returns at the time of sale. VMware s estimate is based on historical return rates, levels of inventory held by distributors and resellers, and other relevant factors. Returns have not been material to date and have been in line with the Company s expectations.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

VMware offers rebates to certain channel partners. When rebates are based on a set percentage of actual sales, VMware recognizes the amount of the rebates as a reduction of revenues when the underlying revenue is recognized. When rebates are earned only if a cumulative level of sales is achieved, VMware recognizes the amount of the rebates as a reduction of revenues proportionally for each sale that is required to achieve the target.

VMware also offers marketing development funds to certain channel partners. VMware records the amount of the marketing development funds, based on the maximum potential liability, as a reduction of revenues at the time the underlying revenue is recognized.

Services revenues

Services revenues consist of software maintenance and professional services. VMware recognizes software maintenance revenues ratably over the contract period. Professional services include design, implementation, and training. Professional services are not considered essential to the functionality of VMware s products as these services do not alter the product capabilities and may be performed by customers or other vendors. Professional services engagements for which VMware is able to make reasonably dependable estimates of progress toward completion are recognized on a proportional performance basis based upon the hours incurred. Revenues on all other professional services engagements are recognized upon completion.

Multiple element arrangements

VMware s software products are typically sold with software maintenance and/or professional services. Vendor-specific objective evidence (VSOE) of fair value for professional services is based upon the standard rates VMware charges for such services when sold separately. VSOE of fair value for software maintenance services is established by the rates charged in stand-alone sales of software maintenance contracts or the stated renewal rate for software maintenance included in the license agreement. The revenues allocated to the software license included in multiple element contracts represent the residual amount of the contract after the fair value of the other elements has been determined.

Customers under software maintenance agreements are entitled to receive updates and upgrades on a when-and-if-available basis, and various types of technical support based on the level of support purchased. In the event specific features or functionality, entitlements, or the release number of an upgrade or new product have been announced but not delivered, and customers will receive that upgrade or new product as part of a current software maintenance contract, a specified upgrade is deemed created and product revenues are deferred on purchases made after the announcement date until delivery of the upgrade or new product. The amount and elements to be deferred are dependent on whether the company has established VSOE of fair value for the upgrade or new product. VSOE of fair value of these upgrades or new products is established based upon the price set by management. VMware has a history of selling these upgrades or new products on a stand-alone basis.

Deferred revenues include unearned software maintenance fees, professional services fees, and license fees.

Research and Development and Capitalized Software Development Costs

Costs related to research and development (R&D) are generally charged to expense as incurred. Capitalization of material development costs of software to be sold, leased, or otherwise marketed are subject to capitalization beginning when technological feasibility has been established, which is at the earlier of completion of a detailed product design or a working model, and ending when the product is available for general release, in accordance with the provisions of FAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Judgment is required in determining when technological feasibility is established. Changes in judgment as to when technological feasibility is established, or changes in the Company s business, including VMware s go-to-market strategy, would likely materially impact the amount of costs capitalized. For example, if the length of time between technological feasibility and general availability is less in the future, the amount of costs capitalized would likely decrease. In addition, VMware s R&D expenses and amounts capitalized as software development costs may not be comparable to VMware s peer companies due to differences in judgment as to when a detailed product design or a working model has been completed or differences in judgment regarding when the product is available for general release. FAS No. 86 requires annual amortization expense of capitalized software development costs to be the greater of the amounts computed using the ratio of current gross revenue to a products total current and anticipated revenues, or the straight-line method over the product s remaining estimated economic life. To date, VMware has amortized these costs using the straight-line method as it is the greater of the two amounts. The costs are amortized over periods ranging from 18 to 24 months, which represent the product s remaining estimated economic life. The ongoing assessment of the recoverability of these costs requires considerable judgment by management with respect to certain external factors such as anticipated future revenue, estimated economic life, and changes in software and hardware technologies. Material differences in amortization amounts could occur as a result of changes in the periods over which VMware actually generates revenues or the amounts of revenues generated.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Unamortized software development costs were $154.5 million and $128.8 million as of March 31, 2009 and December 31, 2008, respectively, and are included in other assets, net.

In the three months ended March 31, 2009 and 2008, VMware capitalized $36.4 million (including $6.4 million of stock-based compensation), and $5.0 million (including $0.9 million of stock-based compensation), respectively, of costs incurred for the development of software products. These amounts have been excluded from R&D expenses on the Company s accompanying consolidated statements of income. Amortization expense from capitalized amounts was $10.7 million and $14.9 million in the three months ended March 31, 2009 and 2008, respectively, and are included in cost of license revenues on the Company s accompanying consolidated statements of income.

Long-Lived Assets

Intangible assets, other than goodwill, are amortized over their estimated useful lives, during which the assets are expected to contribute directly or indirectly to future cash flows, and which range from one to eleven years. In the three months ended March 31, 2009 and 2008, VMware amortized $3.3 million and $3.9 million, respectively, for intangible assets.

VMware reviews long-lived assets for impairment in accordance with FAS No. 144 Accounting for Impairment or Disposal of Long-Lived Assets. VMware reviews for impairment if events or changes in business circumstances indicate that the carrying amounts of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate.

Goodwill is carried at its historical cost. VMware tests goodwill for impairment in accordance with FAS 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.

To date, there have been no impairments of goodwill or other intangible assets.

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. Cash on deposit with banks exceeds the amount of insurance provided on such deposits. These deposits may be redeemed upon demand. VMware places cash and cash equivalents primarily in money market funds and limits the amount of investment with any one issuer. As of March 31, 2009, VMware had $1,854.3 million in money market securities. Of this amount, $735.0 million or 40% were participating in the Temporary Guarantee Program for Money Market Funds, which is backed by the U.S. Treasury Department but limited to the balance in the money market funds as of September 19, 2008. The Temporary Guarantee Program for Money Market funds expires on September 18, 2009. VMware holds a diversified portfolio of money market funds, which invest in municipal bonds and notes, government agency debt, time deposits, corporate bonds, and commercial paper. In addition, VMware monitors the counterparty risk to ensure adequate diversification amongst the financial institutions holding the Company s funds.

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 a credit evaluation. Credit is extended to existing customers based on ongoing credit evaluations, prior payment history, and demonstrated financial stability. Given the recent economic downturn and global financial crisis, VMware continues to apply scrutiny and analysis around the collectibility of transactions with certain customers, including but not limited to those customers in the financial services, insurance, and automotive industries, and the Company continues to monitor the appropriateness of established customer credit limits. VMware does not record accounts receivable or deferred revenue or recognize revenue relating to transactions where collectibility is not probable. The Company recognizes such transactions upon cash collection and recognizes revenue as earned in accordance with the Company s revenue recognition policies.

C. 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. For purposes of computing basic net income per share, the weighted-average number of outstanding shares of common stock excludes potentially dilutive securities. 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. Potentially dilutive securities include stock options, unvested restricted stock units, unvested restricted stock awards, and other unvested restricted

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

stock, using the treasury stock method. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. As of March 31, 2009, VMware had 90.3 million shares of Class A common stock and 300.0 million shares of Class B common stock outstanding that were included in the calculation of basic earnings per share. For purposes of calculating earnings per share, VMware uses the two-class method. As both classes share the same rights in dividends, basic and diluted earnings per share are the same for both classes.

The following table sets forth the computations of basic and diluted net income per share (in thousands, except per share data):

	For the Three Months Ended March 31,	
	2009	2008
Net income	$ 69,935	$ 43,055
Weighted-average shares, basic for Class A and Class B	389,857	381,026
Effect of dilutive securities	1,254	17,037
Weighted-average shares, diluted for Class A and Class B	391,111	398,063
Net income per weighted-average share, basic for Class A and Class B	$ 0.18	$ 0.11
Net income per weighted-average share, diluted for Class A and Class B	$ 0.18	$ 0.11

For the three months ended March 31, 2009, 41.1 million stock options to acquire VMware Class A common stock and 5.0 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the three months ended March 31, 2008, 4.1 million stock options to acquire VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

D. Fair Value Measurements

FAS No. 157 Fair Value Measurements clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, FAS No. 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets, (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly, and (Level 3) unobservable inputs in which there is little or no market data, which requires VMware to develop its own assumptions. This hierarchy requires VMware to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

VMware s cash and cash equivalents as of March 31, 2009 were $2,031.5 million and included $1,854.3 million of money market securities, which are classified within Level 1 of the fair value hierarchy because the securities are valued using quoted prices in active markets for identical assets. There were no other financial assets or liabilities carried at fair value as of March 31, 2009.

E. Goodwill

There were no changes to the carrying amount of goodwill for the three months ended March 31, 2009.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

F. Property and Equipment, net

Property and equipment, net, as of March 31, 2009 and December 31, 2008 consist of the following (table in thousands):

	March 31, 2009	December 31, 2008
Equipment and software	$ 301,871	$ 284,458
Buildings and improvements	253,119	182,118
Furniture and fixtures	47,228	45,904
Construction in progress	821	66,663
Total property and equipment	603,039	579,143
Accumulated depreciation	(187,061)	(160,931)
Total property and equipment, net	$ 415,978	$ 418,212

As of March 31, 2009, the Company occupied the completed portions of its data center facility. Additionally, construction was completed on the Company s headquarters facilities. The related costs for each were transferred from construction in progress to the appropriate categories. As of December 31, 2008, construction was still in process on these facilities.

Depreciation expense was $27.4 million and $18.7 million for the three months ended March 31, 2009 and 2008, respectively.

G. Accrued Expenses

Accrued expenses as of March 31, 2009 and December 31, 2008 consist of the following (table in thousands):

	March 31, 2009	December 31, 2008
Salaries, commissions, and benefits	$ 100,548	$ 105,529
Accrued partner liabilities	42,272	52,914
Other	37,326	39,137
Total	$ 180,146	$ 197,580

Accrued partner liabilities referenced in the table above relate to rebates and marketing development fund accruals for channel partners, x86 system vendors, and system integrators.

H. Long-Term Debt

Note Payable to EMC

In April 2007, VMware declared an $800.0 million dividend to EMC paid in the form of a note payable. The note may be repaid, without penalty, at any time commencing July 2007. Subsequent to receiving the proceeds from the IPO in August 2007, VMware repaid $350.0 million of principal on the note. The interest rate for the three months ended March 31, 2009 and 2008 was 1.99% and 5.28%, respectively. For the three months ended March 31, 2009 and 2008, $2.2 million and $6.0 million of interest expense was recorded related to the note payable. No repayments of principal were made during the first three months of 2009.

I. Income Taxes

Although VMware files a federal consolidated tax return with EMC, VMware has calculated its income tax provision on a stand-alone basis. The Company s effective tax rate in the periods presented is the result of the mix of income earned in various tax jurisdictions that apply a broad range of income tax rates. The provision for income taxes differs from the tax computed at the U.S. federal statutory income tax rate due primarily to the foreign income being taxed in those lower tax rate jurisdictions and that those earnings are considered as indefinitely reinvested in foreign operations.

VMware s effective income tax rate was 18.2% and 15.6% for the three months ended March 31, 2009 and March 31, 2008, respectively. The increase in the rate is primarily due to a forecasted shift of earnings from lower tax non-U.S. jurisdictions to the U.S. and an increase in unrecognized tax benefits relative to income before tax, partially offset by an increase in tax benefits for tax credits relative to income before tax. Income earned abroad is considered indefinitely reinvested in the Company s foreign operations and no additional provision for U.S. taxes has been recorded in income.

As of March 31, 2009, VMware had $55.0 million of gross unrecognized tax benefits and $52.1 million of net unrecognized tax benefits. VMware reports interest and penalties related to unrecognized tax benefits in income tax expense. For the three months

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

ended March 31, 2009, VMware recognized approximately $0.9 million in interest and penalties and had approximately $2.0 million of interest and penalties accrued at March 31, 2009. If the total amount of net unrecognized tax benefits had been recognized, $45.5 million would be a reduction to income tax expense impacting the effective income tax rate and $6.6 million would be a reduction to goodwill if recognized within the measurement period. If this amount is recognized outside the measurement period, it will be a reduction to tax expense. It is reasonably possible that VMware may pay an immaterial amount of the $52.1 million of net unrecognized tax benefits within the next 12 months. However, based on the status of audit examinations and the protocol of finalizing audits, it is not possible to estimate the amount to be paid within the next 12 months. Of the $52.1 million of net unrecognized tax benefits, $50.4 million were classified as a non-current liability on the consolidated balance sheet as of March 31, 2009.

As of March 31, 2009, VMware had a net income tax receivable of $111.1 million. The receivable arose because VMware had a stand-alone taxable loss for the twelve months ended December 31, 2008, which was primarily attributable to tax deductions arising from both non-qualified stock option exercises and from the vesting of restricted stock. Under the tax sharing agreement with EMC, EMC is obligated to pay VMware an amount equal to the tax benefit that EMC will recognize on its consolidated tax return.

J. Commitments and Contingencies

Litigation

VMware is named from time to time as a party to lawsuits in the normal course of its business. In such cases it is the Company s policy to defend against such claims, or if considered appropriate, negotiate a settlement on commercially reasonable terms. However, no assurance can be given that the Company will be able to negotiate settlements on commercially reasonable terms, or at all, or that any litigation resulting from such claims would not have a material adverse effect on the Company s consolidated results of operations, financial position, and cash flows, or consolidated financial statements taken as a whole.

Operating Lease Commitments

VMware leases office facilities and equipment under various operating leases. Facility leases generally include renewal options. VMware s future lease commitments at March 31, 2009 are as follows (table in thousands):

2009	$ 23,105
2010	27,997
2011	24,172
2012	14,460
2013	10,598
Thereafter	269,615
Total minimum lease payments	$ 369,947

The amount of the future lease commitments after 2013 is primarily for the ground lease on VMware s Palo Alto, California headquarters facilities, which expires in 2057. As several of VMware s operating leases are payable in foreign currencies, the amount of operating lease commitments may fluctuate in response to changes in the exchange rate between the U.S. Dollar and the foreign currencies in which the commitments are payable.

K. Stockholders Equity

VMware Stock Options

The following table summarizes option activity since January 1, 2009 for VMware stock options (shares in thousands):

	Number of Shares	Weighted-Average Exercise Price (per share)
Outstanding, January 1, 2009	42,436	$ 26.54
Granted	1,581	23.73
Forfeited	(1,119)	27.20
Expired	(73)	30.26
Exercised	(223)	20.23
Outstanding, March 31, 2009	42,602	26.44

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Cash proceeds from the exercise of stock options for the three months ended March 31, 2009 were $4.5 million. The options exercised during the three months ended March 31, 2009 had a pre-tax intrinsic value of $1.1 million.

VMware Restricted Stock

VMware restricted stock includes restricted stock awards, restricted stock units, and other restricted stock. Other restricted stock includes options exercised by non-employee directors that were required to be exercised within one year of grant, but are subject to a three-year vesting provision. The exercise of those options prior to vesting resulted in the outstanding shares being subject to repurchase and hence restricted until such time as the respective options vest.

The following table summarizes restricted stock activity since January 1, 2009 for VMware restricted stock (shares in thousands):

	Number of Shares	Weighted-Average Grant Date Fair Value (per share)
Outstanding, January 1, 2009	7,626	$ 32.35
Granted	357	23.91
Vested	(822)	36.75
Forfeited	(254)	34.64
Outstanding, March 31, 2009	6,907	31.32

The total fair value of restricted stock that vested in the three months ended March 31, 2009 was $17.4 million. As of March 31, 2009, 6.9 million shares of VMware restricted stock were outstanding, with an aggregate intrinsic value of $161.3 million based on the share price as of March 31, 2009. These shares are scheduled to vest through 2013.

Shares Repurchased for Tax Withholdings

During the three months ended March 31, 2009, VMware repurchased 322,771 shares of Class A common stock for $6.8 million to cover tax withholding obligations. Pursuant to the respective agreements, these shares were repurchased in conjunction with the net share settlement upon the vesting of restricted stock and restricted stock units during the quarter. The $6.8 million is recorded as a reduction to retained earnings as of March 31, 2009. During the three months ended March 31, 2008, 363,337 shares were repurchased for tax withholdings for $20.3 million.

Stock-Based Compensation Expense

The following table summarizes the components of total stock-based compensation expense included in VMware s consolidated statements of income for the three months ended March 31, 2009 and 2008 (table in thousands):

	For the Three Months Ended March 31, 2009	2008
Cost of license revenues	$ 330	$ 263

Cost of services revenues	3,475	3,261
Research and development	23,904	21,097
Sales and marketing	13,834	11,301
General and administrative	8,272	6,239
Stock-based compensation expense	49,815	42,161
Income tax benefit	9,934	8,500
Total stock-based compensation expense, net of tax	$ 39,881	$ 33,661

For the three months ended March 31, 2009 and 2008, VMware capitalized $6.4 million and $0.9 million, respectively, of stock-based compensation expense associated with capitalized software development in accordance with FAS No. 86.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Fair Value of VMware Options

The fair value of each option to acquire VMware Class A common stock granted during the three months ended March 31, 2009 and 2008 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	For the Three Months Ended March 31,	
VMware Stock Options	**2009**	**2008**
Dividend yield	None	None
Expected volatility	38.3%	38.1%
Risk-free interest rate	1.5%	2.2%
Expected term (in years)	3.9	3.4
Weighted-average fair value at grant date	$ 7.51	$ 16.97

	For the Three Months Ended March 31,	
VMware Employee Stock Purchase Plan	**2009**	**2008**
Dividend yield	None	None
Expected volatility	59.3%	37.3%
Risk-free interest rate	0.3%	3.4%
Expected term (in years)	0.5	0.5
Weighted-average fair value at grant date	$ 7.49	$ 22.10

For all equity awards granted in the three months ended March 31, 2009 and 2008, VMware s expected dividend yield input was zero as the Company has not historically paid, nor expects in the future to pay, cash dividends on its common stock. Volatility was based on an analysis of historical stock prices and implied volatilities of publicly-traded companies with similar characteristics, including industry, stage of life cycle, size, and financial leverage. Starting in 2009, volatility was also based upon the implied volatilities of VMware s Class A common stock. The expected term was calculated based on the expected term of similar grants of comparable companies. The risk-free interest rate was based on a zero-coupon U.S. Treasury instrument whose term is consistent with the expected term of the stock options.

L. Related Party Transactions

Transactions with EMC

In the three months ended March 31, 2009 and 2008, VMware recognized professional services revenues of $4.5 million and $3.3 million, respectively, for services provided to EMC s customers pursuant to VMware s contractual agreements with EMC. As of March 31, 2009, $3.7 million of revenues from professional services were included in deferred revenue.

In the three months ended March 31, 2009, VMware recognized revenues from server and desktop products and services purchased by EMC for internal use of $0.6 million pursuant to VMware s contractual agreements with EMC. As of March 31, 2009, $3.7 million of revenues from server and desktop products and services purchased by EMC for internal use were included in deferred revenue.

In the three months ended March 31, 2009, VMware commenced a reseller arrangement with EMC, whereby EMC bundles VMware s products with EMC s hardware and sells them to end users. In the three months ended March 31, 2009, VMware recognized revenues of $2.1 million from products sold pursuant to VMware s reseller arrangement with EMC. As of March 31, 2009, $1.2 million of revenues from products sold under the reseller arrangement were included in deferred revenue.

VMware purchased storage systems and software from EMC for $5.1 million and $10.8 million in the three months ended March 31, 2009 and 2008, respectively. Purchases from EMC were at a discount off of EMC s list price.

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with EMC subsidiaries for support services and EMC employees who are managed by VMware personnel. The costs incurred by EMC on VMware s behalf related to these employees include a mark-up intended to approximate costs that would have been charged had such arrangements been with an unrelated third party. These costs have been charged by EMC and included as expenses in VMware s financial statements. These costs include expenses for salaries and benefits, travel, and rent. Additionally, EMC incurs certain costs on VMware s behalf in the U.S., which primarily relate to a shared system for travel. The total of these costs were $24.5 million and $39.4 million in the three months ended March 31, 2009 and 2008, respectively.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

As calculated under VMware s tax sharing agreement with EMC, VMware paid EMC income taxes of $62.3 million in the three months ended March 31, 2008 for VMware s portion of their consolidated federal income taxes. No payments were made in the three months ended March 31, 2009. The amounts that VMware pays to EMC for VMware s portion of federal income taxes on EMC s consolidated tax return differ from the amounts VMware would owe on a stand-alone basis and the difference is presented as a component of stockholders equity. In the three months ended March 31, 2009 and 2008, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated as VMware s portion of federal income taxes on EMC s consolidated tax return was recorded as a decrease in stockholders equity of $0.7 million and $0.5 million, respectively.

Interest expense with EMC, net, primarily consists of interest expense on the note payable to EMC, offset by interest income that has been earned on VMware s intercompany balance with EMC. In the three months ended March 31, 2009 and 2008, $2.2 million and $6.0 million, respectively, of interest expense were recorded related to the note payable to EMC and were included in interest expense with EMC, net, recorded on the consolidated statements of income. 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.

As of March 31, 2009, VMware had $30.8 million due to EMC, which was partially offset by $12.8 million due from EMC. The net amount due to EMC for the three months ended March 31, 2009 was $18.0 million and resulted from the related party transactions described above. As of March 31, 2009, VMware had $111.1 million of income taxes receivable due from EMC and $21.1 million of income taxes payable due to EMC. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

M. Segment Information

VMware operates in one reportable segment in accordance with the provisions of FAS 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 FAS No. 131 can be found in the consolidated financial statements.

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

	For the Three Months Ended March 31,	
	2009	2008
United States	$ 244,079	$ 225,175
International	226,231	213,000
Total	$ 470,310	$ 438,175

Long-lived assets, which include property and equipment, net, and other assets, net, excluding capitalized software and financial instruments, in the United States at March 31, 2009 and December 31, 2008 were $320.0 million and $325.4 million, respectively. Long-lived assets internationally at March 31, 2009 and December 31, 2008 were $42.5 million and $44.5 million, respectively. No country other than the United States accounted for 10% or more of these assets at March 31, 2009 or December 31, 2008.

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with our quarterly consolidated financial statements and notes thereto which appear elsewhere in this Quarterly Report on Form 10-Q.

This section and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements, within the meaning of the federal securities laws, about our business and prospects. The forward-looking statements do not include the potential impact of any mergers, acquisitions, divestitures, securities offerings or business combinations or other developments in our business that may be announced or consummated after the date hereof. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words outlook, believes, plans, intends, expects, goals, potential, co may, will, should, seeks, predicts, estimates, anticipates and similar expressions are intended to identify forward-looking statements, a not all forward-looking statements contain these words. Our future results may differ materially from our past results and from those projected in the forward-looking statements due to various uncertainties and risks, including those described in Item 1A of Part II (Risk Factors). The forward-looking statements speak only as of the date of this Quarterly Report and undue reliance should not be placed on these statements. We disclaim any obligation to update any forward-looking statements contained herein after the date of this Quarterly Report.

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

Certain tables may not add due to rounding.

Overview

Our primary source of revenues is the licensing of virtualization infrastructure software solutions and related support and services through a variety of distribution channels for use by businesses and organizations of all sizes and across numerous industries in their information technology (IT) infrastructure. Our solutions run on industry-standard desktops and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures. Our virtualization software solutions help eliminate the complexity of maintaining and managing IT infrastructures, reduce both capital and operating costs, and provide a more flexible and dynamic IT environment to better support the needs of business. With our latest platform, VMware vSphere 4, we are helping companies towards the path of cloud computing by providing compatible IT infrastructures for both businesses and cloud service providers.

We have developed a multi-channel distribution model to expand our presence and to reach various segments of the industry. In the first quarter of 2009 we derived over 75% of our revenues from our channel partners, which include distributors, resellers, x86 system vendors and system integrators. We have also developed a network of indirect channel partners who fulfill orders through our direct channel partners. The majority of our revenues result from contracts that include both perpetual software licenses and ongoing software maintenance contracts. License revenues are recognized when the elements of revenue recognition are complete. Software maintenance revenues are recognized ratably over the term of the software maintenance period, and include renewals of software maintenance sold after the initial software maintenance period expires. We also recognize revenues from professional services provided to our customers.

Our current financial focus is on long-term revenue growth to generate cash flows to fund our expansion of industry segment share and our development of virtualization-based products for data centers, desktops and cloud computing. We expect to grow our business by broadening our virtualization infrastructure software solutions technology and product portfolio, increasing product awareness, promoting the adoption of virtualization, and building long-term relationships with our customers through the adoption of enterprise license agreements (ELAs). We recently announced VMware vSphere 4, the next generation of VMware Infrastructure, our flagship virtual data center operating system (VDC-OS) product, and it is expected to be generally available during the second quarter of 2009. We expect to continue to introduce products that build on the vSphere foundation through 2009 and 2010.

Since mid-2008 we have observed that customers are reducing their IT spending in order to preserve cash. As a result, customers are subjecting larger orders, such as ELAs, to a longer review process and in certain cases are purchasing products to meet their immediate needs, foregoing larger discounts offered under ELAs. We believe this trend primarily correlates to the global economic uncertainty and we expect this to continue throughout 2009 and perhaps longer.

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

In evaluating our results, we also focus on operating margin excluding stock-based compensation, employer taxes on employee stock transactions, amortization of intangible assets, the write-off of in-process research and development, and the net effect of the amortization and capitalization of software development costs as we believe this measure reflects our ongoing business in a manner that allows meaningful period-to-period comparisons. We are not currently focused on short-term operating margin expansion, but rather on investing at appropriate rates to support our growth and future product offerings in what may be a substantially more competitive environment; as a result, our future operating margins may decline from current levels.

Our maintenance-related services revenues are recognized ratably over periods of up to five years subsequent to the initial contract, whereas most of our license revenues are generally recognized upon electronic shipment of the software. As a result, variability in operating margin can result from differences in when we price our service and when the cost is incurred. Currently, most of our international revenues are for contracts in U.S. Dollars to international channel partners. A portion of our operating expenses is in currencies other than the U.S. Dollar. Historically, this currency difference between our revenues and operating expenses has caused variability in our operating margins due to fluctuations in the U.S. Dollar compared to other currencies. In conjunction with the planned general release of VMware vSphere 4 in the second quarter of 2009, we plan to invoice and collect in the Euro, the British Pound, the Japanese Yen, and the Australian Dollar. While variability in operating margin may be reduced in future periods due to our plan to invoice in certain of the local currencies in which we also recognize expenses, increased exposure to foreign currency fluctuations will introduce additional risk for variability in revenue-related components of our financial statements.

Our Relationship with EMC

As of March 31, 2009, EMC owned 27,000,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing approximately 84% of our total outstanding shares of common stock and 98% of the combined voting power of our outstanding common stock.

In the first quarters of 2009 and 2008, we recognized professional services revenues of $4.5 and $3.3, respectively, for services provided to EMC s customers pursuant to our contractual agreements with EMC. As of March 31, 2009, $3.7 of revenues from professional services were included in deferred revenue.

In the first quarter of 2009, we recognized revenues from server and desktop products and services purchased by EMC for internal use of $0.6 pursuant to our contractual agreements with EMC. As of March 31, 2009, $3.7 of revenues from server and desktop products and services purchased by EMC for internal use were included in deferred revenue.

In the first quarter of 2009, we commenced a reseller arrangement with EMC, whereby EMC bundles our products with EMC s hardware and sells them to end users. In the first quarter of 2009, we recognized revenues of $2.1 from products sold pursuant to our reseller arrangement with EMC. As of March 31, 2009, $1.2 of revenues from products sold under the reseller arrangement were included in deferred revenue.

We purchased storage systems and software from EMC for $5.1 and $10.8 in the first quarter of 2009 and 2008, respectively. Purchases from EMC were at a discount off of EMC s list price.

In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC employees who are managed by our personnel. The costs incurred by EMC on our behalf related to these employees include a mark-up intended to approximate costs that would have been charged had such arrangements been with an unrelated third party. These costs have been charged by EMC and included as expenses in our financial statements. These costs include expenses for salaries and benefits, travel, and rent. Additionally, EMC incurs certain costs on our behalf in the U.S., which primarily relate to a shared system for travel. The total of these costs were $24.5 and $39.4 in the first quarter of 2009 and 2008, respectively.

As calculated under our tax sharing agreement with EMC, we paid EMC income taxes of $62.3 in the first quarter 2008 for our portion of their consolidated federal income taxes. No payments were made in the first quarter of 2009. The amounts we pay to EMC for our portion of federal income taxes on EMC s consolidated tax return differ from the amounts we would owe on a stand-alone basis and the difference is presented as a component of stockholders equity. In the first quarters of 2009 and 2008, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated as our portion of federal income taxes on EMC s consolidated tax return was recorded as a decrease in stockholders equity of $0.7 and $0.5, respectively.

Interest expense with EMC, net, primarily consists of interest expense on the note payable to EMC, offset by interest income that has been earned on our intercompany balance with EMC. In the first quarter of 2009 and 2008, $2.2 and $6.0, respectively, of interest expense were recorded related to the note payable to EMC and were included in interest expense with EMC, net, recorded on the consolidated statements of income. Our interest income and our expenses as a separate, stand-alone company may be higher or lower than the amounts reflected in the financial statements.

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As of March 31, 2009, we had $30.8 due to EMC, which was partially offset by $12.8 due from EMC. The net amount due to EMC in the first quarter of 2009 was $18.0 and resulted from the related party transactions described above. As of March 31, 2009, we had $111.1 of income taxes receivable due from EMC and $21.1 of income taxes payable due to EMC. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

Given that the amounts we recorded for our intercompany transactions with EMC did not arise from transactions negotiated at arm s-length with an unrelated third party, the financial statements included herein may not necessarily reflect our financial condition, results of operations and cash flows had we engaged in such transactions with an unrelated third party during all periods presented. Accordingly, our historical results should not be relied upon as an indicator of our future performance as a stand-alone company.

Income Statement Presentation

Sources of Revenues

License revenues

Our license revenues consist of revenues earned from the licensing of our software products. These products are generally licensed on a perpetual basis and are generally priced based upon the number of physical desktops or server processors on which our software runs.

Software maintenance revenues

Software maintenance revenues are recognized ratably over the contract period. Typically, our contract periods range from one to five years. Customers receive various types of technical support based on the level of support purchased. Customers who are party to software maintenance agreements with us are entitled to receive product updates and upgrades on a when-and-if-available basis.

Professional services revenues

Professional services include design, implementation and training. Professional services are not considered essential to the functionality of our products, as these services do not alter the product capabilities and may be performed by our customers or other vendors. Professional services engagements for which we are able to make reasonably dependable estimates of progress toward completion are recognized on proportional performance to date based upon the hours incurred. Revenues on all other professional services engagements are recognized upon completion.

Operating Expenses

Cost of license revenues

Our cost of license revenues principally consists of amortization of capitalized software development costs and the cost of fulfillment of our software. The cost of fulfillment of our software includes product packaging, personnel costs and related overhead associated with the physical and electronic delivery of our software products.

Cost of services revenues

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

Research and development expenses

Our research and development (R&D) expenses include the personnel and related overhead associated with the research and development of new product offerings, including depreciation expense, and the enhancement of our existing software offerings.

Sales and marketing expenses

Our sales and marketing expenses include personnel costs and related overhead associated with the sale and marketing of our license and services offerings, as well as the cost of certain marketing initiatives, including our semi-annual VMworld conference.

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, facilities, human resources, IT infrastructure, and legal departments.

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Revenues

Our revenues for the first quarter of 2009 and 2008 are as follows:

	For the Three Months Ended March 31,	
	2009	**2008**
Revenues:		
License	$ 257.0	$ 294.0
Services:		
Software maintenance	175.7	112.1
Professional services	37.6	32.1
Total services	213.3	144.2
	$ 470.3	$ 438.2
Percentage of revenues:		
License	54.6%	67.1%
Services:		
Software maintenance	37.4	25.6
Professional services	8.0	7.3
Total services	45.4	32.9
	100.0%	100.0%
Revenues:		
United States	$ 244.1	$ 225.2
International	226.2	213.0
	$ 470.3	$ 438.2
Percentage of revenues:		
United States	51.9%	51.4%
International	48.1	48.6
	100.0%	100.0%

Total revenues were $470.3 in the first quarter of 2009 and $438.2 in the first quarter of 2008, representing year-over-year increases of $32.1 or 7% in the first quarter of 2009. The growth in revenues in the first quarter of 2009 reflected a decrease of $37.0 in license revenues and an increase of $69.1 in services revenues as compared to the first quarter of 2008. The shift in our revenue mix year-over-year is primarily due to a decline in license revenues as a result of the macro-economic environment, while services revenues benefited from multi-year software maintenance contracts sold in previous periods. International revenues as a percentage of total revenues in the first quarter of 2009 were substantially unchanged from the first quarter of 2008.

We sell our products through a network of channel partners, which includes distributors, resellers, x86 system vendors and systems integrators. As we expand geographically, we may add additional direct channel partners. Our indirect channel partners obtain software licenses and services from our distributors and x86 system vendors and market and sell them to end user customers. In addition, we have a direct sales force that complements these efforts. Our sales force works with our channel partners to introduce them to customers and new sales opportunities. Our channel partners also introduce our sales force to their customers.

Currently, most of our revenue contracts with international customers have been denominated in U.S. Dollars. Although the exchange rates between the U.S. Dollar, the Euro, the British Pound and the Australian Dollar have been volatile in recent pont style="DISPLAY: inline; FONT-FAMILY: times new roman; FONT-SIZE: 10pt">

Depreciation and amortization	26,269	29,534	115,388
Unrealized foreign currency exchange (gain) loss	(81)	(5)	(3)
Gain on sale of assets and amortization of deferred gains (including securities)	(8,364)	(10,950)	(16,813)
Equity (gains) losses of associated companies	(4,681)	163	4
Impairment loss on vessels	-	-	32,042
Gain on repurchase of convertible bond debt	-	-	(4,600)
Provision for doubtful debts	133	-	5,370
Other, net	(66)	(3,881)	168
Change in operating assets and liabilities	(22,823)	(8,119)	20,793
Net cash (used in) provided by operating activities	(28,648)	13,545	68,574
INVESTING ACTIVITIES			
Change in restricted cash	16,410	14,042	13,060
Additions to newbuildings, vessels and equipment	(722)	(565)	(14,503)
Finance lease payments received	498	425	1,824
Proceeds from sale of vessels and equipment	8,443	10,174	10,619
Net investment in associated companies	(5,759)	-	(13,298)
Loan repaid by (to) associated company	250	(250)	(250)
Net cash provided by (used in) investing activities	19,120	23,826	(2,548)
FINANCING ACTIVITIES			
Repayment of long-term debt	(5,694)	(14,343)	(24,921)
Repayment of capital leases	(12,886)	(14,083)	(64,068)
Net cash used in financing activities	(18,580)	(28,426)	(88,989)
Net (decrease) increase in cash and cash equivalents	(28,108)	8,945	(22,963)
Cash and cash equivalents at start of period			

	137,603	160,566	160,566
Cash and cash equivalents at end of period	109,495	169,511	137,603

See accompanying notes that are an integral part of these condensed consolidated financial statements.

FRONTLINE LTD.
CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (in thousands of $ except number of shares)	2013 Jan-Mar	2012 Jan-Mar	2012 Jan-Dec
NUMBER OF SHARES OUTSTANDING			
Balance at beginning and end of period	77,858,502	77,858,502	77,858,502
SHARE CAPITAL			
Balance at beginning and end of period	194,646	194,646	194,646
ADDITIONAL PAID IN CAPITAL			
Balance at beginning of period	821	225,769	225,769
Stock option expense	90	322	821
Transfer to contributed surplus	-		(225,769)
Balance at end of period	911	226,091	821
CONTRIBUTED SURPLUS			
Balance at beginning of period	474,129	248,360	248,360
Transfer from additional paid in capital	-	-	225,769
Balance at end of period	474,129	248,360	474,129
ACCUMULATED OTHER COMPREHENSIVE LOSS			
Balance at beginning of period	(4,155)	(4,779)	(4,779)
Other comprehensive (loss) income	(9)	512	624
Balance at end of period	(4,164)	(4,267)	(4,155)
RETAINED DEFICIT			
Balance at beginning of period	(545,766)	(463,012)	(463,012)
Net (loss) income	(18,755)	7,175	(82,754)
Balance at end of period	(564,521)	(455,837)	(545,766)
FRONTLINE LTD. EQUITY	101,001	208,993	119,675
NONCONTROLLING INTEREST			
Balance at beginning of period	11,474	12,495	12,495
Net loss	(280)	(372)	(1,021)
Balance at end of period	11,194	12,123	11,474
TOTAL EQUITY	112,195	221,116	131,149

See accompanying notes that are an integral part of these condensed consolidated financial statements.

FRONTLINE LTD.
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. GENERAL

Frontline Ltd. (the "Company" or "Frontline") is a Bermuda based shipping company engaged primarily in the ownership and operation of oil tankers. The Company's ordinary shares are listed on the New York Stock Exchange, the Oslo Stock Exchange and the London Stock Exchange.

2. ACCOUNTING POLICIES

Basis of accounting
The condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. The condensed consolidated financial statements do not include all of the disclosures required in the annual consolidated financial statements, and should be read in conjunction with the Company's annual financial statements as at December 31, 2012.

Significant accounting policies
The accounting policies adopted in the preparation of the condensed consolidated financial statements are consistent with those followed in the preparation of the Company's annual consolidated financial statements for the year ended December 31, 2012.

3. FAIR VALUE OF FINANCIAL INSTRUMENTS

Marketable securities of $1.4 million at March 31, 2013 (December 31, 2012: $1.2 million) are measured at fair value on a recurring basis. The fair value of marketable securities is based on the quoted market prices. This fair value falls within the "Level 1" category of ASC 820-10 being "measurements using quoted prices in active markets for identical assets or liabilities".

4. DEBT

In January 2013, the Company sold $6.8 million of the Company's Windsor Petroleum Transport Corporation 7.84% Term Notes (the "Term Notes"), with maturity in January 2021, for proceeds of $4.5 million. The discount on issuance of $2.3 million is recorded as a reduction of debt and is being amortized over the period of the term notes.

The conversion price of the Company's convertible bonds at March 31, 2013 and December 31, 2012 was $36.5567.

5. RELATED PARTY TRANSACTIONS

The Company's most significant related party transactions are with Ship Finance International Limited ("Ship Finance"), a company under the significant influence of our principal shareholder, as the Company leases the majority of its vessels from Ship Finance and pays Ship Finance contingent rental expense and profit share based on the earnings of these vessels.

Amounts earned from other related parties comprise office rental income, technical and commercial management fees, newbuilding supervision fees, freights, corporate and administrative services income and interest income. Amounts paid to related parties comprise primarily rental for office space and guarantee fees.

In January 2013, the Company paid $6.0 million for 1,143,000 shares in a private placement by Frontline 2012 of 59 million new ordinary shares at a subscription price of $5.25 per share. Following the private placement, the Company's ownership in Frontline 2012 was reduced from 7.9% to 6.3%. The Company recognized a gain on the dilution of its ownership of $5.2 million in the first quarter of 2013 in "share of income (losses) from associated companies".

6. COMMITMENTS AND CONTINGENCIES

As of March 31, 2013, the Company was committed to make newbuilding installments of $87.9 million with expected payment of $50.2 million in 2013 and $37.7 million in 2014.

7. SUBSEQUENT EVENTS

At a special general meeting of shareholders held on May 8, 2013 our shareholders approved a decrease in the par value of our ordinary shares from $2.50 to $1.00 per share effective May 14, 2013.

In April 2013, the Company sold $1.7 million of the Company's Term Notes for proceeds of $1.0 million.

In May 2013, the Company sold $8.5 million of the Company's Term Notes for proceeds of $5.2 million.