VMWARE, INC.
Form 10-Q
December 11, 2017
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
(Mark One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended November 3, 2017
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	94-3292913
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer 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 þ 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 þ No o

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

Large accelerated filer	þ	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o
Emerging growth company	o		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. 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 þ

As of December 1, 2017, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 403,138,064, of which 103,138,064 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 (LOSS)
(amounts in millions, except per share amounts, and shares in thousands)
(unaudited)

	Three Months Ended		Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017
Revenue:					
License	$785	$ 691	$2,127	$ 1,907	$ 125
Services	1,191	1,087	3,485	3,153	371
Total revenue	1,976	1,778	5,612	5,060	496
Operating expenses[(1)]:					
Cost of license revenue	38	40	116	121	13
Cost of services revenue	240	226	721	658	80
Research and development	449	389	1,298	1,109	150
Sales and marketing	607	564	1,862	1,708	231
General and administrative	175	178	486	516	63
Realignment and loss on disposition	2	—	88	52	—
Operating income (loss)	465	381	1,041	896	(41)
Investment income	33	21	82	56	8
Interest expense	(28)	(7)	(41)	(20)	(2)
Other income (expense), net	(2)	(8)	51	(8)	1
Income (loss) before income tax	468	387	1,133	924	(34)
Income tax provision (benefit)	25	68	124	179	(26)
Net income (loss)	$443	$ 319	$1,009	$ 745	$ (8)
Net income (loss) per weighted-average share, basic for Classes A and B	$1.09	$ 0.76	$2.47	$ 1.76	$ (0.02)
Net income (loss) per weighted-average share, diluted for Classes A and B	$1.07	$ 0.75	$2.44	$ 1.75	$ (0.02)
Weighted-average shares, basic for Classes A and B	406,733	421,704	407,856	423,341	408,625
Weighted-average shares, diluted for Classes A and B	413,013	425,008	413,957	425,851	408,625

(1) Includes stock-based compensation as follows:

Cost of license revenue	$—	$ —	$1	$ 2	$ —
Cost of services revenue	13	13	38	38	5
Research and development	96	80	266	224	31
Sales and marketing	52	51	150	146	19
General and administrative	21	26	58	62	7

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 (LOSS)
(in millions)
(unaudited)

	Three Months Ended		Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017
Net income (loss)	$443	$ 319	$1,009	$ 745	$ (8)
Other comprehensive income (loss):					
Changes in market value of available-for-sale securities:					
Unrealized gains (losses), net of tax provision (benefit) of ($3), ($2), $5, $12 and $1	(6)	(4)	9	19	2
Reclassification of losses realized during the period, net of tax benefit of $—, $—, $2, $3 and $—	—	—	3	4	—
Net change in market value of available-for-sale securities	(6)	(4)	12	23	2
Changes in market value of effective foreign currency forward contracts:					
Unrealized gains (losses), net of tax provision of $— for all periods	(1)	—	3	—	3
Reclassification of (gains) losses realized during the period, net of tax benefit of $3, $—, $—, $— and $—	(1)	—	(2)	1	—
Net change in market value of effective foreign currency forward contracts	(2)	—	1	1	3
Total other comprehensive income (loss)	(8)	(4)	13	24	5
Total comprehensive income (loss), net of taxes	$435	$ 315	$1,022	$ 769	$ (3)

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)

	November 3, 2017	December 31, 2016	Transition Period February 3, 2017
ASSETS			
Current assets:			
Cash and cash equivalents	$ 6,012	$ 2,790	$ 3,220
Short-term investments	5,600	5,195	5,173
Accounts receivable, net of allowance for doubtful accounts of $2, $2 and $2	900	1,856	1,192
Due from related parties, net	254	132	93
Other current assets	160	362	173
Total current assets	12,926	10,335	9,851
Property and equipment, net	1,031	1,049	1,042
Other assets	282	248	249
Deferred tax assets	641	462	716
Intangible assets, net	443	517	507
Goodwill	4,271	4,032	4,032
Total assets	$ 19,594	$ 16,643	$ 16,397
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	$ 99	$ 125	$ 53
Accrued expenses and other	926	898	887
Unearned revenue	3,500	3,531	3,349
Total current liabilities	4,525	4,554	4,289
Notes payable to Dell	270	1,500	1,500
Long-term debt	3,962	—	—
Unearned revenue	2,147	2,093	1,991
Other liabilities	416	399	401
Total liabilities	11,320	8,546	8,181
Contingencies (refer to Note J)			
Stockholders' equity:			
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 103,819, 108,351 and 110,060 shares	1	1	1
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3	3
Additional paid-in capital	879	1,721	1,843
Accumulated other comprehensive income (loss)	9	(9)	(4)
Retained earnings	7,382	6,381	6,373
Total stockholders' equity	8,274	8,097	8,216
Total liabilities and stockholders' equity	$ 19,594	$ 16,643	$ 16,397

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)

	Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	February 3, 2017
Operating activities:			
Net income (loss)	$1,009	$ 745	$ (8)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	246	261	29
Stock-based compensation	513	472	62
Excess tax benefits from stock-based compensation	—	(7)	(5)
Deferred income taxes, net	100	(24)	(254)
Amortization of debt discount and debt issuance costs	1	—	—
Loss on disposition	80	—	—
Gain on disposition of strategic investments	(38)	(1)	—
Impairment of strategic investments	5	12	—
Gain on extinguishment of debt	(6)	—	—
(Gain) loss on Dell stock purchase	2	—	(1)
Loss on disposal of assets	1	12	—
Other	2	(1)	—
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable	293	513	664
Other assets	(27)	(22)	190
Due to/from related parties, net	(162)	55	39
Accounts payable	39	(26)	(68)
Accrued expenses and other liabilities	27	(64)	(41)
Income taxes payable	(63)	(26)	38
Unearned revenue	342	18	(284)
Net cash provided by operating activities	2,364	1,917	361
Investing activities:			
Additions to property and equipment	(164)	(109)	(18)
Purchases of available-for-sale securities	(3,339)	(3,337)	(38)
Sales of available-for-sale securities	1,745	1,769	43
Maturities of available-for-sale securities	1,207	1,015	20
Proceeds from disposition of assets	—	3	—
Purchases of strategic investments	(33)	(33)	—
Proceeds from sales of strategic investments	6	1	—
Business combinations, net of cash acquired	(236)	(59)	—
Net cash paid on disposition of a business	(47)	—	—
Increase in restricted cash	—	(2)	—
Net cash provided by (used in) investing activities	(861)	(752)	7
Financing activities:			
Proceeds from issuance of common stock	104	106	61

Net proceeds from issuance of long-term debt	3,961	—	—
Repayment of notes payable to Dell	(1,225)	—	—
Payment to acquire non-controlling interests	—	(4)	—
Repurchase of common stock	(1,280)	(1,016)	—
Excess tax benefits from stock-based compensation	—	7	5
Shares repurchased for tax withholdings on vesting of restricted stock	(271)	(97)	(4)
Net cash provided by (used in) financing activities	1,289	(1,004)	62
Net increase in cash and cash equivalents	2,792	161	430
Cash and cash equivalents at beginning of the period	3,220	2,493	2,790
Cash and cash equivalents at end of the period	$6,012	$ 2,654	$ 3,220
Supplemental disclosures of cash flow information:			
Cash paid for interest	$19	$ 21	$ —
Cash paid for taxes, net	87	212	3
Non-cash items:			
Changes in capital additions, accrued but not paid	$19	$ (15)	$ (6)

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 and business mobility solutions that enable businesses to transform the way they build, deliver and consume information technology 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.

Change in Fiscal Year End

Effective January 1, 2017, VMware’s fiscal year changed from a fiscal year ending on December 31 of each calendar year to a fiscal year consisting of a 52- or 53-week period ending on the Friday nearest to January 31 of each year. The period that began on January 1, 2017 and ended on February 3, 2017 is reflected as a transition period (the “Transition Period”). VMware’s first full fiscal year 2018 under the revised fiscal calendar is a 52-week year that began on February 4, 2017 and will end on February 2, 2018.

The Company has included its unaudited condensed consolidated financial statements for the Transition Period in this report on Form 10-Q. As permitted under SEC rules, prior-period financial statements have not been recast, as management believes (i) the three and nine months ended September 30, 2016 are comparable to the three and nine months ended November 3, 2017 and (ii) recasting prior-period results was not practicable or cost justified.

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 fiscal year 2018. 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 Form 10-K filed on February 24, 2017.

Effective September 7, 2016, Dell Technologies Inc. (“Dell”) (formerly Denali Holding Inc.) acquired EMC Corporation (“EMC”), including EMC’s majority control of VMware (the “Dell Acquisition”). As a result of the Dell Acquisition, EMC became a wholly-owned subsidiary of Dell and VMware became an indirectly held, majority-owned subsidiary of Dell. As of November 3, 2017, Dell controlled 81.9% of VMware’s outstanding common stock and 97.6% of the combined voting power of VMware’s outstanding common stock, including 31 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock.

As VMware is a majority-owned and controlled subsidiary of Dell, its results of operations and financial position are consolidated with Dell’s financial statements. Transactions prior to the effective date of the Dell Acquisition represent transactions only with EMC and its consolidated subsidiaries.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with Dell and its consolidated subsidiaries 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 products and services the Company receives from and provides to Dell.

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

Principles of Consolidation
The unaudited condensed consolidated financial statements include the accounts of VMware and its subsidiaries. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with Dell and its consolidated 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 revenue 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
Topic 606, Revenue from Contracts with Customers
During May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606). In 2016, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12, which provide interpretive clarifications on the guidance in Topic 606 (collectively, “Topic 606”). The updated revenue standard replaces all existing revenue recognition guidance under GAAP and establishes common principles for recognizing revenue for all industries. It also provides guidance on the accounting for costs to fulfill or obtain a customer contract. The core principle underlying the updated standard is the recognition of revenue based on consideration expected to be entitled from the transfer of goods or services to a customer. The updated standard is effective for interim and annual periods beginning after December 15, 2017 and permits the use of either the full retrospective or cumulative effect transition method.
VMware plans to adopt Topic 606 using the full retrospective transition method when it becomes effective for the Company in the first quarter of fiscal 2019. Currently, VMware defers all license revenue related to the sale of its perpetual licenses in the event certain revenue recognition criteria are not met. This would include transactions that offer undelivered future products including emerging products that are offered as part of product promotions where vendor-specific objective evidence (“VSOE”) of fair value has not been established. However, under Topic 606, the Company would generally expect that substantially all license revenue related to the sale of its perpetual licenses will be recognized upon delivery, including arrangements that also include offers of future products, such as emerging products that are offered as part of product promotions. Topic 606 is also expected to impact the timing and recognition of costs to obtain contracts with customers, such as commissions. Under the updated standard, incremental costs to obtain contracts with customers are deferred and recognized over the expected period of benefit. As a result, VMware expects deferred commission costs recognized on the consolidated balance sheets to be material upon adoption. The Company is continuing to evaluate the effects that Topic 606 will have on its consolidated financial statements and related disclosures, and its preliminary assessments are subject to change.
ASU No. 2016-02, Leases
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-of-use asset for the right to use the underlying asset for the lease term. The updated standard also requires additional disclosure regarding leasing arrangements. It 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 the updated standard 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.
ASU No. 2016-16, Income Taxes

During October 2016, the FASB issued ASU No. 2016-16, Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory (Topic 740), which requires entities to recognize at the transaction date the income tax consequences of intra-entity asset transfers. Previous guidance required the tax effects from intra-entity asset transfers to be deferred until that asset is sold to a third party or recovered through use. The updated standard is effective for annual and interim periods beginning after December 15, 2017 and requires a modified retrospective transition method. While the Company is continuing to assess the potential effects, the updated standard could have a material impact on the Company’s consolidated financial statements due to the changed treatment of the income tax consequences of business combinations and asset transfers with the Company’s international entities.

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

ASU No. 2016-09, Compensation

VMware adopted ASU No. 2016-09, Compensation–Stock Compensation (Topic 718), on a prospective basis, effective February 4, 2017. Prior periods have not been reclassified to conform to the fiscal 2018 presentation. Net excess tax benefits recognized in connection with stock-based awards are now included in the income tax provision on the condensed consolidated statements of income (loss). Net excess tax benefits recognized during the three and nine months ended November 3, 2017 were $32 million and $76 million, respectively. Prior to adopting the updated standard, such amounts were recognized in additional paid-in capital on the Company's consolidated balance sheets. Additionally, all tax-related cash flows resulting from stock-based awards are reported as operating activities in the statements of cash flows. Prior to adopting the updated standard, excess tax benefits were reported as a cash inflow from financing activities in the statements of cash flows.

B. Related Parties

The information provided below includes a summary of the transactions entered into with Dell and Dell's consolidated subsidiaries, including EMC. Transactions prior to September 7, 2016 reflect transactions only with EMC and its consolidated subsidiaries.

Transactions with Dell

VMware and Dell engaged in the following ongoing intercompany transactions, which resulted in revenue and receipts and unearned revenue for VMware:

- Pursuant to reseller arrangements with Dell, Dell bundles VMware's products and services with Dell's products and sells them to end users. Dell also resells VMware's standalone products and services to end users and other VMware-authorized resellers. Reseller revenue is presented net of related marketing development funds and rebates paid to Dell.
- Dell purchases products and services from VMware for its internal use.
- VMware provides professional services to end users based upon contractual agreements with Dell.
- 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 Dell, 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.

Dell purchases VMware products and services directly from VMware, as well as through VMware's channel partners. Information about VMware's revenue and receipts, and unearned revenue from such arrangements, for the periods presented consisted of the following (table in millions):

	Revenue and Receipts					Unearned Revenue		
	Three Months Ended		Nine Months Ended		Transition Period January 1 to	As of		Transition Period
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017	November 3, 2017	December 31, 2016	February 3, 2017
Reseller revenue	$294	$ 98	$799	$ 261	$ 44	$911	$ 637	$ 616
Internal-use revenue	16	5	25	24	7	19	15	18
Professional services revenue	27	28	82	79	3	—	—	—
Agency fee revenue	—	1	1	3	—	—	—	—
Reimbursement for services to Pivotal	—	—	—	1	—	n/a	n/a	n/a

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

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

- VMware purchases and leases products and purchases services from Dell.
- In certain geographic regions where VMware does not have an established legal entity, VMware contracts with Dell subsidiaries for support services and support from Dell personnel who are managed by VMware. The costs incurred by Dell 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 (loss) and primarily include salaries, benefits, travel and occupancy expenses. Dell also incurs certain administrative costs on VMware's behalf in the United States that are recorded as expenses on VMware's condensed consolidated statements of income (loss).
- From time to time, VMware invoices end users on behalf of Dell for certain services rendered by Dell. Cash related to these services is collected from the end user by VMware and remitted to Dell.

Information about VMware's costs from such arrangements during the periods presented consisted of the following (table in millions):

	Three Months Ended		Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017
Purchases and leases of products and purchases of services	$ 34	$ 24	$ 103	$ 58	$ 14
Dell subsidiary support and administrative costs	30	30	92	74	13

VMware also purchases Dell products through Dell's channel partners. Purchases of Dell products through Dell's channel partners were not significant during the periods presented.

During the second quarter of fiscal 2018, VMware acquired Wavefront, Inc. ("Wavefront"). Upon closing of the acquisition, Dell was paid $20 million in cash for its ownership interest in Wavefront.

Dell Financial Services ("DFS")

DFS provided financing to certain of VMware's end customers based on the customer's discretion. Upon acceptance of the financing arrangement by both VMware's end customer and DFS, amounts classified as trade accounts receivable are reclassified to due from related parties, net on the condensed consolidated balance sheets. Revenue recognized on transactions financed through DFS was recorded net of financing fees, which were $6 million and $15 million during the three and nine months ended November 3, 2017, respectively. Financing fees during the three and nine months ended September 30, 2016 and the Transition Period were not significant.

Tax Sharing Agreement with Dell

VMware has made payments to Dell pursuant to a tax sharing agreement. The following table summarizes the payments made during the periods presented (table in millions):

	Three Months Ended		Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017
Payments from VMware to Dell	$ —	$ 54	$ 12	$ 148	$ —

The timing of the tax payments due to and from related parties is governed by a tax sharing agreement. Payments from VMware to Dell under the tax sharing agreement relate to VMware's portion of federal income taxes on Dell's consolidated tax return as well as state tax payments for combined states. The amounts that VMware pays to Dell for its portion of federal income taxes on Dell’s consolidated tax return differ from the amounts VMware would owe on a separate tax return basis and the difference is presented as a component of stockholders’ equity. The difference between the amount of tax calculated on a separate return basis and the amount of tax calculated pursuant to the tax sharing agreement was estimated at up to $14 million and $16 million during the three and nine months ended November 3, 2017, respectively, subject to final verification, and was

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

$13 million during the nine months ended September 30, 2016. The difference between the amount of tax calculated on a separate return basis and the amount of tax calculated pursuant to the tax sharing agreement was not significant during the three months ended September 30, 2016 and the Transition Period.

Due To/From Related Parties, Net

Amounts due to and from related parties, net as of the periods presented consisted of the following (table in millions):

	November 3, 2017	December 31, 2016	Transition Period February 3, 2017
Due (to) related parties	$ (84)	$ (71)	$ (85)
Due from related parties	338	203	178
Due from related parties, net	$ 254	$ 132	$ 93
Income tax related asset, net	$ —	$ 181	$ —
Income tax due (to) related parties	(17)	—	(21)

Amounts included in due from related parties, net, which are unrelated to DFS and tax obligations, are generally settled in cash within 60 days of each quarter-end.

Stock Purchase Arrangements with Dell

On March 29, 2017, VMware and Dell entered into a stock purchase agreement (the “2017 Purchase Agreement”) pursuant to which VMware and Dell may commit to purchases by VMware of VMware Class A common stock from Dell.

On August 23, 2017, VMware entered into a stock purchase commitment pursuant to the 2017 Purchase Agreement to purchase $300 million of VMware Class A common stock from Dell. During the third quarter of fiscal 2018, VMware paid Dell $300 million in exchange for 2.7 million shares. The aggregate number of shares purchased was determined based upon a volume-weighted average price during a defined period, less an agreed upon discount. On November 3, 2017, the stock purchase with Dell was completed.

On March 29, 2017, VMware entered into a stock purchase commitment pursuant to the 2017 Purchase Agreement to purchase $300 million of VMware Class A common stock from Dell. During the first quarter of fiscal 2018, VMware paid Dell $300 million in exchange for an initial delivery of 2.7 million shares, or approximately 80% of the expected total shares to be received and retired under the arrangement. On May 10, 2017, the stock purchase with Dell was completed and VMware received an additional 0.7 million shares. The aggregate number of 3.4 million shares purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

On December 15, 2016, VMware entered into a stock purchase agreement to purchase $500 million of VMware Class A common stock from Dell. VMware purchased 4.8 million shares for $375 million through December 31, 2016. On February 15, 2017, the stock purchase agreement with Dell was completed. A total of $500 million was paid in exchange for 6.2 million shares. The aggregate number of shares purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

Notes Payable to Dell

On January 21, 2014, VMware entered into a note exchange agreement with Dell providing for the issuance of three promissory notes in the aggregate principal amount of $1,500 million, which consisted of outstanding principal due on the following dates: $680 million due May 1, 2018, $550 million due May 1, 2020 and $270 million due December 1, 2022.

On August 21, 2017, VMware repaid two of the notes payable to Dell in the aggregate principal amount of $1,230 million, representing repayment of the note due May 1, 2018 at par value and repayment of the note due May 1, 2020 at a discount. During the three and nine months ended November 3, 2017, VMware recognized a gain on extinguishment of debt of $6 million, which was recorded in other income (expense), net on the condensed consolidated statements of income (loss). The remaining note payable of $270 million due December 1, 2022 may be prepaid without penalty or premium.

Interest is payable quarterly in arrears, at the annual rate of 1.75%. During the three and nine months ended November 3, 2017, $2 million and $15 million, respectively, of interest expense was recognized. During the three and nine months ended September 30, 2016 and the Transition Period, $7 million, $20 million and $2 million, respectively, of interest expense was recognized.

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C. Business Combinations, Definite-Lived Intangible Assets, Net and Goodwill
Business Combinations
During the second quarter of fiscal 2018, VMware completed the acquisitions of Wavefront and Apteligent, Inc., which were not material to the condensed consolidated financial statements. These acquisitions are a part of a strategy to accelerate the development of VMware's Cloud services and other technologies. The aggregate purchase price for the two acquisitions was $238 million, net of cash acquired of $35 million. The aggregate purchase price included $36 million of identifiable intangible assets and $238 million of goodwill that is not expected to be deductible for tax purposes. The identifiable intangible assets primarily relate to purchased technology, with estimated useful lives of five years. The fair value of assumed unvested equity attributed to post-combination services was $37 million and will be expensed over the remaining requisite service periods on a straight-line basis. The estimated fair value of the stock options assumed by the Company was determined using the Black-Scholes option pricing model.
Prior to the closing of the acquisition, VMware held an ownership interest in Wavefront. Upon completion of the step acquisition, VMware recognized a gain of $34 million in other income (expense), net for the remeasurement of its ownership interest to fair value, which was $49 million. The gain recognized in the step acquisition is not expected to be taxable and resulted in a discrete tax benefit of $13 million during the second quarter of fiscal 2018. Upon closing of the acquisition, Dell was paid $20 million in cash for its ownership interest in Wavefront.
The pro forma financial information assuming the acquisition had occurred as of the beginning of the fiscal year prior to the fiscal year of acquisition, as well as the revenue and earnings generated during the current fiscal year, were not material for disclosure purposes.
Definite-Lived Intangible Assets, Net
As of the periods presented, definite-lived intangible assets consisted of the following (amounts in tables in millions):

	November 3, 2017			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	$ 663	$ (438)	$ 225
Leasehold interest	34.9	149	(27)	122
Customer relationships and customer lists	8.2	135	(75)	60
Trademarks and tradenames	8.5	63	(29)	34
Other	5.7	5	(3)	2
Total definite-lived intangible assets		$ 1,015	$ (572)	$ 443

	December 31, 2016			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	$ 641	$ (358)	$ 283
Leasehold interest	34.9	149	(24)	125
Customer relationships and customer lists	8.3	132	(62)	70
Trademarks and tradenames	8.7	61	(23)	38
Other	5.7	4	(3)	1
Total definite-lived intangible assets		$ 987	$ (470)	$ 517

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	Transition Period February 3, 2017			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	$ 641	$ (366)	$ 275
Leasehold interest	34.9	149	(24)	125
Customer relationships and customer lists	8.3	132	(64)	68
Trademarks and tradenames	8.7	61	(23)	38
Other	5.7	4	(3)	1
Total definite-lived intangible assets		$ 987	$ (480)	$ 507

Amortization expense on definite-lived intangible assets was $34 million and $100 million during the three and nine months ended November 3, 2017, respectively, and $33 million and $99 million during the three and nine months ended September 30, 2016, respectively. Amortization expense on definite-lived intangible assets was $10 million during the Transition Period.

Based on intangible assets recorded as of November 3, 2017 and assuming no subsequent additions, dispositions or impairment of underlying assets, the remaining estimated annual amortization expense over the next five fiscal years and thereafter is expected to be as follows (table in millions):

Remainder of 2018	$34
2019	124
2020	100
2021	46
2022	31
Thereafter	108
Total	$443

Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the nine months ended November 3, 2017 (table in millions):

Balance, February 3, 2017	$4,032
Increase in goodwill related to business combinations	239
Balance, November 3, 2017	$4,271

VMware previously evaluated goodwill for impairment during the fourth quarter of each year. Effective January 1, 2017, the Company changed its fiscal year end from December 31 of each calendar year to a 52- or 53-week period ending on the Friday nearest to January 31 of each year. During the third quarter of fiscal 2018, VMware changed the date of its annual goodwill impairment test from the fourth quarter to the third quarter. Management believes this voluntary change is preferable as the timing of its annual goodwill impairment test during the third quarter aligns with Dell’s. The goodwill impairment test date change was applied prospectively for the fiscal year beginning February 3, 2017 and had no effect on the Company’s condensed consolidated financial statements as of November 3, 2017 and December 31, 2016.

D. Realignment and Loss on Disposition

Disposition of VMware vCloud Air Business

During the second quarter of fiscal 2018, VMware completed the sale of its VMware vCloud Air business (“vCloud Air”) to OVH US LLC (“OVH”). Losses recognized in connection with this transaction were $2 million and $88 million during the three and nine months ended November 3, 2017, respectively, and were recorded in realignment and loss on disposition on the condensed consolidated statements of income (loss). Losses recognized on the disposition of vCloud Air include the impairment of fixed assets identified as part of the sale, as well as the costs associated with certain transition services, which primarily include employee-related expenses and costs associated with data-center colocation services. Transition services are to be provided over a period of 18 months, starting from the date of the sale. The losses recognized on the disposition of vCloud Air are deductible for tax purposes and resulted in a discrete tax benefit of $12 million during the second quarter of fiscal 2018.

In connection with the disposition of vCloud Air, approximately $35 million of total unearned revenue, which included $18 million of unearned license revenue, was transferred to OVH during the second quarter of fiscal 2018.

Realignment

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 related to growth products. As a result of these actions, approximately 800 positions were eliminated during the nine months ended September 30, 2016. VMware recognized $49 million of severance-related realignment expenses during the nine months ended September 30, 2016 on the condensed consolidated statements of income. Additionally, VMware consolidated certain facilities as part of this plan, which resulted in the recognition of $3 million of related expenses during the nine months ended September 30, 2016. Actions associated with this plan were substantially completed by December 31, 2016.

The following table summarizes the activity for the accrued realignment expenses for the period presented (table in millions):

	Nine Months Ended September 30, 2016			
	Balance as of January 1, 2016	Realignment	Utilization	Balance as of September 30, 2016
Severance-related costs	$3	$ 49	$ (51)	$ 1
Costs to exit facilities	—	3	(1)	2
Total	$3	$ 52	$ (52)	$ 3

E. Net Income (Loss) per Share

Basic net income (loss) per share is computed by dividing net income (loss) 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 computation of diluted net income (loss) per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate net income (loss) 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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The following table sets forth the computations of basic and diluted net income (loss) per share during the periods presented (table in millions, except per share amounts and shares in thousands):

	Three Months Ended		Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017
Net income (loss)	$443	$ 319	$1,009	$ 745	$ (8)
Weighted-average shares, basic for Classes A and B	406,733	421,704	407,856	423,341	408,625
Effect of other dilutive securities	6,280	3,304	6,101	2,510	—
Weighted-average shares, diluted for Classes A and B	413,013	425,008	413,957	425,851	408,625
Net income (loss) per weighted-average share, basic for Classes A and B	$1.09	$ 0.76	$2.47	$ 1.76	$ (0.02)
Net income (loss) per weighted-average share, diluted for Classes A and B [(1)]	$1.07	$ 0.75	$2.44	$ 1.75	$ (0.02)

[(1)] During the Transition Period, VMware incurred a net loss. As a result, all potentially dilutive securities were anti-dilutive and excluded from the computation of diluted net loss per share.

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

	Three Months Ended		Nine Months Ended		Transition Period January 1 to
	November 3, 2017	September 30, 2016	November 3, 2017	September 30, 2016	February 3, 2017
Anti-dilutive securities:					
Employee stock options	—	1,655	585	2,027	2,353
Restricted stock units	—	3,632	109	2,416	3,259
Total	—	5,287	694	4,443	5,612

During the three months ended November 3, 2017, there were no anti-dilutive shares.

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F. Cash, Cash Equivalents and Investments
Cash, cash equivalents and investments as of the periods presented consisted of the following (tables in millions):

	November 3, 2017			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	$415	$ —	$ —	$ 415
Cash equivalents:				
Money-market funds	$5,503	$ —	$ —	$ 5,503
U.S. Government and agency obligations	5	—	—	5
U.S. and foreign corporate debt securities	89	—	—	89
Total cash equivalents	$5,597	$ —	$ —	$ 5,597
Short-term investments:				
U.S. Government and agency obligations	$1,000	$ —	$ (4)	$ 996
U.S. and foreign corporate debt securities	4,347	5	(8)	4,344
Foreign governments and multi-national agency obligations	95	—	—	95
Mortgage-backed securities	134	—	(1)	133
Marketable available-for-sale equity securities	15	17	—	32
Total short-term investments	$5,591	$ 22	$ (13)	$ 5,600

	December 31, 2016			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	$512	$ —	$ —	$ 512
Cash equivalents:				
Money-market funds	$2,235	$ —	$ —	$ 2,235
Time deposits	26	—	—	26
Municipal obligations	17	—	—	17
Total cash equivalents	$2,278	$ —	$ —	$ 2,278
Short-term investments:				
U.S. Government and agency obligations	$734	$ —	$ (3)	$ 731
U.S. and foreign corporate debt securities	3,885	2	(18)	3,869
Foreign governments and multi-national agency obligations	32	—	—	32
Municipal obligations	365	—	—	365
Asset-backed securities	4	—	—	4
Mortgage-backed securities	196	—	(2)	194
Total short-term investments	$5,216	$ 2	$ (23)	$ 5,195
Other assets:				
Marketable available-for-sale equity securities	$15	$ 7	$ —	$ 22

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	Transition Period February 3, 2017			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	$720	$ —	$ —	$ 720
Cash equivalents:				
Money-market funds	$2,471	$ —	$ —	$ 2,471
Time deposits	26	—	—	26
Municipal obligations	3	—	—	3
Total cash equivalents	$2,500	$ —	$ —	$ 2,500
Short-term investments:				
U.S. Government and agency obligations	$733	$ —	$ (3)	$ 730
U.S. and foreign corporate debt securities	3,884	3	(16)	3,871
Foreign governments and multi-national agency obligations	32	—	—	32
Municipal obligations	350	—	—	350
Asset-backed securities	4	—	—	4
Mortgage-backed securities	188	—	(2)	186
Total short-term investments	$5,191	$ 3	$ (21)	$ 5,173
Other assets:				
Marketable available-for-sale equity securities	$15	$ 7	$ —	$ 22

VMware evaluated its available-for-sale investments as of November 3, 2017, December 31, 2016 and February 3, 2017 for other-than-temporary declines in fair value and did not consider any to be other-than-temporarily impaired. The realized gains and losses on investments during the three and nine months ended November 3, 2017 and September 30, 2016 and the Transition Period were not significant.

Unrealized losses on cash equivalents and available-for-sale investments, which have been in a net loss position for less than twelve months as of the periods presented, were classified by sector as follows (table in millions):

	November 3, 2017		December 31, 2016		Transition Period February 3, 2017	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and foreign corporate debt securities	$ 2,236	$ (5)	$ 2,595	$ (18)	$ 2,287	$ (16)

As of the periods presented, 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 significant. 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 significant for the periods presented.

Contractual Maturities

The contractual maturities of fixed income securities included in short-term investments on the condensed consolidated balance sheets and held as of November 3, 2017, consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	$ 1,978	$ 1,976
Due after 1 year through 5 years	3,406	3,400
Due after 5 years through 10 years	98	98
Due after 10 years	94	94
Total fixed income securities	$ 5,576	$ 5,568

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G. Debt

Long-term Debt

On August 21, 2017, VMware issued three unsecured senior notes (“Senior Notes”) pursuant to a public debt offering. The proceeds from the issuance were $3,961 million, net of debt discount of $9 million and debt issuance costs of $30 million.

The carrying value of the Senior Notes as of November 3, 2017 was as follows (amounts in millions):

	November 3, 2017	Effective Interest Rate
Long-term debt:		
2.30% Senior Note Due August 21, 2020	$ 1,250	2.56%
2.95% Senior Note Due August 21, 2022	1,500	3.17%
3.90% Senior Note Due August 21, 2027	1,250	4.05%
Total principal amount	4,000	
Less: unamortized discount	(9)	
Less: unamortized debt issuance costs	(29)	
Net carrying amount	$ 3,962	

Interest is payable semiannually in arrears, on February 21 and August 21 of each year. During the three and nine months ended November 3, 2017, $26 million of interest expense, which included amortization of discount and issuance costs, was recognized on the condensed consolidated statements of income (loss). The discount and issuance costs are amortized over the term of the Senior Notes.

The Senior Notes are redeemable in whole at any time or in part from time to time at VMware’s option, subject to a make-whole premium. In addition, upon the occurrence of certain change-of-control triggering events and certain downgrades of the ratings on the Senior Notes, VMware may be required to repurchase the notes at a repurchase price equal to 101% of the aggregate principal plus any accrued and unpaid interest on the date of purchase. The Senior Notes rank equally in right of payment with VMware’s other unsecured and unsubordinated indebtedness. The Senior Notes also include restrictive covenants that, in certain circumstances, limit VMware’s ability to create certain liens, to enter into certain sale and leaseback transactions and to consolidate, merge, sell or otherwise dispose of all or substantially all of VMware’s assets.

Refer to Note B for information regarding the notes payable to Dell.

Revolving Credit Facility

On September 12, 2017, VMware entered into an unsecured credit agreement establishing a revolving credit facility (“Credit Facility”) with a syndicate of lenders that provides the company with a borrowing capacity of up to $1,000 million, which may be used for general corporate purposes. Commitments under the Credit Facility are available for a period of five years, which may be extended, subject to the satisfaction of certain conditions, by up to two one-year periods. As of November 3, 2017, there were no outstanding borrowings under the Credit Facility. The credit agreement contains certain representations, warranties and covenants. Commitment fees, interest rates and other terms of borrowing under the Credit Facility may vary based on VMware’s external credit ratings. The amount paid in connection with the ongoing commitment fee, which is payable quarterly in arrears, was not significant during the three and nine months ended November 3, 2017.

H. 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 as being 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; and

- 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 were primarily classified as Level 2, with the exception of some of the U.S. Government and agency obligations that were classified as Level 1. Additionally, VMware's Level 2 classification included forward contracts, notes payable to Dell and the Senior Notes.

As of November 3, 2017, December 31, 2016 and February 3, 2017, VMware's Level 2 investment securities were generally priced using non-binding market consensus prices that were 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 significant assets or liabilities that were classified as Level 3 of the fair value hierarchy for the periods presented, and there have been no transfers between fair value measurement levels during the periods presented.

The following tables set forth the fair value hierarchy of VMware's cash equivalents, short-term investments and derivatives that were required to be measured at fair value as of the periods presented (tables in millions):

	November 3, 2017		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	$5,503	$—	$5,503
U.S. Government and agency obligations	5	—	5
U.S. and foreign corporate debt securities	—	89	89
Total cash equivalents	$5,508	$89	$5,597
Short-term investments:			
U.S. Government and agency obligations	$728	$268	$996
U.S. and foreign corporate debt securities	—	4,344	4,344
Foreign governments and multi-national agency obligations	—	95	95
Mortgage-backed securities	—	133	133
Marketable available-for-sale equity securities	32	—	32
Total short-term investments	$760	$4,840	$5,600
Other current assets:			
Forward contracts	$—	$5	$5

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	December 31, 2016		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	$2,235	$—	$2,235
Time deposits	—	26	26
Municipal obligations	—	17	17
Total cash equivalents	$2,235	$43	$2,278
Short-term investments:			
U.S. Government and agency obligations	$441	$290	$731
U.S. and foreign corporate debt securities	—	3,869	3,869
Foreign governments and multi-national agency obligations	—	32	32
Municipal obligations	—	365	365
Asset-backed securities	—	4	4
Mortgage-backed securities	—	194	194
Total short-term investments	$441	$4,754	$5,195
Other current assets:			
Derivative due to stock purchase with Dell	$—	$8	$8
Other assets:			
Marketable available-for-sale equity securities	$22	$—	$22

	Transition Period February 3, 2017		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	$2,471	$—	$2,471
Time deposits	—	26	26
Municipal obligations	—	3	3
Total cash equivalents	$2,471	$29	$2,500
Short-term investments:			
U.S. Government and agency obligations	$445	$285	$730
U.S. and foreign corporate debt securities	—	3,871	3,871
Foreign governments and multi-national agency obligations	—	32	32
Municipal obligations	—	350	350
Asset-backed securities	—	4	4
Mortgage-backed securities	—	186	186
Total short-term investments	$445	$4,728	$5,173
Other current assets:			
Derivative due to stock purchase with Dell	$—	$9	$9
Other assets:			
Marketable available-for-sale equity securities	$22	$—	$22

During the first quarter of fiscal 2018, marketable available-for-sale equity securities were reclassified to short-term investments on the condensed consolidated balance sheets, as restrictions on the Company's ability to sell the common stock lapse within twelve months of the balance sheet date. As of December 31, 2016 and February 3, 2017, these securities were classified as other assets on the condensed consolidated balance sheets.

The notes payable to Dell and the Senior Notes were not adjusted to fair value. The fair value of the notes payable to Dell was approximately $255 million, $1,489 million and $1,492 million as of November 3, 2017, December 31, 2016 and February 3, 2017, respectively. The fair value of the Senior Notes was approximately $4,008 million as of November 3, 2017.

Fair value for both the notes payable to Dell and the Senior Notes was estimated primarily based on observable market interest rates (Level 2 inputs).

VMware offers a deferred compensation plan for eligible employees, which allows participants to defer payment for part or all of their compensation. The net impact to the condensed consolidated statements of income (loss) is not significant 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 associated with this plan were the same as the liabilities at approximately $57 million, $35 million and $36 million as of November 3, 2017, December 31, 2016 and February 3, 2017, 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 holds strategic investments in its portfolio accounted for using the cost method. These strategic investments are periodically assessed for other-than-temporary impairment. VMware uses Level 3 inputs as part of its impairment analysis, including pre- and post-money valuations of recent financing events, the impact of financing events on its ownership percentages, and other available information relevant to 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 investment to its fair value.

During the three and nine months ended September 30, 2016, VMware determined that certain strategic investments were considered to be other-than-temporarily impaired and accordingly, approximately $7 million and $12 million, respectively, was recognized as an impairment charge. Impairment charges recognized during the three and nine months ended November 3, 2017 and the Transition Period were not significant. Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware's strategic investments was $148 million, $139 million and $139 million as of November 3, 2017, December 31, 2016 and February 3, 2017, respectively.

I. Derivatives and Hedging Activities

VMware conducts business on a global basis in multiple foreign currencies, subjecting the Company to foreign currency risk. To mitigate a portion of 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 agreements. 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 certain operating expenses denominated in certain foreign currencies, VMware enters into forward contracts that are designated as cash flow hedging instruments as the accounting criteria for such designation are met. Therefore, the effective portion of gains or losses resulting from changes in the fair value of these instruments 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 (loss) in the same period that the underlying expenses are incurred. During the three and nine months ended November 3, 2017 and September 30, 2016 and the Transition Period, the effective portion of gains or losses reclassified to the condensed consolidated statements of income (loss) was not significant. 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 (loss) as incurred.

These forward contracts have contractual maturities of twelve months or less, and as of November 3, 2017, December 31, 2016 and February 3, 2017, outstanding forward contracts had a total notional value of $67 million, $22 million and $250 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 nine months ended November 3, 2017 and September 30, 2016 and the Transition Period, 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

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 (loss).

These forward contracts have a contractual maturity of one month, and as of November 3, 2017, December 31, 2016 and February 3, 2017, outstanding forward contracts had a total notional value of $722 million, $875 million and $834 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 nine months ended November 3, 2017 and September 30, 2016 and the Transition Period, VMware recognized losses of $33 million, $12 million and $18 million, respectively, relating to the settlement of forward contracts. Losses recognized during the three months ended November 3, 2017 and September 30, 2016 were not significant. Gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income (loss).

The combined gains and losses related to forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of $6 million and a net gain of $8 million during the three and nine months ended November 3, 2017, respectively. Net losses during the three and nine months ended September 30, 2016 and the Transition Period were not significant. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income (loss).

J. 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. Following trial, the jury issued its verdict on June 12, 2017, finding that VMware did not infringe on any of the four bases asserted by Phoenix. The Court entered judgment in VMware's favor, and the parties have filed post-trial motions. The Company intends to continue vigorously defending itself against this lawsuit.

On March 4, 2015, Christoph Hellwig, a software developer who alleged 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 alleging copyright infringement for failing to comply with the terms of the open source General Public License v.2 ("GPL v.2"). On July 8, 2016, the German court issued a written decision dismissing Mr. Hellwig's lawsuit. Mr. Hellwig has appealed the Regional Court's decision. No hearing schedule has yet been set by the appellate court.

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.

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 November 3, 2017, amounts accrued relating to these other matters arising as part of the ordinary course of business were considered immaterial. 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.

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

K. Unearned Revenue
Unearned revenue as of the periods presented consisted of the following (table in millions):

	November 3, 2017	December 31, 2016	Transition Period February 3, 2017
Unearned license revenue	$ 503	$ 503	$ 484
Unearned software maintenance revenue	4,623	4,628	4,405
Unearned professional services revenue	521	493	451
Total unearned revenue	$ 5,647	$ 5,624	$ 5,340

Unearned license revenue is generally recognized upon delivery of existing or future products or services, or is 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 VSOE of fair value cannot be established, revenue for the entire order is deferred until all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services and if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance elemen