

RICHARDSON ELECTRONICS LTD/DE
Form 10-Q
October 06, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 27, 2016

OR

**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: 0-12906

RICHARDSON ELECTRONICS, LTD.

(Exact name of registrant as specified in its charter)

**Delaware 36-2096643
(State or other jurisdiction of (I.R.S. Employer**

incorporation or organization) Identification No.)

40W267 Keslinger Road, P.O. Box 393

LaFox, Illinois 60147-0393

(Address of principal executive offices)

Registrant's telephone number, including area code: (630) 208-2200

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 No

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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 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. (Check one):

Large Accelerated Filer

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

As of October 3, 2016, there were outstanding 10,702,932 shares of Common Stock, \$0.05 par value and 2,140,631 shares of Class B Common Stock, \$0.05 par value, which are convertible into Common Stock of the registrant on a share for share basis.

TABLE OF CONTENTS

	Page
Part I. Financial Information	
Item 1. <u>Financial Statements</u>	2
<u>Consolidated Balance Sheets</u>	2
<u>Unaudited Consolidated Statements of Comprehensive Loss</u>	3
<u>Unaudited Consolidated Statements of Cash Flows</u>	4
<u>Unaudited Consolidated Statement of Stockholders' Equity</u>	5
<u>Notes to Unaudited Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	21
Item 4. <u>Controls and Procedures</u>	21
Part II. Other Information	
Item 1. <u>Legal Proceedings</u>	22
Item 1A. <u>Risk Factors</u>	22
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	22
Item 5. <u>Other Information</u>	22
Item 6. <u>Exhibits</u>	22
<u>Signatures</u>	23
<u>Exhibit Index</u>	24

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
Richardson Electronics, Ltd.

Consolidated Balance Sheets

(in thousands, except per share amounts)

	Unaudited August 27, 2016	Audited May 28, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$57,488	\$60,454
Accounts receivable, less allowance of \$380 and \$364	21,545	24,928
Inventories, net	45,187	45,422
Prepaid expenses and other assets	1,744	1,758
Deferred income taxes	—	1,078
Income tax receivable	30	17
Investments - current	6,392	2,268
Total current assets	132,386	135,925
Non-current assets:		
Property, plant and equipment, net	14,425	12,986
Goodwill	6,332	6,332
Intangible assets, net	3,714	3,818
Non-current deferred income taxes	1,304	1,270
Investments - non-current	2,410	7,799
Total non-current assets	28,185	32,205
Total assets	\$160,571	\$168,130
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	12,581	14,896
Accrued liabilities	8,000	9,135
Total current liabilities	20,581	24,031
Non-current liabilities:		
Non-current deferred income tax liabilities	237	1,457
Other non-current liabilities	1,196	967
Total non-current liabilities	1,433	2,424
Total liabilities	22,014	26,455
Stockholders' equity		
Common stock, \$0.05 par value; issued and outstanding 10,703 shares at August 27, 2016, and at May 28, 2016	535	535
Class B common stock, convertible, \$0.05 par value; issued and outstanding 2,141 shares at August 27, 2016, and at May 28, 2016	107	107
Preferred stock, \$1.00 par value, no shares issued	—	—
Additional paid-in-capital	59,072	58,969
Common stock in treasury, at cost, no shares at August 27, 2016, and at May 28, 2016	—	—

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Retained earnings	75,685	79,292
Accumulated other comprehensive income	3,158	2,772
Total stockholders' equity	138,557	141,675
Total liabilities and stockholders' equity	\$160,571	\$168,130

Richardson Electronics, Ltd.**Unaudited Consolidated Statements of Comprehensive Loss***(in thousands, except per share amounts)*

	Three Months Ended	
	August 27, 2016	August 29, 2015
Statements of Comprehensive Loss		
Net sales	\$33,373	\$37,071
Cost of sales	23,133	25,809
Gross profit	10,240	11,262
Selling, general, and administrative expenses	12,327	12,267
Gain on disposal of assets	—	(1)
Operating loss	(2,087)	(1,004)
Other (income) expense:		
Investment/interest income	(11)	(191)
Foreign exchange loss	278	182
Other, net	(1)	36
Total other expense	266	27
Loss before income taxes	(2,353)	(1,031)
Income tax provision	497	368
Net loss	(2,850)	(1,399)
Foreign currency translation gain (loss), net of tax	379	(503)
Fair value adjustments on investments gain (loss)	7	(60)
Comprehensive loss	\$(2,464)	\$(1,962)
Loss per share:		
Common shares - Basic	\$(0.23)	\$(0.10)
Class B common shares - Basic	\$(0.20)	\$(0.10)
Common shares - Diluted	\$(0.23)	\$(0.10)
Class B common shares - Diluted	\$(0.20)	\$(0.10)
Weighted average number of shares:		
Common shares - Basic	10,703	11,486
Class B common shares - Basic	2,141	2,141
Common shares - Diluted	10,703	11,486
Class B common shares - Diluted	2,141	2,141
Dividends per common share	\$0.060	\$0.060
Dividends per Class B common share	\$0.054	\$0.054

Richardson Electronics, Ltd.**Unaudited Consolidated Statements of Cash Flows***(in thousands)*

	Three Months Ended	
	August 27, 2016	August 29, 2015
Operating activities:		
Net loss	\$(2,850)	\$(1,399)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	715	485
Gain on sale of investments	(2)	(11)
Gain on disposal of assets	—	(1)
Share-based compensation expense	103	90
Deferred income taxes	(158)	1
Change in assets and liabilities, net of effect of acquired business:		
Accounts receivable	3,555	(2,525)
Income tax receivable	(13)	548
Inventories	411	(593)
Prepaid expenses and other assets	41	(581)
Accounts payable	(2,338)	(1,521)
Accrued liabilities	(1,144)	(804)
Non-current deferred income tax liabilities	—	228
Long-term liabilities-accrued pension	—	(465)
Other	5	35
Net cash used in operating activities	(1,675)	(6,513)
Investing activities:		
Cash consideration paid for acquired business	—	(12,209)
Capital expenditures	(2,064)	(984)
Proceeds from maturity of investments	1,465	18,350
Proceeds from sales of available-for-sale securities	88	100
Purchases of available-for-sale securities	(88)	(100)
Other	(3)	60
Net cash (used in) provided by investing activities	(602)	5,217
Financing activities:		
Repurchase of common stock	—	(3,308)
Cash dividends paid	(758)	(806)
Other	—	(4)
Net cash used in financing activities	(758)	(4,118)
Effect of exchange rate changes on cash and cash equivalents	69	(695)
Decrease in cash and cash equivalents	(2,966)	(6,109)
Cash and cash equivalents at beginning of period	60,454	74,535
Cash and cash equivalents at end of period	\$57,488	\$68,426

Richardson Electronics, Ltd.**Unaudited Consolidated Statement of Stockholders' Equity***(in thousands)*

	Common	Class B Common	Par Value	Additional Paid In Capital	Common Stock in Treasury	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance May 28, 2016:	10,703	2,141	\$642	\$58,969	\$ —	\$79,292	\$ 2,772	\$141,675
Comprehensive loss								
Net loss	—	—	—	—	—	(2,850)	—	(2,850)
Foreign currency translation	—	—	—	—	—	—	379	379
Fair value adjustments on investments	—	—	—	—	—	—	7	7
Share-based compensation:								
Stock options	—	—	—	103	—	—	—	103
Dividends paid to:								
Common (\$0.06 per share)	—	—	—	—	—	(641)	—	(641)
Class B (\$0.054 per share)	—	—	—	—	—	(116)	—	(116)
Balance August 27, 2016:	10,703	2,141	\$642	\$59,072	\$ —	\$75,685	\$ 3,158	\$138,557

RICHARDSON ELECTRONICS, LTD.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. DESCRIPTION OF THE COMPANY

Richardson Electronics, Ltd. is a leading global provider of engineered solutions, power grid and microwave tubes and related consumables; power conversion and RF and microwave components; high value displays, flat panel detector solutions and replacement parts for diagnostic imaging equipment; and customized display solutions. We serve customers in the alternative energy, healthcare, aviation, broadcast, communications, industrial, marine, medical, military, scientific and semiconductor markets. The Company's strategy is to provide specialized technical expertise and "engineered solutions" based on our core engineering and manufacturing capabilities. The Company provides solutions and adds value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair through its global infrastructure.

Our products include electron tubes and related components, microwave generators, subsystems used in semiconductor manufacturing, and visual technology solutions. These products are used to control, switch or amplify electrical power signals, or are used as display devices in a variety of industrial, commercial, medical, and communication applications.

We have three operating and reportable segments, which we define as follows:

Power and Microwave Technologies Group ("PMT") combines our core engineered solutions, power grid and microwave tube business with new RF and power technologies. As a manufacturer and authorized distributor, PMT's strategy is to provide specialized technical expertise and engineered solutions based on our core engineering and manufacturing capabilities. We provide solutions and add value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair—all through our existing global infrastructure. PMT's focus is on products for power, RF and microwave applications for customers in alternative energy, aviation, broadcast, communications, industrial, marine, medical, military, scientific, and semiconductor markets. PMT focuses on various applications including broadcast transmission, CO2 laser cutting, diagnostic imaging, dielectric and induction heating, high energy transfer, high voltage switching, plasma, power conversion, radar, and radiation oncology. PMT also offers its customers technical services for both microwave and industrial equipment.

Canvys provides customized display solutions serving the corporate enterprise, financial, healthcare, industrial, and medical original equipment manufacturers ("OEM") markets.

Healthcare manufactures, distributes and services high value replacement parts for the healthcare market including hospitals, medical centers, independent service organizations, and multi-vendor service providers. Products include power grid tubes, hydrogen thyratrons, klystrons, magnetrons; Image Systems medical displays and workstations for picture archiving and communication systems ("PACS"); visual solutions for operating rooms/surgical environments; digital radiography solutions including replacement flat panel detectors and upgrades; and additional replacement components currently under development for the diagnostic imaging service market. Through a combination of newly developed products and partnerships, service offerings, and training programs, we believe we can help our customers

improve efficiency and deliver better clinical outcomes while lowering the cost of healthcare delivery.

We currently have operations in the following major geographic regions: North America, Asia/Pacific, Europe, and Latin America.

2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States Generally Accepted Accounting Principles (“GAAP”) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and notes required by GAAP for complete financial statements.

Our fiscal quarter ends on the Saturday nearest the end of the quarter-ending month. The first three months of fiscal 2017 and 2016 contained 13 weeks, respectively.

In the opinion of management, all adjustments, which are of a normal and recurring nature, necessary for a fair presentation of the results of interim periods have been made. All inter-company transactions and balances have been eliminated. The unaudited consolidated financial statements presented herein include the accounts of our wholly owned subsidiaries. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The results of our operations for the three months ended August 27, 2016, are not necessarily indicative of the results that may be expected for the fiscal year ending May 27, 2017.

The financial information contained in this report should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended May 28, 2016, that we filed on July 29, 2016.

3. CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Inventories: Our consolidated inventories are stated at the lower of cost or market, generally using a weighted-average cost method. Our inventories include approximately \$39.7 million of finished goods, \$4.4 million of raw materials, and \$1.1 million of work-in-progress as of August 27, 2016, as compared to approximately \$40.0 million of finished goods, \$4.4 million of raw materials, and \$1.0 million of work-in-progress as of May 28, 2016.

At this time, we do not anticipate any material risks or uncertainties related to possible future inventory write-downs. Provisions for obsolete or slow moving inventories are recorded based upon regular analysis of stock rotation privileges, obsolescence, the exiting of certain markets, and assumptions about future demand and market conditions. If future demand, changes in the industry, or market conditions differ from management's estimates, additional provisions may be necessary. Inventory reserves were approximately \$3.4 million as of August 27, 2016, and as of May 28, 2016.

Revenue Recognition: Our product sales are recognized as revenue upon shipment, when title passes to the customer, when delivery has occurred or services have been rendered, and when collectability is reasonably assured. We also record estimated discounts and returns based on our historical experience. Our products are often manufactured to meet the specific design needs of our customers' applications. Our engineers work closely with customers to ensure that our products will meet their needs. Our customers are under no obligation to compensate us for designing the products we sell.

Loss Contingencies: We accrue a liability for loss contingencies when it is probable that a liability has been incurred and the amount can be reasonably estimated. When only a range of possible loss can be established, the most probable amount in the range is accrued. If no amount within this range is a better estimate than any other amount within the range, the minimum amount in the range is accrued. If we determine that there is at least a reasonable possibility that a loss may have been incurred, we will include a disclosure describing the contingency.

Intangible Assets: Intangible assets are initially recorded at their fair market values determined on quoted market prices in active markets, if available, or recognized valuation models. Intangible assets that have finite useful lives are amortized over their useful lives either on a straight-line basis or over their projected future cash flows and are tested for impairment when events or changes in circumstances occur that indicate possible impairment.

Income Taxes: We recognize deferred tax assets and liabilities based on the differences between financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and determine the need for a valuation allowance based on a number of factors, including both positive and negative evidence. These factors include historical taxable income or loss, projected future taxable income or loss, the expected timing of the reversals of existing temporary differences, and the implementation of tax planning strategies. In circumstances where we, or any of our affiliates, have incurred three years of cumulative losses which constitute significant negative evidence, positive evidence of equal or greater significance is needed to overcome the negative evidence before a tax benefit is recognized for deductible temporary differences and loss carryforwards.

In November 2015, the FASB issued ASU 2015-17, "Balance Sheet Classification of Deferred Taxes." ASU 2015-17 eliminates the prior US GAAP guidance in Topic 740, Income Taxes, that required an entity to separate deferred tax liabilities and assets between current and noncurrent amounts in a classified balance sheet. The amendments in ASU 2015-17 require that all deferred tax liabilities and assets of the same tax jurisdiction or a tax filing group, as well as

any related valuation allowance, be offset and presented as a single noncurrent amount in a classified balance sheet. ASU 2015-17 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. In order to simplify presentation of deferred tax balances, the Company adopted this standard prospectively in the quarter ended August 27, 2016. Periods prior to August 27, 2016 were not retrospectively adjusted.

Accrued Liabilities: Accrued liabilities consist of the following (*in thousands*):

	August 27, 2016	May 28, 2016
Compensation and payroll taxes	\$3,510	\$ 4,054
Professional fees	406	775
Deferred revenue	1,831	1,879
Other accrued expenses	2,253	2,427
Accrued Liabilities	\$8,000	\$ 9,135

4. ACQUISITION

On June 15, 2015, Richardson Electronics, Ltd (“the Company”), acquired certain assets of International Medical Equipment and Services, Inc. (“IMES”), for a purchase price of \$12.2 million. This includes the purchase of inventory, receivables, fixed assets, and certain other assets of the Company. The Company did not acquire any liabilities of IMES. The total consideration paid excludes transaction costs.

IMES, based in South Carolina, provides reliable, cost-saving solutions worldwide for major brands of CT and MRI equipment. This acquisition positions Richardson Healthcare to provide cost effective diagnostic imaging replacement parts and training to hospitals, diagnostic imaging centers, medical institutions, and independent service organizations. IMES offers an extensive selection of replacement parts, as well as an interactive training center, on-site test bays and experienced technicians who provide 24/7 customer support. Replacement parts are readily available and triple tested to provide peace of mind when uptime is critical. IMES core operations have remained in South Carolina. Richardson Healthcare plans to expand IMES’ replacement parts and training offerings geographically to leverage the Company’s global infrastructure. During the fourth quarter of fiscal 2016, IMES opened up their first foreign location in Amsterdam.

The consideration paid by the Company to IMES at closing was \$12.2 million in cash. The following table summarizes the fair values of the assets acquired at the date of the closing of the acquisition (*in thousands*):

Accounts receivable	\$737
Inventories	1,420
Property, plant and equipment	230
Goodwill	6,332
Other intangibles	3,490
Net assets acquired	\$12,209

Intangible assets include trade names with an estimated life of 3 years for \$0.6 million, customer relationships with an estimated life of 20 years for \$2.5 million, non-compete agreements with an estimated life of 5 years for \$0.2 million, and technology with an estimated life of 10 years for \$0.2 million.

Goodwill recognized represents value the Company expects to be created by combining the operations of IMES with the Company’s operations, including the expansion into markets within existing business segments and geographic regions, access to new customers and potential cost savings and synergies.

Goodwill related to the acquisition is deductible for tax purposes.

In connection with the acquisition of IMES, the Company also entered into an Employment, Non-Disclosure, and Non-Compete Agreement (“Employment Agreement”) with Lee A. McIntyre III as the Company’s Executive Vice President, IMES. During the term of his employment, Mr. McIntyre will earn an annual base salary of \$300,000. In addition to his base salary, he will be entitled to an annual bonus equal to 20% of the EBITDA of IMES provided that the EBITDA of the business is at least \$2.0 million inclusive of the bonus payment. The annual bonus payment will terminate after five years. For fiscal year 2016, Mr. McIntyre did not receive a bonus as the minimum EBITDA needed was not achieved.

The financial results for the three months ended August 29, 2015, includes the financial results for IMES from June 15, 2015, through August 29, 2015. The financial transactions for IMES from May 31, 2015, through June 14, 2015, were deemed immaterial for illustrating pro forma financial statements.

5. GOODWILL AND INTANGIBLE ASSETS

The carrying value of goodwill was \$6.3 million as of August 27, 2016, and May 28, 2016.

Goodwill is initially recorded based on the premium paid for acquisitions and is subsequently tested for impairment, using the first day of our fourth quarter as the measurement date. We test goodwill for impairment annually and whenever events or circumstances indicates an impairment may have occurred, such as a significant adverse change in the business climate, loss of key personnel or a decision to sell or dispose of a reporting unit. The goodwill balance in its entirety relates to our IMES reporting unit which is included in our Healthcare segment.

Intangible assets are initially recorded at their fair market values determined on quoted market prices in active markets, if available, or recognized valuation models. Intangible assets that have finite useful lives are amortized over their useful lives either on a straight-line basis or over their projected future cash flows and are tested for impairment when events or changes in circumstances occur that indicate possible impairment.

Our intangible assets represent the fair value for trade name, customer relationships, non-compete agreements, and technology acquired in connection with our acquisitions. Intangible assets subject to amortization are as follows (*in thousands*):

	Intangible Assets Subject to Amortization as of	
	August 27, 2016	May 28, 2016
Gross Amounts:		
Trade Name	\$ 659	\$ 659
Customer Relationships ⁽¹⁾	3,403	3,434
Non-compete Agreements	177	177
Technology	230	230
Total Gross Amounts	\$ 4,469	\$ 4,500
Accumulated Amortization:		
Trade Name	\$ 283	\$ 231
Customer Relationships	380	374
Non-compete Agreements	60	55
Technology	32	22
Total Accumulated Amortization	\$ 755	\$ 682
Net Intangibles	\$ 3,714	\$ 3,818

(1)Change from prior periods reflect impact of foreign currency translation.

The amortization expense associated with the intangible assets subject to amortization for the next five years is presented in the following table (*in thousands*):

Fiscal Year	Amortization Expense
Remaining 2017	\$ 270
2018	432
2019	245
2020	257
2021	245
Thereafter	2,265
Total amortization expense	\$ 3,714

The weighted average number of years of amortization expense remaining is 16.1 years.

6. INVESTMENTS

As of August 27, 2016, we had approximately \$8.2 million invested in time deposits and certificates of deposit (“CD”). Of these, \$6.4 million mature in less than twelve months and \$1.8 million mature in more than twelve months. The fair value of these investments is equal to the face value of each time deposit and CD.

As of May 28, 2016, we have invested in time deposits and certificates of deposit (“CD”) in the amount of \$9.5 million. Of this, \$2.3 million mature in less than twelve months and \$7.2 million mature in greater than twelve months. The fair value of these investments is the face value of each time deposit and CD.

We also have investments in equity securities, all of which are classified as available-for-sale and are carried at their fair value based on quoted market prices. Our investments, which are included in non-current assets, had a carrying amount of \$0.6 million as of August 27, 2016, and May 28, 2016. Proceeds from the sale of securities were \$0.1 million during the first quarter of fiscal 2017 and fiscal 2016. We reinvested proceeds from the sale of securities, and the cost of the equity securities sold was based on a specific identification method. Gross realized gains on those sales were less than \$0.1 million during the first quarter of fiscal 2017 and fiscal 2016. Net unrealized holding gains of less than \$0.1 million during the first quarter of fiscal 2017 and loss of \$0.1 million during the first quarter of fiscal 2016, have been included in accumulated other comprehensive income.

7. WARRANTIES

We offer warranties for the limited number of specific products we manufacture. We also provide extended warranties for some products we sell that lengthen the period of coverage specified in the manufacturer's original warranty. Our warranty terms generally range from one to three years.

We estimate the cost to perform under the warranty obligation and recognize this estimated cost at the time of the related product sale. We record expense related to our warranty obligations as cost of sales in our consolidated statements of comprehensive loss. Each quarter, we assess actual warranty costs incurred on a product-by-product basis and compare the warranty costs to our estimated warranty obligation. With respect to new products, estimates are based generally on knowledge of the products, the extended warranty period, and warranty experience.

Warranty reserves are established for costs that are expected to be incurred after the sale and delivery of products under warranty. Warranty reserves are included in accrued liabilities on our consolidated balance sheets. The warranty reserves are determined based on known product failures, historical experience, and other available evidence.

Warranty reserves were approximately \$0.2 million as of August 27, 2016, and as of May 28, 2016.

8. LEASE OBLIGATIONS, OTHER COMMITMENTS, AND CONTINGENCIES

We lease certain warehouse and office facilities and office equipment under non-cancelable operating leases. Rent expense during the first three months of fiscal 2017 and fiscal 2016 was \$0.5 million. Our future lease commitments for minimum rentals, including common area maintenance charges and property taxes during the next five years are as follows (*in thousands*):

Fiscal Year	Payments
Remaining 2017	\$ 1,256
2018	1,344
2019	1,288
2020	1,126
2021	809
Thereafter	470

9. INCOME TAXES

We recorded an income tax provision of \$0.5 million and \$0.4 million for the first three months of fiscal 2017 and the first three months of fiscal 2016, respectively. The effective income tax rate during the first three months of fiscal 2017 was a tax provision of (21.1%), as compared to a tax provision of (35.7%) during the first three months of fiscal 2016. The difference in rate during the first three months of fiscal 2017, as compared to the first three months of fiscal 2016, reflects the impact of changes in our geographical distribution of income (loss), the recording of provision to return true-ups of various foreign jurisdictions, and our positions with respect to ASC 740-30, Income Taxes - Other Considerations or Special Areas ("ASC 740-30"). The (21.1%) effective income tax rate differs from the federal statutory rate of 34.0% as a result of our geographical distribution of income (loss), the recording of various provision to return true-ups in foreign jurisdictions, the increase in uncertain tax positions as a result of an income tax audit in France, and the recording of a valuation allowance against the increase in our U.S. state and federal net deferred tax assets.

During the first quarter of fiscal year 2017, we completed a distribution of cash from our Chinese entity to our U.S. parent company which consisted of a return of capital for \$10.0 million and a dividend of \$1.3 million. The impact on our income taxes recorded during the first quarter of fiscal 2017 was an increase to our foreign tax credits deferred tax asset of approximately \$3.6 million, a decrease to the U.S. federal net operating loss deferred tax asset of \$4.8 million, and a decrease to our deferred tax liability for earnings considered permanently reinvested of \$1.2 million. In connection with the cash repatriation, we recorded and paid approximately \$0.1 million of withholding tax.

In the normal course of business, we are subject to examination by taxing authorities throughout the world. Generally, years prior to fiscal 2006 are closed for examination under the statute of limitation for U.S. federal, U.S. state and local, or non-U.S. tax jurisdictions. We are also currently under examination in France (fiscal 2013 through 2015) and Thailand (fiscal 2008 through 2011). We are under examination in the state of Illinois for fiscal years 2012 and 2013. Our primary foreign tax jurisdictions are Germany and the Netherlands. We have tax years open in Germany beginning in fiscal 2012 and the Netherlands beginning in fiscal 2010.

We have historically determined that certain undistributed earnings of our foreign subsidiaries, to the extent of cash available, will be repatriated to the U.S. Accordingly, we have provided a deferred tax liability totaling \$5.5 million as of August 27, 2016, on foreign earnings of \$38.2 million. The change from year end May 28, 2016 of a deferred tax liability totaling \$6.7 million on foreign earnings of \$48.7 million relates to reclassification of a deferred tax liability to an actual tax recognition of a dividend paid from China in the first quarter of fiscal 2017, thereby reducing the deferred tax liability and also reducing gross U.S. deferred tax assets fully offset by a valuation allowance. In addition, as of August 27, 2016, the approximate \$5.7 million balance of cumulative positive earnings of some of our foreign subsidiaries from May 28, 2016 has not significantly changed and is still considered permanently reinvested pursuant to ASC 740-30. Due to various tax attributes that are continuously changing, it is not practicable to determine what, if any, tax liability might exist if such earnings were to be repatriated.

As of August 27, 2016, our worldwide liability, from continuing operations, for uncertain tax positions was \$0.2 million, excluding interest and penalties, as compared to \$0.1 million of liabilities for uncertain tax positions as of May 28, 2016. The increase in uncertain tax positions relate to the French tax audit. We record penalties and interest relating to uncertain tax positions in the income tax expense line item within the unaudited consolidated statements of loss. It is not expected that there will be a change in the unrecognized tax benefits within the next 12 months.

The valuation allowance against the net deferred tax assets that will more likely than not be realized was \$5.9 million as of May 28, 2016. The valuation allowance against the net deferred tax assets has increased to \$7.1 million as of August 27, 2016 for additional domestic federal and state net deferred tax assets generated during the first quarter of fiscal year 2017 due to additional losses in the U.S. jurisdiction. A full valuation allowance on the U.S. and state deferred tax assets will be maintained until sufficient positive evidence related to sources of future taxable income exists to support a reversal of the valuation allowance. The amount of the deferred tax asset considered realizable, however, could be adjusted if estimates of future taxable income during the carryforward period are increased, or if objective negative evidence in the form of cumulative losses is no longer present and additional weight may be given to subjective evidence such as our projections for growth.

10. CALCULATION OF EARNINGS PER SHARE

We have authorized 17,000,000 shares of common stock, and 3,000,000 shares of Class B common stock. The Class B common stock has 10 votes per share and has transferability restrictions; however, Class B common stock may be converted into common stock on a share-for-share basis at any time. With respect to dividends and distributions, shares of common stock and Class B common stock rank equally and have the same rights, except that Class B common stock cash dividends are limited to 90% of the amount of Class A common stock cash dividends.

In accordance with ASC 260-10, *Earnings Per Share* (“ASC 260”), our Class B common stock is considered a participating security requiring the use of the two-class method for the computation of basic and diluted earnings per share. The two-class computation method for each period reflects the cash dividends paid per share for each class of stock, plus the amount of allocated undistributed earnings per share computed using the participation percentage which reflects the dividend rights of each class of stock. Basic and diluted earnings per share were computed using the two-class method as prescribed in ASC 260. The shares of Class B common stock are considered to be participating convertible securities since the shares of Class B common stock are convertible on a share-for-share basis into shares of common stock and may participate in dividends with common stock according to a predetermined formula which is 90% of the amount of Class A common stock cash dividends.

The earnings per share (“EPS”) presented in our unaudited consolidated statements of comprehensive loss are based on the following amounts (*in thousands, except per share amounts*):

	For the Three Months Ended			
	August 27, 2016		August 29, 2015	
	Basic	Diluted	Basic	Diluted
Numerator for Basic and Diluted EPS:				
Net loss	\$(2,850)	\$(2,850)	\$(1,399)	\$(1,399)
Less dividends:				
Common stock	641	641	690	690
Class B common stock	116	116	116	116
Undistributed losses	\$(3,607)	\$(3,607)	\$(2,205)	\$(2,205)
Common stock undistributed losses	\$(3,057)	\$(3,057)	\$(1,888)	\$(1,888)
Class B common stock undistributed losses	(550)	(550)	(317)	(317)
Total undistributed losses	\$(3,607)	\$(3,607)	\$(2,205)	\$(2,205)
Denominator for basic and diluted EPS:				
Common stock weighted average shares	10,703	10,703	11,486	11,486
Class B common stock weighted average shares, and shares under if-converted method for diluted EPS	2,141	2,141	2,141	2,141
Effect of dilutive securities				
Dilutive stock options		—		—
Denominator for diluted EPS adjusted for weighted average shares and assumed conversions		12,844		13,627
Net loss per share:				
Common stock	\$(0.23)	\$(0.23)	\$(0.10)	\$(0.10)
Class B common stock	\$(0.20)	\$(0.20)	\$(0.10)	\$(0.10)

Note: Common stock options that were anti-dilutive and not included in diluted earnings per common share for the first quarter of fiscal 2017 and fiscal 2016 were 838 and 888, respectively.

11. SEGMENT REPORTING

In accordance with ASC 280-10, Segment Reporting, we have identified three operating and reportable segments as follows:

Power and Microwave Technologies Group (“PMT”) combines our core engineered solutions, power grid and microwave tube business with new RF and power technologies. As a manufacturer and authorized distributor, PMT’s strategy is to provide specialized technical expertise and engineered solutions based on our core engineering and manufacturing capabilities. We provide solutions and add value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair—all through our existing global infrastructure. PMT’s focus is on products for power, RF and microwave applications for customers in alternative energy, aviation, broadcast, communications, industrial, marine, medical, military, scientific, and semiconductor markets. PMT focuses on various applications including broadcast transmission, CO2 laser cutting, diagnostic imaging, dielectric and induction heating, high energy transfer, high voltage switching, plasma, power conversion, radar, and radiation oncology. PMT also offers its customers technical services for both microwave and industrial equipment.

Canvys provides customized display solutions serving the corporate enterprise, financial, healthcare, industrial, and medical original equipment manufacturers (“OEM”) markets.

Healthcare manufactures, distributes and services high value replacement parts for the healthcare market including hospitals, medical centers, independent service organizations, and multi-vendor service providers. Products include power grid tubes, hydrogen thyratrons, klystrons, magnetrons; Image Systems medical displays and workstations for picture archiving and communication systems (“PACS”); visual solutions for operating rooms/surgical environments; digital radiography solutions including replacement flat panel detectors and upgrades; and additional replacement components currently under development for the diagnostic imaging service market. Through a combination of newly developed products and partnerships, service offerings, and training programs, we believe we can help our customers improve efficiency and deliver better clinical outcomes while lowering the cost of healthcare delivery.

The CEO evaluates performance and allocates resources primarily based on the gross profit of each segment.

Operating results by segment are summarized in the following table (*in thousands*):

	Three Months Ended	
	August 27, 2016	August 29, 2015
PMT		
Net Sales	\$25,381	\$27,195
Gross Profit	7,455	8,138
Canvys		
Net Sales	\$4,620	\$6,681
Gross Profit	1,348	1,709
Healthcare		
Net Sales	\$3,372	\$3,195

Gross Profit 1,437 1,415

Geographic net sales information is primarily grouped by customer destination into five areas: North America; Asia/Pacific; Europe; Latin America; and Other.

Net sales and gross profit by geographic region are summarized in the following table (*in thousands*):

	Three Months Ended	
	August 27, 2016	August 29, 2015
Net Sales		
North America	\$ 13,049	\$ 17,792
Asia/Pacific	7,655	6,132
Europe	10,264	11,358
Latin America	2,390	1,607
Other (1)	15	182
Total	\$ 33,373	\$ 37,071
Gross Profit		
North America	\$ 4,885	\$ 6,199
Asia/Pacific	2,558	1,956
Europe	3,029	3,341
Latin America	917	625
Other (1)	(1,149)	(859)
Total	\$ 10,240	\$ 11,262

(1) Other includes primarily net sales not allocated to a specific geographical region, unabsorbed value-add costs, and other unallocated expenses.

We sell our products to customers in diversified industries and perform periodic credit evaluations of our customers' financial condition. Terms are generally on open account, payable net 30 days in North America, and vary throughout Asia/Pacific, Europe, and Latin America. Estimates of credit losses are recorded in the financial statements based on monthly reviews of outstanding accounts.

12. LITIGATION

We are involved in several pending judicial proceedings concerning matters arising in the ordinary course of business. While the outcome of litigation is subject to uncertainties, based on information available at the time the financial statements were issued, we determined disclosure of contingencies relating to any of our pending judicial proceedings was not necessary because there is less than a reasonable possibility that a material loss will be incurred.

13. FAIR VALUE MEASUREMENTS

ASC 820, *Fair Value Measurements and Disclosures* ("ASC 820"), defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements.

ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists; therefore requiring an entity to develop its own assumptions.

As of August 27, 2016, and May 28, 2016, we held investments that are required to be measured at fair value on a recurring basis. Our investments consist of time deposits and CDs, where face value is equal to fair value, and equity securities of publicly traded companies for which market prices are readily available.

Investments measured at fair value on a recurring basis subject to the disclosure requirements of ASC 820 as of August 27, 2016, and May 28, 2016, were as follows (*in thousands*):

	Level 1
<u>August 27, 2016</u>	
Time deposits/CDs	\$8,239
Equity securities	563
Total	\$8,802
<u>May 28, 2016</u>	
Time deposits/CDs	\$9,517
Equity securities	550
Total	\$10,067

14. Related Party Transaction

On June 15, 2015, the Company entered into a lease agreement for the IMES facility with LDL, LLC. The Executive Vice President of IMES, Lee A. McIntyre III, has an ownership interest in LDL, LLC. The lease agreement provides for monthly payments over five years with total future minimum lease payments of \$0.6 million. Rental expense related to this lease amounted to less than \$0.1 million for the three months ended August 27, 2016, and August 29, 2015. The Company shall be entitled to extend the term of the lease for a period of an additional five years by notifying the landlord in writing of its intention to do so within nine months of the expiration of the initial term.

15. Subsequent event

In September of fiscal 2017, we executed a plan to reduce our workforce as part of our cost savings initiatives to permanently decrease fixed operating costs. As a result, we will be recording approximately \$1.3 million of severance expense during the second quarter of fiscal 2017.

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

Certain statements in this report may constitute "forward-looking" statements within the meaning of the Private Securities Litigation Reform Act of 1995. The terms "may," "should," "could," "anticipate," "believe," "continues," "estimate," "expect," "intend," "objective," "plan," "potential," "project" and similar expressions are intended to identify forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. These statements are based on management's current expectations, intentions or beliefs and are subject to a number of factors, assumptions and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Factors that could cause or contribute to such differences or that might otherwise impact the business include the risk factors set forth in Item 1A, of our Annual Report on Form 10-K filed on July 29, 2016. We undertake no obligation to update any such factor or to publicly announce the results of any revisions to any forward-looking statements contained herein whether as a result of new information, future events or otherwise.

In addition, while we do, from time to time, communicate with securities analysts, it is against our policy to disclose to them any material non-public information or other confidential commercial information. Accordingly, stockholders should not assume that we agree with any statement or report issued by any analyst irrespective of the content of the statement or report. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts, or opinions, such reports are not our responsibility.

INTRODUCTION

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to assist the reader in better understanding our business, results of operations, financial condition, changes in financial condition, critical accounting policies and estimates, and significant developments. MD&A is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and the accompanying notes appearing elsewhere in this filing. This section is organized as follows:

•**Business Overview** – a brief synopsis of our Company for the periods ended August 27, 2016, and August 29, 2015.

•**Results of Operations** – an analysis and comparison of our consolidated results of operations for the three month periods ended August 27, 2016, and August 29, 2015, as reflected in our consolidated statements of comprehensive loss.

•**Liquidity, Financial Position, and Capital Resources** – a discussion of our primary sources and uses of cash for the three month periods ended August 27, 2016, and August 29, 2015, and a discussion of changes in our financial position.

Business Overview

Richardson Electronics, Ltd. is a leading global provider of engineered solutions, power grid and microwave tubes and related consumables; power conversion and RF and microwave components; high value displays, flat panel detector solutions and replacement parts for diagnostic imaging equipment; and customized display solutions. We serve customers in the alternative energy, healthcare, aviation, broadcast, communications, industrial, marine, medical, military, scientific and semiconductor markets. The Company's strategy is to provide specialized technical expertise and "engineered solutions" based on our core engineering and manufacturing capabilities. The Company provides solutions and adds value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair through its global infrastructure.

Our products include electron tubes and related components, microwave generators, subsystems used in semiconductor manufacturing, and visual technology solutions. These products are used to control, switch or amplify electrical power signals, or are used as display devices in a variety of industrial, commercial, medical, and communication applications.

We have three operating and reportable segments which we define as follows:

Power and Microwave Technologies Group (“PMT”) combines our core engineered solutions, power grid and microwave tube business with new RF and power technologies. As a manufacturer and authorized distributor, PMT’s strategy is to provide specialized technical expertise and engineered solutions based on our core engineering and manufacturing capabilities. We provide solutions and add value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair—all through our existing global infrastructure. PMT’s focus is on products for power, RF and microwave applications for customers in alternative energy, aviation, broadcast, communications, industrial, marine, medical, military, scientific, and semiconductor markets. PMT focuses on various applications including broadcast transmission, CO2 laser cutting, diagnostic imaging, dielectric and induction heating, high energy transfer, high voltage switching, plasma, power conversion, radar, and radiation oncology. PMT also offers its customers technical services for both microwave and industrial equipment.

Canvys provides customized display solutions serving the corporate enterprise, financial, healthcare, industrial, and OEM markets.

Healthcare manufactures, distributes and services high value replacement parts for the healthcare market including hospitals, medical centers, independent service organizations, and multi-vendor service providers. Products include power grid tubes, hydrogen thyratrons, klystrons, magnetrons; Image Systems medical displays and workstations for picture archiving and communication systems (“PACS”); visual solutions for operating rooms/surgical environments; digital radiography solutions including replacement flat panel detectors and upgrades; and additional replacement components currently under development for the diagnostic imaging service market. Through a combination of newly developed products and partnerships, service offerings, and training programs, we believe we can help our customers improve efficiency and deliver better clinical outcomes while lowering the cost of healthcare delivery.

We currently have operations in North America, Asia/Pacific, Europe, and Latin America.

RESULTS OF OPERATIONS

Financial Summary – Three Months Ended August 27, 2016

- Net sales for the first quarter of fiscal 2017 were \$33.4 million, a decrease of 10.0%, compared to net sales of \$37.1 million during the first quarter of fiscal 2016.
- Gross margin increased to 30.7% during the first quarter of fiscal 2017, compared to 30.4% during the first quarter of fiscal 2016.
- Selling, general, and administrative expenses were \$12.3 million, or 36.9% of net sales, for the first quarter of fiscal 2017, compared to \$12.3 million, or 33.1% of net sales, for the first quarter of fiscal 2016.
- Operating loss during the first quarter of fiscal 2017 was \$2.1 million, compared to an operating loss of \$1.0 million in the first quarter of fiscal 2016.
- Net loss during the first quarter of fiscal 2017 was \$2.9 million, compared to net loss of \$1.4 million, during the first quarter of fiscal 2016.

Net Sales and Gross Profit Analysis

Net sales by segment and percent change for the first quarter of fiscal 2017 and 2016 were as follows (*in thousands*):

	<u>Net Sales</u> Three Months Ended		FY17 vs. FY16	
	August 27, 2016	August 29, 2015	% Change	
PMT	\$ 25,381	\$ 27,195	-6.7	%
Canvys	4,620	6,681	-30.8	%
Healthcare	3,372	3,195	5.5	%
Total	\$ 33,373	\$ 37,071	-10.0	%

During the first quarter of fiscal 2017 consolidated net sales decreased 10.0% compared to the first quarter of fiscal 2016. Sales for PMT decreased 6.7%, sales for Canvys decreased 30.8%, and sales for Healthcare increased 5.5%. The decline sales for both PMT and Canvys were primarily due to declines in overall demand from key original equipment manufacturers. The increase in Richardson Healthcare was due to an increase in demand for diagnostic imaging replacement parts.

Gross profit by segment and percent change for the first quarter of fiscal 2017 and 2016 were as follows (*in thousands*):

	Gross Profit Three Months Ended					
	August 27, 2016	% of Net Sales		August 29, 2015	% of Net Sales	
PMT	\$7,455	29.4	%	\$ 8,138	29.9	%
Canvys	1,348	29.2	%	1,709	25.6	%
Healthcare	1,437	42.6	%	1,415	44.3	%
Total	\$10,240	30.7	%	\$ 11,262	30.4	%

Gross profit reflects the distribution and manufacturing product margin less manufacturing variances, inventory obsolescence charges, customer returns, scrap and cycle count adjustments, engineering costs, unabsorbed manufacturing labor and overhead, and other provisions.

Consolidated gross profit decreased to \$10.2 million during the first quarter of fiscal 2017, compared to \$11.3 million during the first quarter of fiscal 2016. Consolidated gross profit as a percentage of net sales increased to 30.7% during the first quarter of fiscal 2017, from 30.4% during the first quarter of fiscal 2016, primarily due to higher margins in our Canvys business as a result of an improved product and sales mix and higher margins associated with the sale of diagnostic imaging replacement parts in the Healthcare business.

Power and Microwave Technologies Group

PMT net sales decreased 6.7% to \$25.4 million during the first quarter of fiscal 2017, from \$27.2 million during the first quarter of fiscal 2016. The decline included sales of Electron devices sold into the marine market, and specialty products manufactured in LaFox which are sold primarily into the semiconductor capital equipment market. The sales decline was partially offset by higher sales of new technology partners in power conversion and RF and microwave component and growth of Electron devices in Laser products and Microwave radar applications. Gross margin as a percentage of net sales decreased to 29.4% during the first quarter of fiscal 2017, as compared to 29.9% during the first quarter of fiscal 2016, due to production shutdown and equipment transfer costs incurred at our Brive, France facility.

Canvys

Canvys net sales decreased 30.8% to \$4.6 million during the first quarter of fiscal 2017, from \$6.7 million during the first quarter of fiscal 2016 primarily due to a significant decrease in customer demand in our North America market. Gross margin as a percentage of net sales increased to 29.2% during the first quarter of fiscal 2017 as compared to 25.6% during the first quarter of fiscal 2016, due to product mix and lower inbound freight costs.

Healthcare

Healthcare net sales increased 5.5% to \$3.4 million during the first quarter of fiscal 2017, from \$3.2 million during the first quarter of fiscal 2016 primarily due to increased sales of IMES products. Gross margin as a percentage of net sales decreased to 42.6% during the first quarter of fiscal 2017 as compared to 44.3% during the first quarter of fiscal 2016 due to product mix.

Selling, General, and Administrative Expenses

Selling, general, and administrative expenses (“SG&A”) during the first quarter of fiscal 2017 were flat at \$12.3 million to the first quarter of fiscal 2016. Decreases in SG&A of \$0.4 million in support functions and \$0.1 million in Canvys were offset by an increase of \$0.5 million related to additional investments in our Richardson Healthcare segment to support its expected growth.

Other Income/Expense

Other income/expense was \$0.3 million of expense during the first quarter of fiscal 2017, compared to expense of less than \$0.1 million during the first quarter of fiscal 2016. Other income/expense during the first quarter of fiscal 2017 included \$0.3 million of foreign exchange losses. Other income/expense during the first quarter of fiscal 2016 included \$0.2 million of investment and interest income offset by \$0.2 million of foreign exchange losses. Our foreign exchange gains and losses are primarily due to the translation of U.S. dollars held in non-U.S. entities. We currently do not utilize derivative instruments to manage our exposure to foreign currency.

Income Tax Provision

We recorded an income tax provision of \$0.5 million and \$0.4 million for the first three months of fiscal 2017 and the first three months of fiscal 2016, respectively. The effective income tax rate during the first three months of fiscal 2017 was a tax provision of (21.1%), as compared to a tax provision of (35.7%) during the first three months of fiscal 2016. The difference in rate during the first three months of fiscal 2017, as compared to the first three months of fiscal 2016, reflects the impact of changes in our geographical distribution of income (loss), the recording of provision to

return true-ups of various foreign jurisdictions, and our positions with respect to ASC 740-30, Income Taxes - Other Considerations or Special Areas ("ASC 740-30"). The (21.1%) effective income tax rate differs from the federal statutory rate of 34.0% as a result of our geographical distribution of income (loss), the recording of various provision to return true-ups in foreign jurisdictions, the increase in uncertain tax positions as a result of an income tax audit in France, and the recording of a valuation allowance against the increase in our U.S. state and federal net deferred tax assets.

In the normal course of business, we are subject to examination by taxing authorities throughout the world. Generally, years prior to fiscal 2006 are closed for examination under the statute of limitation for U.S. federal, U.S. state and local, or non-U.S. tax jurisdictions. We are also currently under examination in France (fiscal 2013 through 2015) and Thailand (fiscal 2008 through 2011). We are under examination in the state of Illinois for fiscal years 2012 and 2013. Our primary foreign tax jurisdictions are Germany and the Netherlands. We have tax years open in Germany beginning in fiscal 2012 and the Netherlands beginning in fiscal 2010.

Net Loss and Per Share Data

Net loss during the first quarter of fiscal 2017 was \$2.9 million, or (\$0.23) per diluted common share and (\$0.20) per Class B diluted common share, as compared to net loss of \$1.4 million during the first quarter of fiscal 2016, or (\$0.10) per diluted common share and (\$0.10) per Class B diluted common share.

LIQUIDITY, FINANCIAL POSITION, AND CAPITAL RESOURCES

Our growth and cash needs have been primarily financed through income from operations and cash on hand.

Cash and cash equivalents for the first quarter ended August 27, 2016, were \$57.5 million. Investments included CDs and time deposits classified as short-term investments were \$6.4 million and long-term investments were \$2.4 million, including equity securities of \$0.6 million. Cash and investments at August 27, 2016, consisted of \$25.6 million in North America, \$11.7 million in Europe, \$1.0 million in Latin America, and \$28.0 million in Asia/Pacific. During the first quarter of fiscal 2017, we completed a cash repatriation of \$11.3 million, which included a return of capital and dividend from our Chinese entity to our U.S. parent company.

Cash and cash equivalents were \$60.4 million at May 28, 2016. Investments included CD's and time deposits, classified as short-term investments were \$2.3 million and long-term investments were \$7.8 million, including equity securities of \$0.6 million. Cash and investments at May 28, 2016, consisted of \$18.1 million in North America, \$12.6 million in Europe, \$0.7 million in Latin America, and \$39.1 million in Asia/Pacific.

Cash Flows from Operating Activities

The cash used in operating activities primarily resulted from our net loss, adjusted for non-cash items, and changes in our operating assets and liabilities.

Operating activities used \$1.7 million of cash during the first quarter of fiscal 2017. We had net loss of \$2.9 million during the first quarter of fiscal 2017, which included non-cash stock-based compensation expense of \$0.1 million associated with the issuance of stock option awards and depreciation and amortization expense of \$0.7 million associated with our property and equipment as well as amortization of our intangible assets. Changes in our operating assets and liabilities during the first quarter of fiscal 2017, net of foreign currency exchange gains and losses, included decreases in receivables and inventories of \$3.6 million and \$0.4 million, respectively, offset by decreases in our accounts payable and accrued liabilities of \$2.3 million and \$1.1 million, respectively. The decrease in receivables of \$3.6 million was primarily due to the collection of a large receivable during the first quarter of fiscal 2017 that was invoiced during the fourth quarter of fiscal 2016. The inventory decrease was due to terminating our production at our Brive, France facility during the first quarter of fiscal 2017. Decreases in our accounts payable and liabilities were due to timing of payments for some of our larger vendors and also the result of having shorter payment terms for our Richardson Healthcare vendors.

Operating activities used \$6.5 million of cash during the first quarter of fiscal 2016. We had net loss of \$1.4 million during the first quarter of fiscal 2016, which included non-cash stock-based compensation expense of \$0.1 million associated with the issuance of stock option awards and depreciation and amortization expense of \$0.5 million associated with our property and equipment as well as amortization of our intangible assets. Changes in our operating assets and liabilities, net of effects of acquired businesses and foreign currency exchange gains and losses, was a use of cash of \$5.7 million during the first quarter of fiscal 2016, due primarily to the increase in our accounts receivable of \$2.5 million, the decrease in our accounts payable of \$1.5 million, the increase in inventories of \$0.6 million, the increase in prepaid expenses of \$0.6 million, and the decrease in accrued liabilities of \$0.8 million.

Cash Flows from Investing Activities

The cash flow from investing activities has consisted primarily of purchases and maturities of investments, capital expenditures, and any business acquisition activity.

Cash used by investing activities of \$0.6 million during the first quarter of fiscal 2017, included proceeds from the maturities of investments of \$1.5 million, offset by \$2.1 million in capital expenditures. Capital expenditures relates primarily to our Healthcare growth initiatives and capital used for our new IT system.

Cash provided by investing activities of \$5.2 million during the first quarter of fiscal 2016, included proceeds from the maturities of investments of \$18.4 million, offset by the acquisition of IMES of \$12.2 million and \$1.0 million in capital expenditures. Capital expenditures of \$1.0 million relates primarily to our Healthcare growth initiatives.

Our purchases and proceeds from investments consist of time deposits and CDs. Purchasing of future investments may vary from period to period due to interest and foreign currency exchange rates.

Cash Flows from Financing Activities

The cash flow from financing activities primarily consists of repurchases of common stock and cash dividends paid.

Cash used in financing activities of \$0.8 million during the first quarter of fiscal 2017, resulted from cash used to pay dividends.

Cash used in financing activities of \$4.1 million during the first three months of fiscal 2016, resulted from \$3.3 million of cash used to repurchase common stock under our share repurchase authorization and \$0.8 million of cash used to pay dividends.

Dividend payments for the first quarter of fiscal 2017 were approximately \$0.8 million. All future payments of dividends are at the discretion of the Board of Directors. Dividend payments will depend on earnings, capital requirements, operating conditions, and such other factors that the Board may deem relevant.

We believe that the existing sources of liquidity, including current cash, will provide sufficient resources to meet known capital requirements and working capital needs through the next twelve months.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
Risk Management and Market Sensitive Financial Instruments

We are exposed to many different market risks with the various industries we serve. The primary financial risk we are exposed to is foreign currency exchange, as certain operations, assets, and liabilities of ours are denominated in foreign currencies. We manage these risks through normal operating and financing activities.

The interpretation and analysis of these disclosures should not be considered in isolation since such variances in exchange rates would likely influence other economic factors. Such factors, which are not readily quantifiable, would likely also affect our operations. Additional disclosure regarding various market risks are set forth in Part I, Item 1A, “Risk Factors” of our Annual Report on Form 10-K for the year ended May 28, 2016, filed July 29, 2016.

ITEM 4. CONTROLS AND PROCEDURES

Table of Contents

products. As the number of products and competitors in our market increases and overlaps occur, infringement claims may increase. While we intend to increase the size of our patent portfolio, our competitors and others may now and in the future have significantly larger and more mature patent portfolios than we have. In addition, future litigation may involve patent holding companies or other adverse patent owners who have no relevant product revenue and against whom our own patents may therefore provide little or no deterrence or protection. In addition, we have not registered our trademarks in all of our geographic markets and failure to secure those registrations could adversely affect our ability to enforce and defend our trademark rights. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, could distract our management from our business, and could require us to cease use of such intellectual property. Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation.

Although third parties may offer a license to their technology or other intellectual property, the terms of any offered license may not be acceptable and the failure to obtain a license or the costs associated with any license could cause our business, financial condition, and operating results to be materially and adversely affected. In addition, some licenses may be non-exclusive, and therefore our competitors may have access to the same technology licensed to us. If a third party does not offer us a license to its technology or other intellectual property on reasonable terms, or at all, we could be enjoined from continued use of such intellectual property. As a result, we may be required to develop alternative, non-infringing technology, which could require significant time (during which we would be unable to continue to offer our affected products or services), effort, and expense and may ultimately not be successful. Furthermore, a successful claimant could secure a judgment or we may agree to a settlement that prevents us from distributing certain products or performing certain services or that requires us to pay substantial damages, royalties, or other fees. Any of these events could seriously harm our business, financial condition, and operating results.

In addition, although we have settled our litigation with Juniper, there is no guarantee that future claims of infringement will not arise between us and Juniper or other third parties. Under the Settlement Agreement with Juniper, the parties agreed to a mutual dismissal of all pending litigation, a cross-license of the patents in suit for the life of the patents, and an eight-year mutual covenant not to sue for infringement of any other patents. We also agreed to pay Juniper a one-time settlement amount consisting of \$75.0 million in cash, 1.1 million shares of our common stock, and a warrant to purchase 0.5 million shares of our common stock. After the eight-year covenant not to sue period, Juniper could file additional lawsuits against us, asserting patent infringement for other patents that are not subject to the cross-license.

Our proprietary rights may be difficult to enforce or protect, which could enable others to copy or use aspects of our products without compensating us.

We rely and expect to continue to rely on a combination of confidentiality and license agreements with our employees, consultants, and third parties with whom we have relationships, as well as trademark, copyright, patent, and trade secret protection laws, to protect our proprietary rights. We have filed various applications for certain aspects of our intellectual property. Valid patents may not issue from our pending applications, and the claims eventually allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate defensive protection or competitive advantages to us. Patent applications in the United States are typically not published until 18 months after filing, or, in some cases, not at all, and publications of discoveries in industry-related literature lag behind actual discoveries. We cannot be certain that we were the first to make the inventions claimed in our pending patent applications or that we were the first to file for patent protection, which could prevent our patent applications from issuing as patents or invalidate our patents following issuance.

Additionally, the process of obtaining patent protection is expensive and time-consuming, and we may not be able to prosecute all necessary or desirable patent applications at a reasonable cost or in a timely manner. Additional uncertainty may result from changes to patent-related laws enacted in the United States and other jurisdictions, including the America Invents Act and changes that may bring into question the validity of certain categories of software patents, and from interpretations of the intellectual property laws of the United States and other countries by applicable courts and agencies. As a result, we may not be able to obtain adequate patent protection or effectively

enforce any issued patents.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. We generally enter into confidentiality or license agreements with our employees, consultants, vendors, and customers, and generally limit access to and distribution of our proprietary information. However, we cannot assure you that we have entered into such agreements with all parties who may have or have had access to our confidential information or that the agreements we have entered into will not be breached. We cannot guarantee that any of the measures we have taken will prevent misappropriation of our technology. Because we may be an attractive target for computer hackers, we may have a greater risk of unauthorized access to, and misappropriation of, our proprietary information. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as the laws of the United States, and many foreign countries do not enforce these laws as diligently as government agencies and private parties in the United States. From time to time, we may need to take legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or

- 24 -

Table of Contents

invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, operating results, and financial condition. Attempts to enforce our rights against third parties could also provoke these third parties to assert their own intellectual property or other rights against us, or result in a holding that invalidates or narrows the scope of our rights, in whole or in part. If we are unable to protect our proprietary rights (including aspects of our software and products protected other than by patent rights), we may find ourselves at a competitive disadvantage to others who need not incur the additional expense, time, and effort required to create the innovative products that have enabled us to be successful to date. Any of these events would have a material adverse effect on our business, financial condition, and operating results.

Our use of open source software in our products could negatively affect our ability to sell our products and subject us to possible litigation.

Our products contain software modules licensed to us by third-party authors under “open source” licenses. Some open source licenses contain requirements that we make available source code for modifications or derivative works we create based upon the type of open source software we use. If we combine our proprietary software with open source software in a certain manner, we could, under certain open source licenses, be required to release the source code of our proprietary software to the public. This would allow our competitors to create similar products with lower development effort and time and ultimately could result in a loss of product sales for us.

Although we monitor our use of open source software to avoid subjecting our products to conditions we do not intend, the terms of many open source licenses have not been interpreted by United States courts, and there is a risk that these licenses could be construed in a way that could impose unanticipated conditions or restrictions on our ability to commercialize our products. From time to time, there have been claims against companies that distribute or use open source software in their products and services, asserting that open source software infringes the claimants’ intellectual property rights. We could be subject to suits by parties claiming infringement of intellectual property rights in what we believe to be licensed open source software. Moreover, we cannot assure you that our processes for controlling our use of open source software in our products will be effective. If we are held to have breached the terms of an open source software license, we could be required to seek licenses from third parties to continue offering our products on terms that are not economically feasible, to re-engineer our products, to discontinue the sale of our products if re-engineering could not be accomplished on a timely basis, or to make generally available, in source code form, our proprietary code, any of which could adversely affect our business, operating results, and financial condition.

In addition to risks related to license requirements, usage of open source software can lead to greater risks than use of third-party commercial software, as open source licensors generally do not provide warranties or assurance of title or controls on origin of the software. In addition, many of the risks associated with usage of open source software, such as the lack of warranties or assurances of title, cannot be eliminated, and could, if not properly addressed, negatively affect our business. We have established processes to help alleviate these risks, including a review process for screening requests from our development organizations for the use of open source software, but we cannot be sure that all open source software is submitted for approval prior to use in our products.

Our failure to adequately protect personal information could have a material adverse effect on our business.

A wide variety of provincial, state, national, and international laws and regulations apply to the collection, use, retention, protection, disclosure, transfer, and other processing of personal data. These data protection and privacy-related laws and regulations are evolving and being tested in courts and may result in ever-increasing regulatory and public scrutiny as well as escalating levels of enforcement and sanctions. Our failure to comply with applicable laws and regulations, or to protect such data, could result in enforcement action against us, including fines, imprisonment of company officials and public censure, claims for damages by end-customers and other affected individuals, damage to our reputation and loss of goodwill (both in relation to existing end-customers and prospective end-customers), any of which could have a material adverse effect on our operations, financial performance, and business. Evolving and changing definitions of personal data and personal information, within the European Union, the United States, and elsewhere, especially relating to classification of IP addresses, machine identification, location data, and other information, may limit or inhibit our ability to operate or expand our business, including limiting strategic partnerships that may involve the sharing of data. Even the perception of privacy concerns, whether or not valid, may harm our reputation and inhibit adoption of our products by current and future end-customers.

We license technology from third parties, and our inability to maintain those licenses could harm our business. We incorporate technology that we license from third parties, including software, into our products and services. We cannot be certain that our licensors are not infringing the intellectual property rights of third parties or that our licensors have sufficient rights to the licensed intellectual property in all jurisdictions in which we may sell our products. Some of our agreements with our licensors may be terminated for convenience by them. If we are unable to continue to license any of this technology because of intellectual property infringement claims brought by third parties against our licensors or against us, or if we are unable to continue our license agreements or enter into new licenses on commercially reasonable terms, our ability to develop and sell products and

- 25 -

Table of Contents

services containing that technology would be severely limited, and our business could be harmed. Additionally, if we are unable to license necessary technology from third parties, we may be forced to acquire or develop alternative technology, which we may be unable to do in a commercially feasible manner or at all, and that may require us to use alternative technology of lower quality or performance standards. This would limit and delay our ability to offer new or competitive products and services and increase our costs of production. As a result, our margins, market share, and operating results could be significantly harmed.

Misuse of our products could harm our reputation and divert resources.

Our products may be misused by end-customers or third parties that obtain access to our products. For example, our products could be used to censor private access to certain information on the Internet. Such use of our products for censorship could result in negative press coverage and negatively affect our reputation.

We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets.

Because we incorporate encryption technology into our products, certain of our products are subject to U.S. export controls and may be exported outside the United States only with the required export license or through an export license exception. If we were to fail to comply with U.S. export licensing requirements, U.S. customs regulations, U.S. economic sanctions, or other laws, we could be subject to substantial civil and criminal penalties, including fines, incarceration for responsible employees and managers, and the possible loss of export or import privileges. Obtaining the necessary export license for a particular sale may be time-consuming and may result in the delay or loss of sales opportunities. Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of certain products to U.S. embargoed or sanctioned countries, governments, and persons. Even though we take precautions to ensure that our channel partners comply with all relevant regulations, any failure by our channel partners to comply with such regulations could have negative consequences for us, including reputational harm, government investigations, and penalties.

In addition, various countries regulate the import of certain encryption technology, including through import permit and license requirements, and have enacted laws that could limit our ability to distribute our products or could limit our end-customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products into international markets, prevent our end-customers with international operations from deploying our products globally or, in some cases, prevent or delay the export or import of our products to certain countries, governments, or persons altogether. Any change in export or import regulations, economic sanctions or related legislation, shift in the enforcement or scope of existing regulations, or change in the countries, governments, persons, or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential end-customers with international operations. Any decreased use of our products or limitation on our ability to export to or sell our products in international markets would likely adversely affect our business, financial condition, and operating results.

Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the innovation, creativity, and teamwork fostered by our culture, and our business may be harmed.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, teamwork, passion for customers, and focus on execution, as well as facilitating critical knowledge transfer and knowledge sharing. As we grow and change, we may find it difficult to maintain these important aspects of our corporate culture, which could limit our ability to innovate and operate effectively. Any failure to preserve our culture could also negatively affect our ability to retain and recruit personnel, continue to perform at current levels or execute on our business strategy.

Our financial condition and operating results could suffer if there is an impairment of goodwill or intangible assets. As of July 31, 2015, our goodwill and intangible assets were \$216.2 million, and we have not recorded any goodwill or intangible assets impairments to date. We evaluate our goodwill for impairment on an annual basis in the fourth quarter of our fiscal year, and whenever events or changes in circumstances indicate the carrying amount of goodwill may not be recoverable. Any excess of the goodwill carrying amount over its implied fair value is recognized as an impairment loss. This would result in incremental expense in the period in which the impairment was determined to

have occurred. We cannot accurately predict the amount and timing of an impairment loss and any such impairment would have an adverse effect on our operating results.

Our failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in new products could reduce our ability to compete and could harm our business.

We intend to continue to make investments to support our business growth and may require additional funds to respond to business challenges, including the need to develop new features to enhance our platform, improve our operating infrastructure, or acquire complementary businesses and technologies. Accordingly, we may need to engage in equity or debt financings to secure

- 26 -

Table of Contents

additional funds. If we raise additional equity or equity-linked financing, our stockholders may experience significant dilution of their ownership interests and the market price of our common stock could decline. For example, in June 2014, we issued 0.0% Convertible Senior Notes due 2019 (the “Notes”) and any conversion of some or all of the Notes into common stock will dilute the ownership interests of existing stockholders to the extent we deliver shares upon conversion of any of the Notes. See the risk factor entitled “The issuance of additional stock in connection with financings, acquisitions, investments, our stock incentive plans, the conversion of our Notes, or otherwise will dilute all other stockholders.” Furthermore, if we engage in additional debt financing, the holders of our debt would have priority over the holders of our common stock, and we may be required to accept terms that restrict our ability to incur additional indebtedness. We may also be required to take other actions that would otherwise be in the interests of the debt holders and would require us to maintain specified liquidity or other ratios, any of which could harm our business, operating results, and financial condition. We may not be able to obtain additional financing on terms favorable to us, if at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly impaired, and our business may be adversely affected.

We have a corporate structure aligned with the international nature of our business activities, and if we do not achieve increased tax benefits as a result of our corporate structure, our financial condition and operating results could be adversely affected.

We have reorganized our corporate structure and intercompany relationships to more closely align with the international nature of our business activities. This corporate structure may allow us to reduce our overall effective tax rate through changes in how we use our intellectual property, international procurement, and sales operations. This corporate structure may also allow us to obtain financial and operational efficiencies. These efforts require us to incur expenses in the near term for which we may not realize related benefits. If the structure is not accepted by the applicable taxing authorities, if there are any changes in domestic and international tax laws that negatively impact the structure, including proposed legislation to reform U.S. taxation of international business activities and recent guidance regarding base erosion and profit shifting (“BEPS”) provided by the Organisation for Economic Co-operation and Development, or if we do not operate our business consistent with the structure and applicable tax provisions, we may fail to achieve the reduction in our overall effective tax rate and the other financial and operational efficiencies that we anticipate as a result of the structure and our future financial condition and operating results may be negatively impacted.

We may have exposure to greater than anticipated tax liabilities.

Our income tax obligations are based in part on our corporate structure and intercompany arrangements, including the manner in which we develop, value, and use our intellectual property and the valuations of our intercompany transactions. The tax laws applicable to our business, including the laws of the United States and other jurisdictions, are subject to interpretation and certain jurisdictions may aggressively interpret their laws in an effort to raise additional tax revenue. The taxing authorities of the jurisdictions in which we operate may challenge our methodologies for valuing developed technology or intercompany arrangements, which could increase our worldwide effective tax rate and harm our financial position and operating results. It is possible that tax authorities may disagree with certain positions we have taken and any adverse outcome of such a review or audit could have a negative effect on our financial position and operating results. Further, the determination of our worldwide provision for income taxes and other tax liabilities requires significant judgment by management, and there are transactions where the ultimate tax determination is uncertain. Although we believe that our estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our consolidated financial statements and may materially affect our financial results in the period or periods for which such determination is made.

If our estimates or judgments relating to our critical accounting policies are based on assumptions that change or prove to be incorrect, our operating results could fall below our publicly announced guidance or the expectations of securities analysts and investors, resulting in a decline in the market price of our common stock.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. We base our estimates on historical experience and on various other assumptions

that we believe to be reasonable under the circumstances, as provided in the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in Part II, Item 7 of this Annual Report on Form 10-K, the results of which form the basis for making judgments about the carrying values of assets, liabilities, equity, revenue, and expenses that are not readily apparent from other sources. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below our publicly announced guidance or the expectations of securities analysts and investors, resulting in a decline in the market price of our common stock. Significant assumptions and estimates used in preparing our consolidated financial statements include those related to revenue recognition, share-based compensation, contract manufacturing liabilities, warranties, loss contingencies, income taxes, and, with respect to

- 27 -

Table of Contents

business combinations, determining purchase price allocation and estimating the fair value of assets acquired and liabilities assumed.

Failure to comply with governmental laws and regulations could harm our business.

Our business is subject to regulation by various federal, state, local, and foreign governmental agencies, including agencies responsible for monitoring and enforcing employment and labor laws, workplace safety, product safety, environmental laws, consumer protection laws, anti-bribery laws, import/export controls, federal securities laws, and tax laws and regulations. In certain jurisdictions, these regulatory requirements may be more stringent than those in the United States. Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation resulting from any alleged noncompliance, our business, operating results, and financial condition could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management's attention and resources and an increase in professional fees. Enforcement actions, litigation, and sanctions could harm our business, operating results, and financial condition.

If we fail to comply with environmental requirements, our business, financial condition, operating results, and reputation could be adversely affected.

We are subject to various environmental laws and regulations including laws governing the hazardous material content of our products and laws relating to the collection of and recycling of electrical and electronic equipment. Examples of these laws and regulations include the European Union (EU) Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS) and the EU Waste Electrical and Electronic Equipment Directive (WEEE Directive), as well as the implementing legislation of the EU member states. Similar laws and regulations have been passed or are pending in China, South Korea, Norway, and Japan and may be enacted in other regions, including in the United States, and we are, or may in the future be, subject to these laws and regulations.

The EU RoHS and the similar laws of other jurisdictions limit the content of certain hazardous materials such as lead, mercury, and cadmium in the manufacture of electrical equipment, including our products. Currently, our products comply with the EU RoHS requirements. However, if there are changes to this or other laws (or their interpretation) or if new similar laws are passed in other jurisdictions, we may be required to reengineer our products to use components compatible with these regulations. This reengineering and component substitution could result in additional costs to us or disrupt our operations or logistics.

The WEEE Directive requires electronic goods producers to be responsible for the collection, recycling, and treatment of such products. Changes in interpretation of the directive may cause us to incur costs or have additional regulatory requirements to meet in the future in order to comply with this directive, or with any similar laws adopted in other jurisdictions.

We are also subject to environmental laws and regulations governing the management of hazardous materials, which we use in small quantities in our engineering labs. Our failure to comply with past, present, and future similar laws could result in reduced sales of our products, substantial product inventory write-offs, reputational damage, penalties, and other sanctions, any of which could harm our business and financial condition. We also expect that our products will be affected by new environmental laws and regulations on an ongoing basis. To date, our expenditures for environmental compliance have not had a material impact on our operating results or cash flows, and although we cannot predict the future impact of such laws or regulations, they will likely result in additional costs and may increase penalties associated with violations or require us to change the content of our products or how they are manufactured, which could have a material adverse effect on our business, operating results, and financial condition. We are exposed to fluctuations in currency exchange rates, which could negatively affect our financial condition and operating results.

Our sales contracts are primarily denominated in U.S. dollars, and therefore, substantially all of our revenue is not subject to foreign currency risk. However, strengthening of the U.S. dollar increases the real cost of our products to our end-customers outside of the United States, leading to delays in the purchase of our products and the lengthening of our sales cycle. If the U.S. dollar continues to strengthen, this could adversely affect our financial condition and

operating results. In addition, increased international sales in the future, including through our channel partners and other partnerships, may result in greater foreign currency denominated sales, increasing our foreign currency risk. Moreover, operating expenses incurred outside the United States and denominated in foreign currencies are increasing and are subject to fluctuations due to changes in foreign currency exchange rates. If we are not able to successfully hedge against the risks associated with currency fluctuations, our financial condition and operating results could be adversely affected. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedging transactions may be limited and we may not be able to successfully hedge our exposure, which could adversely affect our financial condition and operating results.

- 28 -

Table of Contents

Our business is subject to the risks of earthquakes, fire, power outages, floods, and other catastrophic events, and to interruption by man-made problems such as terrorism.

A significant natural disaster, such as an earthquake, fire, flood, or significant power outage could have a material adverse impact on our business, operating results, and financial condition. Both our corporate headquarters and the location where our products are manufactured are located in the San Francisco Bay Area, a region known for seismic activity. In addition, natural disasters could affect our supply chain, manufacturing vendors, or logistics providers' ability to provide materials and perform services such as manufacturing products or assisting with shipments on a timely basis. In the event our or our service providers' information technology systems or manufacturing or logistics abilities are hindered by any of the events discussed above, shipments could be delayed, resulting in missed financial targets, such as revenue and shipment targets, for a particular quarter. In addition, acts of terrorism and other geo-political unrest could cause disruptions in our business or the business of our supply chain, manufacturers, logistics providers, channel partners, or end-customers or the economy as a whole. Any disruption in the business of our supply chain, manufacturers, logistics providers, channel partners, or end-customers that impacts sales at the end of a fiscal quarter could have a significant adverse impact on our future quarterly results. All of the aforementioned risks may be further increased if the disaster recovery plans for us and our suppliers prove to be inadequate. To the extent that any of the above should result in delays or cancellations of customer orders, or the delay in the manufacture, deployment, or shipment of our products, our business, financial condition, and operating results would be adversely affected.

Risks Related to Our Notes

We may not have the ability to raise the funds necessary to settle conversions of the Notes or to repurchase the Notes upon a fundamental change, and our future debt may contain limitations on our ability to pay cash upon conversion or repurchase of the Notes.

Holders of the Notes will have the right to require us to repurchase all or a portion of their Notes upon the occurrence of a fundamental change at a repurchase price equal to 100% of the principal amount of the Notes to be repurchased, plus accrued and unpaid special interest, if any, to, but excluding, the fundamental change repurchase date. In addition, upon conversion of the Notes, we will be required to make cash payments for each \$1,000 in principal amount of Notes converted of at least the lesser of \$1,000 and the sum of the daily conversion values. However, we may not have enough available cash or be able to obtain financing at the time we are required to make repurchases of Notes surrendered therefor or pay cash with respect to Notes being converted.

In addition, our ability to repurchase or to pay cash upon conversion of the Notes may be limited by law, regulatory authority or agreements governing our future indebtedness. Our failure to repurchase the Notes at a time when the repurchase is required by the indenture governing the Notes or to pay cash upon conversion of the Notes as required by the indenture would constitute a default under the indenture. A default under the indenture or the fundamental change itself could also lead to a default under agreements governing our future indebtedness. If the payment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness and repurchase the Notes or to pay cash upon conversion of the Notes.

We may still incur substantially more debt or take other actions which would diminish our ability to make payments on the Notes when due.

We and our subsidiaries may be able to incur substantial additional debt in the future, subject to the restrictions contained in our debt instruments, some of which may be secured debt. We are not restricted under the terms of the indenture governing the Notes from incurring additional debt, securing existing or future debt, recapitalizing our debt or taking a number of other actions that are not limited by the terms of the indenture governing the Notes that could have the effect of diminishing our ability to make payments on the Notes when due. While the terms of any future indebtedness we may incur could restrict our ability to incur additional indebtedness, any such restrictions will indirectly benefit holders of the Notes only to the extent any such indebtedness or credit facility is not repaid or does not mature while the Notes are outstanding.

The accounting method for convertible debt securities that may be settled in cash, such as the Notes, could have a material effect on our reported financial results.

Under GAAP, we must separately account for the liability and equity components of convertible debt instruments (such as the Notes) that may be settled entirely or partially in cash upon conversion in a manner that reflects our economic interest cost. GAAP further requires the equity component of the Notes to be included in the additional paid-in capital section of stockholders' equity on our consolidated balance sheet, and the value of the equity component is treated as a debt discount for purposes of accounting for the debt component of the Notes. As a result, we are required to record non-cash interest expense in current and future periods as a result of the amortization of the discounted carrying value of the Notes to their face amount over the term of the Notes.

- 29 -

Table of Contents

In addition, under certain circumstances, convertible debt instruments (such as the Notes) that may be settled entirely or partly in cash are currently accounted for utilizing the treasury stock method, the effect of which is that the shares issuable upon conversion of the Notes are not included in the calculation of diluted earnings per share except to the extent that the conversion value of the Notes exceeds their principal amount. Under the treasury stock method, for diluted earnings per share purposes, the transaction is accounted for as if the number of shares of common stock that would be necessary to settle such excess, if we elected to settle such excess in shares, are issued. We cannot be sure that the accounting standards in the future will continue to permit the use of the treasury stock method. If we are unable to use the treasury stock method in accounting for the shares issuable upon conversion of the Notes, then our diluted earnings per share would be adversely affected.

Risks Related to Ownership of Our Common Stock

Our actual operating results may differ significantly from our guidance.

From time to time, we have released, and may continue to release, guidance in our quarterly earnings releases, quarterly earnings conference call, or otherwise, regarding our future performance that represents our management's estimates as of the date of release. This guidance, which includes forward-looking statements, has been and will be based on projections prepared by our management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party compiles or examines the projections. Accordingly, no such person expresses any opinion or any other form of assurance with respect to the projections.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We intend to state possible outcomes as high and low ranges which are intended to provide a sensitivity analysis as variables are changed but are not intended to imply that actual results could not fall outside of the suggested ranges. The principal reason that we release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such persons.

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results will vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon our guidance in making an investment decision regarding our common stock.

Any failure to successfully implement our operating strategy or the occurrence of any of the events or circumstances set forth in this "Risk Factors" section in this Annual Report on Form 10-K could result in the actual operating results being different from our guidance, and the differences may be adverse and material.

The market price of our common stock historically has been volatile and the value of your investment could decline. The market price of our common stock has been volatile since our initial public offering (IPO). Since shares of our common stock were sold in our IPO in July 2012 at a price of \$42.00 per share, the reported high and low sales prices of our common stock has ranged from \$200.55 to \$39.08, through September 1, 2015. The market price of our common stock may fluctuate widely in response to various factors, some of which are beyond our control. These factors include:

- announcements of new products, services or technologies, commercial relationships, acquisitions or other events by us or our competitors;
- price and volume fluctuations in the overall stock market from time to time;
- news announcements that affect investor perception of our industry, including reports related to the discovery of significant cyber attacks;
- significant volatility in the market price and trading volume of technology companies in general and of companies in our industry;
- fluctuations in the trading volume of our shares or the size of our public float;
- actual or anticipated changes in our operating results or fluctuations in our operating results;

• whether our operating results meet the expectations of securities analysts or investors;
• actual or anticipated changes in the expectations of securities analysts or investors;
• litigation involving us, our industry, or both;

- 30 -

Table of Contents

- regulatory developments in the United States, foreign countries or both;
- major catastrophic events;
- sales of large blocks of our stock;
- departures of key personnel; or
- economic uncertainty around the world, in particular, macroeconomic challenges in Europe.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the market price of our common stock could decline for reasons unrelated to our business, operating results, or financial condition. The market price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. The market price of our common stock could also be affected by possible sales of our common stock by investors who view the Notes as a more attractive means of equity participation in us and by hedging or arbitrage trading activity that we expect to develop involving our common stock as a result of the existence of the Notes. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been brought against that company. Securities litigation could result in substantial costs and divert our management's attention and resources from our business. This could have a material adverse effect on our business, operating results, and financial condition.

The convertible note hedge and warrant transactions may affect the value of our common stock.

In connection with the sale of the Notes, we entered into convertible note hedge transactions with certain counterparties. We also entered into warrant transactions with the counterparties pursuant to which we sold warrants for the purchase of our common stock. The convertible note hedge transactions are expected generally to reduce the potential dilution to our common stock upon any conversion of Notes and/or offset any cash payments we are required to make in excess of the principal amount of any converted Notes, as the case may be. The warrants could separately have a dilutive effect to the extent that the market price per share of our common stock exceeds the strike price of the warrants unless, subject to certain conditions, we elect to cash settle the warrants.

The counterparties or their respective affiliates may modify their hedge positions by entering into or unwinding various derivatives with respect to our common stock and/or purchasing or selling our common stock or other securities of ours in secondary market transactions prior to the maturity of the Notes (and are likely to do so during any observation period related to a conversion of Notes). This activity could also cause or avoid an increase or a decrease in the market price of our common stock or the Notes, which could affect a Note holder's ability to convert the Notes and, to the extent the activity occurs during any observation period related to a conversion of Notes, it could affect the amount and value of the consideration that such Note holder will receive upon conversion of the Notes.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the price of the Notes or our common stock. In addition, we do not make any representation that the counterparties or their respective affiliates will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

Substantial future sales of shares of our common stock could cause the market price of our common stock to decline. The market price of our common stock could decline as a result of substantial sales of our common stock, particularly sales by our directors, executive officers, employees and significant stockholders, a large number of shares of our common stock becoming available for sale, or the perception in the market that holders of a large number of shares intend to sell their shares. As of July 31, 2015, we had approximately 84.8 million shares of our common stock outstanding.

We have also registered shares of our common stock that we may issue under our employee equity incentive plans. These shares will be able to be sold freely in the public market upon issuance.

The issuance of additional stock in connection with financings, acquisitions, investments, our stock incentive plans, the conversion of our Notes, or otherwise will dilute all other stockholders.

Our amended and restated certificate of incorporation authorizes us to issue up to 1,000,000,000 shares of common stock and up to 100,000,000 shares of preferred stock with such rights and preferences as may be determined by our board of directors. Subject to compliance with applicable rules and regulations, we may issue shares of common stock or securities convertible into shares of our common stock from time to time in connection with a financing,

acquisition, investment, our stock incentive plans, the conversion of our Notes, or otherwise. Any such issuance could result in substantial dilution to our existing stockholders and cause the market price of our common stock to decline.

- 31 -

Table of Contents

We do not intend to pay dividends for the foreseeable future.

We have never declared or paid any dividends on our common stock. We intend to retain any earnings to finance the operation and expansion of our business, and we do not anticipate paying any cash dividends in the future. As a result, you may only receive a return on your investment in our common stock if the market price of our common stock increases.

The requirements of being a public company may strain our resources, divert management's attention, and affect our ability to attract and retain qualified board members.

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the listing requirements of the New York Stock Exchange (NYSE), and other applicable securities rules and regulations. Compliance with these rules and regulations have increased our legal and financial compliance costs, made some activities more difficult, time-consuming or costly, and increased demand on our systems and resources. Among other things, the Exchange Act requires that we file annual, quarterly, and current reports with respect to our business and operating results and maintain effective disclosure controls and procedures and internal control over financial reporting. In order to maintain and, if required, improve our disclosure controls and procedures and internal control over financial reporting to meet this standard, significant resources and management oversight may be required. As a result, management's attention may be diverted from other business concerns, which could harm our business and operating results. Although we have already hired additional employees to comply with these requirements, we may need to hire even more employees in the future, which will increase our costs and expenses.

We are also subject to the independent auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act ("Section 404"), enhanced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, and the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved. While we were able to determine in our management's report for fiscal 2015 that our internal control over financial reporting is effective, as well as provide an unqualified attestation report from our independent registered public accounting firm to that effect, we have and will continue to consume management resources and incur significant expenses for Section 404 compliance on an ongoing basis. In the event that our chief executive officer, chief financial officer, or independent registered public accounting firm determines in the future that our internal control over financial reporting is not effective as defined under Section 404, we could be subject to one or more investigations or enforcement actions by state or federal regulatory agencies, stockholder lawsuits or other adverse actions requiring us to incur defense costs, pay fines, settlements or judgments and causing investor perceptions to be adversely affected and potentially resulting in a decline in the market price of our stock.

In addition, changing laws, regulations, and standards related to corporate governance and public disclosure, such as continued rulemaking pursuant to the Dodd-Frank Act of 2010 and related rules and regulations regarding the disclosure of conflict minerals that are mandated by the Dodd-Frank Act, are creating uncertainty for public companies, increasing legal and financial compliance costs, and making some activities more time-consuming. These laws, regulations, and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We intend to invest resources to comply with evolving laws, regulations, and standards, and this investment may result in increased general and administrative expense and a diversion of management's time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new laws, regulations, and standards differ from the activities intended by regulatory or governing bodies, regulatory authorities may initiate legal proceedings against us and our business may be harmed.

We also expect that being a public company and these new rules and regulations will make it more expensive for us to obtain and maintain director and officer liability insurance, and in the future, we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These factors could also make it more difficult for us to attract and retain qualified members of our board of directors, particularly to serve on our Audit Committee and

Compensation Committee, and qualified executive officers.

We are obligated to maintain proper and effective internal control over financial reporting. We may not complete our analysis of our internal control over financial reporting in a timely manner, or this internal control may not be determined to be effective, which may adversely affect investor confidence in our company and, as a result, the value of our common stock.

We are required, pursuant to the Exchange Act, to furnish a report by management on, among other things, the effectiveness of our internal control over financial reporting. This assessment will need to include disclosure of any material weaknesses identified by our management in our internal control over financial reporting, as well as a statement that our auditors have issued an attestation report on our internal controls.

While we were able to determine in our management's report for fiscal 2015 that our internal control over financial reporting is effective, as well as provide an unqualified attestation report from our independent registered public accounting firm to

- 32 -

Table of Contents

that effect, we may not be able to complete our evaluation, testing, and any required remediation in a timely fashion or our independent registered public accounting firm may not be able to formally attest to the effectiveness of our internal control over financial reporting in the future. During the evaluation and testing process, if we identify one or more material weaknesses in our internal control over financial reporting that we are unable to remediate before the end of the same fiscal year in which the material weakness is identified, we will be unable to assert that our internal controls are effective. If we are unable to assert that our internal control over financial reporting is effective, or if our independent registered public accounting firm is unable to attest to the effectiveness of our internal controls or determine we have a material weakness in our internal controls, we could lose investor confidence in the accuracy and completeness of our financial reports, which would cause the price of our common stock to decline.

If securities or industry analysts do not publish research or reports about our business, or publish inaccurate or unfavorable research reports about our business, our share price and trading volume could decline.

The trading market for our common stock, to some extent, depends on the research and reports that securities or industry analysts publish about us or our business. We do not have any control over these analysts. If one or more of the analysts who cover us should downgrade our shares or change their opinion of our shares, industry sector, or products, our share price would likely decline. If one or more of these analysts should cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which could cause our share price or trading volume to decline.

Our charter documents and Delaware law, as well as certain provisions of our Notes, could discourage takeover attempts and lead to management entrenchment, which could also reduce the market price of our common stock.

Our amended and restated certificate of incorporation and amended and restated bylaws contain provisions that could delay or prevent a change in control of our company. These provisions could also make it difficult for stockholders to elect directors that are not nominated by the current members of our board of directors or take other corporate actions, including effecting changes in our management. These provisions include:

- a classified board of directors with three-year staggered terms, which could delay the ability of stockholders to change the membership of a majority of our board of directors;

- the ability of our board of directors to issue shares of preferred stock and to determine the price and other terms of those shares, including preferences and voting rights, without stockholder approval, which could be used to significantly dilute the ownership of a hostile acquiror;

- the exclusive right of our board of directors to elect a director to fill a vacancy created by the expansion of our board of directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors;

- a prohibition on stockholder action by written consent, which forces stockholder action to be taken at an annual or special meeting of our stockholders;

- the requirement that a special meeting of stockholders may be called only by the chairman of our board of directors, our president, our secretary, or a majority vote of our board of directors, which could delay the ability of our stockholders to force consideration of a proposal or to take action, including the removal of directors;

- the requirement for the affirmative vote of holders of at least 66 2/3% of the voting power of all of the then outstanding shares of the voting stock, voting together as a single class, to amend the provisions of our amended and restated certificate of incorporation relating to the issuance of preferred stock and management of our business or our amended and restated bylaws, which may inhibit the ability of an acquiror to effect such amendments to facilitate an unsolicited takeover attempt;

- the ability of our board of directors, by majority vote, to amend the bylaws, which may allow our board of directors to take additional actions to prevent an unsolicited takeover and inhibit the ability of an acquiror to amend the bylaws to facilitate an unsolicited takeover attempt; and

- advance notice procedures with which stockholders must comply to nominate candidates to our board of directors or to propose matters to be acted upon at a stockholders' meeting, which may discourage or deter a potential acquiror from conducting a solicitation of proxies to elect the acquiror's own slate of directors or otherwise attempting to obtain control of us.

In addition, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us for a certain period of time. Additionally, certain provisions of our Notes could make it more difficult or more expensive for a third party to acquire us. The application of Section 203 or certain provisions of our Notes also could have

- 33 -

Table of Contents

the effect of delaying or preventing a change in control of us. Any of these provisions could, under certain circumstances, depress the market price of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our corporate headquarters is located in Santa Clara, California where we currently lease approximately 300,000 square feet of space under a lease agreement that expires in July 2023, with two separate five-year options to extend the lease term. We also lease space for operations and sales personnel in locations throughout the United States and various international locations, including the Netherlands, Singapore, Israel, the United Kingdom, Japan, Australia, and France.

In May 2015, we entered into three lease agreements for an aggregate of approximately 752,000 square feet of space in Santa Clara, California to serve as our future corporate headquarters. The property is currently under construction. In August 2015, we executed an expansion notice under one of these lease agreements. Refer to Note 8. Commitments and Contingencies of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information.

We believe that our current facilities are adequate to meet our current needs. We intend to expand our facilities or add new facilities as we add employees and enter new geographic markets, and we believe that suitable additional or alternative space will be available as needed to accommodate ongoing operations and any such growth. However, we expect to incur additional expenses in connection with such new or expanded facilities.

ITEM 3. LEGAL PROCEEDINGS

The information set forth under the "Litigation" subheading in Note 8. Commitments and Contingencies of Notes to Consolidated Financial Statements in Part II, Item 8 of this Annual Report on Form 10-K is incorporated herein by reference.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

Table of Contents

PART II

ITEM MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND
5. ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock, \$0.0001 par value per share, began trading on the New York Stock Exchange (NYSE) on July 20, 2012, where its prices are quoted under the symbol "PANW."

Holders of Record

As of September 1, 2015, there were 87 holders of record of our common stock. Because many of our shares of common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Price Range of Our Common Stock

The following table sets forth the reported high and low sales prices of our common stock for the periods indicated, as regularly quoted on the NYSE:

	High	Low
Year Ended July 31, 2014		
First Quarter	\$50.50	\$42.04
Second Quarter	\$64.92	\$40.36
Third Quarter	\$80.84	\$57.02
Fourth Quarter	\$85.78	\$57.47
Year Ended July 31, 2015		
First Quarter	\$108.50	\$76.86
Second Quarter	\$130.00	\$102.02
Third Quarter	\$158.24	\$121.31
Fourth Quarter	\$200.55	\$144.42

Dividend Policy

We have never declared or paid, and do not anticipate declaring or paying in the foreseeable future, any cash dividends on our capital stock. Any future determination as to the declaration and payment of dividends, if any, will be at the discretion of our board of directors, subject to applicable laws and will depend on then existing conditions, including our financial condition, operating results, contractual restrictions, capital requirements, business prospects, and other factors our board of directors may deem relevant.

Securities Authorized for Issuance under Equity Compensation Plans

See Part III, Item 12 "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" of this Annual Report on Form 10-K for more information regarding securities authorized for issuance.

Recent Sale of Unregistered Securities

There were no sales of unregistered securities during fiscal 2015 other than those transactions previously reported to the SEC on our Current Reports on Form 8-K.

Stock Price Performance Graph

This performance graph shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), or incorporated by reference into any filing of Palo Alto Networks, Inc. under the Securities Act of 1933, as amended, or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

This performance graph compares the cumulative total return on our common stock with that of the NYSE Composite Index and the NYSE Arca Tech 100 Index. This performance graph assumes \$100 was invested on July 20, 2012, the date our common stock commenced trading on the NYSE, in each of the common stock of Palo Alto Networks, Inc., the NYSE Composite Index,

Table of Contents

and the NYSE Arca Tech 100 Index, and assumes the reinvestment of any dividends. The stock price performance on this performance graph is not necessarily indicative of future stock price performance.

Company/Index	7/20/2012	7/31/2012	7/31/2013	7/31/2014	7/31/2015
Palo Alto Networks, Inc.	\$100.00	\$107.55	\$92.11	\$152.19	\$349.76
NYSE Composite Index	\$100.00	\$101.34	\$123.19	\$138.23	\$140.24
NYSE Arca Tech 100 Index	\$100.00	\$101.35	\$127.39	\$154.80	\$171.76

- 36 -

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA

The selected consolidated statement of operations data for fiscal 2015, 2014, and 2013 and the consolidated balance sheet data as of July 31, 2015 and 2014 are derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The selected consolidated statement of operations data for fiscal 2012 and 2011 and the consolidated balance sheet data as of July 31, 2013, 2012, and 2011 are derived from audited financial statements not included in this Annual Report on Form 10-K. Our historical results are not necessarily indicative of the results that may be expected in the future. The selected consolidated financial data below should be read in conjunction with the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Part II, Item 7 of this Annual Report on Form 10-K and our consolidated financial statements and related notes included in Part II, Item 8 of this Annual Report on Form 10-K.

	Year Ended July 31,				
	2015	2014	2013	2012	2011
	(in thousands)				
Selected Consolidated Statements of Operations Data:					
Revenue:					
Product	\$492,658	\$340,143	\$243,707	\$174,462	\$84,800
Services	435,394	258,036	152,400	80,676	33,797
Total revenue	928,052	598,179	396,107	255,138	118,597
Cost of revenue:					
Product ⁽¹⁾	131,094	85,503	63,412	44,615	21,766
Services ⁽¹⁾	120,405	74,125	46,344	25,938	10,507
Total cost of revenue	251,499	159,628	109,756	70,553	32,273
Total gross profit	676,553	438,551	286,351	184,585	86,324
Operating expenses:					
Research and development ⁽¹⁾	185,828	104,813	62,482	38,570	21,366
Sales and marketing ⁽¹⁾	522,696	334,763	199,771	115,917	62,254
General and administrative ⁽¹⁾	101,565	73,149	42,719	26,207	13,108
Legal settlement	—	141,173	—	—	—
Total operating expenses	810,089	653,898	304,972	180,694	96,728
Operating income (loss)	(133,536)	(215,347)	(18,621)	3,891	(10,404)
Interest expense	(22,325)	(1,883)	(74)	(36)	(25)
Other income (expense), net	284	(4,930)	39	(1,056)	(1,623)
Income (loss) before income taxes	(155,577)	(222,160)	(18,656)	2,799	(12,052)
Provision for income taxes	9,405	4,292	10,590	2,062	476
Net income (loss)	\$(164,982)	\$(226,452)	\$(29,246)	\$737	\$(12,528)
Net income (loss) attributable to common stockholders, basic and diluted	\$(164,982)	\$(226,452)	\$(29,246)	\$—	\$(12,528)
Net income (loss) per share attributable to common stockholders, basic and diluted	\$(2.02)	\$(3.05)	\$(0.43)	\$0.00	\$(0.88)
Weighted-average shares used to compute net income (loss) per share attributable to common stockholders, basic and diluted	81,619	74,291	68,682	19,569	14,201

(1) Includes share-based compensation expense as follows:

Table of Contents

	Year Ended July 31,				
	2015	2014	2013	2012	2011
	(in thousands)				
Cost of product revenue	\$3,858	\$1,636	\$765	\$121	\$27
Cost of services revenue	20,425	9,434	3,586	653	179
Research and development	74,837	29,524	9,931	3,733	1,020
Sales and marketing	84,113	42,647	20,493	4,267	1,133
General and administrative	38,198	16,668	9,101	5,151	2,374
Total share-based compensation	\$221,431	\$99,909	\$43,876	\$13,925	\$4,733
	July 31,				
	2015	2014	2013	2012	2011
	(in thousands)				
Selected Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$375,814	\$653,812	\$310,614	\$322,642	\$40,517
Investments	952,006	320,570	126,321	—	—
Working capital	41,803	610,155	323,597	259,651	9,739
Total assets	1,965,178	1,478,466	585,606	407,804	91,172
Convertible senior notes, net	—	466,875	—	—	—
Preferred stock warrant liability	—	—	—	—	2,068
Redeemable convertible preferred stock	—	—	—	—	64,491
Common stock including additional paid-in capital	988,695	804,414	381,710	309,099	9,311
Total stockholders' equity (deficit)	\$487,899	\$468,583	\$272,420	\$229,071	\$(71,454)

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes appearing elsewhere in this Annual Report on Form 10-K. The following discussion and analysis contains forward-looking statements based on current expectations and assumptions that are subject to risks and uncertainties, which could cause our actual results to differ materially from those anticipated or implied by any forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Annual Report on Form 10-K, and in particular, the risks discussed under the caption "Risk Factors" in Part I, Item 1A of this report.

Our Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is organized as follows:

Overview. A discussion of our business and overall analysis of financial and other highlights in order to provide context for the remainder of MD&A.

Key Financial Metrics. A summary of our GAAP and non-GAAP key financial metrics, which management monitors to evaluate our performance.

Results of Operations. A discussion of the nature and trends of the components of our financial results and an analysis of our financial results comparing fiscal 2015 to 2014 and fiscal 2014 to 2013.

Liquidity and Capital Resources. An analysis of changes in our balance sheets and cash flows, and a discussion of our financial condition and our ability to meet cash needs.

Contractual Obligations and Commitments. An overview of our contractual obligations, contingent liabilities, commitments, and off-balance sheet arrangements outstanding as of July 31, 2015, including expected payment schedule.

Critical Accounting Policies and Estimates. A discussion of accounting policies that require critical estimates, assumptions, and judgments.

- Recent Accounting Pronouncements. A discussion of expected impacts of impending accounting changes on financial information to be reported in the future.

- 38 -

Table of Contents

Overview

We have pioneered the next-generation of security with our innovative platform that empowers enterprises, service providers, and government entities to secure their organizations by safely enabling the increasingly complex and rapidly growing number of applications running on their networks and by preventing breaches in real-time that stem from targeted cyber attacks. Our platform uses an innovative traffic classification engine that identifies network traffic by application, user, and content. As a result, it provides in-depth visibility into all traffic and all applications, at the user level, at all times, and at the full speed of the network in order to control usage, content, risks, and cyber threats. Our security platform consists of three major elements: our Next-Generation Firewall, our Advanced Endpoint Protection, and our Threat Intelligence Cloud. Our Next-Generation Firewall delivers application, user, and content visibility and control as well as protection against network-based cyber threats integrated within the firewall through our proprietary hardware and software architecture. Our Advanced Endpoint Protection prevents cyber attacks that aim to exploit software vulnerabilities on a broad variety of fixed and virtual endpoints and servers. Our Threat Intelligence Cloud provides central intelligence capabilities, security for SaaS applications, and automated delivery of preventative measures against cyber attacks.

The network-based element of our platform is delivered in the form of a physical or virtual appliance and includes a suite of subscription services. The cyber attack prevention capabilities of our platform are delivered in the form of subscription services that can be used either in the public cloud or in a private cloud using a dedicated appliance. Our subscription services can be easily activated on any of our appliances without requiring additional hardware or processing resources, thereby providing a seamless implementation path for our end-customers.

For fiscal 2015, 2014, and 2013, revenues were \$928.1 million, \$598.2 million, and \$396.1 million, respectively, representing year over year growth of 55.1% for fiscal 2015 and 51.0% for fiscal 2014. All three components of our hybrid SaaS revenue model experienced year over year growth, led by revenue from subscription services, which grew 72.6% to \$212.7 million, followed by support and maintenance services, which grew 65.2% to \$222.7 million, and product, which grew 44.8% to \$492.7 million.

Our growth reflects the rapid adoption of our hybrid SaaS revenue model, which consists of product, subscriptions, and support and maintenance. We believe this model will enable us to benefit from recurring revenues as we continue to grow our installed end-customer base. Our growth was also driven by increased security spending by customers, as security continues to be a critical business imperative for every business in the world. As of July 31, 2015, we had sold our products and services to more than 26,000 end-customers in over 140 countries. Our end-customers represent a broad range of industries including education, energy, financial services, government entities, healthcare, Internet and media, manufacturing, public sector, and telecommunications, and include some of the largest Fortune 100 and Global 2000 companies in the world.

Product revenue is generated from sales of our appliances, primarily our Next-Generation Firewall, which is available in physical and virtualized form. Our Next-Generation Firewall incorporates our proprietary PAN-OS operating system, which provides a consistent set of capabilities across our entire product line. Our products are designed for different performance requirements throughout an organization, ranging from the PA-200, which is designed for enterprise remote offices, to the PA-7080, which is especially suited for service provider customers. The same firewall functionality that is delivered in our physical appliances is also available in our VM-Series virtual firewalls, which secure virtualized and cloud-based computing environments.

Services revenue is generated from sales of subscriptions and support and maintenance, which together provide us with a source of recurring services revenue. Our subscriptions provide our end-customers with real-time access to the latest antivirus, intrusion prevention, web filtering, and modern malware prevention capabilities across fixed and mobile devices.

We maintain a field sales force that works closely with our channel partners in developing sales opportunities. We use a two-tier, indirect fulfillment model whereby we sell our products and services to our global distributor channel partners, which, in turn, sell our products and services to our reseller network, which then sell to our end-customers. We leverage our appliances to sell SaaS subscription services to meet our customers' evolving security requirements. When end-customers purchase an appliance, they typically purchase one or more of our subscriptions for additional functionality, as well as support and maintenance in order to receive ongoing security updates,

upgrades, bug fixes, and repairs.

We continue to invest in innovation and strengthening our product portfolio, which resulted in several new product offerings and announcements during fiscal 2015. These new product offerings include: Traps, our Advanced Endpoint Protection service; the PA-3060 appliance, which is aimed at mid-sized datacenters; the M-500 management appliance, which is aimed at data centers and large enterprise deployments; and the AutoFocus cyber threat intelligence service, which provides prioritized actionable intelligence on targeted cyber attacks and is expected to be generally available in fiscal 2016. In August 2015, we announced the launch of the PA-7080 appliance, which is our top-of-the-line chassis-based appliance ideally suited for service provider customers. Additionally, in May 2015, we acquired CirroSecure, which expands the functionality of our platform by providing additional security for SaaS applications. The CirroSecure technology will be the foundation for a new subscription service called Aperture, which we expect to launch in fiscal 2016.

- 39 -

Table of Contents

We believe that the growth of our business and our short-term and long-term success are dependent upon many factors, including our ability to extend our technology leadership, grow our base of end-customers, expand deployment of our platform and services within existing end-customers, extend the length of service terms within existing end-customers, and focus on end-customer satisfaction. While these areas present significant opportunities for us, they also pose challenges and risks that we must successfully address in order to sustain the growth of our business and improve our operating results.

To manage any future growth effectively, we must continue to improve and expand our information technology and financial infrastructure, our operating and administrative systems and controls, and our ability to manage headcount, capital, and processes in an efficient manner. Additionally, we face intense competition in our market, and to succeed, we need to innovate and offer products that are differentiated from existing infrastructure products, as well as effectively hire, retain, train, and motivate qualified personnel and senior management. If we are unable to successfully address these challenges, our business, operating results, and prospects could be adversely affected.

Key Financial Metrics

We monitor the key financial metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts, and assess operational efficiencies. We discuss revenue, gross margin, and the components of operating loss and margin below under “—Financial Overview” and “—Results of Operations.” The following tables summarize deferred revenue, cash flow provided by operating activities, free cash flow (non-GAAP), and billings (non-GAAP).

	July 31,		
	2015		2014
	(in thousands)		
Total deferred revenue	\$713,654		\$422,578
Cash, cash equivalents, and investments	\$1,327,820		\$974,382
	Year Ended July 31,		
	2015	2014	2013
	(dollars in thousands)		
Total revenue	\$928,052	\$598,179	\$396,107
Year over year percentage increase	55.1	% 51.0	% 55.3
Gross margin percentage	72.9	% 73.3	% 72.3
Operating loss	\$(133,536)	) \$(215,347)	) \$(18,621)
Operating margin percentage	(14.4	)% (36.0	)% (4.7
Billings (non-GAAP)	\$1,219,128	\$771,375	\$509,529
Cash flow provided by operating activities	\$350,304	\$88,406	\$114,519
Free cash flow (non-GAAP)	\$316,476	\$52,299	\$92,077

Deferred Revenue. Our deferred revenue consists of amounts that have been invoiced, but have not been recognized as revenue as of the period end. The majority of our deferred revenue balance consists of subscription and support and maintenance revenue that is recognized ratably over the contractual service period. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods.

Cash Flow Provided by Operating Activities. We monitor cash flow provided by operating activities as a measure of our overall business performance. Our cash flow provided by operating activities is driven in large part by sales of our products and from up-front payments for both subscriptions and support and maintenance services. Monitoring cash flow provided by operating activities enables us to analyze our financial performance without the non-cash effects of certain items such as depreciation, amortization, and share-based compensation costs, thereby allowing us to better understand and manage the cash needs of our business.

Free Cash Flow (non-GAAP). We define free cash flow, a non-GAAP financial measure, as cash provided by operating activities less purchases of property, equipment, and other assets. We consider free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after the purchases of property, equipment, and other productive assets, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, and strengthening the balance sheet.

Table of Contents

A limitation of the utility of free cash flow as a measure of our financial performance and liquidity is that it does not represent the total increase or decrease in our cash balance for the period. In addition, it is important to note that other companies, including companies in our industry, may not use free cash flow, may calculate free cash flow in a different manner than we do, or may use other financial measures to evaluate their performance, all of which could reduce the usefulness of free cash flow as a comparative measure. A reconciliation of free cash flow to cash flow provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

	Year Ended July 31,		
	2015	2014	2013
	(in thousands)		
Free cash flow (non-GAAP):			
Cash flow provided by operating activities	\$350,304	\$88,406	\$114,519
Less: purchases of property, equipment, and other assets	33,828	36,107	22,442
Free cash flow (non-GAAP) ⁽¹⁾	\$316,476	\$52,299	\$92,077
Net cash used in investing activities	\$(679,006)	\$(320,348)	\$(151,565)
Net cash provided by financing activities	\$50,704	\$575,140	\$25,018

(1) Includes our cash payments of \$75.0 million and \$20.0 million in fiscal 2014 for the legal settlement with Juniper and the Mutual Covenant Not to Sue and Release Agreement with Fortinet, respectively.

Billings (non-GAAP). We define billings, a non-GAAP financial measure, as total revenue plus the change in deferred revenue, net of acquired deferred revenue, during the period. Billings is a key measure used by our management to manage our business because billings drive deferred revenue, which is an important indicator of the health and visibility of our business. We consider billings to be a useful metric for management and investors, particularly as we experience increased sales of subscriptions and strong renewal rates for subscriptions and support and maintenance services, and monitor our near term cash flows. We believe that billings provides useful information to investors and others in understanding and evaluating our operating results in the same manner as our management. However, it is important to note that other companies, including companies in our industry, may not use billings, may calculate billings differently, may have different billing frequencies, or may use other financial measures to evaluate their performance, all of which could reduce the usefulness of billings as a comparative measure. A reconciliation of billings to revenue, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

	Year Ended July 31,		
	2015	2014	2013
	(in thousands)		
Billings (non-GAAP):			
Total revenue	\$928,052	\$598,179	\$396,107
Add: change in total deferred revenue, net of acquired deferred revenue	291,076	173,196	113,422
Billings (non-GAAP)	\$1,219,128	\$771,375	\$509,529

Table of Contents

Results of Operations

The following tables summarize our results of operations for the periods presented and as a percentage of our total revenue for those periods. The period to period comparison of results is not necessarily indicative of results for future periods.

	Year Ended July 31, 2015		2014		2013			
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue		
(dollars in thousands)								
Consolidated Statements of Operations Data:								
Revenue:								
Product	\$492,658	53.1	% \$340,143	56.9	% \$243,707	61.5	%	
Services	435,394	46.9	% 258,036	43.1	% 152,400	38.5	%	
Total revenue	928,052	100.0	% 598,179	100.0	% 396,107	100.0	%	
Cost of revenue:								
Product	131,094	14.1	% 85,503	14.3	% 63,412	16.0	%	
Services	120,405	13.0	% 74,125	12.4	% 46,344	11.7	%	
Total cost of revenue	251,499	27.1	% 159,628	26.7	% 109,756	27.7	%	
Total gross profit	676,553	72.9	% 438,551	73.3	% 286,351	72.3	%	
Operating expenses:								
Research and development	185,828	20.0	% 104,813	17.5	% 62,482	15.8	%	
Sales and marketing	522,696	56.3	% 334,763	56.0	% 199,771	50.4	%	
General and administrative	101,565	11.0	% 73,149	12.2	% 42,719	10.8	%	
Legal settlement	—	—	% 141,173	23.6	% —	—	%	
Total operating expenses	810,089	87.3	% 653,898	109.3	% 304,972	77.0	%	
Operating loss	(133,536)	(14.4)	% (215,347)	(36.0)	% (18,621)	(4.7)	%	
Interest expense	(22,325)	(2.4)	% (1,883)	(0.3)	% (74)	—	%	
Other income (expense), net	284	—	% (4,930)	(0.8)	% 39	—	%	
Loss before income taxes	(155,577)	(16.8)	% (222,160)	(37.1)	% (18,656)	(4.7)	%	
Provision for income taxes	9,405	1.0	% 4,292	0.8	% 10,590	2.7	%	
Net loss	\$(164,982)	(17.8)	% \$(226,452)	(37.9)	% \$(29,246)	(7.4)	%	
Number of employees at period end	2,637		1,722		1,147			

Revenue

We derive revenue from sales of our products and services. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is reasonably assured.

Our total revenue is comprised of the following:

Product Revenue. Product revenue is derived primarily from sales of our appliances. Product revenue also includes revenue derived from software licenses of Panorama, GlobalProtect, and the VM-Series. We recognize product revenue at the time of shipment, provided that all other revenue recognition criteria have been met. As a percentage of total revenue, we expect our product revenue to vary from quarter to quarter based on seasonal and cyclical factors.

Services Revenue. Services revenue is derived primarily from sales of our subscriptions and support and maintenance. Our contractual subscription and support and maintenance terms are typically one year, although we also offer three to five year terms. We recognize revenue from subscriptions and support and maintenance over the contractual service period. As a percentage of total revenue, we expect our services revenue to vary from quarter to quarter and increase over the long term as we introduce new subscriptions, renew existing services contracts, and expand our installed end-customer base.

Table of Contents

	Year Ended July 31, 2015				Change Amount	%	Year Ended July 31, 2014			
	2015 Amount	2014 Amount	Change Amount	%			2014 Amount	2013 Amount	Change Amount	%
(dollars in thousands)										
Revenue:										
Product	\$492,658	\$340,143	\$152,515	44.8	%	\$340,143	\$243,707	\$96,436	39.6	%
Services										
Subscription	212,676	123,236	89,440	72.6	%	123,236	71,203	52,033	73.1	%
Support and maintenance	222,718	134,800	87,918	65.2	%	134,800	81,197	53,603	66.0	%
Total services	435,394	258,036	177,358	68.7	%	258,036	152,400	105,636	69.3	%
Total revenue	\$928,052	\$598,179	\$329,873	55.1	%	\$598,179	\$396,107	\$202,072	51.0	%
Revenue by geographic theater:										
Americas	\$639,328	\$396,626	\$242,702	61.2	%	\$396,626	\$247,616	\$149,010	60.2	%
EMEA	178,719	126,915	51,804	40.8	%	126,915	91,496	35,419	38.7	%
APAC	110,005	74,638	35,367	47.4	%	74,638	56,995	17,643	31.0	%
Total revenue	\$928,052	\$598,179	\$329,873	55.1	%	\$598,179	\$396,107	\$202,072	51.0	%

Product revenue increased \$152.5 million, or 44.8%, for fiscal 2015 compared to fiscal 2014 and increased \$96.4 million, or 39.6%, for fiscal 2014 compared to fiscal 2013. The increases in both periods were driven by increased demand for our higher end appliances. The impact of changes in pricing on our product revenue was insignificant. Services revenue increased \$177.4 million, or 68.7%, for fiscal 2015 compared to fiscal 2014 and increased \$105.6 million, or 69.3%, for fiscal 2014 compared to fiscal 2013. The increases in both periods were due to increased sales to new and existing end-customers. The relative increases in subscription revenue and support and maintenance revenue will fluctuate over time, depending on the mix of services revenue and the introduction of new subscription offerings. The impact of changes in pricing on our services revenue was insignificant.

With respect to geographic theaters, the Americas contributed the largest portion of the year over year increases in revenue for both fiscal 2015 and fiscal 2014 due to its larger and more established sales force compared to our other theaters. Revenue from both EMEA and APAC increased year over year for both fiscal 2015 and fiscal 2014 due to our investment in increasing the size of our sales force and number of channel partners in these theaters.

Cost of Revenue

Our cost of revenue consists of cost of product revenue and cost of services revenue. Our cost of revenue includes costs paid to our third-party contract manufacturer and personnel costs, which consist of salaries, benefits, bonuses, and share-based compensation associated with our operations, global customer support, and technical operations organizations. Our cost of revenue also includes allocated costs, which consist of certain facilities, depreciation, benefits, recruiting, and information technology costs that we allocate based on headcount, as well as amortization of intellectual property licenses and intangible assets.

Cost of Product Revenue. Cost of product revenue primarily includes costs paid to our third-party contract manufacturer. Our cost of product revenue also includes amortization of intellectual property licenses, product testing costs, allocated costs, warranty costs, shipping costs, and personnel costs associated with logistics and quality control. We expect our cost of product revenue to increase as our product revenue increases.

Cost of Services Revenue. Cost of services revenue includes personnel costs for our global customer support and technical operations organizations, amortization of acquired intangible assets, allocated costs, and URL filtering database service fees. We expect our cost of services revenue to increase as our installed end-customer base grows.

Table of Contents

	Year Ended July 31, 2015				Change Amount	%	Year Ended July 31, 2014			
	2014	2013	Change Amount	%			2014	2013	Change Amount	%
	(dollars in thousands)									
Cost of revenue:										
Product	\$131,094	\$85,503	\$45,591	53.3	%	\$85,503	\$63,412	\$22,091	34.8	%
Services	120,405	74,125	46,280	62.4	%	74,125	46,344	27,781	59.9	%
Total cost of revenue	\$251,499	\$159,628	\$91,871	57.6	%	\$159,628	\$109,756	\$49,872	45.4	%
Includes share-based compensation of:										
Product	\$3,858	\$1,636	\$2,222	135.8	%	\$1,636	\$765	\$871	113.9	%
Services	20,425	9,434	10,991	116.5	%	9,434	3,586	5,848	163.1	%
Total share-based compensation included in cost of revenue	\$24,283	\$11,070	\$13,213	119.4	%	\$11,070	\$4,351	\$6,719	154.4	%

Product cost increased \$45.6 million, or 53.3%, for fiscal 2015 compared to fiscal 2014 due to an increase in product unit volume, as well as amortization of intellectual property licenses of \$10.2 million.

Product cost increased \$22.1 million, or 34.8%, for fiscal 2014 compared to fiscal 2013 due to an increase in product unit volume. Product cost for fiscal 2014 also includes amortization of intellectual property licenses of \$2.0 million. Services cost increased \$46.3 million, or 62.4%, for fiscal 2015 compared to fiscal 2014 due to increases in personnel costs of \$25.8 million related to increasing our headcount, third-party professional services costs of \$4.8 million to expand our customer service capabilities to support our growing installed end-customer base, amortization of acquired intangible assets of \$4.5 million, and allocated costs of \$4.2 million.

Services cost increased \$27.8 million, or 59.9%, for fiscal 2014 compared to fiscal 2013 due to an increase in personnel costs of \$14.8 million related to increasing our headcount, allocated costs of \$5.5 million, professional services costs of \$2.1 million, amortization of acquired intangible assets of \$1.6 million, and other costs incurred to expand our customer service capabilities to support our growing installed end-customer base.

Gross Margin

Gross margin, or gross profit as a percentage of revenue, has been and will continue to be affected by a variety of factors, including the average sales price of our products, manufacturing costs, the mix of products sold, and the mix of revenue between products and services. For sales of our products, our higher throughput firewall products generally have higher gross margins than our lower throughput firewall products within each product series. For sales of our services, our subscriptions typically have higher gross margins than our support and maintenance. We expect our gross margins to fluctuate over time depending on the factors described above.

	Year Ended July 31, 2015		2014	2013					
	Amount	Gross Margin		Amount	Gross Margin				
	(dollars in thousands)								
Gross profit:									
Product	\$361,564	73.4	%	\$254,640	74.9	%	\$180,295	74.0	%
Services	314,989	72.3	%	183,911	71.3	%	106,056	69.6	%
Total gross profit	\$676,553	72.9	%	\$438,551	73.3	%	\$286,351	72.3	%

Gross margin decreased 40 basis points for fiscal 2015 compared to fiscal 2014. The decrease of 150 basis points in product margin was due to increased amortization of intellectual property licenses. The increase of 100 basis points in services margin was due to contributions from our higher margin subscription services, partially offset by an 80 basis points decrease due to amortization of purchased intangible assets.

Table of Contents

Gross margin increased 100 basis points for fiscal 2014 compared to fiscal 2013. The increase of 90 basis points in product margin was due to continued focus on material cost reductions, partially offset by amortization of intellectual property licenses of \$2.0 million. The increase of 170 basis points in services margin was due to contributions from our higher margin subscription services.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, general and administrative, and legal settlement expense. Personnel costs are the most significant component of operating expenses and consist of salaries, benefits, bonuses, share-based compensation, and with regard to sales and marketing expense, sales commissions. Our operating expenses also include allocated costs, which consist of certain facilities, depreciation, benefits, recruiting, and information technology costs that we allocate based on headcount. We expect operating expenses to increase in absolute dollars and decrease over the long term as a percentage of revenue as we continue to scale our business. As of July 31, 2015, we expect to recognize approximately \$557.0 million of share-based compensation expense over a weighted-average period of approximately three years, excluding additional share-based compensation expense related to any future grants of share-based awards. Share-based compensation expense, net of forfeitures, is recognized on a straight-line basis over the requisite service periods of the awards.

Research and Development. Research and development expense consists primarily of personnel costs. Research and development expense also includes prototype related expenses and allocated costs. We expect research and development expense to increase in absolute dollars as we continue to invest in our future products and services, although our research and development expense may fluctuate as a percentage of total revenue.

Sales and Marketing. Sales and marketing expense consists primarily of personnel costs, including commission costs. We expense commission costs as incurred. Sales and marketing expense also includes costs for market development programs, promotional and other marketing costs, travel costs, professional services, and allocated costs. We continue to increase the size of our sales force and have also substantially grown our sales presence internationally. We expect sales and marketing expense to continue to increase in absolute dollars as we increase the size of our sales and marketing organizations to increase touch points with end-customers and to expand our international presence, although our sales and marketing expense may fluctuate as a percentage of total revenue.

General and Administrative. General and administrative expense consists of personnel costs for our executive, finance, human resources, legal, and information technology organizations, professional services, and certain non-recurring general expenses. Professional services consist primarily of legal, auditing, accounting, and other consulting costs. We expect general and administrative expense to increase in absolute dollars due to additional costs associated with accounting, compliance, insurance, and investor relations, although our general and administrative expense may fluctuate as a percentage of total revenue.

Legal Settlement. Legal settlement expense consists of charges related to the Settlement Agreement with Juniper and the Mutual Covenant Not to Sue and Release Agreement with Fortinet. Refer to the discussion under Note 9. Legal Settlement of Notes to Consolidated Financial Statements in Part II, Item 8 of this Annual Report on Form 10-K for information related to these matters.

Table of Contents

	Year Ended July 31, 2015				Change Amount	%	Year Ended July 31, 2014			
	2015 Amount	2014 Amount	Change Amount	%			2014 Amount	2013 Amount	Change Amount	%
(dollars in thousands)										
Operating expenses:										
Research and development	\$ 185,828	\$ 104,813	\$ 81,015	77.3	%	\$ 104,813	\$ 62,482	\$ 42,331	67.7	%
Sales and marketing	522,696	334,763	187,933	56.1	%	334,763	199,771	134,992	67.6	%
General and administrative	101,565	73,149	28,416	38.8	%	73,149	42,719	30,430	71.2	%
Legal settlement	—	141,173	(141,173)	(100.0	)%	141,173	—	141,173	NM	
Total operating expenses	\$ 810,089	\$ 653,898	\$ 156,191	23.9	%	\$ 653,898	\$ 304,972	\$ 348,926	114.4	%
Includes share-based compensation of:										
Research and development	\$ 74,837	\$ 29,524	\$ 45,313	153.5	%	\$ 29,524	\$ 9,931	\$ 19,593	197.3	%
Sales and marketing	84,113	42,647	41,466	97.2	%	42,647	20,493	22,154	108.1	%
General and administrative	38,198	16,668	21,530	129.2	%	16,668	9,101	7,567	83.1	%
Total share-based compensation included in operating expenses	\$ 197,148	\$ 88,839	\$ 108,309	121.9	%	\$ 88,839	\$ 39,525	\$ 49,314	124.8	%

Research and development expense increased \$81.0 million, or 77.3%, for fiscal 2015 compared to fiscal 2014 due to an increase in personnel costs of \$73.7 million largely due to an increase in headcount and an increase in allocated costs of \$5.3 million.

Research and development expense increased \$42.3 million, or 67.7%, for fiscal 2014 compared to fiscal 2013 due to an increase in personnel costs of \$31.4 million largely due to an increase in headcount, an increase in allocated costs of \$6.4 million, and an increase in development costs of \$2.5 million to support continued investment in our future product and service offerings.

Sales and marketing expense increased \$187.9 million, or 56.1%, for fiscal 2015 compared to fiscal 2014 due to an increase in personnel costs of \$140.4 million largely due to an increase in headcount, an increase in allocated costs of \$12.3 million, an increase in demand generation activities, trade shows, and other marketing activities of \$11.8 million, and an increase in travel and entertainment costs of \$11.8 million.

Sales and marketing expense increased \$135.0 million, or 67.6%, for fiscal 2014 compared to fiscal 2013 due to an increase in personnel costs of \$94.6 million largely due to an increase in headcount, an increase in allocated costs of \$13.9 million, an increase in travel and entertainment costs of \$8.9 million, an increase in professional services costs of \$7.6 million, and an increase in demand generation activities, trade shows, and other marketing activities of \$6.1 million.

General and administrative expense increased \$28.4 million, or 38.8%, for fiscal 2015 compared to fiscal 2014 due to an increase in personnel costs of \$31.4 million largely due to an increase in headcount and an increase in professional services costs of \$7.5 million. In addition, in fiscal 2014, we recognized expenses related to the intellectual property litigation with Juniper of \$11.3 million and expenses related to our acquisitions of Cyvera and Morta of \$4.4 million.

General and administrative expense increased \$30.4 million, or 71.2%, for fiscal 2014 compared to fiscal 2013 due to an increase in professional services costs of \$12.5 million, including expenses related to the intellectual property litigation with Juniper of \$7.7 million and expenses related to our acquisitions of Cyvera and Morta of \$4.4 million, an increase in personnel costs of \$12.3 million, largely due to an increase in headcount, and an increase in allocated costs of \$2.4 million.

We incurred legal settlement expenses of \$121.2 million and \$20.0 million in fiscal 2014 related to the Settlement Agreement with Juniper and the Mutual Covenant Not to Sue and Release Agreement with Fortinet, respectively.

- 46 -

Table of Contents

Interest Expense

Interest expense primarily consists of the amortization of the debt discount and debt issuance costs related to the Notes issued on June 30, 2014. This interest expense is non-cash and will range from \$23.4 million to \$25.7 million per year through fiscal 2019.

	Year Ended July 31,				Year Ended July 31,			
	2015	2014	Change	%	2014	2013	Change	%
	Amount	Amount	Amount		Amount	Amount	Amount	

(dollars in thousands)

Interest expense	\$22,325	\$1,883	\$20,442	NM	\$1,883	\$74	\$1,809	NM
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Interest expense increased \$20.4 million for fiscal 2015 compared to fiscal 2014 and increased \$1.8 million for fiscal 2014 compared to fiscal 2013 due to the amortization of the debt discount and debt issuance costs related to the Notes.

Other Income (Expense), Net

Other income (expense), net includes interest income earned on our cash, cash equivalents, and investments, foreign currency remeasurement gains and losses, and foreign currency transaction gains and losses.

	Year Ended July 31,				Year Ended July 31,			
	2015	2014	Change	%	2014	2013	Change	%
	Amount	Amount	Amount		Amount	Amount	Amount	

(dollars in thousands)

Other income (expense), net	\$284	\$(4,930)	\$5,214	NM	\$(4,930)	\$39	\$(4,969)	NM
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In fiscal 2014, we recorded an expense of \$5.9 million in other income (expense), net to record the change in fair value of the warrant issued to Juniper in connection with the Settlement Agreement. The warrant was classified as a liability on our consolidated balance sheets and remeasured to fair value from June 3, 2014, the issuance date of the warrant, through July 1, 2014, the date the warrant was exercised. In addition, for fiscal 2015 compared to fiscal 2014, our interest income and our foreign currency remeasurement losses increased by \$2.9 million and \$3.3 million, respectively.

Provision for Income Taxes

Provision for income taxes consists primarily of income taxes in foreign jurisdictions in which we conduct business, withholding taxes, federal and state income taxes in the United States, and amortization of our deferred tax charges. We maintain a full valuation allowance for domestic deferred tax assets, including net operating loss carryforwards and tax credits.

In fiscal 2015, we recorded deferred tax charges of \$36.8 million. The current portion of the deferred tax charges is included in prepaid expenses and other current assets and the remainder in other assets in our consolidated balance sheets. The deferred tax charges are being amortized on a straight-line basis over approximately seven years as a component of provision for income taxes.

	Year Ended July 31,				Year Ended July 31,			
	2015	2014	Change	%	2014	2013	Change	%
	Amount	Amount	Amount		Amount	Amount	Amount	

(dollars in thousands)

Provision for income taxes	\$9,405	\$4,292	\$5,113	119.1	\$4,292	\$10,590	\$(6,298)	(59.5)
Effective tax rate	(6.0)	(1.9)			(1.9)	(56.8)		

We recorded an income tax provision for fiscal 2015 due to federal, state, and foreign income taxes, foreign withholding taxes, and amortization of our deferred tax charges. The provision for income taxes increased \$5.1 million for fiscal 2015 compared to fiscal 2014 due to amortization of our deferred tax charges and a shift in geographical mix of income, partially offset by the tax benefit from a partial release of the valuation allowance in connection with the acquisition of CirroSecure.

We recorded an income tax provision for fiscal 2014 due to foreign income taxes and foreign withholding taxes. The provision for income taxes decreased \$6.3 million for fiscal 2014 compared to fiscal 2013 due to decreased U.S. taxable income, primarily attributable to the Settlement Agreement with Juniper and the Mutual Covenant Not to Sue and Release Agreement with Fortinet.

- 47 -

Table of Contents

Liquidity and Capital Resources

	July 31, 2015 (in thousands)	2014
Working capital ⁽¹⁾	\$41,803	\$610,155
Cash, cash equivalents, and investments:		
Cash and cash equivalents	\$375,814	\$653,812
Investments	952,006	320,570
Total cash, cash equivalents, and investments	\$1,327,820	\$974,382

As of July 31, 2015, the net carrying amount of the Notes and related debt issuance costs were classified as current liabilities and current assets, respectively, in our consolidated balance sheets. Refer to Note 7. Convertible Senior Notes of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information.

At July 31, 2015, our cash and cash equivalents and investments of \$1.3 billion were held for working capital purposes, of which approximately \$84.0 million was held outside of the United States. We do not provide for federal income taxes on the undistributed earnings of our foreign subsidiaries, all of which we expect to reinvest outside of the United States indefinitely. However, if these funds were needed for our domestic operations, we would be required to accrue and pay U.S. taxes on undistributed earnings of foreign subsidiaries. There are no other restrictions on the use of these funds. If we were to repatriate these earnings to the United States, any associated income tax liability would be insignificant.

In June 2014, we issued the Notes, which mature on July 1, 2019, with an aggregate principal amount of \$575.0 million. Prior to January 1, 2019, holders may surrender their Notes for early conversion under certain circumstances. Upon conversion of the Notes, we will pay cash up to the aggregate principal amount of the Notes to be converted, and we may choose to pay or deliver, as the case may be, cash, shares of our common stock or a combination of cash and shares of our common stock with respect to the remainder of our conversion obligation in excess of the aggregate principal amount of the Notes being converted.

During the fiscal quarter ended July 31, 2015, the last reported sale price of our common stock was greater than or equal to 130% of the conversion price of the Notes for at least 20 of the last 30 consecutive trading days of such quarter. As a result, holders may convert their Notes at any time during the fiscal quarter ending October 31, 2015. Refer to Note 7. Convertible Senior Notes of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for information on the Notes.

The following table summarizes our cash flows for the years ended July 31, 2015, 2014, and 2013.

	Year Ended July 31,		
	2015	2014	2013
	(in thousands)		
Cash provided by operating activities	\$350,304	\$88,406	\$114,519
Cash used in investing activities	(679,006)	(320,348)	(151,565)
Cash provided by financing activities	50,704	575,140	25,018
Net increase (decrease) in cash and cash equivalents	\$(277,998)	\$343,198	\$(12,028)

We believe that our cash flow from operations with existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for the foreseeable future. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to acquire or invest in complementary businesses and technologies, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products. In addition, from time to time we may incur additional tax liability in connection with certain tax structuring decisions.

We may also choose to seek additional equity or debt financing. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional

capital when desired, our business, operating results, and financial condition may be adversely affected.

- 48 -

Table of Contents

Operating Activities

Our operating activities have consisted of net loss adjusted for certain non-cash items and changes in assets and liabilities.

Cash provided by operating activities in fiscal 2015 was \$350.3 million, an increase of \$261.9 million compared to fiscal 2014. The increase was due to growth of our business and changes in our assets and liabilities during fiscal 2015. Additionally, in fiscal 2014, we made a total of \$95.0 million in payments related to legal settlements. Changes in assets and liabilities for fiscal 2015 compared to fiscal 2014 include an increase in sales of subscriptions and support and maintenance contracts to new and existing customers as reflected by an increase in deferred revenue. In addition, during fiscal 2015, we made a tax payment of \$12.8 million in connection with an intercompany transfer of intellectual property.

Cash provided by operating activities in fiscal 2014 was \$88.4 million, a decrease of \$26.1 million compared to fiscal 2013, due to payments of \$75.0 million and \$20.0 million in fiscal 2014 for the legal settlement with Juniper and the Mutual Covenant Not to Sue and Release Agreement with Fortinet, respectively. The decrease was partially offset by an increase in sales of subscriptions and support and maintenance contracts to new and existing customers as reflected by an increase in deferred revenue.

Investing Activities

Our investing activities have consisted of capital expenditures, net investment purchases, sales, and maturities, and business acquisitions. We expect to continue such activities as our business grows.

Cash used in investing activities during fiscal 2015 was \$679.0 million, an increase of \$358.7 million compared to fiscal 2014. The increase was due to higher net purchases of available-for-sale investments in fiscal 2015, partially offset by higher payments made in fiscal 2014 related to our acquisitions.

Cash used in investing activities during fiscal 2014 was \$320.3 million, an increase of \$168.8 million compared to fiscal 2013. The increase was due to net cash payments of \$85.7 million related to our acquisitions in fiscal 2014, an increase of \$69.4 million in net purchases of available-for-sale investments, and an increase of \$13.7 million in purchases of property, equipment, and other assets.

Financing Activities

Our financing activities have consisted of proceeds from the issuance of the Notes and proceeds from sales of shares through employee equity incentive plans.

Cash provided by financing activities during fiscal 2015 was \$50.7 million, a decrease of \$524.4 million compared to fiscal 2014. The decrease was due to net proceeds from the issuance of the Notes of \$527.7 million in fiscal 2014.

Cash provided by financing activities during fiscal 2014 was \$575.1 million, an increase of \$550.1 million compared to fiscal 2013. The increase was primarily due to net proceeds from the issuance of the Notes of \$527.7 million. The remaining increase was due to higher proceeds from the sale of shares through employee equity incentive plans during fiscal 2014 and the last payments of our initial public offering costs in fiscal 2013.

Contractual Obligations and Commitments

The following summarizes our contractual obligations and commitments as of July 31, 2015:

	Payments Due by Period				
	Total	Less Than 1 Year (in thousands)	1 - 3 Years	3- 5 Years	More Than 5 Years
0.0% Convertible Senior Notes due 2019 (1)	\$575,000	\$—	\$—	\$—	\$575,000
Operating lease obligations (2) (3)	409,156	20,821	51,507	83,626	253,202
Purchase obligations (4)	42,805	42,805	—	—	—
Total (5)	\$1,026,961	\$63,626	\$51,507	\$83,626	\$828,202

As of July 31, 2015, holders may convert their Notes at any time during the fiscal quarter ending October 31, 2015.

(1) Refer to Note 7. Convertible Senior Notes of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information.

Table of Contents

Consists of contractual obligations from our non-cancelable operating leases. In August 2015, we executed an expansion notice under one of our existing lease agreements in Santa Clara, California. As the related lease has not yet been executed, future non-cancelable minimum rental payments related to the expansion notice are not included in the table above. Refer to Note 8. Commitments and Contingencies of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information.

(2) Excludes contractual sublease proceeds of \$8.2 million, of which \$3.0 million will be received in less than one year and \$5.2 million will be received in one to three years.

(3) Consists of minimum purchase commitments of products and components with our independent contract manufacturer and original design manufacturers. Obligations under contracts that we can cancel without a significant penalty are not included in the table above.

(4) No amounts related to income taxes are included. As of July 31, 2015, we had approximately \$40.6 million of tax liabilities recorded related to uncertainty in income tax positions.

Off-Balance Sheet Arrangements

Through July 31, 2015, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities, that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with U.S. GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. We evaluate our estimates and assumptions on an ongoing basis. Actual results may differ from these estimates. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

The critical accounting policies requiring estimates, assumptions, and judgments that we believe have the most significant impact on our consolidated financial statements are described below.

Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is reasonably assured. Most of our arrangements, other than renewals of subscriptions and support and maintenance, are multiple-element arrangements with a combination of hardware, software, subscriptions, support and maintenance, and other services. For multiple-element arrangements, we allocate revenue to each unit of accounting based on an estimated selling price at the arrangement inception. The estimated selling price for each element is based upon the following hierarchy:

• Vendor-specific objective evidence (VSOE) of selling price, if available,

• Third-party evidence (TPE) of selling price, if VSOE of selling price is not available, or

• Best estimate of selling price (BESP), if neither VSOE of selling price nor TPE of selling price are available.

We establish VSOE of selling price using the prices charged for a deliverable when sold separately. We establish TPE of selling price by evaluating similar and interchangeable competitor products or services in standalone arrangements with similarly situated partners. We establish BESP primarily based on historical transaction pricing, whereby historical transactions are segregated based on our pricing model and our go-to-market strategy, which include factors such as type of sales channel (reseller, distributor, or end-customer), the geographies in which our products and services were sold (domestic or international), and offering type (products or services). To further support the best estimate of selling price as determined by the historical transaction pricing or when such information is unavailable, such as when there are limited sales of a new product or service, we consider the same factors we have established through our pricing model and go-to-market strategy. The determination of BESP is made through consultation with and approval by our management. In determining BESP, we rely on certain assumptions and apply significant judgment. As our business offerings evolve over time, we may be required to modify our estimated selling prices in subsequent periods, and the timing of our revenue recognition could be affected.

Share-Based Compensation

Compensation expense related to share-based transactions is measured and recognized in the financial statements based on fair value estimated on the grant date. The fair value of restricted stock units (RSUs) is based on the closing market price of our

- 50 -

Table of Contents

common stock on the date of grant. The fair value of stock options and shares sold through our employee stock purchase plan (ESPP) are estimated on the grant date using the Black Scholes option pricing model, which requires the use of subjective assumptions, including the expected term of the award and the expected volatility of the price of our common stock.

We recognize share-based compensation expense on a straight-line basis over the requisite service periods of the awards, net of estimated forfeitures. Our estimated forfeiture rate is based on an analysis of our actual historical forfeitures. A change in our estimated forfeiture rate could have a significant impact on our share-based compensation expense as the cumulative effect of adjusting the rate is recognized in the period the forfeiture estimate is changed. We will continue to use judgment in evaluating the assumptions related to our share-based compensation expense on a prospective basis. As we continue to accumulate additional data, we may have refinements to our estimates, which could materially impact our future share-based compensation expense.

Income Taxes

We account for income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in our financial statements or tax returns. In addition, deferred tax assets are recorded for the future benefit of utilizing net operating losses and research and development credit carryforwards. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized.

Significant judgment is required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, we consider all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies. In the event that we change our determination as to the amount of deferred tax assets that can be realized, we will adjust our valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made.

We apply the authoritative accounting guidance prescribing a threshold and measurement attribute for the financial recognition and measurement of a tax position taken or expected to be taken in a tax return. We recognize liabilities for uncertain tax positions based on a two-step process. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more likely than not to be realized upon ultimate settlement.

Significant judgment is also required in evaluating our uncertain tax positions and determining our provision for income taxes. Although we believe our reserves are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences may impact the provision for income taxes in the period in which such determination is made.

Contract Manufacturer Liabilities

We outsource most of our manufacturing, repair, and supply chain management operations to our independent contract manufacturer, which procures components and assembles our products based on our demand forecasts. These forecasts of future demand are based upon historical trends and analysis from our sales and product management functions as adjusted for overall market conditions. We accrue for costs for manufacturing commitments in excess of our forecasted demand, including costs for excess components or for carrying costs incurred by our contract manufacturer. Actual component usage and product demand may be materially different from our forecast, and could be caused by factors outside of our control, which could have an adverse impact on our results of operations. To date, we have not accrued significant costs associated with this exposure.

Loss Contingencies

We are subject to the possibility of various loss contingencies arising in the ordinary course of business. We accrue for loss contingencies when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. If we determine that a loss is possible and the range of the loss can be

reasonably determined, then we disclose the range of the possible loss. We regularly evaluate current information available to us to determine whether an accrual is required, an accrual should be adjusted or a range of possible loss should be disclosed.

From time to time, we are involved in disputes, litigation, and other legal actions. However, there are many uncertainties associated with any litigation, and these actions or other third-party claims against us may cause us to incur substantial settlement charges, which are inherently difficult to estimate and could adversely affect our results of operations. The actual liability in any

- 51 -

Table of Contents

such matters may be materially different from our estimates, which could result in the need to adjust our liability and record additional expenses.

Goodwill, Intangibles, and Other Long-Lived Assets

We make significant estimates, assumptions, and judgments when valuing goodwill and other purchased intangible assets in connection with the initial purchase price allocation of an acquired entity, as well as when evaluating impairment of goodwill and other purchased intangible assets on an ongoing basis. These estimates are based upon a number of factors, including historical experience, market conditions, and information obtained from the management of the acquired company. Critical estimates in valuing certain intangible assets include, but are not limited to, cash flows that an asset is expected to generate in the future, discount rates, the time and expense that would be necessary to recreate the assets, and the profit margin a market participant would receive. The amounts and useful lives assigned to identified intangible assets impacts the amount and timing of future amortization expense.

We evaluate goodwill for impairment on an annual basis in our fourth fiscal quarter or more frequently if we believe impairment indicators exist. We first analyze qualitative factors, which include industry and market considerations, overall financial performance, and other relevant events and factors affecting the reporting unit. If qualitative factors indicate that it is more likely than not that the reporting unit's fair value is less than its carrying amount, then we will perform the quantitative analysis required under the two-step goodwill impairment test.

Under the two-step goodwill impairment test, we first compare the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of the reporting unit is estimated using significant judgment based on a combination of the income and the market approaches. If the fair value of the reporting unit does not exceed the carrying amount of the net assets assigned to the reporting unit, then we perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. When the carrying amount of a reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference. Determining the fair value of a reporting unit is highly judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, operating trends, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

We evaluate long-lived assets, such as property, equipment, and purchased intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Such events or changes in circumstances include, but are not limited to, a significant decrease in the fair value of the underlying asset or asset group, a significant decrease in the benefits realized from the acquired assets, difficulty and delays in integrating the business, or a significant change in the operations of the acquired assets or use of an asset. A long-lived asset is considered impaired if its carrying amount exceeds the estimated future undiscounted cash flows the asset or asset group is expected to generate. If a long-lived asset is considered to be impaired, the impairment to be recognized is the amount by which the carrying amount of the asset exceeds the fair value of the asset or asset group. To date, we have not recognized any impairment losses on our goodwill, intangible assets, and long-lived assets.

Recent Accounting Pronouncements

Refer to "Recent Accounting Pronouncements" in Note 1. Description of Business and Summary of Significant Accounting Policies of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exchange Risk

Our sales contracts are primarily denominated in U.S. dollars. A portion of our operating expenses are incurred outside of the United States and are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro, British Pound, Singapore Dollar, Israeli Shekel, and Japanese Yen. Additionally, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in our statement of operations. The effect of an immediate 10% adverse change in foreign exchange rates on monetary assets and liabilities at July 31, 2015 would not be material to our financial condition or results of

operations. To date, foreign currency transaction gains and losses and exchange rate fluctuations have not been material to our financial statements, and we have not engaged in any foreign currency hedging transactions.

- 52 -

Table of Contents

As our international operations grow, our risks associated with fluctuation in currency rates will become greater, and we will continue to reassess our approach to managing this risk. In addition, currency fluctuations or a weakening U.S. dollar can increase the costs of our international expansion.

Interest Rate Risk

The primary objectives of our investment activities are to preserve principal, provide liquidity, and maximize income without significantly increasing risk. Some of the securities we invest in are subject to interest risk. To minimize this risk, we maintain our portfolio of cash, cash equivalents, and short-term investments in a variety of securities, including commercial paper, money market funds, U.S. government and agency securities, and corporate debt securities. Due to the short duration and conservative nature of our investment portfolio, a movement of 10% in market interest rates would not have a material impact on our operating results and the total value of the portfolio. The effect of an immediate 10% change in interest rates at July 31, 2015 would not have been material to our operating results and the total value of the portfolio assuming consistent investment levels.

Market Risk and Market Interest Risk

In June 2014, we issued \$575.0 million aggregate principal amount of 0.0% convertible senior notes due 2019 (the "Notes"). We carry this instrument at face value less unamortized discount on our balance sheet. As this instrument does not bear interest, we have no financial and economic interest exposure associated with changes in interest rates. However, the fair value of fixed rate instruments fluctuate when interest rates change, and additionally, in the case of the Notes, when the market price of our common stock fluctuates.

ITEM 8. FINANCIAL STATEMENTS AND
SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

<u>Reports of Independent Registered Public Accounting Firm</u>	<u>55</u>
<u>Management's Report on Internal Control Over Financial Reporting</u>	<u>57</u>
<u>Consolidated Balance Sheets</u>	<u>58</u>
<u>Consolidated Statements of Operations</u>	<u>59</u>
<u>Consolidated Statements of Comprehensive Loss</u>	<u>60</u>
<u>Consolidated Statements of Stockholders' Equity</u>	<u>61</u>
<u>Consolidated Statements of Cash Flows</u>	<u>62</u>
<u>Notes to Consolidated Financial Statements</u>	<u>63</u>

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Palo Alto Networks, Inc.

We have audited the accompanying consolidated balance sheets of Palo Alto Networks, Inc. as of July 31, 2015 and 2014, and the related consolidated statements of operations, comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended July 31, 2015. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Palo Alto Networks, Inc. at July 31, 2015 and 2014, and the consolidated results of its operations and its cash flows for each of the three years in the period ended July 31, 2015, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Palo Alto Networks, Inc.'s internal control over financial reporting as of July 31, 2015, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated September 17, 2015 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Jose, California

September 17, 2015

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Palo Alto Networks, Inc.

We have audited Palo Alto Networks, Inc.'s internal control over financial reporting as of July 31, 2015, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). Palo Alto Networks, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Palo Alto Networks, Inc. maintained, in all material respects, effective internal control over financial reporting as of July 31, 2015, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Palo Alto Networks, Inc. as of July 31, 2015 and 2014, and the related consolidated statements of operations, comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended July 31, 2015 of Palo Alto Networks, Inc. and our report dated September 17, 2015 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
San Jose, California
September 17, 2015

Table of Contents

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management's Report on Internal Control Over Financial Reporting

The management of Palo Alto Networks, Inc. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934 for the Company. The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

The Company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the Consolidated Financial Statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of July 31, 2015, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework (2013 framework). Based on that assessment, management concluded that, as of July 31, 2015, the Company's internal control over financial reporting was effective.

The effectiveness of the Company's internal control over financial reporting as of July 31, 2015, has been audited by Ernst & Young LLP, the independent registered public accounting firm that audits the Company's Consolidated Financial Statements, as stated in their report preceding this report, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of July 31, 2015.

PALO ALTO NETWORKS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	July 31, 2015	2014
Assets		
Current assets:		
Cash and cash equivalents	\$375,814	\$653,812
Short-term investments	413,165	118,690
Accounts receivable, net of allowance for doubtful accounts of \$723 and \$471 at July 31, 2015 and July 31, 2014, respectively	212,366	135,518
Prepaid expenses and other current assets	72,685	50,306
Total current assets	1,074,030	958,326
Property and equipment, net	62,878	48,744
Long-term investments	538,841	201,880
Goodwill	163,522	155,033
Intangible assets, net	52,656	47,955
Other assets	73,251	66,528
Total assets	\$1,965,178	\$1,478,466
Liabilities, temporary equity, and stockholders' equity		
Current liabilities:		
Accounts payable	\$13,204	\$14,526
Accrued compensation	79,795	48,727
Accrued and other liabilities	28,291	25,000
Deferred revenue	423,853	259,918
Convertible senior notes, net	487,084	—
Total current liabilities	1,032,227	348,171
Convertible senior notes, net	—	466,875
Long-term deferred revenue	289,801	162,660
Other long-term liabilities	67,335	32,177
Commitments and contingencies (Note 8)		
Temporary equity	87,916	—
Stockholders' equity:		
Preferred stock, \$0.0001 par value; 100,000 shares authorized; none issued and outstanding at July 31, 2015 and July 31, 2014	—	—
Common stock, \$0.0001 par value; 1,000,000 shares authorized; 84,788 and 79,519 shares issued and outstanding at July 31, 2015 and July 31, 2014, respectively	8	8
Additional paid-in capital	988,687	804,406
Accumulated other comprehensive loss	(88	) (105
Accumulated deficit	(500,708	) (335,726
Total stockholders' equity	487,899	468,583
Total liabilities, temporary equity, and stockholders' equity	\$1,965,178	\$1,478,466

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Year Ended July 31,		
	2015	2014	2013
Revenue:			
Product	\$492,658	\$340,143	\$243,707
Services	435,394	258,036	152,400
Total revenue	928,052	598,179	396,107
Cost of revenue:			
Product	131,094	85,503	63,412
Services	120,405	74,125	46,344
Total cost of revenue	251,499	159,628	109,756
Total gross profit	676,553	438,551	286,351
Operating expenses:			
Research and development	185,828	104,813	62,482
Sales and marketing	522,696	334,763	199,771
General and administrative	101,565	73,149	42,719
Legal settlement (Note 9)	—	141,173	—
Total operating expenses	810,089	653,898	304,972
Operating loss	(133,536)	(215,347)	(18,621)
Interest expense	(22,325)	(1,883)	(74)
Other income (expense), net	284	(4,930)	39
Loss before income taxes	(155,577)	(222,160)	(18,656)
Provision for income taxes	9,405	4,292	10,590
Net loss	\$(164,982)	\$(226,452)	\$(29,246)
Net loss per share, basic and diluted	\$(2.02)	\$(3.05)	\$(0.43)
Weighted-average shares used to compute net loss per share, basic and diluted	81,619	74,291	68,682

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

	Year Ended July 31,		
	2015	2014	2013
Net loss	\$(164,982)	\$(226,452)	\$(29,246)
Other comprehensive income (loss), net of tax:			
Change in unrealized gains (losses) on investments	30	(72)	(15)
Reclassification adjustment for realized net gains on investments included in net loss	(13)	(17)	(1)
Net change	17	(89)	(16)
Comprehensive loss	\$(164,965)	\$(226,541)	\$(29,262)

See notes to consolidated financial statements.

- 60 -

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)

	Common Stock		Additional	Accumulated	Accumulated	Total
	Shares	Amount	Paid-In Capital	Other Comprehensive Loss	Deficit	Stockholders' Equity
Balance as of July 31, 2012	67,852	\$ 7	\$309,092	\$ —	\$ (80,028)	\$ 229,071
Net loss	—	—	—	—	(29,246)	(29,246)
Other comprehensive loss	—	—	—	(16)	—	(16)
Issuance of common stock in connection with employee equity incentive plans and related excess tax benefit	3,760	—	28,907	—	—	28,907
Share-based compensation for equity based awards	—	—	43,704	—	—	43,704
Balance as of July 31, 2013	71,612	7	381,703	(16)	(109,274)	272,420
Net loss	—	—	—	—	(226,452)	(226,452)
Other comprehensive loss	—	—	—	(89)	—	(89)
Issuance of common stock in connection with employee equity incentive plans and related excess tax benefit	4,806	1	48,001	—	—	48,002
Share-based compensation for equity based awards	—	—	99,774	—	—	99,774
Issuance of common stock in connection with legal settlement	1,544	—	113,332	—	—	113,332
Issuance of common stock in connection with acquisition	1,557	—	87,477	—	—	87,477
Equity component of convertible senior notes, net	—	—	106,836	—	—	106,836
Purchase of convertible senior note hedges	—	—	(110,975)	—	—	(110,975)
Issuance of warrants	—	—	78,258	—	—	78,258
Balance as of July 31, 2014	79,519	8	804,406	(105)	(335,726)	468,583
Net loss	—	—	—	—	(164,982)	(164,982)
Other comprehensive income	—	—	—	17	—	17
Issuance of common stock in connection with employee equity incentive plans and related excess tax benefit	5,269	—	50,882	—	—	50,882
Share-based compensation for equity based awards	—	—	221,315	—	—	221,315
Temporary equity reclassification	—	—	(87,916)	—	—	(87,916)
Balance as of July 31, 2015	84,788	\$ 8	\$988,687	\$ (88)	\$ (500,708)	\$ 487,899

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended July 31,		
	2015	2014	2013
Cash flows from operating activities			
Net loss	\$(164,982)	\$(226,452)	\$(29,246)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Share-based compensation for equity based awards	221,315	99,774	43,704
Issuance of common stock for legal settlement	—	46,173	—
Depreciation and amortization	28,881	19,419	9,892
Amortization of investment premiums, net of accretion of purchase discounts	3,161	1,518	1,943
Amortization of debt discount and debt issuance costs	22,265	1,826	—
Change in fair value of common stock warrant	—	5,859	—
Excess tax benefit from share-based compensation arrangements	(2,455)	(957)	(6,762)
Loss on facility sublease	—	—	262
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable, net	(76,830)	(47,949)	(41,819)
Prepaid expenses and other assets	(34,185)	(10,308)	(8,865)
Accounts payable	(3,498)	(1,100)	5,830
Accrued compensation	31,068	26,331	10,697
Accrued and other liabilities	34,488	1,076	15,461
Deferred revenue	291,076	173,196	113,422
Net cash provided by operating activities	350,304	88,406	114,519
Cash flows from investing activities			
Purchases of investments	(987,598)	(506,642)	(345,324)
Proceeds from sales of investments	18,508	74,597	13,491
Proceeds from maturities of investments	339,040	233,530	202,710
Business acquisitions, net of cash acquired	(15,128)	(85,726)	—
Purchases of property, equipment, and other assets	(33,828)	(36,107)	(22,442)
Net cash used in investing activities	(679,006)	(320,348)	(151,565)
Cash flows from financing activities			
Proceeds from borrowings on convertible senior notes, net	—	560,433	—
Proceeds from issuance of warrants	—	78,258	—
Purchase of convertible note hedges	—	(110,975)	—
Proceeds from sales of shares through employee equity incentive plans	48,249	46,599	21,032
Excess tax benefit from share-based compensation arrangements	2,455	957	6,762
Payments of initial public offering costs	—	—	(2,698)
Repurchases of restricted common stock from terminated employees	—	(132)	(78)
Net cash provided by financing activities	50,704	575,140	25,018
Net increase (decrease) in cash and cash equivalents	(277,998)	343,198	(12,028)
Cash and cash equivalents—beginning of period	653,812	310,614	322,642
Cash and cash equivalents—end of period	\$375,814	\$653,812	\$310,614
Supplemental disclosures of cash flow information			
Cash paid for income taxes	\$17,530	\$1,523	\$304
Cash paid for interest	\$61	\$44	\$58
Non-cash investing and financing activities			
Issuance of common stock in connection with acquisition	\$—	\$87,477	\$—

See notes to consolidated financial statements.

- 62 -

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Palo Alto Networks, Inc. (the “Company,” “we,” “us,” or “our”), located in Santa Clara, California, was incorporated in March 2005 under the laws of the State of Delaware and commenced operations in April 2005. We offer a next-generation security platform that empowers enterprises, service providers, and government entities to secure their organizations by safely enabling the increasingly complex and rapidly growing number of applications running on their networks and by preventing breaches in real-time that stem from targeted cyber attacks.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (GAAP). The consolidated financial statements include all adjustments necessary for a fair presentation of our annual results. All adjustments are of a normal recurring nature. Certain prior period amounts have been reclassified to conform with current period presentation.

Principles of Consolidation

The consolidated financial statements include our accounts and our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such management estimates include, but are not limited to the best estimate of selling price for our products and services, share-based compensation, fair value of assets acquired and liabilities assumed in business combinations, the assessment of recoverability of our property and equipment, identified intangibles and goodwill, future taxable income, contract manufacturer liabilities, and loss contingencies. We base our estimates on historical experience and also on assumptions that we believe are reasonable. Actual results could differ materially from those estimates.

Concentrations

Financial instruments that subject us to concentrations of credit risk consist primarily of cash and cash equivalents, investments, and accounts receivable. We invest only in high-quality credit instruments and maintain our cash and cash equivalents and available-for-sale investments in fixed income securities. Management believes that the financial institutions that hold our investments are financially sound and, accordingly, are subject to minimal credit risk.

Deposits held with banks may exceed the amount of insurance provided on such deposits.

Our accounts receivables are primarily derived from our channel partners representing various geographical locations. We perform ongoing credit evaluations of our channel partners and generally do not require collateral on accounts receivable. We maintain an allowance for doubtful accounts for estimated potential credit losses. As of July 31, 2015, two channel partners represented 36% and 30% of our gross accounts receivable. For fiscal 2015, three channel partners represented 31%, 29%, and 11% of our total revenue. We rely on an independent contract manufacturer to assemble most of our products and sole suppliers for a certain number of our components.

Comprehensive Loss

Comprehensive loss is comprised of net loss and other comprehensive income (loss). Unrealized gains and losses on available-for-sale investments are included in our other comprehensive income or loss.

Foreign Currency Transactions

The functional currency of our foreign subsidiaries is the U.S. dollar. Monetary assets and liabilities denominated in foreign currencies have been remeasured into U.S. dollars using the exchange rates in effect at the balance sheet dates. Foreign currency denominated income and expenses have been remeasured using the average exchange rates in effect during each period. Foreign currency remeasurement gains and losses and foreign currency transaction gains and losses are not significant to the financial statements.

Table of Contents

Cash and Cash Equivalents

We consider all highly liquid investments held at financial institutions, such as commercial paper, money market funds, and other money market securities with original maturities of three months or less at date of purchase to be cash equivalents.

Fair Value

We define fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities which are required to be recorded at fair value, we consider the principal or most advantageous market in which to transact and the market-based risk. We apply fair value accounting for all financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. The carrying amounts reported in the consolidated financial statements approximate the fair value for cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities, due to their short-term nature.

Investments

We classify our investments as available-for-sale at the time of purchase since it is our intent that these investments are available for current operations, and include these investments on our consolidated balance sheet as either short-term or long-term investments depending on their maturity. Investments not considered cash equivalents and with maturities one year or less from the consolidated balance sheet date are classified as short-term investments. Investments with maturities greater than one year from the consolidated balance sheet date are classified as long-term investments.

Investments are considered impaired when a decline in fair value is judged to be other-than-temporary. We consult with our investment managers and consider available quantitative and qualitative evidence in evaluating potential impairment of our investments on a quarterly basis. If the cost of an individual investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established.

Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount, net of allowances for doubtful accounts. The allowance for doubtful accounts is based on our assessment of the collectability of accounts. Management regularly reviews the adequacy of the allowance for doubtful accounts by considering the age of each outstanding invoice, each channel partner's expected ability to pay, and the collection history with each channel partner, when applicable, to determine whether a specific allowance is appropriate. Accounts receivable deemed uncollectible are charged against the allowance for doubtful accounts when identified. As of July 31, 2015 and 2014, the allowance for doubtful accounts activity was not significant.

Property and Equipment

Property and equipment are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three to ten years. Leasehold improvements are depreciated over the shorter of the estimated useful lives of the improvements or the remaining lease term.

Business Combinations

We include the results of operations of the businesses that we acquire as of the respective dates of acquisition. We allocate the fair value of the purchase price of our acquisitions to the tangible assets acquired, liabilities assumed, and intangible assets acquired, based on their estimated fair values. The excess of the purchase price over the fair values of these identifiable assets and liabilities is recorded as goodwill. Additional information existing as of the acquisition date but unknown to us may become known during the remainder of the measurement period, not to exceed 12 months from the acquisition date, which may result in changes to the amounts and allocations recorded.

Amortization of Intangible Assets

Purchased intangible assets with finite lives are carried at cost, less accumulated amortization. Amortization is computed over the estimated useful lives of the respective assets. Acquisition-related in-process research and development represents the fair value of incomplete research and development projects that have not reached technological feasibility as of the date of acquisition. Initially, these assets are not subject to amortization. Assets

related to projects that have been completed are transferred to developed technology, which are subject to amortization.

- 64 -

Table of Contents

Impairment of Goodwill, Intangible Assets, and Long-Lived Assets

Goodwill is evaluated for impairment on an annual basis in the fourth quarter of our fiscal year, and whenever events or changes in circumstances indicate the carrying amount of goodwill may not be recoverable. We have elected to first assess qualitative factors to determine whether it is more likely than not that the fair value of our single reporting unit is less than its carrying amount. If we determine that it is more likely than not that the fair value of our single reporting unit is less than its carrying amount, then the two-step goodwill impairment test will be performed. The first step, identifying a potential impairment, compares the fair value of our single reporting unit with its carrying amount. If the carrying amount exceeds its fair value, the second step will be performed; otherwise, no further step is required. The second step, measuring the impairment loss, compares the implied fair value of the goodwill with the carrying amount of the goodwill. Any excess of the goodwill carrying amount over the implied fair value is recognized as an impairment loss.

We evaluate events and changes in circumstances that could indicate carrying amounts of purchased intangible assets and long-lived assets may not be recoverable. When such events or changes in circumstances occur, we assess the recoverability of these assets by determining whether or not the carrying amount will be recovered through undiscounted expected future cash flows. If the total of the future undiscounted cash flows is less than the carrying amount of an asset, we record an impairment loss for the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Through July 31, 2015, we have not recognized any impairment losses on our goodwill, intangible assets, and long-lived assets.

Contract Manufacturer Liabilities

We outsource most of our manufacturing, repair, and supply chain management operations to our independent contract manufacturer and payments to it are a significant portion of our product cost of revenues. Although we could be contractually obligated to purchase manufactured products, we generally do not own the manufactured products. Product title transfers from our independent contract manufacturer to us and immediately to our channel partners upon shipment. Our independent contract manufacturer assembles our products using design specifications, quality assurance programs, and standards that we establish and it procures components and assembles our products based on our demand forecasts. These forecasts represent our estimates of future demand for our products based upon historical trends and analysis from our sales and product management functions as adjusted for overall market conditions. If the actual component usage and product demand are significantly lower than forecast, we accrue for costs for contractual manufacturing commitments in excess of our forecasted demand including costs for excess components or for carrying costs incurred by our contract manufacturer. Through July 31, 2015, we have not accrued any significant costs associated with this exposure.

Convertible Senior Notes

On June 30, 2014, we issued \$575.0 million aggregate principal amount of 0.0% Convertible Senior Notes due 2019 (the "Notes"). In accounting for the issuance of the Notes, we separated the Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the par value of the Notes as a whole. This difference represents a debt discount that is amortized to interest expense using the effective interest method over the term of the Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification. In accounting for the transaction costs related to the issuance of the Notes, we allocated the total amount incurred to the liability and equity components using the same proportions as the proceeds from the Notes. Transaction costs attributable to the liability component are being amortized to interest expense using the effective interest method over the term of the Notes. Transaction costs attributable to the equity component were netted with the equity component of the Notes in additional paid-in capital in the consolidated balance sheets. When the Notes are convertible, the net carrying amount of the Notes and related debt issuance costs will be classified as current liabilities and current assets, respectively, in our consolidated balance sheets. In addition, a portion of the equity component representing the conversion option will be reclassified to temporary equity in our consolidated balance sheets.

Revenue Recognition

We generate revenue from the sales of hardware and software products, subscriptions, support and maintenance, and other services primarily through a direct sales force and indirect relationships with channel partners, and, to a lesser extent, directly to end-customers.

Revenue is recognized when all of the following criteria are met:

• Persuasive Evidence of an Arrangement Exists. We rely upon non-cancelable sales agreements and purchase orders to determine the existence of an arrangement.

• Delivery has Occurred. We use shipping documents or transmissions of product or service contract registration codes to determine delivery.

- 65 -

Table of Contents

• The Fee is Fixed or Determinable. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction.

• Collectability is Reasonably Assured. We assess collectability based on credit analysis and payment history.

We recognize product revenue at the time of shipment provided that all other revenue recognition criteria have been met. Our channel partners generally receive an order from an end-customer prior to placing an order with us. In addition, payment from our channel partners is not contingent on the partner's success in sales to end-customers. Our channel partners generally do not stock appliances and only have limited stock rotation rights and no price protection rights. When necessary, we make certain estimates and maintain allowances for sales returns and other programs based on our historical experience. To date, these estimates have not been significant. We recognize services revenue from subscriptions and support and maintenance ratably over the contractual service period, which is typically one to five years. Other services revenue is recognized as the services are rendered.

Most of our arrangements, other than renewals of subscriptions and support and maintenance, are multiple-element arrangements with a combination of hardware, software, subscriptions, support and maintenance, and other services. Products and services generally qualify as separate units of accounting. Our hardware deliverables typically include proprietary operating system software, which together deliver the essential functionality of our products. For multiple-element arrangements, we allocate revenue to each unit of accounting based on an estimated selling price at the arrangement inception. The estimated selling price for each element is based upon the following hierarchy: vendor-specific objective evidence (VSOE) of selling price, if available, third-party evidence (TPE) of selling price, if VSOE of selling price is not available, or best estimate of selling price (BESP), if neither VSOE of selling price nor TPE of selling price are available. The total arrangement consideration is allocated to each separate unit of accounting using the relative estimated selling prices of each unit based on the aforementioned selling price hierarchy. We limit the amount of revenue recognized for delivered elements to an amount that is not contingent upon future delivery of additional products or services or meeting of any specified performance conditions.

In multiple-element arrangements where software deliverables are included, revenue is allocated to each separate unit of accounting for each of the non-software deliverables and to the software deliverables as a group using the relative estimated selling prices of each of the deliverables in the arrangement based on the aforementioned estimated selling price hierarchy. The arrangement consideration allocated to the software deliverables as a group is then allocated to each software deliverable using the residual method when VSOE of fair value of the undelivered items exists. Under the residual method, the amount of revenue allocated to delivered elements equals the total arrangement consideration less the aggregate fair value of any undelivered elements. In determining VSOE of fair value, we evaluate whether a substantial majority of the historical prices charged for a product or service sold on a standalone basis, as represented by a percentage of list price, fall within a reasonably narrow range. If VSOE of fair value of one or more undelivered items does not exist, revenue from the software portion of the arrangement is deferred and recognized at the earlier of: (i) delivery of those elements or (ii) when fair value can be established unless support and maintenance is the only undelivered element, in which case, the entire software arrangement fee is recognized ratably over the contractual service period.

We account for multiple agreements with a single partner as one arrangement if the contractual terms and/or substance of those agreements indicate that they may be so closely related that they are, in effect, parts of a single arrangement. Revenues are reported net of sales taxes. Shipping charges billed to channel partners are included in revenues and related costs are included in cost of revenue. Sales commissions and other incremental costs to acquire contracts are also expensed as incurred. After receipt of a partner order, any amounts billed in excess of revenue recognized are recorded as deferred revenue.

Advertising Costs

Advertising costs, which are expensed and included in sales and marketing expense when incurred, were \$4.8 million, \$3.7 million, and \$1.8 million, during the years ended July 31, 2015, 2014, and 2013, respectively.

Software Development Costs

Internally developed software includes enterprise-level business software that we are customizing to meet our specific operational needs. These capitalized costs consisted of the external direct costs and the internal payroll and payroll

related costs that are related to the implementation of our enterprise resource planning software system and will be amortized over a useful life of three to five years.

The costs to develop software that is marketed externally have not been capitalized as we believe our current software development process is essentially completed concurrent with the establishment of technological feasibility. As such, all related software development costs are expensed as incurred and included in research and development expense in our consolidated statements of operations.

- 66 -

Table of Contents

Share-Based Compensation

Compensation expense related to share-based transactions, including employee and non-employee director awards, is measured and recognized in the financial statements based on fair value on the grant date. We recognize share-based compensation expense, net of estimated forfeitures, on a straight-line basis over the requisite service periods of the related awards.

Leases

We rent our facilities under operating lease agreements and recognize related rent expense on a straight-line basis over the term of the lease. Some of our lease agreements contain rent holidays, scheduled rent increases, lease incentives, and renewal options. Rent holidays and scheduled rent increases are included in the determination of rent expense to be recorded over the lease term. Lease incentives are recognized as a reduction of rent expense on a straight-line basis over the term of the lease. Renewals are not assumed in the determination of the lease term unless they are deemed to be reasonably assured at the inception of the lease. We begin recognizing rent expense on the date that we obtain the legal right to use and control the leased space.

Income Taxes

We account for income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in our financial statements or tax returns. In addition, deferred tax assets are recorded for the future benefit of utilizing net operating losses and research and development credit carryforwards. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized.

Significant judgment is required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, we consider all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies. In the event that we change our determination as to the amount of deferred tax assets that can be realized, we will adjust our valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made. We apply the authoritative accounting guidance prescribing a threshold and measurement attribute for the financial recognition and measurement of a tax position taken or expected to be taken in a tax return. We recognize liabilities for uncertain tax positions based on a two-step process. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more likely than not to be realized upon ultimate settlement.

Loss Contingencies

We are subject to the possibility of various loss contingencies arising in the ordinary course of business. In determining loss contingencies, we consider the likelihood of loss or impairment of an asset, or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss. An estimated loss contingency is accrued when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. If we determine that a loss is possible and the range of the loss can be reasonably determined, then we disclose the range of the possible loss. We regularly evaluate current information available to us to determine whether an accrual is required, an accrual should be adjusted or a range of possible loss should be disclosed.

Recent Accounting Pronouncements

In April 2015, the Financial Accounting Standards Board (FASB) issued new authoritative guidance on fees paid in a cloud computing arrangement. The standard requires customers in a cloud computing arrangement to evaluate whether the arrangement includes a software license. If the arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If the arrangement does not include a software license, the customer should account for the arrangement as a service contract. The standard is effective for us for our first quarter of fiscal 2017, although early adoption is permitted, and will be applied on either a prospective or retrospective basis. We are currently evaluating adoption methods and whether this standard will have a material impact on our consolidated financial statements.

In April 2015, the FASB issued updated authoritative guidance to simplify the presentation of debt issuance costs. The amended standard requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability, consistent with the presentation of debt discounts, instead of being presented as an asset. The amended standard is effective for us for our first quarter of fiscal 2017, although early adoption is permitted, and will be applied on a retrospective basis. We do not expect the adoption of the standard will have a material impact on our consolidated financial statements.

In May 2014, the FASB issued new authoritative guidance on revenue from contracts with customers. The new standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to

- 67 -

Table of Contents

which the entity expects to be entitled in exchange for those goods or services. The standard also requires significantly expanded disclosures about revenue recognition. In July 2015, the FASB decided to delay the effective date of the new standard by one year. The guidance is now effective for us for our first quarter of fiscal 2019 using either of two methods: (i) retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within the guidance; or (ii) retrospective with the cumulative effect of initially applying the guidance recognized at the date of initial application and providing certain additional disclosures as defined per the guidance. Early adoption as of the original effective date is permitted. We are currently evaluating adoption methods and whether this standard will have a material impact on our consolidated financial statements.

In July 2013, the FASB issued new authoritative guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The standard requires us to present an unrecognized tax benefit as a reduction of a deferred tax asset for a net operating loss (NOL) carryforward or other tax credit carryforward when settlement in this manner is available under applicable tax law. The guidance was effective for us in the first quarter of fiscal 2015. Our adoption of this guidance did not have an impact on our consolidated financial statements.

2. Fair Value Measurements

We categorize assets and liabilities recorded at fair value on our consolidated balance sheets based upon the level of judgment associated with inputs used to measure their fair value. The categories are as follows:

Level 1—Inputs are unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2—Inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the assets or liabilities, either directly or indirectly through market corroboration, for substantially the full term of the financial instruments.

Level 3—Inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. The inputs require significant management judgment or estimation.

The following table presents the fair value of our financial assets and liabilities using the above input categories as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31, 2015				July 31, 2014			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Short-term investments:								
Certificates of deposit	\$—	\$1,000	\$—	\$1,000	\$—	\$—	\$—	\$—
Corporate debt securities	—	97,825	—	97,825	—	22,239	—	22,239
U.S. government and agency securities	—	314,340	—	314,340	—	96,451	—	96,451
Total short-term investments	—	413,165	—	413,165	—	118,690	—	118,690
Long-term investments:								
Certificates of deposit	—	—	—	—	—	1,000	—	1,000
Corporate debt securities	—	92,902	—	92,902	—	39,018	—	39,018
U.S. government and agency securities	—	445,939	—	445,939	—	161,862	—	161,862
Total long-term investments	—	538,841	—	538,841	—	201,880	—	201,880
Other assets:								
Certificates of deposit	—	—	—	—	1,220	—	—	1,220
Total other assets	—	—	—	—	1,220	—	—	1,220
Total assets measured at fair value	\$—	\$952,006	\$—	\$952,006	\$1,220	\$320,570	\$—	\$321,790

Refer to Note 7. Convertible Senior Notes for the carrying amount and estimated fair value of our convertible senior notes as of July 31, 2015.

Table of Contents

3. Investments

The following tables summarize the unrealized gains and losses and fair value of our investments as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Certificates of deposit	\$1,000	\$—	\$—	\$1,000
Corporate debt securities	190,882	24	(179)	) 190,727
U.S. government and agency securities	760,212	271	(204)	) 760,279
Total	\$952,094	\$295	\$(383)	) \$952,006
	July 31, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Certificates of deposit	\$1,000	\$—	\$—	\$1,000
Corporate debt securities	61,299	16	(58)	) 61,257
U.S. government and agency securities	258,376	45	(108)	) 258,313
Total	\$320,675	\$61	\$(166)	) \$320,570

The following tables present our investments that were in an unrealized loss position as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31, 2015					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate debt securities	\$134,976	\$(179)	) \$—	\$—	\$134,976	\$(179)
U.S. government and agency securities	348,991	(204)	) —	—	348,991	(204)
Total	\$483,967	\$(383)	) \$—	\$—	\$483,967	\$(383)
	July 31, 2014					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate debt securities	\$43,868	\$(58)	) \$—	\$—	\$43,868	\$(58)
U.S. government and agency securities	142,490	(108)	) —	—	142,490	(108)
Total	\$186,358	\$(166)	) \$—	\$—	\$186,358	\$(166)

Unrealized losses related to these investments are due to interest rate fluctuations as opposed to credit quality. In addition, we do not intend to sell and it is not likely that we would be required to sell these investments before recovery of their amortized cost basis, which may be at maturity. As a result, there is no other-than-temporary impairment for these investments at July 31, 2015 and 2014.

We received proceeds of \$18.5 million, \$74.6 million, and \$13.5 million from sales of investments during the years ended July 31, 2015, 2014, and 2013, respectively. We use the specific identification method to determine the cost basis of investments sold.

Table of Contents

The following table summarizes the amortized cost and fair value of our investments as of July 31, 2015, by contractual years-to-maturity (in thousands):

	Amortized Cost	Fair Value
Due within one year	\$413,148	\$413,165
Due between one and three years	538,946	538,841
Total	\$952,094	\$952,006

4. Acquisitions

Business Combinations

Fiscal 2015

CirroSecure, Inc.

On May 22, 2015, we completed our acquisition of CirroSecure, Inc. (“CirroSecure”), a privately-held cybersecurity company. The acquisition expands the functionality of our next-generation security platform by providing additional security for SaaS applications. We have accounted for this transaction as a business combination in exchange for total cash consideration of \$15.3 million.

We allocated the purchase consideration to the assets acquired and liabilities assumed based on their estimated fair values and as a result, recorded a developed technology intangible asset of \$11.0 million, goodwill of \$8.1 million, and net liabilities of \$3.8 million in our consolidated balance sheets as of the acquisition date. The developed technology will be amortized over an estimated useful life of seven years. The goodwill is attributable to the assembled workforce and expected post-acquisition synergies and is not deductible for income tax purposes. Adjustments to the allocation of the purchase consideration, specifically income taxes payable and deferred taxes, may be required as additional information is received and certain tax returns are finalized. We expect to finalize the allocation of the purchase consideration to the assets acquired and liabilities assumed as soon as practicable, but not later than 12 months from the acquisition date.

CirroSecure’s operating results are included in our consolidated statements of operations from the date of the acquisition and are considered immaterial for purposes of pro forma financial disclosures.

Fiscal 2014

Cyvera Ltd.

On April 9, 2014, we completed our acquisition of Cyvera Ltd. (“Cyvera”), a privately-held cybersecurity company located in Tel Aviv, Israel. The acquisition extends our next-generation security platform with an innovative approach to preventing attacks on the endpoint. We have accounted for this transaction as a business combination in exchange for total consideration of approximately \$177.6 million, which consisted of the following (in thousands):

	Amount
Cash	\$90,170
Common stock (1.3 million shares)	87,477
Total	\$177,647

As part of the acquisition, we agreed to replace Cyvera's unvested options with our restricted stock units with an estimated fair value of \$6.4 million. Of the total estimated fair value, a portion was allocated to the purchase consideration and the remainder was allocated to future services and will be expensed over the remaining service periods on a straight-line basis as share-based compensation.

In addition, we issued 0.3 million shares of restricted common stock with a total fair value of \$17.6 million to certain Cyvera employees. The restriction on these shares will be released over a period of three years from the acquisition date, subject to continued employment. These shares were excluded from the purchase consideration and are being expensed over the remaining service periods on a straight-line basis as share-based compensation.

We expensed the related acquisition costs in the amount of \$3.9 million in general and administrative expenses for the year ended July 31, 2014.

Table of Contents

The following table summarizes our allocation of the purchase consideration based on the fair value of assets acquired and liabilities assumed (in thousands):

	Amount	
Cash	\$6,930	
Goodwill	145,275	
Identified intangible assets	42,300	
Accrued and other liabilities, net	(6,950)
Long-term deferred tax liability, net	(9,908)
Total	\$177,647	

The fair values of assets acquired and liabilities assumed in the table above have been adjusted to reflect changes due to tax returns filed during the measurement period.

The following table presents details of the identified intangible assets acquired as of the date of acquisition (in thousands, except years):

	Fair Value	Estimated Useful Life
Developed technology	\$34,500	7 years
In-process research and development	7,600	N/A
Other	200	2 years
Total	\$42,300	

Goodwill generated from this business combination is primarily attributable to the assembled workforce and synergies from combined selling opportunities of both network security products and endpoint security products. The goodwill is not deductible for income tax purposes.

The following table presents the unaudited pro forma financial information for the years ended July 31, 2014 and 2013, as though the companies were combined as of August 1, 2012 (in thousands):

	Year Ended July 31,	
	2014	2013
Total revenue	\$598,254	\$396,131
Net loss	\$(241,920	) \$(43,041

The pro forma financial information for the years ended July 31, 2014 and 2013 has been calculated after adjusting our results and those of Cyvera to reflect the business combination accounting effects resulting from this acquisition as though the acquisition occurred as of August 1, 2012, including acquisition related transaction costs, the amortization expense from acquired intangible assets, and post-acquisition share-based compensation expense related to restricted common stock and the replacement of unvested Cyvera options. The pro forma financial information is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of our fiscal 2013.

The pro forma financial information for the years ended July 31, 2014 and 2013 combines our historical results for the years ended July 31, 2014 and 2013 and the adjusted historical results of Cyvera for the twelve months ended June 30, 2014 and 2013, due to differences in reporting periods and considering the date we acquired Cyvera.

Morta Security, Inc.

On December 26, 2013, we completed our acquisition of Morta Security, Inc. ("Morta"), a privately-held cybersecurity company. We have accounted for this transaction as a business combination and exchanged total cash consideration of \$10.3 million. Morta brings us a team of cybersecurity experts which will enhance the proven detection and prevention capabilities of our WildFire offering.

Table of Contents

The following table summarizes our allocation of the purchase consideration based on the fair value of assets acquired and liabilities assumed (in thousands):

	Amount
Goodwill	\$ 10,127
Identified intangible assets	2,200
Net liabilities assumed	(1,982)
Total	\$ 10,345

The fair values of assets acquired and liabilities assumed in the table above have been adjusted to reflect changes due to tax returns filed during the measurement period.

The following table presents details of the identified intangible assets acquired (in thousands, except years):

	Fair Value	Estimated Useful Life
In-process research and development held for defensive purposes	\$ 1,900	3 years
Other	300	2 years
Total	\$ 2,200	

Morta's operating results are included in our consolidated statements of operations from the date of the acquisition and are considered immaterial for purposes of pro forma financial disclosures. Goodwill generated from this business combination is primarily attributable to human capital with threat intelligence experience and capabilities, and is not deductible for income tax purposes.

5. Goodwill and Intangible Assets

Goodwill

The following table presents the changes in the carrying amount of goodwill during the years ended July 31, 2015 and 2014 (in thousands):

	Amount
Balance as of July 31, 2013	\$—
Goodwill acquired	155,033
Balance as of July 31, 2014	155,033
Goodwill acquired	8,120
Measurement period adjustments	369
Balance as of July 31, 2015	\$ 163,522

There was no impairment of goodwill during the years ended July 31, 2015 and 2014.

Table of Contents

Purchased Intangible Assets

The following table presents details of our purchased intangible assets as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31, 2015			2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets with finite lives:						
Developed technology	\$53,100	\$ (7,738)	\$45,362	\$34,500	\$ (1,643)	\$32,857
Acquired intellectual property	8,156	(1,888)	6,268	6,546	(958)	5,588
In-process research and development held for defensive purposes	1,900	(1,003)	897	1,900	(370)	1,530
Other	500	(371)	129	500	(120)	380
Total intangible assets with finite lives	63,656	(11,000)	52,656	43,446	(3,091)	40,355
In-process research and development with indefinite lives	—	—	—	7,600	—	7,600
Total purchased intangible assets	\$63,656	\$ (11,000)	\$52,656	\$51,046	\$ (3,091)	\$47,955

We recognized amortization expense of \$7.9 million, \$2.9 million, and \$0.1 million for the years ended July 31, 2015, 2014, and 2013, respectively. Our in-process research and development acquired from Cyvera in April 2014 was transferred to developed technology during the year ended July 31, 2015 and is being amortized over its estimated useful life of seven years.

The following table summarizes our estimated future amortization expense of intangible assets with finite lives by type as of July 31, 2015 (in thousands):

	Fiscal Years Ending July 31,					
	2016	2017	2018	2019	2020	2021 and Thereafter
Developed technology	\$7,586	\$7,586	\$7,586	\$7,586	\$7,586	\$7,432
Acquired intellectual property	947	853	617	511	485	2,855
In-process research and development held for defensive purposes	633	264	—	—	—	—
Other	129	—	—	—	—	—
Total future amortization expense	\$9,295	\$8,703	\$8,203	\$8,097	\$8,071	\$10,287

6. Property and Equipment

The following table presents details of property and equipment, net as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31,	
	2015	2014
Computers, equipment, and software	\$62,599	\$38,147
Leasehold improvements	25,461	21,258
Demonstration units	15,971	14,832
Furniture and fixtures	6,631	5,129
Total property and equipment	110,662	79,366
Less: accumulated depreciation	(47,784)	(30,622)
Total property and equipment, net	\$62,878	\$48,744

We recognized depreciation expense of \$20.3 million, \$14.0 million, and \$9.8 million related to property and equipment during the years ended July 31, 2015, 2014, and 2013, respectively.

Table of Contents

7. Convertible Senior Notes

Convertible Senior Notes

On June 30, 2014, we issued \$575.0 million aggregate principal amount of 0.0% Convertible Senior Notes due 2019 (the “Notes”). The Notes are governed by an indenture between us, as the issuer, and U.S. Bank National Association, as Trustee (the “Indenture”). The Notes are unsecured, unsubordinated obligations that do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness, or the issuance or repurchase of securities by us or any of our subsidiaries. The Notes mature on July 1, 2019 unless converted or repurchased in accordance with their terms prior to such date. We cannot redeem the Notes prior to maturity.

The Notes are convertible for up to 5.2 million shares of our common stock at an initial conversion rate of approximately 9.068 shares of common stock per \$1,000 principal amount, which is equal to an initial conversion price of approximately \$110.28 per share of common stock, subject to adjustment. Holders of the Notes may surrender their Notes for conversion at their option at any time prior to the close of business on the business day immediately preceding January 1, 2019, only under the following circumstances:

- during any fiscal quarter commencing after the fiscal quarter ending on October 31, 2014 (and only during such fiscal quarter), if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding fiscal quarter is greater than or equal to 130% of the conversion price for the Notes on each applicable trading day;
- during the five business day period after any five consecutive trading day period (the “measurement period”), in which the trading price per \$1,000 principal amount of Notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate for the Notes on each such trading day; or
- upon the occurrence of specified corporate events.

On or after January 1, 2019, holders may convert all or any portion of their Notes at any time prior to the close of business on the second scheduled trading day immediately preceding the maturity date regardless of the foregoing conditions. Upon conversion, holders will receive cash equal to the aggregate principal amount of the Notes to be converted, and, at our election, cash and/or shares of our common stock for any amounts in excess of the aggregate principal amount of the Notes being converted.

The conversion price will be subject to adjustment in some events. Holders of the Notes who convert their Notes in connection with certain corporate events that constitute a “make-whole fundamental change” per the Indenture are, under certain circumstances, entitled to an increase in the conversion rate. Additionally, upon the occurrence of a corporate event that constitutes a “fundamental change” per the Indenture, holders of the Notes may require us to repurchase for cash all or a portion of the Notes at a purchase price equal to 100% of the principal amount of the Notes plus accrued and unpaid contingent interest.

In accounting for the issuance of the Notes, we separated the Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the par value of the Notes as a whole. The difference between the principal amount of the Notes and the liability component (the “debt discount”), is amortized to interest expense using the effective interest method over the term of the Notes. The equity component of the Notes was recorded in additional paid-in capital in our consolidated balance sheets and is not remeasured as long as it continues to meet the conditions for equity classification.

In accounting for the transaction costs related to the issuance of the Notes, we allocated the total amount incurred to the liability and equity components using the same proportions as the proceeds from the Notes. Transaction costs attributable to the liability component were recorded in other assets in our consolidated balance sheets and are being amortized to interest expense in our consolidated statements of operations using the effective interest method over the term of the Notes. Transaction costs attributable to the equity component were netted with the equity component of the Notes in additional paid-in capital in our consolidated balance sheets. We recorded liability issuance costs, or debt issuance costs, of \$12.5 million and equity issuance costs of \$2.9 million.

During the fiscal quarter ended April 30, 2015, the last reported sale price of our common stock was greater than or equal to 130% of the conversion price of the Notes for at least 20 of the last 30 consecutive trading days of such quarter (the “stock price conversion right”). As a result, holders could convert their Notes at any time during the fiscal quarter ending July 31, 2015. Accordingly, we reclassified the net carrying amount of the Notes and related debt issuance costs to current liabilities and current assets, respectively, in our consolidated balance sheets. We also reclassified a portion of the equity component representing the conversion option to temporary equity in our consolidated balance sheets. The stock price conversion right continued to be met during the fiscal quarter ended July 31, 2015, and as a result, holders may convert their Notes at any time during the fiscal quarter ending October 31, 2015. Accordingly, a portion of the equity component remained classified in temporary equity in our consolidated balance sheets. The portion of the equity component classified as temporary equity is measured as the difference between the principal and net carrying amount of the Notes.

- 74 -

Table of Contents

The following table sets forth the components of the Notes as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31, 2015	2014
Liability:		
Principal	\$575,000	\$575,000
Less: debt discount, net of amortization	87,916	108,125
Net carrying amount	\$487,084	\$466,875
Equity (including temporary equity)	\$(109,785	) \$(109,785

The total estimated fair value of the Notes was \$994.8 million and \$587.1 million at July 31, 2015 and July 31, 2014, respectively. The fair value was determined based on the closing trading price per \$100 of the Notes as of the last day of trading for the period. We consider the fair value of the Notes at July 31, 2015 and July 31, 2014 to be a Level 2 measurement. The fair value of the Notes is primarily affected by the trading price of our common stock and market interest rates. As of July 31, 2015, the if-converted value of the Notes exceeded its principal amount by \$376.7 million.

The following table sets forth interest expense recognized related to the Notes for the years ended July 31, 2015 and July 31, 2014 (dollars in thousands):

	Year Ended July 31,	
	2015	2014
Amortization of debt issuance costs	\$2,056	\$166
Amortization of debt discount	20,209	1,660
Total interest expense recognized	\$22,265	\$1,826
Effective interest rate of the liability component	4.8	% 4.8

Note Hedges

To minimize the impact of potential economic dilution upon conversion of the Notes, we entered into convertible note hedge transactions (the "Note Hedges") with respect to our common stock concurrent with the issuance of the Notes. The Note Hedges cover up to 5.2 million shares of our common stock at a strike price per share that corresponds to the initial conversion price of the Notes, which are also subject to adjustment, and are exercisable upon conversion of the Notes. The Note Hedges will expire upon maturity of the Notes. The Note Hedges are separate transactions and are not part of the terms of the Notes. Holders of the Notes will not have any rights with respect to the Note Hedges. The shares receivable related to the Note Hedges are excluded from the calculation of diluted earnings per share as they are antidilutive.

We paid an aggregate amount of \$111.0 million for the Note Hedges, which is included in additional paid-in capital in our consolidated balance sheets.

Warrants

Separately, but concurrently with our issuance of the Notes, we entered into warrant transactions (the "Warrants") whereby we sold warrants to acquire up to 5.2 million shares of our common stock at a strike price of approximately \$137.85 per share, subject to adjustments. The shares issuable under the Warrants will be included in the calculation of diluted earnings per share when the average market value per share of our common stock for the reporting period exceeds the strike price of the Warrants. The Warrants are separate transactions and are not part of the Notes or Notes Hedges, and are not remeasured through earnings each reporting period. Holders of the Notes and Note Hedges will not have any rights with respect to the Warrants.

We received aggregate proceeds of \$78.3 million from the sale of the Warrants, which is included in additional paid-in capital in our consolidated balance sheets.

8. Commitments and Contingencies**Leases**

We lease our facilities under various non-cancelable operating leases, which expire through the year ending July 31, 2028.

Table of Contents

In September 2012, we entered into two lease agreements for an aggregate of approximately 300,000 square feet of space in Santa Clara, California to serve as our corporate headquarters beginning in November 2013. The leases commenced in November 2012 and August 2013, expire in July 2023, and allow for two separate 5-year options to extend the lease term. Payments under these leases are approximately \$94.3 million over the lease term. Each lease has a rent holiday, which was included in the determination of rent expense.

In July 2013, we entered into a 51-month sub-lease agreement for our previous corporate headquarters with a commencement date of January 2014. Net proceeds from this sub-lease are approximately \$10.7 million over the lease term. The sub-lease agreement contains a rent credit of \$0.5 million, which was included in the determination of rental income.

In May 2015, we entered into three lease agreements for approximately 752,000 square feet of corporate office space in Santa Clara, California to serve as our future corporate headquarters. The first lease will commence in May 2016 and expire in April 2021, although it can also be terminated by us under certain conditions. The remaining two leases will commence in May 2017 and expire in April 2028, however, the property is currently under construction and as a result, the lease commencement dates may change based on progress of the construction project. The leases contain a rent holiday period, scheduled rent increases, lease incentives, and renewal options which allow the lease terms to be extended through April 2046. Rental payments under the three lease agreements are approximately \$275.1 million over the lease term. In August 2015, we executed the expansion notice under the lease agreements to notify the landlord of our intent to lease approximately 300,000 square feet of additional space in a building that will be constructed at a future date. The lease related to this additional space has not yet been executed.

We recognized rent expense of \$15.4 million, \$13.2 million, and \$4.4 million for the years ended July 31, 2015, 2014, and 2013, respectively. Rent expense is recognized on a straight-line basis over the term of the lease.

The following table presents details of the aggregate future non-cancelable minimum rental payments under our operating leases as of July 31, 2015 (in thousands):

	Amount
Years ending July 31:	
2016	\$20,821
2017	24,374
2018	27,133
2019	41,583
2020	42,043
2021 and thereafter	253,202
Committed gross lease payments	409,156
Less: proceeds from sublease rental	8,174
Net operating lease obligation	\$400,982

Contract Manufacturer Commitments

Our independent contract manufacturer procures components and assembles our products based on our forecasts.

These forecasts are based on estimates of demand for our products primarily for the next twelve months, which are in turn based on historical trends and an analysis from our sales and product marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate supply, we may issue forecasts and orders for components and products that are non-cancelable. Obligations under contracts that we can cancel without a significant penalty are not included. As of July 31, 2015, we had \$42.8 million of open orders.

Litigation

In December 2011, Juniper Networks, Inc. (“Juniper”) filed a complaint against us in the United States District Court for the District of Delaware alleging patent infringement, which sought preliminary and permanent injunctions against infringement, treble damages, and attorneys’ fees. On September 30, 2013, we filed a lawsuit against Juniper in the United States District Court for the Northern District of California alleging that Juniper’s products infringe three of our U.S. patents, and sought monetary damages and a permanent injunction. On May 27, 2014, we entered into a Settlement, Release and Cross-License Agreement (the “Settlement Agreement”) with Juniper to resolve all pending litigation between the parties, including those discussed above. Refer to Note 9. Legal Settlement for more

information on the Settlement Agreement.

In addition to the above matter, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. Such matters are subject to many uncertainties and outcomes are not predictable

- 76 -

Table of Contents

with assurance. We accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss.

To the extent there is a reasonable possibility that a loss exceeding amounts already recognized may be incurred and the amount of such additional loss would be material, we will either disclose the estimated additional loss or state that such an estimate cannot be made. As of July 31, 2015, we have not recorded any significant accruals for loss contingencies associated with such legal proceedings, determined that an unfavorable outcome is probable or reasonably possible, or determined that the amount or range of any possible loss is reasonably estimable.

Indemnification

Under the indemnification provisions of our standard sales related contracts, we agree to defend our end-customers against third-party claims asserting infringement of certain intellectual property rights, which may include patents, copyrights, trademarks, or trade secrets, and to pay judgments entered on such claims. Our exposure under these indemnification provisions is generally limited to the total amount paid by our end-customer under the agreement. However, certain agreements include indemnification provisions that could potentially expose us to losses in excess of the amount received under the agreement. In addition, we indemnify our officers, directors, and certain key employees while they are serving in good faith in their company capacities. To date, there have been no claims under any indemnification provisions.

9. Legal Settlement

Settlement, Release and Cross-License Agreement with Juniper

On May 27, 2014, we entered into the Settlement Agreement with Juniper, whereby we resolved all pending litigation matters. Under the terms of the Settlement Agreement, we agreed to pay Juniper a one-time settlement amount comprised of \$75.0 million in cash, 1.1 million shares of our common stock, and a warrant to purchase 0.5 million shares of our common stock, in exchange for the following:

- Mutual dismissal with prejudice of all pending litigation between the parties and general release of all liability for Palo Alto Networks and Juniper,

- Cross-license between both parties for the patents-in-suit and associated family members and counterparts worldwide for the life of the patents, and

- Mutual covenant not to sue for infringement of any other patents for a period of eight years.

The fair value of the total consideration as of the settlement date was \$182.5 million, which was comprised of \$75.0 million in cash, \$75.2 million in common stock, and \$32.2 million in warrant. The fair values of the common stock and warrant were measured using the closing price of our common stock on the settlement date.

The warrant was issued on June 3, 2014 and entitled Juniper to purchase up to 0.5 million shares of common stock at an exercise price of \$0.0001 per share and was classified as a liability during the period it was outstanding. On July 1, 2014, Juniper exercised the warrant in full. Accordingly, we recorded the change in the fair value of the warrant liability through the exercise date of \$5.9 million within other income (expense), net in our consolidated statement of operations for the year ended July 31, 2014.

We accounted for the Settlement Agreement as a multiple-element arrangement and allocated the fair value of the consideration as of the settlement date to the identifiable elements based on their estimated fair values. Of the total settlement amount, \$61.3 million was allocated to the licensing of intellectual property, \$54.3 million was allocated to the mutual dismissal of claims, and the remaining amount was allocated to the mutual covenant not to sue. The mutual dismissal of claims and the mutual covenant not to sue have no identifiable future benefit, and as a result we recorded a settlement charge within legal settlement expense in our consolidated statement of operations for the year ended July 31, 2014. The licensing of intellectual property is being amortized to cost of product revenue in our consolidated statements of operations over the estimated period of benefit of five years.

Mutual Covenant Not to Sue and Release Agreement

On January 27, 2014, we executed a Mutual Covenant Not to Sue and Release Agreement with Fortinet, Inc., thereby extending an existing covenant for six more years. We evaluated the transaction as a multiple-element arrangement and allocated the one-time payment that we made in the amount of \$20.0 million to each identifiable element using its relative fair value. Based on our estimates of fair value, we determined that the primary benefit of the arrangement is avoided litigation cost and the release of any potential past claims, with no material value attributable to future use or

benefit. Accordingly, we recorded a \$20.0 million settlement charge within legal settlement expense in our consolidated statement of operations for the year ended July 31, 2014.

- 77 -

Table of Contents

10. Stockholders' Equity

In October 2012, we completed our secondary offering whereby certain stockholders of our company sold 4.8 million shares of common stock to the public at a price of \$63.00 per share. The aggregate offering price for shares sold in the offering was approximately \$290.3 million, net of underwriting discounts and commissions. We did not receive any proceeds from the sale of shares in this offering. Offering expenses were paid by the stockholders who sold shares of common stock in the offering.

11. Equity Award Plans

Share-Based Compensation Plans

2012 Equity Incentive Plan

Our 2012 Equity Incentive Plan (our "2012 Plan") was adopted by our board of directors and approved by the stockholders on June 5, 2012 and was effective one business day prior to the effectiveness of our registration statement for our initial public offering (IPO). Our 2012 Plan replaced our 2005 Equity Incentive Plan (our "2005 Plan"), which terminated upon the completion of our IPO, however, awards that were outstanding upon termination remained outstanding pursuant to their original terms. Our 2012 Plan provides for the granting of stock options, restricted stock awards, restricted stock units (RSUs), stock appreciation rights, performance units, and performance shares to our employees, directors, and consultants.

Awards granted under our 2012 Plan vest over the periods determined by the board of directors, generally three to four years, and expire no more than ten years after the date of grant. In the case of an incentive stock option granted to an employee, who at the time of grant owns stock representing more than 10% of the total combined voting power of all classes of stock, the exercise price shall be no less than 110% of the fair value per share on the date of grant, and expire five years from the date of grant, and for options granted to any other employee, the per share exercise price shall be no less than 100% of the fair value per share on the date of grant. In the case of a non-statutory stock option and options granted to consultants, the per share exercise price shall be no less than 100% of the fair value per share on the date of grant. Stock that is purchased prior to vesting is subject to our right of repurchase at any time following termination of the participant. Since our IPO in 2012, awards granted under our 2012 Plan consist primarily of RSUs, which generally vest over a period of three to four years from the date of grant. Until vested, RSUs do not have the voting and dividend participation rights of common stock and the shares underlying the awards are not considered issued and outstanding.

A total of 18.5 million shares of our common stock are reserved for issuance pursuant to our 2012 Plan as of July 31, 2015. This includes shares that are (i) reserved but unissued under our 2005 Plan on the effective date of our 2012 Plan or (ii) returned to our 2005 Plan as a result of expiration or termination of options. On the first day of each fiscal year, the number of shares in the reserve may be increased by the lesser of (i) 8,000,000 shares, (ii) 4.5% of the outstanding shares of common stock on the last day of our immediately preceding fiscal year, or (iii) such other amount as determined by our board of directors.

2012 Employee Stock Purchase Plan

Our 2012 Employee Stock Purchase Plan (our "2012 ESPP") was adopted by our board of directors and approved by the stockholders on June 5, 2012 and was effective upon completion of our IPO.

Our 2012 ESPP permits eligible employees to acquire shares of our common stock at 85% of the lower of the fair market value of our common stock on the first trading day of each offering period or on the exercise date. Each offering period will be approximately six months starting on the first trading date on or after March 15 and September 15 of each year. Participants may purchase shares of common stock through payroll deductions of up to 15% of their eligible compensation, subject to purchase limits of 625 shares during a six month period or \$25,000 worth of stock for each calendar year.

A total of 1.8 million shares of our common stock are available for sale under our 2012 ESPP as of July 31, 2015. On the first day of each fiscal year, the number of shares in the reserve may be increased by the lesser of (i) 2,000,000 shares, (ii) 1% of the outstanding shares of our common stock on the first day of the fiscal year, or (iii) such other amount as determined by our board of directors.

Table of Contents

Stock Option Activities

A summary of the activity under our stock plans during the reporting period and a summary of information related to options exercisable, vested, and expected to vest are presented below (in thousands, except per share amounts):

	Options Outstanding			Aggregate Intrinsic Value
	Number of Shares	Weighted- Average Exercise Price Per Share	Weighted- Average Remaining Contractual Term (Years)	
Balance—July 31, 2014	5,830	\$13.02	7.0	\$395,507
Options granted	—	—		
Options forfeited	(54	) 17.43		
Options exercised	(2,505	) 11.99		
Balance—July 31, 2015	3,271	\$13.74	6.2	\$562,906
Options vested and expected to vest—July 31, 2015	3,254	\$13.70	6.1	\$560,111
Options exercisable—July 31, 2015	2,578	\$12.13	6.1	\$447,799

The weighted-average grant-date fair value of options granted during the year ended July 31, 2013 was \$26.09. The intrinsic value of options exercised during the years ended July 31, 2015, 2014, and 2013 was \$301.1 million, \$198.8 million, and \$186.8 million, respectively. The grant-date fair value of options vested during the years ended July 31, 2015, 2014, and 2013 was \$14.6 million, \$17.1 million, and \$21.4 million, respectively.

RSU Activities

A summary of the activity under our stock plans during the reporting period and a summary of information related to RSUs vested and expected to vest are presented below (in thousands, except per share amounts):

	RSUs Outstanding			Aggregate Intrinsic Value
	Number of Shares	Weighted- Average Grant-Date Fair Value Per Share	Weighted- Average Remaining Contractual Term (Years)	
Balance—July 31, 2014	6,046	\$59.84	1.4	\$488,880
RSUs granted	4,142	122.36		
RSUs vested	(2,511	) 58.40		
RSUs forfeited	(494	) 70.55		
Balance—July 31, 2015	7,183	\$95.66	1.2	\$1,334,817
RSUs vested and expected to vest—July 31, 2015	6,582	\$94.90	1.2	\$1,223,133

The weighted-average grant-date fair value of RSUs granted during the years ended July 31, 2015, 2014, and 2013 was \$122.36, \$61.00, and \$54.51, respectively. The aggregate fair value, as of the respective vesting dates, of RSUs vested during the years ended July 31, 2015, 2014, and 2013 was \$350.4 million, \$57.4 million, and \$0.3 million, respectively.

Table of Contents

Shares Available for Grant

The following table presents the stock activity and the total number of shares available for grant as of July 31, 2015 (in thousands):

	Number of shares
Balance—July 31, 2014	8,066
Authorized	3,578
RSUs granted	(4,142
Repurchased	—
Options forfeited	54
RSUs forfeited	494
Balance—July 31, 2015	8,050

Employee Stock Purchase Plan

We recognized compensation expense of \$6.7 million, \$4.5 million, and \$5.3 million in connection with our 2012 ESPP during the years ended July 31, 2015, 2014, and 2013, respectively. Employees purchased 0.2 million shares of common stock at an average exercise price of \$75.09 per share during the year ended July 31, 2015.

Share-Based Compensation

We record share-based compensation awards based on fair value as of the grant date. For option awards and ESPP offerings we use the Black-Scholes option-pricing model to determine fair value. We recognize such costs as compensation expense on a straight-line basis over the requisite service period of the award. The assumptions for our option-pricing model are determined as follows:

Risk-Free Interest Rate

We base the risk-free interest rate used in the Black-Scholes valuation model on the implied yield available on U.S. Treasury zero-coupon issues with an equivalent remaining term of the options for each option group or the term of our 2012 ESPP offering.

Expected Term

The expected term represents the period that our share-based awards are expected to be outstanding. We determined the expected term assumption based on the contractual term of the options adjusted for estimates of our employees' expected exercise and expected post-vesting termination behavior. For our 2012 ESPP, the expected term is based on the length of the offering period.

Volatility

Beginning in fiscal 2014, we determine the price volatility factor based on the historical volatility of our common stock. Prior to fiscal 2014, we determined the price volatility factor based on the historical volatilities of our peer group as we did not have sufficient trading history for our common stock.

Dividend Yield

The expected dividend assumption is based on our current expectations about our anticipated dividend policy.

The following table summarizes the assumptions related to our stock options:

	Year Ended July 31, 2013
Risk-free interest rate	1.0%
Expected term	6 years
Volatility	50%
Dividend yield	—%

Table of Contents

The following table summarizes the assumptions related to our 2012 ESPP:

	Year Ended July 31,		
	2015	2014	2013
Risk-free interest rate	0.1%	0.1%	0.1%
Expected term	< 1 year	< 1 year	< 1 year
Volatility	40%	40%	42%
Dividend yield	—%	—%	—%

The following table summarizes share-based compensation included in costs and expenses (in thousands):

	Year Ended July 31,		
	2015	2014	2013
Cost of product revenue	\$3,858	\$1,636	\$765
Cost of services revenue	20,425	9,434	3,586
Research and development	74,837	29,524	9,931
Sales and marketing	84,113	42,647	20,493
General and administrative	38,198	16,668	9,101
Total share-based compensation	\$221,431	\$99,909	\$43,876

At July 31, 2015, total compensation cost related to unvested share-based awards granted but not yet recognized was \$557.0 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of three years. Future grants will increase the amount of compensation expense to be recorded in these periods.

For the year ended July 31, 2014, we accelerated the vesting of certain share-based awards in connection with our acquisitions of Morta and Cyvera and as a result, we recorded \$3.4 million of compensation expense within general and administrative expense. For the year ended July 31, 2013, we modified the terms of certain share-based awards for a former employee and as a result, we recorded \$1.9 million of compensation expense within sales and marketing expense.

12. Income Taxes

The following table presents the components of income (loss) before income taxes (in thousands):

	Year Ended July 31,		
	2015	2014	2013
United States	\$(47,493	) \$(149,243	) \$5,198
Foreign	(108,084	) (72,917	) (23,854
Total	\$(155,577	) \$(222,160	) \$(18,656

Table of Contents

The following table summarizes the provision for income taxes (in thousands):

	Year Ended July 31,		
	2015	2014	2013
Federal:			
Current	\$ 1,757	\$ 795	\$ 5,883
Deferred	(2,972) —	—
State:			
Current	682	230	1,758
Deferred	(431	) (324) —
Foreign:			
Current	10,738	4,679	3,296
Deferred	(369	) (1,088	) (347
Total	\$ 9,405	\$ 4,292	\$ 10,590

The following table presents the items accounting for the difference between income taxes computed at the federal statutory income tax rate and the provision for income taxes:

	Year Ended July 31,			
	2015	2014	2013	
Federal statutory rate	35.0	% 35.0	% 35.0	%
Effect of:				
State taxes, net of federal tax benefit	3.6	1.3	1.0	
Foreign income at other than U.S. rates	(6.5	) (12.1	) (62.4)
Change in valuation allowance	(28.5	) (21.3	) (32.5)
Share-based compensation	(10.2	) (3.2	) (16.1)
Meals and entertainment	(0.6	) (0.3	) (2.0)
Amortization of deferred tax charges	(2.2) —	—	
Research credits	6.7	1.3	25.2	
Other, net	(3.3	) (2.6	) (5.0)
Total	(6.0	)% (1.9	)% (56.8)%

During the year ended July 31, 2015, we completed several changes to our corporate structure to more closely align with the global nature of our business. As a result, we recorded deferred tax charges in prepaid expenses and other current assets and other assets on our consolidated balance sheets. These amounts are being amortized on a straight-line basis over the life of the associated assets as a component of provision for income taxes in our consolidated statements of operations.

Table of Contents

The following table presents the components of our deferred tax assets and liabilities as of July 31, 2015 and July 31, 2014 (in thousands):

	July 31, 2015	2014
Deferred tax assets:		
Accruals and reserves	\$38,936	\$7,942
Deferred revenue	35,261	30,430
Research and development and foreign tax credits	20,123	8,741
Net operating loss carryforwards	18,376	32,282
Share-based compensation	35,893	17,715
Gross deferred tax assets	148,589	97,110
Valuation allowance	(138,354	) (89,309
Total deferred tax assets	10,235	7,801
Deferred tax liabilities:		
Fixed assets and intangible assets	(7,919	) (15,040
Other deferred tax liabilities	(1,631	) (565
Total deferred tax liabilities	(9,550	) (15,605
Total	\$685	\$(7,804

A valuation allowance is provided when it is more likely than not that the deferred tax asset will not be realized. Realization of deferred tax assets is dependent upon future taxable income, if any, the amount and timing of which are uncertain. At such time, if it is determined that it is more likely than not that the deferred tax assets are realizable, the valuation allowance will be adjusted. As of July 31, 2015, we have provided a valuation allowance for our federal, state, and certain foreign deferred tax assets that we believe will, more likely than not, be unrealizable. The net valuation allowance increased by approximately \$49.0 million from the year ended July 31, 2014 to the year ended July 31, 2015, which was primarily attributable to an increase in deferred tax assets in our federal and state jurisdictions.

Due to our acquisition of CirroSecure, a deferred tax liability was established for the book-tax basis difference related to purchased intangibles. The net deferred tax liability from acquisitions provided an additional source of income to support the realizability of our pre-existing deferred tax assets and as a result, we released a portion of the valuation allowance that was established in the previous year and recorded a tax benefit of \$3.4 million for the year ended July 31, 2015.

As of July 31, 2015, we had federal, state, and foreign NOL carryforwards of approximately \$752.9 million, \$808.5 million, and \$12.5 million, respectively as reported on our tax returns, available to reduce future taxable income, if any. If not utilized, our federal and state NOL carryforwards will expire in various amounts from the years ending July 31, 2027 through 2035 and July 31, 2017 through 2035, respectively. Our foreign NOL will carry forward indefinitely.

As of July 31, 2015, we had federal and state research and development tax credit carryforwards of approximately \$17.2 million and \$21.8 million, respectively as reported on our tax returns. If not utilized, the federal credit carryforwards will expire in various amounts from the years ending July 31, 2026 through 2035. The state credit will carry forward indefinitely.

As of July 31, 2015, we had foreign tax credit carryforwards of \$1.1 million as reported on our tax returns. If not utilized, the foreign tax credit carryforwards will expire in various amounts from the years ending July 31, 2021 through 2025.

Utilization of the NOL carryforwards and credits may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of NOLs and credits before utilization.

We use the with-and-without approach to determine the recognition and measurement of excess tax benefits resulting from share-based awards. Accordingly, we have elected to recognize excess income tax benefits from share-based awards in additional paid-in capital only if an incremental income tax benefit would be realized after considering all

other tax attributes presently available to us. As of July 31, 2015, we had excess tax benefits from share-based awards of \$680.7 million, \$648.2 million, and \$12.5 million included in federal, state, and foreign NOL, respectively. We also had \$5.3 million of excess tax benefits from share-based awards included in federal research and development tax credit. The impact of this excess tax benefit is recognized as additional paid-in capital when it reduces taxes payable. We have elected to account for the indirect effects of share-based awards on other tax attributes, such as the research, foreign and other tax credits, through the consolidated statements of operations.

- 83 -

Table of Contents

During the years ended July 31, 2015, 2014, and 2013, we recorded excess tax benefits that resulted from allocating certain tax effects related to exercises of stock options and vesting of RSUs directly to stockholders' equity in the amount of \$2.5 million, \$1.0 million, and \$6.8 million, respectively.

In December 2014, the Tax Increase Prevention Act of 2014 was signed into law, which retroactively extends the federal research and development credit, bonus depreciation, and other corporate tax incentives through December 31, 2014. Due to the valuation allowance against our domestic deferred tax assets, we did not recognize any discrete tax benefits during the year ended July 31, 2015 as a result of the legislation.

As of July 31, 2015, we had \$67.2 million of unrecognized tax benefits, \$10.8 million of which would affect income tax expense if recognized, after consideration of our valuation allowance in the United States and other assets. As of July 31, 2014, we had \$10.4 million of unrecognized tax benefits, \$3.9 million of which would affect income tax expense if recognized, after consideration of our valuation allowance in the United States. As of July 31, 2015, our federal, state, and foreign returns for the tax years 2008 through the current period remain open to examination. Fiscal years outside the normal statute of limitation remain open to audit by tax authorities due to tax attributes generated in earlier years, which have been carried forward and may be audited in subsequent years when utilized. We do not expect the amount of unrecognized tax benefits as of July 31, 2015 to change significantly over the next 12 months.

We recognize both interest and penalties associated with uncertain tax positions as a component of income tax expense. During the years ended July 31, 2015, 2014, and 2013, we recognized income tax expense related to interest and penalties of \$1.1 million, \$0.3 million, and \$0.2 million, respectively. We had accrued interest and penalties on our consolidated balance sheets related to unrecognized tax benefits of \$1.8 million and \$0.6 million as of July 31, 2015 and 2014, respectively. The ultimate amount and timing of any future cash settlements cannot be predicted with reasonable certainty.

The following table presents a reconciliation of the beginning and ending amount of our gross unrecognized tax benefits (in thousands):

	Year Ended July 31,		
	2015	2014	2013
Unrecognized tax benefits at the beginning of the period	\$10,385	\$6,561	\$2,630
Additions for tax positions taken in prior years	6,061	428	585
Reductions for tax positions taken in prior years	(612	) —	(3
Additions for tax positions taken in the current year	51,324	3,396	3,349
Unrecognized tax benefits at the end of the period	\$67,158	\$10,385	\$6,561

As of July 31, 2015, we had approximately \$7.0 million of undistributed earnings in foreign subsidiaries. We expect to permanently reinvest these earnings outside of the United States to fund future foreign operations. We project that we will have sufficient cash flow in the United States and will not need to repatriate the foreign earnings to finance our domestic operations. If we were to distribute these earnings to the United States, we would be subject to U.S. income taxes, an adjustment for foreign tax credits, and foreign withholding taxes. We have not recorded a deferred tax liability on any portion of our undistributed earnings in foreign subsidiaries. If we were to repatriate these earnings to the United States, any associated income tax liability would be insignificant.

13. Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by basic weighted-average shares outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by diluted weighted-average shares outstanding, including potentially dilutive securities.

The following table presents the computation of basic and diluted net loss per share of common stock (in thousands, except per share data):

	Year Ended July 31,		
	2015	2014	2013
Net loss	\$(164,982	) \$(226,452	) \$(29,246
Weighted-average shares used to compute net loss per share, basic and diluted	81,619	74,291	68,682
Net loss per share, basic and diluted	\$(2.02	) \$(3.05	) \$(0.43

Table of Contents

The following securities were excluded from the computation of diluted net loss per share of common stock for the periods presented as their effect would have been antidilutive (in thousands):

	Year Ended July 31,		
	2015	2014	2013
Options	3,271	5,830	10,033
RSUs	7,183	6,046	2,241
ESPP shares	78	95	114
Convertible senior notes	5,214	5,214	—
Warrants related to the issuance of convertible senior notes	5,214	5,214	—
Total	20,960	22,399	12,388

14. Employee Benefit Plan

We have established a 401(k) tax-deferred savings plan which permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code. We are responsible for administrative costs of the plan and have made no contributions to the plan since inception.

15. Segment Information

We conduct business globally and are primarily managed on a geographic theater basis. Our chief operating decision maker reviews financial information presented on a consolidated basis accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. We have one business activity and there are no segment managers who are held accountable for operations, operating results, and plans for levels, components, or types of products or services below the consolidated unit level. Accordingly, we are considered to be in a single reportable segment and operating unit structure.

The following table presents revenue by geographic theater (in thousands):

	Year Ended July 31,		
	2015	2014	2013
Revenue:			
Americas			
United States	\$593,741	\$363,174	\$228,604
Other Americas	45,587	33,452	19,012
Total Americas	639,328	396,626	247,616
EMEA	178,719	126,915	91,496
APAC	110,005	74,638	56,995
Total revenue	\$928,052	\$598,179	\$396,107

The following table presents revenue for groups of similar products and services (in thousands):

	Year Ended July 31,		
	2015	2014	2013
Revenue:			
Product	\$492,658	\$340,143	\$243,707
Services			
Subscription	212,676	123,236	71,203
Support and maintenance	222,718	134,800	81,197
Total services	435,394	258,036	152,400
Total revenue	\$928,052	\$598,179	\$396,107

Substantially all of our assets were attributable to the Americas operations as of July 31, 2015 and 2014.

Table of Contents

16. Selected Quarterly Financial Data (Unaudited)

The following tables set forth selected unaudited financial data for the years ended July 31, 2015 and 2014 (in thousands, except per share amounts):

	Three Months Ended			
	Oct. 31, 2014	Jan. 31, 2015	Apr. 30, 2015	Jul. 31, 2015
Revenue:				
Product	\$ 101,476	\$ 115,621	\$ 121,524	\$ 154,037
Services	90,870	102,034	112,648	129,842
Total revenue	192,346	217,655	234,172	283,879
Cost of revenue:				
Product	29,141	30,640	32,851	38,462
Services	24,320	28,685	31,544	35,856
Total cost of revenue	53,461	59,325	64,395	74,318
Total gross profit	138,885	158,330	169,777	209,561
Operating expenses:				
Research and development	37,305	46,948	48,486	53,089
Sales and marketing	106,366	122,875	131,026	162,429
General and administrative	18,977	27,023	26,989	28,576
Total operating expenses	162,648	196,846	206,501	244,094
Operating loss	(23,763	) (38,516	) (36,724	) (34,533
Interest expense	(5,489	) (5,539	) (5,631	) (5,666
Other income (expense), net	341	344	(55	) (346
Loss before income taxes	(28,911	) (43,711	) (42,410	) (40,545
Provision for (benefit from) income taxes	1,157	(703	) 3,525	5,426
Net loss	\$(30,068	) \$(43,008	) \$(45,935	) \$(45,971
Net loss per share, basic and diluted	\$(0.38	) \$(0.53	) \$(0.56	) \$(0.55

Table of Contents

	Three Months Ended			
	Oct. 31, 2013	Jan. 31, 2014	Apr. 30, 2014	Jul. 31, 2014
Revenue:				
Product	\$75,485	\$80,823	\$84,128	\$99,707
Services	52,695	60,245	66,572	78,524
Total revenue	128,180	141,068	150,700	178,231
Cost of revenue:				
Product	17,954	20,221	20,425	26,903
Services	15,853	17,283	19,285	21,704
Total cost of revenue	33,807	37,504	39,710	48,607
Total gross profit	94,373	103,564	110,990	129,624
Operating expenses:				
Research and development	19,893	24,253	27,837	32,830
Sales and marketing	67,366	76,734	83,995	106,668
General and administrative	14,125	19,733	23,717	15,574
Legal settlement (Note 9)	—	20,000	121,173	—
Total operating expenses	101,384	140,720	256,722	155,072
Operating loss	(7,011	) (37,156	) (145,732	) (25,448
Interest expense	(8	) (14	) (13	) (1,848
Other income (expense), net	405	(170	) 430	(5,595
Loss before income taxes	(6,614	) (37,340	) (145,315	) (32,891
Provision for (benefit from) income taxes	1,247	2,606	1,272	(833
Net loss	\$(7,861	) \$(39,946	) \$(146,587	) \$(32,058
Net loss per share, basic and diluted	\$(0.11	) \$(0.55	) \$(1.96	) \$(0.41

ITEM CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND
9. FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our chief executive officer and chief financial officer concluded that, as of July 31, 2015, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission (SEC) rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Management’s Annual Report on Internal Control Over Financial Reporting

For “Management’s Annual Report on Internal Control Over Financial Reporting” see the report under Part II, Item 8 of this Annual Report on Form 10-K, which report is incorporated herein by reference.

Table of Contents

For the “Report of Independent Registered Public Accounting Firm,” see the report under Part II, Item 8 of this Annual Report on Form 10-K, which report is incorporated herein by reference.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the quarter ended July 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

- 88 -

Table of Contents

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Executive Officers and Directors

The information required by this item will be contained in our definitive proxy statement to be filed with the SEC in connection with our 2015 annual meeting of stockholders (the "Proxy Statement"), which is expected to be filed not later than 120 days after the end of our fiscal year ended July 31, 2015, and is incorporated in this report by reference.

ITEM 11. EXECUTIVE
COMPENSATION

The information required by this item will be set forth in the Proxy Statement and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND
RELATED STOCKHOLDER MATTERS

The information required by this item will be set forth in the Proxy Statement and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item will be set forth in the Proxy Statement and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item will be set forth in the Proxy Statement and is incorporated herein by reference.

Table of Contents

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Documents filed as part of this Annual Report on Form 10-K are as follows:

1. Consolidated Financial Statements

Our Consolidated Financial Statements are listed in the “Index to Consolidated Financial Statements” under Part II, Item 8 of this Annual Report on Form 10-K.

2. Financial Statement Schedules

Financial statement schedules have been omitted because they are not required, not applicable, not present in amounts sufficient to require submission of the schedule, or the required information is shown in the Consolidated Financial Statements or Notes thereto.

3. Exhibits

The documents listed in the Exhibit Index of this Annual Report on Form 10-K are incorporated by reference or are filed with this Annual Report on Form 10-K, in each case as indicated therein (numbered in accordance with Item 601 of Regulation S-K).

- 90 -

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on September 17, 2015.

PALO ALTO NETWORKS, INC.

By: /s/ MARK D. MCLAUGHLIN

Mark D. McLaughlin

Chief Executive Officer and President

Table of Contents

POWER OF ATTORNEY

KNOW ALL THESE PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Mark D. McLaughlin and Steffan C. Tomlinson, and each of them, as his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or any of them, or their or his substitutes, may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated:

Signature	Title	Date
/s/ MARK D. MCLAUGHLIN Mark D. McLaughlin	Chief Executive Officer, President and Director (Principal Executive Officer)	September 17, 2015
/s/ STEFFAN C. TOMLINSON Steffan C. Tomlinson	Chief Financial Officer (Principal Accounting and Financial Officer)	September 17, 2015
/s/ NIR ZUK Nir Zuk	Chief Technical Officer and Director	September 17, 2015
/s/ ASHEEM CHANDNA Asheem Chandna	Director	September 17, 2015
/s/ JOHN M. DONOVAN John M. Donovan	Director	September 17, 2015
/s/ CARL ESCHENBACH Carl Eschenbach	Director	September 17, 2015
/s/ JAMES J. GOETZ James J. Goetz	Director	September 17, 2015
/s/ STANLEY J. MERESMAN Stanley J. Meresman	Director	September 17, 2015
/s/ DANIEL J. WARMENHOVEN Daniel J. Warmenhoven	Director	September 17, 2015

Table of Contents

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Form	Incorporated by		Filing Date
			Reference File No.	Exhibit	
3.1	Restated Certificate of Incorporation of the Registrant.	10-K	001-35594	3.1	October 4, 2012
3.2	Amended and Restated Bylaws of the Registrant.	10-K	001-35594	3.2	October 4, 2012
4.1	Warrant to Purchase Stock by Juniper Networks, Inc.	8-K	001-35594	4.1	June 4, 2014
4.2	Indenture between the Registrant and U.S. Bank National Association, dated as of June 30, 2014.	8-K	001-35594	4.1	July 1, 2014
10.1*	Form of Indemnification Agreement between the Registrant and its directors and officers.	S-1/A	333-180620	10.1	July 9, 2012
10.2*	2005 Equity Incentive Plan and related form agreements under 2005 Equity Incentive Plan.	S-1/A	333-180620	10.2	July 9, 2012
10.3*	2012 Equity Incentive Plan and related form agreements under 2012 Equity Incentive Plan, as amended.	10-K	001-35594	10.3	September 18, 2014
10.4*	2012 Employee Stock Purchase Plan and related form agreements under 2012 Employee Stock Purchase Plan, as amended and restated.	10-Q	001-35594	10.2	November 25, 2014
10.5*	Employee Incentive Compensation Plan, as amended and restated.	10-Q	001-35594	10.2	November 25, 2014
10.6*	Offer Letter between the Registrant and Mark D. McLaughlin, dated July 21, 2011, as amended.	S-1	333-180620	10.6	April 6, 2012
10.7*	Offer Letter between the Registrant and Steffan C. Tomlinson, dated January 17, 2012.	S-1	333-180620	10.7	April 6, 2012
10.8*	Letter Agreement between the Registrant and Nir Zuk, dated December 19, 2011.	S-1	333-180620	10.8	April 6, 2012
10.9*	Letter Agreement between the Registrant and René Bonvanie, dated December 19, 2011.	S-1	333-180620	10.10	April 6, 2012
10.10*	Letter Agreement between the Registrant and Wilson Xu, dated September 4, 2014.	10-K	001-35594	10.29	September 18, 2014

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10.11*	Offer Letter between the Registrant and Stanley J. Meresman, dated September 8, 2014.	8-K	001-35594	10.1	September 22, 2014
10.12*	Offer Letter between the Registrant and Daniel J. Warmenhoven, dated February 14, 2012.	S-1	333-180620	10.13	April 6, 2012
10.13*	Offer Letter between the Registrant and Mark F. Anderson, dated May 23, 2012.	S-1/A	333-180620	10.16	July 9, 2012
10.14*	Offer Letter between the Registrant and John M. Donovan, dated September 14, 2012.	8-K	001-35594	10.1	September 20, 2012
10.15*	Offer Letter between the Registrant and Carl Eschenbach, dated May 9, 2013.	8-K	001-35594	10.1	May 30, 2013
10.16	Lease between the Registrant and Santa Clara Office Partners LLC, dated October 20, 2010, as amended.	S-1	333-180620	10.14	April 6, 2012
10.17	Amendment No. 2 to Lease between the Registrant and Santa Clara Office Partners LLC, dated July 2, 2013.	10-K	001-35594	10.17	September 25, 2013
10.18	Lease between the Registrant and SI 34 LLC, dated September 17, 2012.	10-K	001-35594	10.16	October 4, 2012

Table of Contents

Exhibit Number	Exhibit Description	Form	Incorporated by		Filing Date
			Reference File No.	Exhibit	
10.19	Lease between the Registrant and SI 34 LLC, dated September 17, 2012.	10-K	001-35594	10.16	October 4, 2012
10.20**	Manufacturing Services Agreement between the Registrant and Flextronics Telecom Systems Ltd., dated September 20, 2010.	S-1	333-180620	10.15	April 6, 2012
10.21*	Amendment to Restricted Stock Agreement, dated as of March 8, 2013, by and between the Registrant and Nir Zuk.	8-K	001-35594	10.1	March 11, 2013
10.22*	Amendment to Restricted Stock Agreement, dated as of March 8, 2013, by and between the Registrant and Rajiv Batra.	8-K	001-35594	10.2	March 11, 2013
10.23	Settlement, Release and Cross-License Agreement, dated May 27, 2014, by and between the Registrant and Juniper Networks, Inc.	8-K	001-35594	10.1	May 28, 2014
10.24	Share Purchase Agreement between the Registrant, Cyvera Ltd., Palo Alto Networks Holding B.V., the shareholders of Cyvera Ltd. and Shareholder Representative Services LLC, dated March 22, 2014.	10-Q	001-35594	10.1	June 3, 2014
10.25	Amendment No. 1 to the Share Purchase Agreement between the Registrant, Cyvera Ltd., Palo Alto Networks Holding B.V., the shareholders of Cyvera Ltd. and Shareholder Representative Services LLC, dated April 9, 2014.	10-Q	001-35594	10.2	June 3, 2014
10.26	Purchase Agreement, dated June 24, 2014, by and among the Registrant and J.P. Morgan Securities LLC, RBC Capital Markets, LLC and Citigroup Global Markets Inc., as representatives of the initial purchasers named therein.	8-K	001-35594	10.1	June 26, 2014
10.27	Form of Convertible Note Hedge Confirmation.	8-K	001-35594	10.2	June 26, 2014
10.28	Form of Warrant Confirmation.	8-K	001-35594	10.3	June 26, 2014
10.29	Lease between the Registrant and Santa Clara Campus Property Owner I LLC, dated May 28, 2015.				

- 10.30 Lease between the Registrant and Santa Clara Campus Property Owner I LLC, dated May 28, 2015.
- 10.31 Lease between the Registrant and Santa Clara Campus Property Owner I LLC, dated May 28, 2015.
- 21.1 List of subsidiaries of the Registrant.
- 23.1 Consent of Independent Registered Public Accounting Firm.
- 24.1 Power of Attorney (contained in the signature page to this Annual Report on Form 10-K).
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 32.1† Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

Exhibit Number	Exhibit Description	Form	Incorporated by		Filing Date
			Reference File No.	Exhibit	
32.2†	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.				
101.INS	XBRL Instance Document.				
101.SCH	XBRL Taxonomy Schema Linkbase Document.				
101.CAL	XBRL Taxonomy Calculation Linkbase Document.				
101.DEF	XBRL Taxonomy Definition Linkbase Document.				
101.LAB	XBRL Taxonomy Labels Linkbase Document.				
101.PRE	XBRL Taxonomy Presentation Linkbase Document.				

*Indicates a management contract or compensatory plan or arrangement.

Registrant has omitted portions of the relevant exhibit and filed such exhibit separately with the Securities and

**Exchange Commission pursuant to a request for confidential treatment under Rule 406 under the Securities Act of 1933, as amended.

The certifications attached as Exhibit 32.1 and Exhibit 32.2 that accompany this Annual Report on Form 10-K, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of the Registrant under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Annual Report on Form 10-K, irrespective of any general incorporation language contained in such filing.