Palo Alto Networks Inc
Form 10-Q
June 03, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended April 30, 2014

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 001-35594

Palo Alto Networks, Inc.
(Exact name of registrant as specified in its charter)

Delaware	20-2530195
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

4401 Great America Parkway
Santa Clara, California 95054
(Address of principal executive office, including zip code)
(408) 753-4000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

The number of shares outstanding of the registrant's common stock as of May 12, 2014 was 77,077,404.

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PART I

ITEM 1. FINANCIAL STATEMENTS

PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands, except per share data)

	April 30, 2014	July 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$234,790	$310,614
Short-term investments	133,180	109,007
Accounts receivable, net of allowance for doubtful accounts of $693 and $51 at April 30, 2014 and July 31, 2013, respectively	114,789	87,461
Prepaid expenses and other current assets	33,686	22,617
Total current assets	516,445	529,699
Property and equipment, net	48,488	32,086
Long-term investments	103,902	17,314
Goodwill	155,086	—
Intangible assets, net	49,613	1,358
Other assets	6,853	5,149
Total assets	$880,387	$585,606
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$24,641	$15,544
Accrued and other liabilities	150,296	14,609
Accrued compensation	29,188	22,004
Deferred revenue	231,226	153,945
Total current liabilities	435,351	206,102
Deferred revenue—non-current	136,707	95,285
Other long-term liabilities	36,636	11,799
Commitments and contingencies (Note 6)		
Stockholders’ equity:		
Preferred stock; $0.0001 par value; 100,000 shares authorized; none issued and outstanding at April 30, 2014 and July 31, 2013	—	—
Common stock; $0.0001 par value; 1,000,000 shares authorized; 77,055 and 71,612 shares issued and outstanding at April 30, 2014 and July 31, 2013, respectively	7	7
Additional paid-in capital	575,293	381,703
Accumulated other comprehensive gain (loss)	61	(16)
Accumulated deficit	(303,668)	(109,274)
Total stockholders’ equity	271,693	272,420
Total liabilities and stockholders’ equity	$880,387	$585,606

See notes to condensed consolidated financial statements.

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PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited, in thousands, except per share data)

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
Revenue:				
Product	$84,128	$60,793	$240,436	$178,251
Services	66,572	40,496	179,512	105,471
Total revenue	150,700	101,289	419,948	283,722
Cost of revenue:				
Product	20,425	15,855	58,600	46,907
Services	19,285	11,835	52,421	32,591
Total cost of revenue	39,710	27,690	111,021	79,498
Total gross profit	110,990	73,599	308,927	204,224
Operating expenses:				
Research and development	27,837	16,048	71,983	44,855
Sales and marketing	83,995	51,733	228,095	140,136
General and administrative	23,717	12,268	57,575	30,971
Legal settlement (Note 12)	121,173	—	141,173	—
Total operating expenses	256,722	80,049	498,826	215,962
Operating loss	(145,732)	(6,450)	(189,899)	(11,738)
Interest income	272	133	619	347
Other income (expense), net	145	(157)	11	(387)
Loss before income taxes	(145,315)	(6,474)	(189,269)	(11,778)
Provision for income taxes	1,272	808	5,125	1,632
Net loss	$(146,587)	$(7,282)	$(194,394)	$(13,410)
Net loss per share, basic and diluted	$(1.96)	$(0.10)	$(2.66)	$(0.20)
Weighted-average shares used to compute net loss per share, basic and diluted	74,967	69,575	73,127	67,980

See notes to condensed consolidated financial statements.

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PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(Unaudited, in thousands)

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
Net loss	$(146,587)	$(7,282)	$(194,394)	$(13,410)
Other comprehensive gain, net of tax:				
Change in unrealized gains (losses) on investments	18	34	87	23
Reclassification adjustment for realized net gains on investments included in net loss	—	—	(10)	—
Net change	18	34	77	23
Comprehensive loss	$(146,569)	$(7,248)	$(194,317)	$(13,387)

See notes to condensed consolidated financial statements.

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PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Nine Months Ended April 30,	
	2014	2013
Cash flows from operating activities		
Net loss	$(194,394)	$(13,410)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	11,638	7,221
Amortization of investment premiums, net of accretion of purchase discounts	1,180	1,445
Share-based compensation for equity based awards	66,685	29,608
Excess tax benefit from share-based compensation	(758)	(177)
Changes in operating assets and liabilities:		
Accounts receivable, net	(27,220)	(45,847)
Prepaid expenses and other assets	(7,926)	(5,991)
Accounts payable	8,965	3,347
Accrued and other liabilities	137,835	13,097
Deferred revenue	118,551	83,496
Net cash provided by operating activities	114,556	72,789
Cash flows from investing activities		
Purchase of property, equipment, and other assets	(31,379)	(16,595)
Purchase of investments	(316,911)	(310,683)
Proceeds from sales of investments	6,630	13,491
Proceeds from maturities of investments	198,080	117,150
Acquisition of business, net of cash acquired	(85,726)	—
Net cash used in investing activities	(229,306)	(196,637)
Cash flows from financing activities		
Excess tax benefit from share-based compensation	758	177
Proceeds from exercise of stock options	25,431	11,195
Proceeds from employee stock purchase plan	12,869	6,267
Repurchase of restricted common stock from terminated employees	(132)	(71)
Payment of initial public offering costs	—	(2,698)
Net cash provided by financing activities	38,926	14,870
Net decrease in cash and cash equivalents	(75,824)	(108,978)
Cash and cash equivalents—beginning of period	310,614	322,642
Cash and cash equivalents—end of period	$234,790	$213,664

See notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
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 enterprise security platform that allows enterprises, service providers, and government entities to simultaneously empower and secure their organization by safely enabling the increasingly complex and rapidly growing number of applications running on their networks and preventing breaches stemming from targeted cyber attacks. Our enterprise security platform consists of three major elements: our Next-Generation Firewall, our Next-Generation Endpoint Protection, and our Next-Generation 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 Next-Generation Endpoint Protection protects against cyber attacks that aim to exploit software vulnerabilities on a broad variety of fixed and virtual endpoints. Our Next-Generation Threat Intelligence Cloud provides central intelligence capabilities as well as automation of delivery of preventative measures against cyber attacks. We primarily sell our products and services to end-customers through our channel partners and infrequently directly to end-customers. Our partners are supported by our sales and marketing organization in the Americas, in Europe, the Middle East, and Africa (EMEA), and in Asia Pacific and Japan (APAC).
Basis of Presentation
The accompanying condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles, consistent in all material respects with those applied in our Annual Report on Form 10-K for the fiscal year ended July 31, 2013. The condensed consolidated financial statements include all adjustments necessary for a fair presentation of our quarterly results. All adjustments are of a normal recurring nature. We have made estimates and judgments affecting the amounts reported in our condensed consolidated financial statements and the accompanying notes. The actual results that we experience may differ materially from our estimates. Certain prior period amounts have been reclassified to conform with current period presentation.
Principles of Consolidation
The condensed consolidated financial statements include our accounts and our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.
Summary of Significant Accounting Policies
There have been no material changes to our significant accounting policies as of and for the three and nine months ended April 30, 2014, as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended July 31, 2013, except for the inclusion of a policy related to business combinations, amortization of intangible assets, and broadening our policy on the Impairment of Long-Lived Assets to include policies related to goodwill and intangible assets.
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, while assets related to projects that have been abandoned are impaired and expensed to research and development.

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

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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.

Recent Accounting Pronouncements

In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740)-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 is effective for us in the first quarter of fiscal 2015 and will be applied prospectively. Early adoption is permitted. We do not believe the adoption of this guidance will have a material impact on our condensed consolidated financial statements.

In February 2013, the FASB issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220)-Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The standard requires entities to present (either on the face of the income statement or in the notes) the effects on the line items of the income statement for amounts reclassified out of accumulated other comprehensive income. The guidance was effective for us in the first quarter of fiscal 2014. Our adoption of this guidance did not impact our financial statements as the guidance is related to disclosure only and we did not have significant reclassifications out of accumulated other comprehensive income.

2. Fair Value Measurements

We categorize assets and liabilities recorded at fair value on our condensed 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.

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The following table presents the fair value of our financial assets and liabilities using the above input categories (in thousands):

	April 30, 2014				July 31, 2013			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Cash equivalents:								
Certificates of deposit	$—	$—	$—	$—	$1,822	$—	$—	$1,822
U.S. government and agency securities	—	4,000	—	4,000	—	46,700	—	46,700
Money market funds	—	—	—	—	131,845	—	—	131,845
Total cash equivalents	—	4,000	—	4,000	133,667	46,700	—	180,367
Short-term investments:								
Corporate debt securities	—	27,583	—	27,583	—	32,834	—	32,834
U.S. government and agency securities	—	105,597	—	105,597	—	76,173	—	76,173
Total short-term investments	—	133,180	—	133,180	—	109,007	—	109,007
Long-term investments:								
Certificates of deposit	—	3,001	—	3,001	—	—	—	—
Corporate debt securities	—	18,390	—	18,390	—	12,317	—	12,317
U.S. government and agency securities	—	82,511	—	82,511	—	4,997	—	4,997
Total long-term investments	—	103,902	—	103,902	—	17,314	—	17,314
Other assets:								
Restricted cash	1,220	—	—	1,220	1,221	—	—	1,221
Total other assets	1,220	—	—	1,220	1,221	—	—	1,221
Total assets measured at fair value	$1,220	$241,082	$—	$242,302	$134,888	$173,021	$—	$307,909

3. Investments

The following tables summarize our unrealized gains and losses and fair value of investments as of April 30, 2014 and July 31, 2013 (in thousands):

	April 30, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Certificates of deposit	$3,000	$1	$—	$3,001
Corporate debt securities	45,957	22	(6)	45,973
U.S. government and agency securities	192,064	68	(24)	192,108
Total	$241,021	$91	$(30)	$241,082

	July 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Certificates of deposit	$1,822	$—	$—	$1,822
Corporate debt securities	45,173	12	(34)	45,151
U.S. government and agency securities	127,864	8	(2)	127,870
Money market funds	131,845	—	—	131,845
Total	$306,704	$20	$(36)	$306,688

The following tables present our investments that were in an unrealized loss position as of April 30, 2014 and July 31, 2013 (in thousands):

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	April 30, 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	16,766	(6)	—	—	16,766	(6)
U.S. government and agency securities	33,601	(24)	—	—	33,601	(24)
Total	$50,367	$(30)	$—	$—	$50,367	$(30)

	July 31, 2013					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate debt securities	$31,429	$(34)	$—	$—	$31,429	$(34)
U.S. government and agency securities	15,926	(2)	—	—	15,926	(2)
Total	$47,355	$(36)	$—	$—	$47,355	$(36)

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 more likely than not 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 April 30, 2014.

The following table summarizes the amortized cost and fair value of our investments as of April 30, 2014, by contractual years-to-maturity (in thousands):

	Amortized Cost	Fair Value
Due within one year	$137,154	$137,180
Due within one to two years	103,867	103,902
Total	$241,021	$241,082

4. Acquisitions

Business Combinations

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 $177,647,000, which consisted of the following (in thousands):

	Amount
Cash	$90,170
Common stock (1,281,000 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 $6,353,000. 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 276,000 shares of restricted common stock with a total fair value of $17,612,000 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.

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We expensed the related acquisition costs in the amount of $3,583,000 in general and administrative expenses in the three and nine months ended April 30, 2014.

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

	Amount
Cash	$6,930
Goodwill	144,992
Identified intangible assets	42,300
Accrued and other liabilities, net	(6,950)
Long-term deferred tax liability, net	(9,625)
Total	$177,647

We expect to finalize the valuation as soon as practicable, but not later than 12 months from the acquisition date.

The following table presents details of the identified intangible assets acquired (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 tax deductible for Israeli income tax purposes.

Cyvera's operating results are included in our Condensed Consolidated Statements of Operations from the date of the acquisition and are considered immaterial for purposes of financial disclosures.

The following table presents the unaudited pro forma financial information for the three and nine months ended April 30, 2014 and 2013, as though the companies were combined as of August 1, 2012 (in thousands):

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
Total revenue	$150,732	$101,295	$420,023	$283,739
Net loss	$(149,776)	$(10,744)	$(210,276)	$(23,502)

The pro forma financial information for the three and nine months ended April 30, 2014 and 2013 has been calculated after adjusting the results of Cyvera to reflect the business combination accounting effects resulting from this acquisition as though the acquisition occurred as of August 1, 2012, including 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 three and nine months ended April 30, 2014 and 2013 combines the historical results of the Company for the three and nine months ended April 30, 2014 and 2013 and the adjusted historical results of Cyvera for the three and nine months ended March 31, 2014 and 2013, due to differences in reporting periods and considering the date the Company 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 $10,345,000, of which $2,500,000 was withheld for Morta's indemnification obligations. Morta brings us a team of cybersecurity experts which will enhance the proven detection and prevention capabilities of our WildFire offering.

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

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	Amount
Goodwill	$10,094
Identified intangible assets	2,200
Net liabilities assumed	(1,949)
Total	$10,345

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 Condensed 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 tax deductible for U.S. federal income tax purposes.

Other Purchased Intangible Assets

On September 4, 2013 we entered into an agreement to purchase intellectual property for $5,000,000, which is being amortized over a weighted-average period of 13 years.

5. Goodwill and Intangible Assets

Goodwill

The following table presents details of our goodwill during the nine months ended April 30, 2014 (in thousands):

	Gross Carrying Amount	Accumulated Impairment Loss	Net Carrying Amount
Balance as of July 31, 2013	$—	$—	$—
Goodwill acquired	155,086	—	155,086
Balance as of April 30, 2014	$155,086	$—	$155,086

Purchased Intangible Assets

The following tables present details of our purchased intangible assets as of April 30, 2014 and July 31, 2013 (in thousands):

	April 30, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets with finite lives:			
Developed technology	$34,500	$(411)	$34,089
Acquired intellectual property	6,546	(753)	5,793
In-process research and development held for defensive purposes	1,900	(212)	1,688
Other	500	(57)	443
Total intangible assets with finite lives	43,446	(1,433)	42,013
In-process research and development with indefinite lives	7,600	—	7,600
Total purchased intangible assets	$51,046	$(1,433)	$49,613

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	July 31, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Acquired intellectual property	$1,546	$(188)	$1,358

Amortization expense was $820,000 and $1,245,000 for the three and nine months ended April 30, 2014, respectively, and $42,000 and $68,000 for the three and nine months ended April 30, 2013, respectively.

The following table summarizes our estimated future amortization expense of intangible assets with finite lives by type as of April 30, 2014 (in thousands):

	Fiscal Years Ending July 31,					
	Remaining 2014	2015	2016	2017	2018	2019 and Thereafter
Developed technology	$1,232	$4,928	$4,928	$4,928	$4,928	$13,145
Acquired intellectual property	205	761	704	611	484	3,028
In-process research and development held for defensive purposes	158	633	633	264	—	—
Other	63	250	130	—	—	—
Total future amortization expense	$1,658	$6,572	$6,395	$5,803	$5,412	$16,173

6. Commitments and Contingencies

Leases

We lease our facilities under various non-cancelable operating leases, which expire through the year ending July 31, 2023.

The following table presents details of the aggregate future non-cancelable minimum rental payments on our operating leases as of April 30, 2014 (in thousands):

	Amount
Fiscal years ending July 31:	
Remaining 2014	$2,930
2015	13,778
2016	14,018
2017	13,052
2018	11,774
2019 and thereafter	52,300
Committed gross lease payments	107,852
Less: proceeds from sublease rental	10,700
Net operating lease obligation	$97,152

Contract Manufacturer Commitments

Our independent contract manufacturer procures components and assembles our products based on our forecasts. These forecasts are based on estimates of future demand for our products, 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 April 30, 2014, we had $29,407,000 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. The complaint sought preliminary and permanent injunctions against

infringement, treble damages, and attorneys' fees. On September 4, 2012, Juniper filed a motion to amend its complaint to allege that our appliances infringe two additional U.S. patents but also to withdraw its allegations as to a previously-asserted patent. This amended complaint was officially filed on September 25, 2012, pursuant to a stipulation between the parties. On October 12, 2012, we filed an answer to Juniper’s amended complaint, which denied that we infringed Juniper’s patents and asserted that Juniper’s patents were invalid. The Court issued an order on February 6, 2014, in which the Court construed several disputed claim limitations, granted Juniper’s motion for summary judgment of assignor estoppel, precluding us from raising in the litigation challenges to the validity of Juniper’s patents, denied Juniper’s motion for summary judgment of infringement, and granted in part and denied in part our motion for summary judgment of non-infringement. A trial took place in February 2014. Following the trial, the jury was unable to reach a verdict and the Court declared a mistrial.

On September 13, 2012, we filed with the U.S. Patent and Trademark Office requests for inter partes reexamination of five of the six patents asserted by Juniper in its original complaint. On October 19 and December 3, 2012, the U.S. Patent and Trademark Office granted our requests for reexamination for three patents, rejecting a number of the claims asserted in the litigation, and on November 15 and 26, 2012, the U.S. Patent and Trademark Office denied our requests for reexamination as to two other patents. On June 20, 2013 and July 23, 2013, we filed with the U.S. Patent and Trademark Office petitions for inter partes review for two other patents asserted by Juniper in the litigation. A hearing to resolve claim construction issues, as well as motions for summary judgment, was heard on November 15, 2013.

On September 30, 2013, we filed a lawsuit against Juniper in the United States District Court for the Northern District of California. The lawsuit alleged that Juniper’s products infringe three of our U.S. patents, and sought monetary damages and a permanent injunction. On November 21, 2013, Juniper filed an answer and counterclaims in a separate action in the United States District Court for the Northern District of California. In its counterclaims Juniper sought a declaration that the asserted patents owned by us are not infringed and are invalid. Juniper’s counterclaims also asserted that our products infringe three additional Juniper patents.

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 12 Subsequent Events 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 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. We have made an assessment of the probability of incurring any such losses and whether or not those losses are estimable.

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.

7. 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 $20,000,000 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 $20,000,000 settlement charge within operating expenses during the three months ended January 31, 2014.

8. Equity Award Plans

Stock Option Activities

A summary of the activity under our stock plans and changes 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):

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	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance—July 31, 2013	10,033	$11.74	7.8	$373,228
Options granted	—	—		
Options forfeited	(488)	15.17		
Options exercised	(2,949)	8.62		
Balance—April 30, 2014	6,596	12.88	7.3	$334,417
Options vested and expected to vest—April 30, 2014	6,410	$12.77	7.3	$325,692
Options exercisable—April 30, 2014	3,668	$10.25	7.0	$195,614

Restricted Stock Units (RSUs) Activities

A summary of the activity under our stock plans and changes 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			
	Number of Shares	Weighted-Average Grant-Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance—July 31, 2013	2,241	$54.36	1.5	$109,675
RSUs granted	4,073	56.77		
RSUs vested	(646)	55.95		
RSUs forfeited	(358)	55.29		
Balance—April 30, 2014	5,310	$55.95	1.5	$337,610
RSUs vested and expected to vest—April 30, 2014	4,782	$55.89	1.4	$304,040

Shares Available for Grant

The following table presents the stock activity and the total number of shares available for grant as of April 30, 2014 (in thousands):

	Number of Shares
Balance—July 31, 2013	8,932
Authorized	3,223
RSUs granted	(4,073)
Repurchased	27
Options forfeited	488
RSUs forfeited	358
Balance—April 30, 2014	8,955

Employee Stock Purchase Plan (ESPP)

Compensation expense recognized in connection with the 2012 Employee Stock Purchase Plan was $1,142,000 and $3,217,000 for the three and nine months ended April 30, 2014, respectively, and $1,132,000 and $3,943,000 for the three and nine months ended April 30, 2013, respectively.

Share-Based Compensation

The following table summarizes the assumptions used to value grants related to the 2012 ESPP in each period:

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	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
Risk-free interest rate	0.1%	0.1%	0.1%	0.1%
Expected term (years)	<1 year	<1 year	<1 year	<1 year
Volatility	41%	41%	40%	41%
Dividend yield	—%	—%	—%	—%

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

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
Cost of revenue	$3,156	$1,364	$7,311	$2,799
Research and development	8,666	3,024	17,825	6,687
Sales and marketing	12,372	5,686	29,050	13,919
General and administrative	3,798	2,560	12,601	6,325
Total	$27,992	$12,634	$66,787	$29,730

At April 30, 2014, total compensation cost related to unvested share-based awards granted to employees under our stock plans but not yet recognized was $282,866,000, 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.

During the nine months ended April 30, 2014, we accelerated the vesting of certain share-based awards and as a result, in the three and nine months ended April 30, 2014, we recorded compensation expense within general and administrative expense of $62,000 and $3,446,000, respectively.

During the three months ended October 31, 2012, we modified the terms of certain share-based awards and as a result, in the three and nine months ended April 30, 2013, we recorded compensation expense within sales and marketing expense of nil and $1,861,000, respectively.

9. Income Taxes

Our provision for income taxes for the three and nine months ended April 30, 2014 reflects an effective tax rate of negative 1% and negative 3%, respectively. Our effective tax rates for these periods were negative due to the fact that we recorded a provision for income taxes on year-to-date losses. The key components of our income tax provision, and the related effective tax rate, consist of foreign tax losses which derive no benefit, non-deductible share-based compensation and foreign withholding taxes. As compared to the same periods last year, our negative effective tax rate changed due to fluctuations in our overall loss before income taxes and the geographic mix of income due to global expansion.

Our provision for income taxes for the three and nine months ended April 30, 2013 reflects an effective tax rate of negative 12% and negative 14%, respectively, and consists of foreign income and withholding taxes.

10. Net Income (Loss) Per Share

Basic net income (loss) per common 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.

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

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
Net loss	$(146,587)	$(7,282)	$(194,394)	$(13,410)
Weighted-average shares used to compute net loss per share, basic and diluted	74,967	69,575	73,127	67,980
Net loss per share, basic and diluted	$(1.96)	$(0.10)	$(2.66)	$(0.20)

The following outstanding options, RSUs, and ESPP shares were excluded from the computation of diluted net loss per common share for the periods presented as their effects would have been antidilutive (in thousands):

	April 30, 2014	April 30, 2013
Options to purchase common stock	6,596	10,637
RSUs	5,310	1,798
ESPP shares	41	—

11. Related Party Transactions

Certain members of our board of directors serve as board members or executive officers of certain of our customers and in some cases are also investors of these customers. We believe these transactions with related party customers are carried out on terms that are consistent with similar transactions with our comparable customers. We had sales transactions with significant related party customers of $1,619,000 and $3,776,000 for the three and nine months ended April 30, 2014, respectively, and $903,000 and $2,381,000 for the three and nine months ended April 30, 2013, respectively. Amounts payable to and due from related party customers were not material at April 30, 2014.

12. Subsequent Events

On May 27, 2014, we entered into a Settlement, Release and Cross-License 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 of approximately $175,000,000, which was comprised of $75,000,000 in cash, 1,081,000 shares of our common stock with an approximate value of $70,000,000, and a warrant to purchase 463,000 shares of our common stock with an approximate value of $30,000,000, 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.

For accounting purposes, the fair value of the total consideration as of the settlement date was $182,473,000 . The fair values of the common stock and warrant were measured using the closing price of our common stock on the settlement date.

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, $61,300,000 was allocated to the licensing of intellectual property, $54,300,000 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 covenant not to sue have no identifiable future benefit, and as a result we accrued a settlement charge within operating expenses as of and for the three and nine months ended April 30, 2014. The licensing of intellectual property will be recorded in our fiscal fourth quarter and will be amortized over the estimated period of benefit of five years.

The warrant entitles Juniper to purchase up to 463,000 shares of common stock at an exercise price of $0.0001 per share and will expire seven months from the date of its issuance. Once issued, the liability-classified warrant will be remeasured through earnings at the end of each reporting period until exercised. The amount of future remeasurement is undeterminable and will be driven predominantly by increases or decreases in our stock price.

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ITEM 2. 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 condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q. The following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, among other things: statements regarding trends in revenue, cost of revenue, gross margin, cash flows, operating expenses, including future share-based compensation expense, interest and other income, income taxes, investments and liquidity; expected growth in our installed base, the sufficiency of our existing cash and investments to meet our cash needs for the foreseeable future; and other statements regarding our future operations, financial condition and prospects, and business strategies. Forward-looking statements generally can be identified by words such as "anticipates," "believes," "could," "estimates," "expects," "intends," "may," "plans," "predicts," "projects," "would," "will be," "will continue," "will lik similar expressions. These forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties, which could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q, and in particular, the risks discussed under the caption "Risk Factors" in Part II, Item 1A of this report and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

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

- Overview. 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. An analysis of our Generally Accepted Accounting Principles (GAAP) and non-GAAP key financial metrics, which management monitors to evaluate our performance.
- Financial Overview. Discussion of the nature and trends of components of our financial results.
- Results of Operations. An analysis of our financial results comparing the three and nine months ended April 30, 2014 to the three and nine months ended April 30, 2013.
- Liquidity and Capital Resources. An analysis of changes in our balance sheets and cash flows, and discussion of our financial condition and our ability to meet cash needs.
- 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.
- Available Information. A discussion of sources of additional information available to investors.

Overview

We have pioneered the next-generation of enterprise security with our innovative platform that allows enterprises, service providers, and government entities to simultaneously empower and secure their organizations by safely enabling the increasingly complex and rapidly growing number of applications running on their networks and by preventing breaches stemming from targeted cyber attacks. Our enterprise security platform consists of three major elements: our Next-Generation Firewall, our Next-Generation Endpoint Protection, and our Next-Generation 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 Next-Generation Endpoint Protection protects against cyber attacks that aim to exploit software vulnerabilities on a broad variety of fixed and virtual endpoints. Our Next-Generation Threat Intelligence Cloud provides central intelligence capabilities as well as automated delivery of preventative measures against cyber attacks. The cloud-based element of our platform is delivered in the form of a service that can be used either in the public cloud or in a private cloud using our dedicated WildFire appliance, WF-500.

We derive revenue from sales of our products and services, which together comprise our platform. Product revenue is generated from sales of our Next-Generation Firewall, which is available in hardware and virtualized form factors. Our Next-Generation Firewall incorporates our proprietary PAN-OS operating system, which provides a consistent set of capabilities across our entire product line. These capabilities include: application visibility and control (App-ID), user identification (User-ID), site-to-site virtual private network (VPN), remote access Secure Sockets Layer (SSL) VPN, and Quality-of-Service (QoS). Our

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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-7050, which is designed for data centers and high-speed networks. The same firewall functionality that is delivered in the hardware appliances is also available in the VM-Series virtual firewalls, which secure virtualized and cloud-based computing environments. Multiple firewalls can leverage our WildFire appliance, WF-500, which identifies, analyzes, and blocks known and unknown malware in a private cloud-based environment. Our platform can be centrally managed in both virtualized and hardware appliances across an organization with our Panorama product. In addition, our GlobalProtect appliance, GP-100, provides mobile device management, malware detection, and shares device state information to safely enable mobile devices for business use.

Services revenue is generated from sales of subscriptions, including our Next-Generation Endpoint Protection, and support and maintenance. Our Threat Prevention, URL Filtering, GlobalProtect, and WildFire 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. Our Next-Generation Endpoint Protection protects against cyber attacks that exploit software vulnerabilities in Windows-based fixed and virtual endpoints through the use of its unique capability of stopping the underlying exploit techniques, and can prevent cyber attacks without relying on prior knowledge of the attack. 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 leverage our appliances to sell SaaS (software as a service) subscription services to meet our customers' evolving enterprise security requirements. Our hybrid SaaS revenue model consists of product, subscriptions, and support and maintenance, which will enable us to benefit from recurring revenues as we continue to grow our installed base. Sales of these services increase our deferred revenue balance and contribute significantly to our positive cash flow provided by operating activities.

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. Our channel partners purchase our products and services at a discount to our list prices before reselling them to our end-customers. Our channel partners generally receive an order from an end-customer prior to placing an order with us and generally do not stock appliances.

We continue to invest in innovation and strengthening our product portfolio, which resulted in several new product offerings during fiscal 2014. These new product offerings include: the PA-7050 firewall, the fastest Next-Generation Firewall in the industry with a throughput of 120Mbps; the GP-100 mobile security management appliance, which offers an easy to deploy, high-performance, dedicated management appliance for our GlobalProtect customers; and the VM-1000-HV virtual Next-Generation Firewall, which is fully integrated with VMware, Inc.'s NSX virtualization platform.

In addition, we extended our next-generation enterprise security platform and our technology leadership with the acquisitions of Cyvera Ltd. ("Cyvera") and Morta Security, Inc. ("Morta"). Cyvera's offering protects enterprises from cyber threats by using an innovative approach to block unknown, zero-day attacks on the endpoint. Through fiscal 2015, we intend to invest approximately $3.5 million in the forth quarter of fiscal 2014 and $25.0 million in fiscal 2015 in research and development, customer support, and growing our Next-Generation Endpoint Protection sales force. We anticipate billings (non-GAAP) and revenue of our Next-Generation Endpoint will begin ramping in the second half of fiscal 2015 with a more meaningful revenue contribution in fiscal 2016. Morta provides a team of cybersecurity experts that will enhance our WildFire threat detection and prevention offering. These enhancements enable quick discovery and elimination of previously unknown malware, zero-day exploits, and advanced persistent threats.

During the third quarter of fiscal 2014, we added more than 1,300 end-customers including some of the largest Fortune 100 and Global 2000 companies in the world. As of April 30, 2014, we had more than 17,000 end-customers in over 130 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. As of April 30, 2014, we had 1,556 employees.

We have experienced rapid growth and increased demand for our products in recent periods. For the third quarter of fiscal 2014 and 2013, revenues were $150.7 million and $101.3 million, respectively, representing year-over-year growth of 48.8%, despite continued uncertainty in the macroeconomic environment. These macroeconomic factors may continue to impact overall spending in information technology (IT) by our customers, which could adversely affect our revenues and operating results.

All three components of our hybrid SaaS revenue model experienced year-over-year growth, led by revenue from subscription services, which grew 71.4% to $32.0 million, followed by support and maintenance services, which grew 58.4% to $34.6 million, and product, which grew 38.4% to $84.1 million. The growth reflected increasing recurring revenue in our business model and rapid adoption of high margin subscription services in our base of end-customers.

In May 2014, we entered into a Settlement, Release and Cross-License Agreement ("settlement agreement") with Juniper Networks, Inc. ("Juniper"). Under the terms of the settlement agreement, we agreed to pay to Juniper $75.0 million in cash and transfer 1.1 million shares of our common stock with an approximate value of $70.0 million and a warrant to purchase 0.5 million

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shares of our common stock with an approximate value of $30.0 million. The terms of the settlement agreement provide for mutual dismissal with prejudice of all pending litigation between the parties, 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. The settlement with Juniper resolves all pending litigation matters between us and will allow us to further focus on innovating and strengthening our product portfolio, servicing our customers, and growing our business.

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).

	April 30, 2014	July 31, 2013
	(in thousands)	
Total deferred revenue	$367,933	$249,230
Cash, cash equivalents, and investments	$471,872	$436,935

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
Total revenue	$150,700	$101,289	$419,948	$283,722
Year-over-year percentage increase	48.8 %	54.2 %	48.0 %	58.1 %
Gross margin percentage	73.6 %	72.7 %	73.6 %	72.0 %
Operating loss [(1)(2)(3)(4)]	$(145,732)	$(6,450)	$(189,899)	$(11,738)
Operating margin percentage	(96.7)%	(6.4)%	(45.2)%	(4.1)%
Billings (non-GAAP)	$193,890	$132,410	$538,499	$367,218
Cash flow provided by operating activities			$114,556	$72,789
Free cash flow (non-GAAP)			$83,177	$56,194

(1) Includes share-based compensation expense of $28.0 million and $66.8 million for the three and nine months ended April 30, 2014, respectively, and $12.6 million and $29.7 million for the three and nine months ended April 30, 2013, respectively.

(2) Includes intellectual property litigation expense of $4.7 million and $9.3 million for the three and nine months ended April 30, 2014, respectively, and $1.3 million and $2.3 million for the three and nine months ended April 30, 2013, respectively.

(3) Includes legal settlement expense of $121.2 million and $141.2 million for the three and nine months ended April 30, 2014, respectively, and nil for the three and nine months ended April 30, 2013.

(4)

Includes acquisition transaction costs of $3.6 million and $4.0 million for the three and nine months ended April 30, 2014, respectively, and nil for the three and nine months ended April 30, 2013.

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- Deferred Revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet 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 assets, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, and strengthening the balance sheet. However, it is important to note that other companies, including companies in our industry, may not use free cash flow, may calculate free cash flow differently, 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:

	Nine Months Ended April 30,	
	2014	2013
	(in thousands)	
Cash Flow:		
Cash flow provided by operating activities	$114,556	$72,789
Less: purchase of property, equipment, and other assets	31,379	16,595
Free cash flow (non-GAAP)	$83,177	$56,194
Net cash used in investing activities	$(229,306)	$(196,637)
Net cash provided by financing activities	$38,926	$14,870

- 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:

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
	(in thousands)			
Billings (non-GAAP):				
Total revenue	$150,700	$101,289	$419,948	$283,722
Add: change in total deferred revenue, net of acquired deferred revenue	43,190	31,121	118,551	83,496

Billings (non-GAAP)	$193,890	$132,410	$538,499	$367,218

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Financial Overview

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. The substantial majority of our product revenue is derived from sales of our appliances. Product revenue also includes revenue derived from software licenses of Panorama, Virtual Systems Upgrades, 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 Threat Prevention, URL Filtering, GlobalProtect, and WildFire subscriptions and support and maintenance. Revenue from our Next-Generation Endpoint Protection is immaterial for the three and nine months ended April 30, 2014. We expect that revenue from our Next-Generation Endpoint Protection will increase in the future. Threat Prevention, URL Filtering, GlobalProtect, and WildFire subscriptions are priced as a percentage of the appliance's list price. Our contractual subscription and support and maintenance terms are typically one to five years. 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 end-customer base.

Cost of Revenue

Our total 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, bonuses, and share-based compensation associated with our operations and global customer support 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, and amortization expense of 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 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 organization, amortization expense of intangible assets acquired, allocated costs, and URL filtering database service fees. We expect our cost of services revenue to increase as our end-customer base grows.

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.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, general and administrative expense, 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. We expect operating expenses to increase in absolute dollars, although they may fluctuate as a percentage of revenue from quarter to quarter, as we continue to grow in response to demand for our products and services. As of April 30, 2014, we expect to recognize approximately $282.9 million of share-based compensation over a weighted-average period of three years, excluding additional share-based compensation related to any future grants of share-based awards. Share-based compensation, 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

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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 as well as professional services and certain non-recurring general expenses. General and administrative personnel include our executive, finance, human resources, and legal organizations. 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, Inc. ("Fortinet"). Refer to the discussion under Note 12 Subsequent Events and Note 7 Mutual Covenant Not to Sue and Release Agreement of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for information related to these matters.

Interest Income

Interest income consists of income earned on our cash, cash equivalents, and investments. We expect interest income will increase as we grow our cash and investments portfolio depending on our average investment balances during the period, types and mix of investments, and market interest rates.

Other Income (Expense), Net

Other income (expense), net consists primarily of foreign currency re-measurement gains and losses and foreign currency transaction gains and losses. We expect other income (expense), net to fluctuate depending on foreign exchange rate movements.

Provision for Income Taxes

Provision for income taxes consists primarily of income taxes in foreign jurisdictions in which we conduct business, withholding taxes, and federal and state income taxes in the United States. We maintain a full valuation allowance for domestic deferred tax assets, including net operating loss carryforwards and tax credits. We expect the provision for income taxes to increase in future years. We implemented our corporate structure and intercompany relationships to more closely align with the international nature of our business in the fourth quarter of fiscal 2013. Income in certain countries may be taxed at statutory tax rates that are lower than the U.S. statutory tax rate. As a result, our overall effective tax rate over the long term may be lower than the U.S. federal statutory tax rate on positive income through changes in international procurement and sales operations.

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.

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	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
	(in thousands)			
Condensed Consolidated Statements of Operations Data:				
Revenue:				
Product	$84,128	$60,793	$240,436	$178,251
Services	66,572	40,496	179,512	105,471
Total revenue	150,700	101,289	419,948	283,722
Cost of revenue:				
Product	20,425	15,855	58,600	46,907
Services	19,285	11,835	52,421	32,591
Total cost of revenue	39,710	27,690	111,021	79,498
Total gross profit	110,990	73,599	308,927	204,224
Operating expenses:				
Research and development	27,837	16,048	71,983	44,855
Sales and marketing	83,995	51,733	228,095	140,136
General and administrative	23,717	12,268	57,575	30,971
Legal settlement	121,173	—	141,173	—
Total operating expenses	256,722	80,049	498,826	215,962
Operating loss	(145,732)	(6,450)	(189,899)	(11,738)
Interest income	272	133	619	347
Other income (expense), net	145	(157)	11	(387)
Loss before income taxes	(145,315)	(6,474)	(189,269)	(11,778)
Provision for income taxes	1,272	808	5,125	1,632
Net loss	$(146,587)	$(7,282)	$(194,394)	$(13,410)

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	Three Months Ended April 30,		Nine Months Ended April 30,	
	2014	2013	2014	2013
	(as a percentage of revenue)			
Condensed Consolidated Statements of Operations Data:				
Revenue:				
Product	55.8 %	60.0 %	57.3 %	62.8 %
Services	44.2 %	40.0 %	42.7 %	37.2 %
Total revenue	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenue:				
Product	13.6 %	15.7 %	14.0 %	16.5 %
Services	12.8 %	11.6 %	12.4 %	11.5 %
Total cost of revenue	26.4 %			