Palo Alto Networks Inc
Form 10-Q
February 24, 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 January 31, 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 February 10, 2014 was 74,064,857.

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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)

	January 31, 2014	July 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$261,867	$310,614
Short-term investments	176,345	109,007
Accounts receivable, net of allowance for doubtful accounts of $466 and $51 at January 31, 2014 and July 31, 2013, respectively	86,090	87,461
Prepaid expenses and other current assets	30,985	22,617
Total current assets	555,287	529,699
Property and equipment, net	45,735	32,086
Long-term investments	63,105	17,314
Other assets	24,899	6,507
Total assets	$689,026	$585,606
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$10,341	$15,544
Accrued and other liabilities	20,425	14,609
Accrued compensation	29,713	22,004
Deferred revenue	202,330	153,945
Total current liabilities	262,809	206,102
Deferred revenue—non-current	122,261	95,285
Other long-term liabilities	19,512	11,799
Commitments and contingencies (Note 6)		
Stockholders’ equity:		
Preferred stock; $0.0001 par value; 100,000 shares authorized; none issued and outstanding at January 31, 2014 and July 31, 2013	—	—
Common stock; $0.0001 par value; 1,000,000 shares authorized; 73,998 and 71,612 shares issued and outstanding at January 31, 2014 and July 31, 2013, respectively	7	7
Additional paid-in capital	441,475	381,703
Accumulated other comprehensive gain (loss)	43	(16)
Accumulated deficit	(157,081)	(109,274)
Total stockholders’ equity	284,444	272,420
Total liabilities and stockholders’ equity	$689,026	$585,606

See notes to condensed consolidated financial statements.

PALO ALTO NETWORKS, INC.

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

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
Revenue:				
Product	$80,823	$61,944	$156,308	$117,458
Services	60,245	34,555	112,940	64,975
Total revenue	141,068	96,499	269,248	182,433
Cost of revenue:				
Product	20,221	16,636	38,175	31,052
Services	17,283	10,982	33,136	20,756
Total cost of revenue	37,504	27,618	71,311	51,808
Total gross profit	103,564	68,881	197,937	130,625
Operating expenses:				
Research and development	24,253	15,495	44,146	28,807
Sales and marketing	76,734	45,796	144,100	88,403
General and administrative	39,733	9,747	53,858	18,703
Total operating expenses	140,720	71,038	242,104	135,913
Operating loss	(37,156)	(2,157)	(44,167)	(5,288)
Interest income	187	116	347	214
Other expense, net	(371)	(60)	(134)	(230)
Loss before income taxes	(37,340)	(2,101)	(43,954)	(5,304)
Provision for income taxes	2,606	512	3,853	824
Net loss	$(39,946)	$(2,613)	$(47,807)	$(6,128)
Net loss attributable to common stockholders	$(39,946)	$(2,613)	$(47,807)	$(6,128)
Net loss per share attributable to common stockholders, basic and diluted	$(0.55)	$(0.04)	$(0.66)	$(0.09)
Weighted-average shares used to compute net loss per share attributable to common stockholders, basic and diluted	72,854	67,651	72,260	67,225

See notes to condensed consolidated financial statements.

PALO ALTO NETWORKS, INC.

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

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
Net loss	$(39,946)	$(2,613)	$(47,807)	$(6,128)
Other comprehensive gain (loss), net of tax:				
Change in unrealized gains (losses) on investments	48	16	69	(11)
Reclassification adjustment for realized net gains on investments included in net loss	(10)	—	(10)	—
Net change	38	16	59	(11)
Comprehensive loss	$(39,908)	$(2,597)	$(47,748)	$(6,139)

See notes to condensed consolidated financial statements.

PALO ALTO NETWORKS, INC.

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

	Six Months Ended January 31,	
	2014	2013
Cash flows from operating activities		
Net loss	$(47,807)	$(6,128)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	7,082	4,468
Amortization of investment premiums, net of accretion of purchase discounts	747	822
Share-based compensation for equity based awards	38,729	17,030
Excess tax benefit from share-based compensation	(674)	(106)
Changes in operating assets and liabilities:		
Accounts receivable, net	1,371	(22,944)
Prepaid expenses and other assets	(6,207)	(7,290)
Accounts payable	(4,387)	1,716
Accrued and other liabilities	16,062	17,640
Deferred revenue	75,361	52,375
Net cash provided by operating activities	80,277	57,583
Cash flows from investing activities		
Purchase of property, equipment, and other assets	(25,483)	(10,236)
Purchase of investments	(249,803)	(252,633)
Proceeds from sales of investments	6,630	13,491
Proceeds from maturities of investments	129,096	57,150
Acquisition of business, net of cash acquired	(10,102)	—
Net cash used in investing activities	(149,662)	(192,228)
Cash flows from financing activities		
Excess tax benefit from share-based compensation	674	106
Proceeds from exercise of stock options	14,085	2,554
Proceeds from employee stock purchase plan	5,988	—
Repurchase of restricted common stock from terminated employees	(109)	(35)
Payment of initial public offering costs	—	(2,698)
Net cash provided by (used in) financing activities	20,638	(73)
Net decrease in cash and cash equivalents	(48,747)	(134,718)
Cash and cash equivalents—beginning of period	310,614	322,642
Cash and cash equivalents—end of period	$261,867	$187,924

See notes to condensed consolidated financial statements.

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 network security platform that allows enterprises, service providers, and government entities to secure their networks and safely enable the increasingly complex and rapidly growing number of applications running on their networks. The core of our platform is our Next-Generation Firewall that delivers application, user, and content visibility and control integrated within the firewall through our proprietary operating system, hardware, and software architecture. 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.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its 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 six months ended January 31, 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 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.

Goodwill, Intangible Assets, and Impairment of 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 value 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 long-lived assets, including property and equipment and purchased intangible assets subject to amortization, may not be recoverable. When such events or changes in circumstances occur, we assess the recoverability of long-lived assets by determining whether or not the carrying amount of such assets 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. 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.

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

	January 31, 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	—	38,000	—	38,000	—	46,700	—	46,700
Money market funds	—	—	—	—	131,845	—	—	131,845
Total cash equivalents	—	38,000	—	38,000	133,667	46,700	—	180,367
Short-term investments:								
Corporate debt securities	—	27,555	—	27,555	—	32,834	—	32,834
U.S. government and agency securities	—	148,790	—	148,790	—	76,173	—	76,173
Total short-term investments	—	176,345	—	176,345	—	109,007	—	109,007
Long-term investments:								
Certificates of deposit	—	2,999	—	2,999	—	—	—	—
Corporate debt securities	—	18,879	—	18,879	—	12,317	—	12,317
U.S. government and agency securities	—	41,227	—	41,227	—	4,997	—	4,997
Total long-term investments	—	63,105	—	63,105	—	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	$277,450	$—	$278,670	$134,888	$173,021	$—	$307,909

3. Investments

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

	January 31, 2014				
	Amortized Cost	Unrealized Gains	Unrealized Losses		Estimated Fair Value
Certificates of deposit	$3,000	$—	$(1	)	$2,999
Corporate debt securities	46,419	23	(8	)	46,434
U.S. government and agency securities	227,988	35	(6	)	228,017
Total	$277,407	$58	$(15	)	$277,450

	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 January 31, 2014 and July 31, 2013 (in thousands):

	January 31, 2014					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Certificates of deposit	$2,999	$(1)	$—	$—	$2,999	$(1)
Corporate debt securities	16,834	(8)	—	—	16,834	(8)
U.S. government and agency securities	29,645	(6)	—	—	29,645	(6)
Total	$49,478	$(15)	$—	$—	$49,478	$(15)

	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 January 31, 2014.

The following table summarizes the amortized cost and fair value of our investments as of January 31, 2014, by contractual years-to-maturity (in thousands):

	Amortized Cost	Fair Value
Due within one year	$214,320	$214,345
Due within one to two years	63,087	63,105
Total	$277,407	$277,450

4. Acquisitions

Business Combination

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 price based on the fair value of assets acquired and liabilities assumed (in thousands):

	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 will be 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 six months ended January 31, 2014 (in thousands):

	Gross Carrying Amount	Accumulated Impairment Loss	Net Carrying Amount
Balance as of July 31, 2013	$—	$—	$—
Goodwill acquired	10,094	—	10,094
Balance as of January 31, 2014	$10,094	$—	$10,094

Purchased Intangible Assets

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

	January 31, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Acquired intellectual property	$6,546	$(548)	$5,998
In-process research and development held for defensive purposes	1,900	(53)	1,847
Other	300	(12)	288
Total	$8,746	$(613)	$8,133

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

Amortization expense was $270,000 and $425,000 for the three and six months ended January 31, 2014, respectively, and $13,000 and $26,000 for the three and six months ended January 31, 2013, respectively.

The following table summarizes our estimated future amortization expense of intangible assets by type as of January 31, 2014 (in thousands):

	Fiscal Years Ending July 31,					
	Remaining 2014	2015	2016	2017	2018	2019 and Thereafter
Acquired intellectual property	$410	$761	$704	$611	$484	$3,028
In-process research and development held for defensive purposes	317	633	633	264	—	—
Other	75	150	63	—	—	—
Total future amortization expense	$802	$1,544	$1,400	$875	$484	$3,028

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 January 31, 2014 (in thousands):

	Amount
Fiscal years ending July 31:	
Remaining 2014	$5,575
2015	13,599
2016	13,824
2017	12,858
2018	11,693
2019 and thereafter	52,300
Committed gross lease payments	109,849
Less: proceeds from sublease rental	10,700
Net operating lease obligation	$99,149

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 January 31, 2014, we had $32,150,000 of open orders.

Litigation

In December 2011, Juniper Networks, Inc. filed a complaint against us in the United States District Court for the District of Delaware alleging patent infringement. The complaint seeks preliminary and permanent injunctions against infringement, treble damages, and attorney’s fees. On February 9, 2012, we filed a response to the complaint, which denied all claims and asserted that the claimant’s patents were invalid. On February 28, 2012, Juniper filed a motion to strike our defense of invalidity based on the legal doctrine of “assignor estoppel.” On March 23, 2012, we filed a brief in opposition to that motion. Juniper filed a brief in response on April 2, 2012. On August 2, 2012, the District Court issued an order granting Juniper’s motion as to one of the patents in suit (the ’634 patent) but denying Juniper’s motion as to the five other patents in suit. 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. Juniper now alleges that our appliances infringe seven of its patents. 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. We did not file a request for reexamination on the withdrawn patent. 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. 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. We have the opportunity to seek review of these denials within the U.S. Patent and Trademark Office. Each party served its opening expert report on April 12, 2013, and rebuttal expert report on May 13, 2013, and supplemental expert reports on June 11, 2013. The parties filed opening and responsive briefs regarding claim construction, filed their opening summary judgment briefs on August 20, 2013, and filed opposition briefs and additional summary judgment motions on September 12, 2013. 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. The Patent and Trademark Office granted both of those petitions and instituted trials to take place in August 2014 and September 2014. A hearing to resolve claim construction issues, as well as motions for summary judgment, was heard on November 15, 2013.

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, 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 began on February 24, 2014, and we are vigorously defending ourselves from such claims. At this stage in the litigation we do not believe that a loss is probable and we are unable to estimate a possible loss or range of possible loss.

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

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, 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 expense in general and administrative expense 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):

	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	(414	)	14.94		
Options exercised	(1,812	)	7.78		
Balance—January 31, 2014	7,807		12.49	7.5	$366,617
Options vested and expected to vest—January 31, 2014	7,586		$12.38	7.4	$357,073
Options exercisable—January 31, 2014	4,335		$9.73	7.2	$215,536

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	3,612	54.72		
RSUs vested	(447)	56.42		
RSUs forfeited	(205)	54.57		
Balance—January 31, 2014	5,201	$54.42	1.6	$309,199
RSUs vested and expected to vest—January 31, 2014	4,640	$54.44	1.6	$275,848

Shares Available for Grant

The following table presents the stock activity and the total number of shares available for grant as of January 31, 2014 (in thousands):

	Number of Shares
Balance—July 31, 2013	8,932
Authorized	3,223
RSUs granted	(3,612)
Repurchased	21
Options forfeited	414
RSUs forfeited	205
Balance—January 31, 2014	9,183

Employee Stock Purchase Plan (ESPP)

Compensation expense recognized in connection with the 2012 Employee Stock Purchase Plan was $1,073,000 and $2,075,000 for the three and six months ended January 31, 2014, respectively, and $1,467,000 and $2,811,000 for the three and six months ended January 31, 2013, respectively.

Share-Based Compensation

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

	Three Months Ended January 31, 2014	Six Months Ended January 31, 2014
Risk-free interest rate	N/A	—%
Expected term (years)	N/A	< 1 year
Volatility	N/A	39%
Dividend yield	N/A	—%

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

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
Cost of revenue	$2,405	$825	$4,155	$1,435
Research and development	5,807	1,973	9,159	3,663
Sales and marketing	9,745	3,935	16,678	8,233
General and administrative	6,427	2,021	8,803	3,765
Total	$24,384	$8,754	$38,795	$17,096

At January 31, 2014, total compensation cost related to unvested share-based awards granted to employees under our stock plans but not yet recognized was $266,970,000, 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 three months ended January 31, 2014, we accelerated the vesting of certain share-based awards and as a result, in the three and six months ended January 31, 2014, we recorded compensation expense within general and administrative expense of $3,384,000.

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 six months ended January 31, 2013, we recorded compensation expense within sales and marketing expense of $461,000 and $1,861,000, respectively.

9. Income Taxes

Our provision for income taxes for the three and six months ended January 31, 2014 reflects an effective tax rate of negative 7% and negative 9%, 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 decreased due to an increase in our loss before income taxes.

Our provision for income taxes for the three and six months ended January 31, 2013 reflects an effective tax rate of negative 24% and negative 16%, 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.

10. Net Income (Loss) Per Share

We compute net income (loss) per share of common stock using the two-class method required for participating securities. We consider shares issued upon the early exercise of options subject to repurchase and unvested restricted shares to be participating securities because holders of such shares have non-forfeitable dividend rights in the event of our declaration of a dividend for common shares. In accordance with the two-class method, earnings allocated to these participating securities, which include participation rights in undistributed earnings with common stock, are subtracted from net income to determine net income (loss) attributable to common stockholders.

Basic net income (loss) per common share is computed by dividing net income (loss) attributable to common stockholders by basic weighted-average shares outstanding during the period. All participating securities are excluded from basic weighted-average shares outstanding. In computing diluted net income (loss) attributable to common stockholders, undistributed earnings are re-allocated to reflect the potential impact of dilutive securities. Diluted net income (loss) per share attributable to common stockholders is computed by dividing net income (loss) attributable to common stockholders 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):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
Net loss attributable to common stockholders	$(39,946)	$(2,613)	$(47,807)	$(6,128)
Weighted-average shares used to compute net loss per share, basic and diluted	72,854	67,651	72,260	67,225
Net loss per share attributable to common stockholders, basic and diluted	$(0.55)	$(0.04)	$(0.66)	$(0.09)

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

	January 31, 2014	January 31, 2013
Options to purchase common stock	7,807	12,797
RSUs	5,201	1,580
ESPP shares	132	—

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, interest and other income, income taxes, investments and liquidity; 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," "estimates," "expects," "intends," "plans," "predicts," "projects," "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 six months ended January 31, 2014 to the three and six months ended January 31, 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 network security with our innovative platform that allows enterprises, service providers, and government entities to secure their networks and safely enable the increasingly complex and rapidly growing number of applications running on their networks. The core of our platform is our Next-Generation Firewall, which delivers application, user, and content visibility and control as well as protection against cyber threats integrated within the firewall through our proprietary hardware and software architecture. Our products and services can address a broad range of our end-customers' network security requirements, from the data center to the network perimeter, as well as the distributed enterprise, which includes branch offices and a growing number of mobile devices.

We derive revenue from sales of our products and services, which together comprise our platform. Product revenue is primarily generated from sales of our Next-Generation Firewall which is available in hardware and virtualized platforms. All of our products incorporate 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 products are designed for different performance requirements throughout an organization which range from the PA-200, which is designed for enterprise remote offices, to the PA-5060, which is designed for high-speed data centers. The same firewall functionality that is delivered in the hardware platforms is also available in the VM-Series virtual firewalls which secure virtualized and cloud-based computing environments. Multiple firewalls can leverage the 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 platforms across an organization with our Panorama product.

Services revenue includes sales of subscriptions 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. When end-customers purchase a product, 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 hardware platform 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 focus on extending our technology leadership, and in November 2013 we announced a jointly-developed solution with VMware, Inc. that combines our VM-Series virtualized next-generation security platform with the VMware NSX network virtualization platform. With this joint solution, customers will be able to unify next-generation network security across their physical and virtual environments with a single point of management. In December 2013, we completed our acquisition of Morta Security, Inc. which brings to us a team of cybersecurity experts as well as technology that will be used to 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 (APTs). In February 2014, we announced the launch of our new PA-7050 chassis, with next-generation firewall functions such as full application enablement, IPS, AV, and WildFire active on all traffic. The PA-7050 delivers consistent performance at speeds much higher than our previous offerings. Product and service revenue or financial performance can be affected when new products or new service offerings are anticipated or introduced.

During the second quarter of fiscal 2014, we added more than 1,200 end-customers including some of the largest Fortune 100 and Global 2000 companies in the world. As of January 31, 2014, we had more than 16,000 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 January 31, 2014, we had 1,375 employees.

We have experienced rapid growth and increased demand for our products in recent periods. For the second quarter of fiscal 2014 and 2013, revenues were $141.1 million and $96.5 million, respectively, representing year-over-year growth of 46.2%, despite continued uncertainty in the macroeconomic environment, in particular, the temporary shutdown of the U.S. Government. 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 model experienced year-over-year growth, led by revenue from subscription services which grew 76.0%, followed by support and maintenance services which grew 72.8%, and product which grew 30.5%. The growth reflected the increasing recurring revenue in the business model and the rapid adoption of high margin subscription services in our customer base.

We believe that the growth of our business and our short 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 income (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).

	January 31, 2014	July 31, 2013
	(in thousands)	
Total deferred revenue	$324,591	$249,230
Cash, cash equivalents, and investments	$501,317	$436,935

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
	(dollars in thousands)			
Total revenue	$141,068	$96,499	$269,248	$182,433
Year-over-year percentage increase	46.2 %	70.2 %	47.6 %	60.3 %
Gross margin percentage	73.4 %	71.4 %	73.5 %	71.6 %
Operating loss [(1)(2)(3)]	$(37,156)	$(2,157)	$(44,167)	$(5,288)
Operating margin percentage	(26.3)%	(2.2)%	(16.4)%	(2.9)%
Billings (non-GAAP)	$186,703	$124,274	$344,609	$234,808
Cash flow provided by operating activities			$80,277	$57,583
Free cash flow (non-GAAP)			$54,794	$47,347

(1) Includes share-based compensation expense of $24.4 million and $38.8 million for the three and six months ended January 31, 2014, respectively, and $8.8 million and $17.1 million for the three and six months ended January 31, 2013, respectively.

(2) Includes IP litigation expense of $2.7 million and $4.5 million for the three and six months ended January 31, 2014, respectively, and $0.4 million and $1.0 million for the three and six months ended January 31, 2013, respectively.

(3) Includes a payment for the mutual release of claims and an extension of an existing mutual covenant not to sue for six years in the amount of $20.0 million for the three and six months ended January 31, 2014, and $0 for the three and six months ended January 31, 2013.

- 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 (used in) operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

	Six Months Ended January 31,	
	2014	2013
	(in thousands)	
Cash Flow:		
Cash flow provided by operating activities	$80,277	$57,583
Less: purchase of property, equipment, and other assets	25,483	10,236
Free cash flow (non-GAAP)	$54,794	$47,347
Net cash used in investing activities	$(149,662)	$(192,228)
Net cash provided by (used in) financing activities	$20,638	$(73)

- Billings (non-GAAP). We define billings, a non-GAAP financial measure, as total revenue plus the change in 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 January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
	(in thousands)			
Billings (non-GAAP):				
Total revenue	$141,068	$96,499	$269,248	$182,433
Add: change in total deferred revenue	45,635	27,775	75,361	52,375
Billings (non-GAAP)	$186,703	$124,274	$344,609	$234,808

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. Our 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.

- 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, 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, and general and administrative 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 January 31, 2014, we expect to recognize approximately $267.0 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 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 legal costs related to ongoing IP litigation and additional costs associated with accounting, compliance, insurance, and investor relations, although our general and administrative expense may fluctuate as a percentage of total revenue. Refer to the discussion under “Legal Proceedings” included in Part II, Item 1 of this Quarterly Report on Form 10-Q for information related to pending litigation.

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 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.

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
	(in thousands)			
Condensed Consolidated Statements of Operations Data:				
Revenue:				
Product	$80,823	$61,944	$156,308	$117,458
Services	60,245	34,555	112,940	64,975
Total revenue	141,068	96,499	269,248	182,433
Cost of revenue:				
Product	20,221	16,636	38,175	31,052
Services	17,283	10,982	33,136	20,756
Total cost of revenue	37,504	27,618	71,311	51,808
Total gross profit	103,564	68,881	197,937	130,625
Operating expenses:				
Research and development	24,253	15,495	44,146	28,807
Sales and marketing	76,734	45,796	144,100	88,403
General and administrative	39,733	9,747	53,858	18,703
Total operating expenses	140,720	71,038	242,104	135,913
Operating loss	(37,156)	(2,157)	(44,167)	(5,288)
Interest income	187	116	347	214
Other expense, net	(371)	(60)	(134)	(230)
Loss before income taxes	(37,340)	(2,101)	(43,954)	(5,304)
Provision for income taxes	2,606	512	3,853	824
Net loss	$(39,946)	$(2,613)	$(47,807)	$(6,128)

	Three Months Ended January 31,		Six Months Ended January 31,	
	2014	2013	2014	2013
	(as a percentage of revenue)			
Condensed Consolidated Statements of Operations Data:				
Revenue:				
Product	57.3 %	64.2 %	58.1 %	64.4 %
Services	42.7 %	35.8 %	41.9 %	35.6 %
Total revenue	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenue:				
Product	14.3 %	17.2 %	14.2 %	17.0 %
Services	12.3 %	11.4 %	12.3 %	11.4 %
Total cost of revenue	26.6 %	28.6 %	26.5 %	28.4 %
Total gross profit	73.4 %	71.4 %	73.5 %	71.6 %
Operating expenses:				
Research and development	17.2 %	16.1 %	16.4 %	15.8 %
Sales and marketing	54.4 %	47.5 %	53.5 %	48.5 %
General and administrative	28.1 %	10.0 %	20.0 %	10.2 %
Total operating expenses	99.7 %	73.6 %	89.9 %	74.5 %
Operating loss	(26.3)%	(2.2)%	(16.4)%	(2.9)%
Interest income	0.1 %	0.1 %	0.1 %	0.1 %
Other expense, net	(0.3)%	(0.1)%	— %	(0.1)%
Loss before income taxes	(26.5)%	(2.2)%	(16.3)%	(2.9)%
Provision for income taxes	1.8 %	0.5 %	1.4 %	0.5 %
Net loss	(28.3)%	(2.7)%	(17.7)%	(3.4)%

Comparison of the Three and Six Month Periods Ended January 31, 2014 and 2013

Revenue

	Three Months Ended January 31,				Six Months Ended January 31,			
	2014	2013	Change		2014	2013	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in thousands)							
Revenue:								
Product	$80,823	$61,944	$18,879	30.5 %	$156,308	$117,458	$38,850	33.1 %
Services	60,245	34,555	25,690	74.3 %	112,940	64,975	47,965	73.8 %
Total revenue	$141,068	$96,499	$44,569	46.2 %	$269,248	$182,433	$86,815	47.6 %
Revenue by geographic theater:								
Americas	$90,869	$60,279	$30,590	50.7 %	$177,035	$114,936	$62,099	54.0 %
EMEA	33,098	24,217	8,881	36.7 %	56,973	43,894	13,079	29.8 %
APAC	17,101	12,003	5,098	42.5 %	35,240	23,603	11,637	49.3 %
Total revenue	$141,068	$96,499	$44,569	46.2 %	$269,248	$182,433	$86,815	47.6 %

Product revenue increased $18.9 million, or 30.5%, for the three months ended January 31, 2014 compared to the three months ended January 31, 2013. The increase was driven by increased demand for our PA-3000 Series firewalls, which we launched in November 2012.

Product revenue increased $38.9 million, or 33.1%, for the six months ended January 31, 2014 compared to the six months ended January 31, 2013. The increase was driven by increased demand for our PA-3000 Series firewalls, which we launched in November 2012.

Service revenue increased $25.7 million, or 74.3%, for the three months ended January 31, 2014 compared to the three months ended January 31, 2013. The increase was driven by a 76.0% increase in our subscription revenue and a 72.8% increase in our support and maintenance revenue due to increased sales to new and existing end-customers. The relative increases in subscriptions and support and maintenance will fluctuate over time, depending on the mix of services revenue and the introduction of new services offerings.

Service revenue increased $48.0 million, or 73.8%, for the six months ended January 31, 2014 compared to the six months ended January 31, 2013. The increase was driven by a 74.0% increase in our support and maintenance revenue and a 73.6% increase in our subscription revenue due to increased sales to new and existing end-customers. The relative increases in subscriptions and support and maintenance will fluctuate over time, depending on the mix of services revenue and the introduction of new services offerings.

With respect to geographic theaters, the Americas contributed the largest portion of the increase in revenue for the three and six months ended January 31, 2014 due to its larger and more established sales force compared to our other theaters. Revenue from both EMEA and APAC increased for the three and six months ended January 31, 2014 due to our investment in our sales force and number of partners in these theaters.

Cost of Revenue and Gross Margin

	Three Months Ended January 31,				Six Months Ended January 31,			
	2014		2013		2014		2013	
	Amount	Gross Margin	Amount	Gross Margin	Amount	Gross Margin	Amount	Gross Margin
	(dollars in thousands)							
Cost of revenue:								
Product	$20,221		$16,636		$38,175		$31,052	
Services	17,283		10,982		33,136		20,756	
Total cost of revenue	$37,504		$27,618		$71,311		$51,808	
Gross profit:								
Product	$60,602	75.0 %	$45,308	73.1 %	$118,133	75.6 %	$86,406	73.6 %
Services	42,962	71.3 %	23,573	68.2 %	79,804	70.7 %	44,219	68.1 %
Total gross profit	$103,564	73.4 %	$68,881	71.4 %	$197,937	73.5 %	$130,625	71.6 %

Product cost increased $3.6 million, or 21.5%, for the three months ended January 31, 2014 compared to the three months ended January 31, 2013 due to an increase in product unit volume, including sales of our PA-3000 Series firewalls, partially offset by decreases in manufacturing cost.

Product cost increased $7.1 million, or 22.9%, for the six months ended January 31, 2014 compared to the six months ended January 31, 2013 due to an increase in product unit volume, including sales of our PA-3000 Series firewalls, partially offset by decreases in manufacturing cost.

Service cost increased $6.3 million, or 57.4%, for the three months ended January 31, 2014 compared to the three months ended January 31, 2013 due to an increase in personnel costs of $3.1 million related to increasing our headcount, allocated costs of $1.2 million and other costs incurred to expand our customer service capabilities to support our growing end-customer base.

Service cost increased $12.4 million, or 59.6%, for the six months ended January 31, 2014 compared to the six months ended January 31, 2013 due to an increase in personnel costs of $6.2 million related to increasing our headcount, allocated costs of $2.9 million, professional services costs of $1.1 million and other costs incurred to expand our customer service capabilities to support our growing end-customer base.

Gross margin increased 200 basis points for the three months ended January 31, 2014 compared to the three months ended January 31, 2013. The increase of 190 basis points in product margin was due to continued focus on material cost reductions. The increase of 310 basis points in services margin was due to an increase in support and maintenance without a proportionate increase in our global customer service organization costs. The mix in services revenue was largely unchanged on a period over period basis.

Gross margin increased 190 basis points for the six months ended January 31, 2014 compared to the six months ended January 31, 2013. The increase of 200 basis points in product margin was due to continued focus on material cost reductions. The increase of 260 basis points in services margin was due to an increase in support and maintenance without a proportionate increase in our global customer service organization costs. The mix in services revenue was largely unchanged on a period over period basis.

Operating Expenses

	Three Months					Six Months Ended				
	Ended January 31,					January 31,				
	2014	2013	Change			2014	2013	Change		
	Amount	Amount	Amount	%		Amount	Amount	Amount	%	
	(dollars in thousands)									
Operating expenses:										
Research and development	$24,253	$15,495	$8,758	56.5	%	$44,146	$28,807	$15,339	53.2	%
Sales and marketing	76,734	45,796	30,938	67.6	%	144,100	88,403	55,697	63.0	%
General and administrative	39,733	9,747	29,986	307.6	%	53,858				