ALBANY INTERNATIONAL CORP /DE/
Form DEF 14A
April 12, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant x

Filed by a Party other than the Registrant o

Albany International Corp.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

April 3, 2010

To the Stockholders of Albany International Corp.:

You are cordially invited to attend the 2010 Annual Meeting of Stockholders of Albany International Corp., which will be held at the Hilton Garden Inn, 100 High Street, Portsmouth, New Hampshire, at 9:00 a.m. on Thursday, May 27, 2010. Please join us prior to the Annual Meeting at 8:30 a.m. to meet the Directors in the meeting room.

Whether or not you attend the Annual Meeting, it is important that your shares be represented and voted at the meeting. Therefore, you are urged to vote and submit your proxy promptly by phone, via the Internet, or by signing, dating, and returning a proxy card. If you decide to attend the Annual Meeting, you will be able to vote in person, even if you have previously submitted your proxy.

If you plan to attend the meeting, and have requested and received physical copies of these meeting materials, please so indicate on the enclosed proxy card so that we can make the necessary arrangements. (An addressed, postage-prepaid envelope is enclosed for your return of the proxy.)

Information about the meeting, including a description of the various matters on which the stockholders will act, can be found in the accompanying Notice of Annual Meeting and Proxy Statement. The Annual Report for the fiscal year ended December 31, 2009 also accompanies these materials.

Sincerely yours,

ERLAND E. KAILBOURNE
Chairman of the Board

JOSEPH G. MORONE
President and Chief Executive Officer

ALBANY INTERNATIONAL CORP.
1373 Broadway, Albany, New York 12204
Mailing Address: P. O. Box 1907, Albany, New York 12201

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD MAY 27, 2010

The Annual Meeting of Stockholders of Albany International Corp. will be held at the Hilton Garden Inn, 100 High Street, Portsmouth, New Hampshire, on Thursday, May 27, 2010, at 9:00 a.m. Eastern Time, for the following purposes:

1. To elect eight Directors to serve until the next Annual Meeting of Stockholders and until their successors have been elected and qualified;

2. to ratify the appointment of PricewaterhouseCoopers LLP as our independent auditor; and

3. to transact such other business as may properly come before the meeting or any adjournment or adjournments thereof.

Only stockholders of record at the close of business on April 2, 2010, will be entitled to vote at the Annual Meeting of Stockholders or any adjournment or adjournments thereof.

Whether or not you expect to attend the Annual Meeting in person, we urge you to vote your shares at your earliest convenience by telephone, via the Internet, or by signing, dating, and returning a proxy card. Submitting your proxy now will not prevent you from voting your shares at the meeting if you desire to do so, as your proxy is revocable at your option.

CHARLES J. SILVA, JR.
Secretary

April 3, 2010

PROXY STATEMENT

This proxy statement is furnished in connection with the solicitation by the Board of Directors of Albany International Corp. (the Company), 1373 Broadway, Albany, New York 12204 (P.O. Box 1907, Albany, New York 12201), of proxies in the accompanying form for use at the Annual Meeting of Stockholders to be held on May 27, 2010, and at any adjournment or adjournments thereof.

Voting Procedures

Each properly executed proxy in the accompanying form received prior to the Annual Meeting will be voted with respect to all shares represented thereby and will be voted in accordance with the specifications, if any, made thereon. **If no specification is made, the shares will be voted in accordance with the recommendation of the Board of Directors. In addition, the shares will be voted in the discretion of the proxies with respect to (1) any matter of which we did not have notice prior to February 28, 2010, (2) the election of a person as a director in substitution for a nominee named in this proxy statement who, at the time of the meeting, is unable, or for good cause is unwilling, to serve, (3) any stockholder proposal properly excluded from this proxy statement, and (4) matters incident to the conduct of the meeting.** If a stockholder is a participant in our Dividend Reinvestment Plan or the Albany International Corp. ProsperityPlus Savings Plan, a properly executed proxy will also serve as voting instructions with respect to shares in the stockholder s account in such plans. A proxy may be revoked at any time prior to the voting thereof. This proxy statement and the accompanying form of proxy are first being made available to our stockholders on or about April 12, 2010.

The only persons entitled to vote at the Annual Meeting (including any adjournment or adjournments) are (1) holders of record at the close of business on April 2, 2010, of the Company s Class A Common Stock outstanding on such date and (2) holders of record at the close of business on April 2, 2010, of our Class B Common Stock outstanding on such date. As of April 2, 2010, there were 27,786,832 shares of the Company s Class A Common Stock outstanding and 3,236,098 shares of our Class B Common Stock outstanding. Each share of Class A Common Stock is entitled to one vote, and each share of Class B Common Stock is entitled to ten votes, on each matter to be voted upon.

Under our By Laws, a copy of which is available at the Corporate Governance section of our website (www.albint.com), the presence, in person or by proxy, of shares having a majority of the total number of votes entitled to be cast at the meeting is necessary to constitute a quorum. Under Delaware law, if a quorum is present, a plurality of the votes cast at the meeting by the shares present in person or by proxy and entitled to vote is required for the election of directors, and a majority of the votes entitled to be cast at the meeting by the shares present in person or by proxy is required for any other action. Shares present at the meeting in person or by proxy and entitled to vote that abstain or fail to vote on any matter will be counted as present and entitled to vote but such abstention or failure to vote will not be counted as an affirmative or negative vote.

Under New York Stock Exchange rules, brokerage firms are permitted to vote in their discretion on certain matters on behalf of clients who have been requested to provide voting instructions, and have failed to do so, by a date specified in a statement from the brokerage firm accompanying proxy materials distributed to its clients. Brokerage firms generally do not have such discretion, however, as to any contested action, any authorization for a merger or consolidation, any equity-compensation plan, any election of directors, or any matter that may affect substantially the rights or privileges of stockholders. In such a case, broker nonvotes would be treated as shares that are present at the meeting but fail to vote. The Company anticipates that brokerage firms will be able to vote in their discretion only on the proposal to ratify the selection of PricewaterhouseCoopers LLC as auditors.

ELECTION OF DIRECTORS

All of the members of the Board of Directors are elected annually to serve until the next Annual Meeting of Stockholders and until their successors are elected and qualified. Pursuant to the By Laws, the Board of Directors may increase or decrease the number of directors from time to time, but not to fewer than three. The Board of Directors has determined that, until further action by the Board, the number of directors of the Company, from and after the time of the 2010 Annual Meeting of Stockholders, shall be eight. Accordingly, the number of directors to be elected at the 2010 Annual Meeting of Stockholders is eight. The Board of Directors has nominated *for* election the eight persons listed below, all of whom are currently serving as directors. Unless otherwise specified on the proxy, the shares represented by a proxy in the accompanying form will be voted for the election of the eight persons listed below. If, at the time of the meeting, any nominee is unable, or for good cause unwilling, to serve, which event is not anticipated, the shares will be voted for a substitute nominee proposed by the Board of Directors, unless the Board reduces the number of directors. The biographical sketches below highlight some of the specific experience, qualifications, attributes or skills that contributed to the nominee s selection by the Board.

JOSEPH G. MORONE joined the Company as President on August 1, 2005. He has been a Director of the Company since 1996. He has served as President and Chief Executive Officer since January 1, 2006. From 1997 to July 2005, Dr. Morone served as President of Bentley University. Prior to joining Bentley, Dr. Morone served as Dean of the Lally School of Management and Technology at Rensselaer Polytechnic Institute and held the Andersen Consulting Professorship of Management. He is lead director of Transworld Entertainment Corporation. In addition to the extensive knowledge of the Company and its operations gained as CEO, Dr. Morone s other contributions to the Board include experience leading other complex organizations, and his understanding of technology strategy and other issues confronting business organizations generally. Age 56.

CHRISTINE L. STANDISH has been a Director of the Company since 1997. From 1989 to 1991, she served the Company as a Corporate Marketing Associate, and was previously employed as a Graphic Designer for Skidmore, Owings & Merrill. She is a Director of the J. S. Standish Company, where she serves as President in charge of the Standish Family Philanthropic Fund. She is a member of the Board of Trustees of the Albany Academies, the Community Foundation for the Greater Capital Region and Siena College. She is the sister of John C. Standish and the daughter of J. Spencer Standish. J. Spencer Standish and related persons hold in the aggregate shares entitling them to cast a majority of the combined votes entitled to be cast by all stockholders of the Company. As the Board seeks to safeguard and promote the interests of the Company s shareholders, oversee Company management, and otherwise discharge its fiduciary obligations, Ms. Standish is able to provide a direct perspective as the representative of the Company s largest shareholder group. Age 44.

2

ERLAND E. KAILBOURNE has been a Director of the Company since 1999 and Chairman of the Board since May 9, 2008. He currently serves as Chairman of the Board of Financial Institutions, Inc., and its wholly owned subsidiary, Five Star Bank, which provides commercial banking services to customers in Western and Central New York State. From May 2002 until March 2003 he served as Chairman and interim Chief Executive Officer of Adelphia Communications Corp. (Adelphia filed a petition under Chapter 11 of the United States Bankruptcy Code in 2002.) He retired as Chairman and Chief Executive Officer (New York Region) of Fleet National Bank, a banking subsidiary of Fleet Financial Group, Inc., in 1998. He was Chairman and Chief Executive Officer of Fleet Bank, also a banking subsidiary of Fleet Financial Group, Inc., from 1993 until its merger into Fleet National Bank in 1997. He is a Director of the New York ISO, The John R. Oishei Foundation, Rand Capital Corporation, Allegany Co-op Insurance Company, and the Farash Corporation. Mr. Kailbourne s broad experience as a director on numerous boards of public and private companies and foundations, his 37 years of experience in banking and finance, and his operational experience as chief executive officer of large organizations make him a valuable addition to the board of any public or private company, especially in oversight of risk management, liquidity, and finance matters. Age 68.

JOHN C. STANDISH has been a Director of the Company since 2001 and Vice Chairman of the Board since May 9, 2008. He previously served as Senior Vice President Manufacturing, Americas Business Corridor from March 2005 to January 2008, Director of North American Dryer Manufacturing from 2003 to March 2005, Director, PAC Pressing and Process Technology from 2000 to 2003, Manager of the Company s forming and engineered fabrics manufacturing facility in Portland, Tennessee from 1998 to 2000, Production Manager of Albany International B.V. in Europe from 1994 to 1998, a Department Manager for the Press Fabrics Division from 1991 to 1994, and Design Engineer for Albany International Canada from 1986 to 1991. He is Chairman of the J. S. Standish Company, and Director of the United Way of the Greater Capital Region. He is the brother of Christine L. Standish and the son of J. Spencer Standish. In addition to being a member of the Standish family, the Company s largest shareholder group, John acquired extensive hands-on experience in the Company s PMC operations as an employee, and holds a master s degree in textiles and wood and paper sciences. Age 46.

JUHANI PAKKALA has been a Director of the Company since 2004. Mr. Pakkala previously served as President and Chief Executive Officer of Metso Paper Inc. (formerly Valmet Corporation), in Finland, from 1999 until his retirement in July 2003. Metso Paper, a subsidiary of Metso Corporation, is one of the world s largest suppliers of pulp and paper process machinery and equipment. Prior to that time, Mr. Pakkala served in a number of executive positions in companies in the Metso (formerly Valmet) Group in Finland, the United States, and Canada. As former CEO of Metso, one of two global suppliers of paper machines, Mr. Pakkala is able to bring a deep knowledge of the paper industry, as well as the perspective gained as a supplier of equipment to the same customer base as the Company s PMC segment. He has a keen understanding of markets served by the PMC segment, and a practical understanding of relevant technologies and product and process innovation. As a CEO, he also has direct experience in the oversight of manufacturing, sales and marketing, financial reporting and other functions in a corporation of a size and with a global operation comparable to that of the Company. Age 63.

PAULA H. J. CHOLMONDELEY has been a Director of the Company since February 2005. From 2000 to 2004, she was a Vice President and General Manager of Sappi Fine Papers, North America, responsible for the Specialty Products Division. She previously served in executive and financial positions in a number of corporations, including Owens Corning, the Faxon Company, Blue Cross of Greater Philadelphia, and the Westinghouse Elevator Company. She also served as a White House Fellow assisting the U.S. Trade Representative during the Reagan Administration. Ms. Cholmondeley is a former certified public accountant, and serves on the Board of Directors of four other publicly traded companies: Terex Corporation, Ultralife Batteries, Inc., Dentsply International, and Minerals Technologies Inc. She is also an independent trustee of Nationwide Mutual Funds. Ms. Cholmondeley s extensive experience in finance, including as a chief financial officer, and her background in public accounting, make her especially suited to the role of an audit committee financial expert on the Company s Audit Committee. Her international and manufacturing experience, within the paper industry and elsewhere, is also a valuable contribution to the Board. In addition, she brings extensive governance experience as the result of her service on various public company boards and involvement in various governance organizations. Age 63.

JOHN F. CASSIDY, JR. has been a Director of the Company since November 2005. From January 1989 to May 2005, he served as Senior Vice President, Science and Technology, at United Technologies Corp., a diversified company with extensive aerospace operations. He served at the General Electric Corporate Research and Development Laboratories from 1981 to 1988. Dr. Cassidy is a member of the Board of Trustees of Rensselaer at Hartford, a member of the Connecticut Academy of Science and Engineering and a senior member of the Institute for Electrical and Electronics Engineers and the Society of Automotive Engineers. He serves on the Board of Directors of the Connecticut Technology Council, the Detroit-based Convergence Electronics Transportation Association, and the Convergence Educational Foundation. Mr. Cassidy s extensive background in research and development at UTC and GE are valuable attributes for oversight of the Company s research and development operations as well as growth in its Albany Engineered Composites segment, which seeks to expand its role as a key supplier to customers in the aerospace industry. Age 65.

EDGAR G. HOTARD has been a Director of the Company since November 2006. Mr. Hotard has been an independent consultant/investor since his retirement as President and Chief Operating Officer of Praxair, Inc. in 1999. In 1992, he co-led the spin-off of Praxair from Union Carbide Corporation, where he served as Corporate Vice President. He has served as a Venture Partner of ARCH Venture Partners since September 2004, and as Managing General Partner of Hotard Holdings Ltd., an investment partnership, since September 2006. He also serves as an advisor to the Monitor Group, a global strategy consulting firm, for their Asian practice, and as the Chairman of the Monitor Group (China). Mr. Hotard is a member of the Board of Directors of Global Industries, Ltd., privately held Shona Energy Company, Inc., Koning Corp. and WinVivo Corp. He was a founding sponsor of the China Economic and Technology Alliance and of a joint MBA program between Renmin University, Beijing, and the School of Management, State University of Buffalo, New York. Mr. Hotard has extensive experience in helping non-Chinese companies develop their businesses and business relationships in China. This understanding and background are helpful as the Board oversees management s efforts to address shifting demand toward China in its core PMC business, and its ramp-up of expanded operations in Asia. Age 66.

CORPORATE GOVERNANCE

Board Leadership Structure. Since becoming a public company in 1984, the Company has at times operated under a traditional U.S. board leadership structure (with the roles of CEO and Chairman combined), while at other times the positions of the Chairman and the top executive officer have been separated. Dr. Morone s predecessor as CEO, Frank R. Schmeler, served as Chairman of the Board and CEO from 2000 until early 2006. From August 2003 until early 2006, Thomas R. Beecher, Jr. served as the Company s non-management Lead Director. Dr. Morone was appointed as President in 2005, and became CEO at the beginning of 2006. At that time, the Board determined that it would be desirable for the Company s departing CEO, Frank Schmeler, to remain in the position of Chairman, in a non-management capacity. Mr. Schmeler stepped down as Chairman in May of 2008, and was succeeded by Erland E. Kailbourne, who by that time had over nine years of experience serving on our board, had previously served as chairman and CEO of Fleet Bank, and had acquired years of experience and service on several public and private company boards.

The Board of Directors expects the Chairman of the Board to function as a liaison and independent conduit between the members of the Board and the Company s CEO between meetings of the Board, and to preside over meetings of, and provide leadership to, the non-management members of the Board. The Chairman is also primarily responsible for setting Board meeting agendas, in cooperation with the CEO and Secretary. (Other responsibilities of the Chairman are described in the Company s Corporate Governance Guidelines.) The Board has found that having a non-management director function in this role, whether as a ‘lead director or as Chairman, facilitates communication, helps ensure that issues of concern to non-management directors are given an opportunity for discussion at meetings, and contributes generally to a more effective use of management and Board time. The Board also believes the current board leadership has served the Company well during Dr. Morone s tenure as CEO, allowing him to devote his attention to the management of the Company during what has been a challenging and dynamic period. The Board engages in an annual self-evaluation process to determine whether the Board is discharging its responsibilities and operating effectively, and to consider changes in membership, structure, or process that could improve performance. While we believe that the current Board leadership structure is appropriate for the Company at the present time, it is possible that alternative Board leadership structures, including those that combine the offices of Chairman and CEO, could be appropriate for the Company under different circumstances.

Risk Oversight. The Board of Directors oversees the Company s risk management processes. The Company s CEO reviews directly with the Board, at least annually, the most significant top-level enterprise risks facing the Company, and the processes by which the Company mitigates such risks. The Board also reviews management s annual operating plan and strategic plan to ensure that they are consistent with, and appropriately address, the Company s risks and risk management processes. The Company s Audit Committee is responsible for assisting the Board in its oversight of the Company s risk management processes. The Audit Committee periodically reviews and discusses, with management, the Company s internal audit department and the independent auditors, the adequacy of the processes by which the Company handles risk assessment and risk management. The Committee receives periodic reports from the Company s finance department regarding liquidity and other financial risks; from the finance and internal audit function regarding internal control risks; and from the finance, legal and internal audit departments regarding processes for addressing fraud, legal and compliance risks, and the adequacy of the Company s disclosure controls and procedures. The Audit Committee also reviews and discusses with management the risk factors disclosed by the Company in its periodic filings with the SEC before such filings are made.

Although the Board oversees the Company s risk management, day-to-day management of risk remains the responsibility of management.

Director Independence. The Corporate Governance Rules of the New York Stock Exchange (the NYSE Rules) provide that a company of which more than 50% of the voting power is held by an individual, a group, or another company will be considered to be a controlled company. As of April 3, 2010, J. Spencer Standish, related persons (including his children, Christine L. Standish and John C. Standish, directors of the Company; and J. S. Standish Company, a corporation of which he is a director and as to which he holds the power to elect all of the directors), and Thomas R. Beecher, Jr., as sole trustee of trusts for the benefit of descendents of J. Spencer Standish, held, in the aggregate, shares entitling them to cast approximately 53.79% of the combined votes entitled to be cast by all stockholders of the Company. Accordingly, we are a controlled company under the NYSE Rules. The Company has elected to avail itself of the provisions of the NYSE Rules exempting a controlled company from

the requirements that the Board of Directors include a majority of independent directors (as defined by the NYSE Rules) and that the Compensation and Governance Committees be composed entirely of independent directors. As a result, not all of the members of the Compensation Committee or the Governance Committee are independent. The Board of Directors has determined, however, that all of the members of the Audit Committee and Director Cassidy (who is expected to be named to the Audit Committee during 2010, assuming his reelection to the Board) are independent. The Board is not required to make this determination with respect to any other director, and it has not done so. A description of transactions, relationships, or arrangements (if any) considered by the Board in making these determinations is set forth in the Audit Committee discussion below.

Meeting Attendance. The Board of Directors met 13 times in 2009. Each incumbent director attended (in person or by telephone) 75% or more of the aggregate number of meetings of the Board and of the committees of the Board on which he or she served. It is the policy of the Company that all persons who are candidates for election to the Board of Directors at an Annual Meeting of Stockholders should attend that meeting (either in person or, if necessary, by telephone). All of the candidates for election to the Board of Directors were present at the Annual Meeting of Stockholders in 2009.

Committees. The standing committees of the Board of Directors are a Governance Committee, an Audit Committee, and a Compensation Committee. During 2009, the Governance Committee met four times and the Audit Committee met eight times (including, in the second, third, and fourth quarters, a single meeting held in two parts to review the Company s quarterly operating results and earnings release (the first part) and the Quarterly Report on Form 10-Q (the second part)). The Compensation Committee met seven times during 2009.

Governance Committee. The Governance Committee reviews and recommends changes in the Company s Corporate Governance Guidelines and governance and management structure; evaluates the effectiveness of the Board of Directors, its committees, and the directors; recommends to the Board of Directors the persons to be nominated for election as directors; and reviews management succession planning. A copy of the Charter of the Governance Committee is available at the Corporate Governance section of our website (www.albint.com). The current members of the Governance Committee are John Standish (Chairman), John Cassidy, and Edgar Hotard. Chairman Erland E. Kailbourne also participates in Committee meetings as an *ex officio* nonvoting member.

The Governance Committee considers, on an ongoing basis, the skills, background, and experience that should be represented on the Board of Directors and its committees, the performance of incumbent directors, the appropriate size of the Board of Directors, potential vacancies on the Board, and other factors relating to the efficacy of the Board. The Committee and the Board seek to maintain a group of Board members that, in the aggregate, possesses the skills, background and experience necessary and desirable to effectively address the issues and challenges the Company will confront. The Board does not expect that any single member will possess all of these attributes, and therefore seeks to accomplish this by selecting candidates with diverse skills and backgrounds. The Committee discusses with the Board, at least annually, the various qualifications and skills that should be represented on the Board and its committees, taking into account the nature of the business and the objectives of the Company as they may evolve over time. The Committee also reviews, on an annual basis, the performance of the sitting members of the Board, and makes recommendations to the Board regarding those directors to be nominated for reelection by the stockholders.

Although the Governance Committee does not employ professional consultants for this purpose, members of the Committee communicate with knowledgeable persons on a continuing basis to identify potential candidates for Board membership. Any qualified potential candidates so identified are then discussed by the Committee and the Board, and if the potential candidate appears likely to be a substantial addition to the Board, he or she is then interviewed by members of the Committee and the Board. The Governance Committee then considers the reports of the interviews and other information that has been gathered and determines whether to recommend to the Board of Directors that the person be elected as a director.

Stockholders may send recommendations of persons to be considered by the Governance Committee for nomination for election as directors to: Chairman, Governance Committee, Albany International Corp., P.O. Box 1907, Albany, New York 12201. Our Corporate Governance Guidelines, a copy of which is available at the Corporate Governance section of our website (www.albint.com), set forth criteria to be employed by the Governance Committee and the Board of Directors in determining whether a person is qualified to serve as a director of the Company.

Recommendations by stockholders should include information relevant to these criteria. The Governance Committee will give consideration to persons recommended by stockholders in the same manner that it employs when considering recommendations from other sources.

All of the nominees for election as directors at the 2010 Annual Meeting are standing for reelection by stockholders.

Audit Committee. The Audit Committee assists the Board of Directors in fulfilling its fiduciary responsibilities regarding the Company s accounting and financial reporting practices and internal controls with respect to accounting, finance, legal compliance, and ethics. It also provides a means of open communication among the independent auditors, management, the Company s internal auditors, and the Board of Directors. The Board has also designated the Audit Committee as the Company s Qualified Legal Compliance Committee pursuant to the rules of the Securities and Exchange Commission with respect to Section 307 of the Sarbanes-Oxley Act. Under the NYSE Rules, the Audit Committee has sole authority to hire and fire our auditors. A copy of the current Charter of the Audit Committee is available at the Corporate Governance section of our website (www.albint.com). The current members of the Audit Committee are Paula H. J. Cholmondeley (Chairman), Edgar G. Hotard, and Juhani Pakkala. Chairman Erland E. Kailbourne also participates in Committee meetings as an *ex officio* nonvoting member.

The Audit Committee has provided the following report:

The Audit Committee has reviewed and discussed with management and the independent auditors, PricewaterhouseCoopers LLP (PwC), the financial statements for 2009, including management s report with respect to internal control over financial reporting. The Audit Committee has discussed with PwC the matters required to be discussed by the statement on Auditing Standards No. 61, as amended, as adopted by the Public Company Accounting Oversight Board (PCAOB), and has received from PwC the written disclosures and the communications relating to PwC s independence required by PCAOB rules. The Audit Committee has discussed with PwC its independence, and has considered whether the provision by PwC of the services referred to below under **RATIFICATION OF INDEPENDENT AUDITORS** is compatible with maintaining the independence of PwC.

Based on the foregoing discussions and review, the Audit Committee recommended to the Board of Directors that the audited statements for 2009 be included in the Company s Annual Report on Form 10-K for 2009 filed with the Securities and Exchange Commission.

The financial reporting process of the Company, including the system of internal controls and the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, is the responsibility of the Company s management. The Company s independent auditors (PwC) are responsible for auditing the Company s financial statements and internal controls over financial reporting. The Audit Committee monitors and reviews these processes. As required by the NYSE Rules, the Board of Directors has determined that, in their judgment, all of the members of the Audit Committee are financially literate and at least one member of the Committee has accounting or related financial management expertise. The Board has also determined that the Chairman of the Committee, Paula H. J. Cholmondeley, is a financial expert as such term is defined in Item 407 of Regulation S-K of the Securities and Exchange Commission. The members of the Audit Committee are not employees of the Company and do not represent themselves as experts in the field of accounting or auditing.

The Charter of the Audit Committee provides that the members of the Committee are entitled to rely, and they do rely, on advice, information, and representations that they receive from the independent auditors, management, and the head of internal audit. Accordingly, the review, discussions, and communications conducted by the Audit Committee do not assure that the financial statements of the Company are presented in accordance with accounting principles generally accepted in the United States of America, that the audit of the Company s financial statements has been carried out in accordance with auditing standards generally accepted in the United States of America, or that the Company s independent auditors are, in fact, independent.

The Audit Committee:
Paula H. J. Cholmondeley, Chairman
Edgar G. Hotard
Juhani Pakkala

The Board of Directors has determined that none of the members of the Audit Committee has any relationship with the Company that may interfere with the exercise of his or her independence from management and the Company and, on that basis, has determined that each of them is independent within the meaning of the Sarbanes-Oxley Act and the NYSE Rules.

Mr. Pakkala was initially elected to the Audit Committee in August 2004. At that time, the Board considered his prior employment at Metso Paper Inc., a manufacturer of papermaking equipment. The Company has supplied products and services to Metso from time to time, and has also pursued other contractual agreements with them from time to time, mostly related to development of new products. Mr. Pakkala retired from Metso Paper in 2003, and since that time has maintained no relationship with Metso, other than the ownership of an option to purchase some shares of Metso Corporation, the parent company of Metso Paper (which option has since been exercised and the shares sold), and rights to receive amounts under Metso pension and deferred compensation plans, all of which he acquired while a Metso Paper employee. The Board at that time determined that these factors did not rise to the level of a material relationship with the Company within the meaning of the NYSE Rules, and did not constitute a relationship with the Company that may interfere with the exercise of his independence from management.

Mr. Hotard was elected to the Audit Committee in May 2007. Mr. Hotard has provided services as an independent contractor to Monitor, a management consulting firm. The Company engaged Monitor during 2007 and 2008 to provide consulting services related to its Albany Engineered Composites business. Fees paid to Monitor during 2007 and 2008 were approximately $380,000 and $249,000, respectively. Mr. Hotard is not, and has never been, a Monitor employee. He has provided consulting services to Monitor s affiliate, Monitor Consulting Hong Kong Ltd, for the past eight years, functioning as an advisor for Monitor s Asia consulting practice, and serving as the Chair of Monitor Group (China), representing Monitor before the Chinese government and industry associations involved with China (e.g., the U.S. China Business Council) and Chinese companies state-owned and private.

In exchange for these services, Mr. Hotard receives a monthly retainer and reimbursement of travel expenses. The monthly retainer is not based on any revenue-generation goals, and is independent of any consulting fees Monitor collects anywhere in the world, including fees received from the Company. He is also entitled to receive performance-based incentives related to identifying investment opportunities for Monitor Capital. Incentives are not tied to revenue-generation goals. He receives no portion of the fees paid by the Company to Monitor in the U.S., nor any commission or other compensation, direct or indirect, related to the Company s engagement of Monitor. Payments to Monitor did not exceed 2% of Monitor s net revenues during any of the last three years.

Based on these facts, the Company s Board has determined that the retention of Monitor in the U.S. to provide consulting services did not constitute a material relationship between the Company and Mr. Hotard, and did not compromise his independence.

After due inquiry, the Board is not aware of, and therefore did not consider, any other transactions, relationships, or arrangements with any of the other members of the Audit Committee when determining their independence.

The Board of Directors has also examined whether Director John Cassidy has any relationship with the Company that may interfere with the exercise of his independence from management and the Company. The Board expects that Mr. Cassidy may be appointed to the Audit Committee during 2010, assuming his reelection to the Board in May. From January 1989 until May 2005, Mr. Cassidy served as Senior Vice President, Science and Technology, at United Technologies Corp. United Technologies is a customer of Albany Engineered Composites.

Pursuant to a consulting agreement with United Technologies, Mr. Cassidy provides advice and assistance to his successor from time to time, in exchange for a consulting fee based on time spent providing such advice and assistance. Amounts paid to Mr. Cassidy pursuant to this arrangement were less than $100,000 during 2009. Mr. Cassidy receives no other direct or indirect compensation from United Technologies, other than amounts under pension and deferred compensation plans that were earned before May 2005. Payments by United Technologies for goods or services to the Company (including Albany Engineered Composites) did not exceed 2% of net sales of United Technologies during any of the last three years. After due inquiry of Mr. Cassidy as well as Company management,

the Board is not aware of any other transactions, relationships, or arrangements between Mr. Cassidy and the Company and, on that basis, has determined that he is independent within the meaning of the Sarbanes-Oxley Act and the NYSE Rules.

The Board of Directors has determined that Ms. Cholmondeley possesses all of the attributes of an audit committee financial expert, as such term is defined in Item 407 of Regulation S-K of the Securities and Exchange Commission. Ms. Cholmondeley also serves on the audit committees of Dentsply International, Ultralife Batteries, Inc. and Minerals Technologies Inc., each of which is a public company. The Audit Committee Charter does not permit any member of the Audit Committee to serve on the audit committees of more than two other public companies, unless the Board of Directors has determined that such simultaneous service would not impair the ability of such member to serve effectively on our Audit Committee, and such determination is disclosed in our annual proxy statement. In the case of Ms. Cholmondeley, the Board of Directors has made such a determination. In making this determination, the Board took into account Ms. Cholmondeley s representation that she does not intend to accept any employment other than as a member of governing boards, and that she would consult with the Chairman of the Governance Committee before accepting any employment, undertaking any additional board or committee positions, or making any other new and material time commitments. Pursuant to the NYSE Rules, the Board of Directors has determined that all of the current members of the Audit Committee are financially literate and that at least one member of the Committee has accounting or related financial management expertise. The Board of Directors believes that all of the current members of the Audit Committee are well qualified to perform the functions for which the Committee is responsible.

Compensation Committee. The Compensation Committee is generally responsible for determining the compensation of our directors and executive officers. A copy of the Committee s Charter is available at the Corporate Governance section of our website (www.albint.com). The current members of the Compensation Committee are John F. Cassidy, Jr. (Chairman), Paula H. J. Cholmondeley, Christine L. Standish, and Juhani Pakkala. Chairman Erland E. Kailbourne also participates in Committee meetings as an *ex officio* nonvoting member.

As specified in its charter, the Compensation Committee is directly responsible for determining the compensation of the Company s Chief Executive Officer as well as the other senior executive officers of the Company. The Committee also assists the Board of Directors in the creation and implementation of employee compensation, incentive, and benefit policies and plans; administers (or oversees the administration by management of) pension and other employee benefit plans; and approves grants and awards under our stock option and restricted stock unit plans, and our 2005 Incentive Plan (except for awards intended to preserve deductibility under Section 162(m) of the Internal Revenue Code, which awards are approved by a separate committee of independent directors designated for such purpose). These duties and responsibilities may be delegated to a subcommittee comprising one or more members of the Committee.

The Committee s Charter indicates that input from management is both expected and in some instances required in connection with the Committee s exercise of its responsibilities. See **The Role of Executive Officers in the Compensation Process** on page 23.

In addition, the Committee s charter charges the Committee with the responsibility to obtain advice and assistance from outside legal or other advisors or consultants as the Committee may from time to time deem appropriate, and to determine the compensation and other terms of service of such advisors and consultants. The Committee has exclusive power to select, retain, and terminate the services of any such advisors or consultants to assist in evaluating the compensation of the Chief Executive Officer or senior executives, and sole power to determine the compensation and other terms of service of such consultants. The Charter provides that we shall provide for the payment of fees and compensation to any advisors or consultants so employed by the Committee. The Company paid $23,376 to Watson Wyatt Worldwide during 2009 for compensation-related services. (See **Compensation Philosophy and Objectives** on page 15 for a discussion of compensation-related services provided by Watson Wyatt during 2009.) (Effective January 1, 2010, Watson Wyatt was merged with Towers Perrin and became Towers Watson. The Company retained Towers Perrin during 2009 to provide actuarial and related services with respect to certain of the Company s benefit plans, and expects to retain Towers Watson to provide such services during 2010.)

Compensation Committee Interlocks and Insider Participation. Directors Cassidy, Cholmondeley, Pakkala and Christine Standish served on the Compensation Committee during all of 2009.

No member of the Committee was an employee during 2009. Christine Standish is an officer and director of J. S. Standish Co. (See **SHARE OWNERSHIP** on page 12.) Her husband, Christopher Wilk, received compensation and benefits during 2009 as described below under **Certain Business Relationships and Related Person Transactions.**

Non-management directors. Meetings of the non-management directors, as defined by the NYSE Rules, are regularly held at the conclusion of each meeting of the Board. The current non-management directors include all of the directors other than Dr. Morone. Meetings of the non-management directors during 2009 were chaired by the Chairman. The Chairman also acts as a liaison between the directors and the Chief Executive Officer and facilitates communication among the directors. Interested persons may communicate with the Chairman and the non-management directors by writing to: Chairman, Albany International Corp., P.O. Box 1907, Albany, New York 12201.

Shareholder communications. It is our policy to forward to each member of the Board of Directors any communications addressed to the Board of Directors as a group, and to forward to each director any communication addressed specifically to such director. Such communications may be sent to: Albany International Corp., P.O. Box 1907, Albany, New York 12201.

Available Information. The Company s Corporate Governance Guidelines, Business Ethics Policy, and Code of Ethics for the Chief Executive Officer, Chief Financial Officer and Controller, and the charters of the Audit, Compensation, and Governance Committees of the Board of Directors are all available at the Corporate Governance section of the Company s website (www.albint.com).

Certain Business Relationships and Related Person Transactions

Christine L. Standish and John C. Standish are directors of the Company. Christopher Wilk, Ms. Standish s husband, was a Company employee until January 1, 2009. He received $45,107 from the Company during 2009 pursuant to his separation agreement, as well as $6,773 as the result of the vesting on his separation date of restricted stock units granted to him in prior years. In addition, he received $29,563 in consulting fees pursuant to a post-employment consulting arrangement that ended on March 31, 2009.

The Company has adopted a written policy requiring review of relationships and transactions in which directors or executive officers, or members of their immediate families, are participants in order to determine whether such persons have a direct or indirect material interest. The Company s Legal Department is responsible for developing and implementing processes and controls designed to obtain information relating to any such relationship or transaction, and for determining whether disclosure of such relationships or transactions is required. The Audit Committee of the Board of Directors is responsible for reviewing such information, and making recommendations to the disinterested members of the Board regarding the ratification or approval of such relationships or transactions. As set forth in the policy, the Audit Committee considers each transaction in light of relevant factors, including any benefits to the Company, whether the terms are arm s-length and in the ordinary course, the direct or indirect nature of the related person s interest in the transaction, the size and expected term of the transaction, and such other facts and circumstances as may bear on the materiality of the transaction or relationship. No director may participate in the review, ratification or approval of any transaction in which such director has an interest. The transactions described above were reviewed pursuant to this policy.

Chairman Emeritus

As Chairman Emeritus of the Board of Directors, J. Spencer Standish is invited to all meetings of the Board and Compensation Committee of the Board and normally attends such meetings. He receives limited but regular assistance from Company administrative personnel in managing his correspondence and travel arrangements. He visits Company facilities in the United States and abroad from time to time, and consults with senior management from time to time on Company matters. Mr. Standish was reimbursed a total of $370 for Company-related expenses

incurred during 2009 in connection with such visits, his attendance at meetings, and such consultations. Other than his pension under the Company s retirement plans, and reimbursement of these expenses, Mr. Standish receives no fees or compensation for his activities with respect to the Company.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires our directors and officers, and any persons holding more than 10% of our Class A Common Stock, to file with the Securities and Exchange Commission reports disclosing their initial ownership of the Company s equity securities, as well as subsequent reports disclosing changes in such ownership. To the Company s knowledge, based solely on a review of such reports furnished to us and written representations by such persons that no other reports were required, all persons who were subject to the reporting requirements of Section 16(a) complied with such requirements during the year ended December 31, 2009, except (1) J. Spencer Standish acquired 104 shares of Class B Common Stock on August 28, which transaction was reported on September 14; (2) the vesting and settlement of Restricted Stock Units held by Christopher Wilk, spouse of Director Christine L. Standish, at the time of his departure from the Company on January 1, was reported by Ms. Standish on January 23; and (3) the disposition by Mr. Wilk of shares of Class A Common Stock held in his 401(k) account on August 3, as part of a rollover of his account to a personal retirement plan, was reported by Ms. Standish on September 11.

11

SHARE OWNERSHIP

As of the close of business on March 31, 2010, each of the directors and the Named Executive Officers, and all current directors and officers as a group, beneficially owned shares of our capital stock as follows:

	Shares of Class A Common Stock Beneficially Owned (a)	Percent of Outstanding Class A Common Stock	Shares of Class B Common Stock Beneficially Owned	Percent of Outstanding Class B Common Stock
Joseph G. Morone	76,441(b)	(c)		
Christine L. Standish	159,934(d)	(c)	153,022(e)	4.73%
Erland E. Kailbourne	14,167	(c)		
John C. Standish	161,172(f)	(c)	153,022(g)	4.73%
Juhani Pakkala	8,742	(c)		
Paula H. J. Cholmondeley	10,519(h)	(c)		
John F. Cassidy, Jr.	9,840	(c)		
Edgar G. Hotard	8,890	(c)		
Michael C. Nahl	183,694(i)	(c)	1,050(c)	(c)
Daniel Halftermeyer	42,600(j)	(c)		
Michael Joyce	13,625(k)	(c)		
Michael K. Burke	498(l)	(c)		
All officers and directors as a group (19 persons)	616,729	2.22%	155,776	4.81%

(a) Because shares of Class B Common Stock are convertible at any time into shares of Class A Common Stock on a one-for-one basis, they are reflected in the above table both as Class B shares beneficially owned and as Class A shares beneficially owned. Beneficial ownership has the meaning specified under Rule 13d-3 of the Securities Exchange Act.

(b) Includes (i) 72,379 shares owned outright and (ii) 4,062 shares held in the Company s employee stock ownership plan.

(c) Ownership is less than 1%.

(d) Includes (i) 6,595 shares owned outright, (ii) 153,022 shares issuable upon conversion of an equal number of shares of Class B Common Stock, and (iii) 317 shares held by Ms. Standish in her account in the Company s 401(k) retirement savings and employee stock ownership plans. The nature of Ms. Standish s beneficial ownership of the Class B shares is described in note (e) below.

(e) Includes (i) 1,704 shares owned outright and (ii) 151,318 shares owned by the Standish Delta Trust. Does not include (i) 247,153 shares held by a trust for her sole benefit, as to which she has no voting or investing power, (ii) 868,117 shares held by J. S. Standish Company, of which she is a director, (iii) 10,700 shares held by the Christine L. Standish Gift Trust, a trust for the benefit of her descendants as to which she has no voting or investment power, or (iv) 120,000 shares held by The Christine L. Standish Delta Trust, a trust for the benefit of her descendants as to which she has no voting or investment power.

(f) Includes (i) 153,022 shares issuable upon conversion of an equal number of shares of Class B Common Stock, (ii) 530 shares held by Mr. Standish in his account in the Company s 401(k) retirement savings and employee stock ownership plans, and (iii) 7,620 shares issuable upon exercise of options currently exercisable. The nature of Mr. Standish s beneficial ownership of the Class B shares is described in note (g) below. Does not include 11 shares owned by his spouse, as to which shares he disclaims beneficial ownership.

(g) Includes (i) 1,704 shares owned outright and (ii) 151,318 shares owned by the Standish Delta Trust. Does not include (i) 247,154 shares held by a trust for his sole benefit, as to which he has no voting or investment power,

12

(ii) 868,117 shares held by J. S. Standish Company, of which he is a director, (iii) 10,700 shares held by the John C. Standish Gift Trust, a trust for the benefit of his descendants as to which he has no voting or investment power, or (iv) 120,000 shares held by the John C. Standish Delta Trust, a trust for the benefit of his descendants as to which he has no voting or investment power.

(h) Includes (i) 9,056 shares owned outright, and (ii) 1,463 shares in a retirement plan.

(i) Includes (i) 27,760 shares owned outright, (ii) 4,884 shares held in the Company s employee stock ownership plan, (iii) 150,000 shares issuable upon exercise of options exercisable currently or within 60 days, and (iv) 1,050 shares issuable upon conversion of an equal number of shares of Class B Common Stock.

(j) Includes (i) 16,800 shares owned outright and (ii) 25,800 shares issuable upon exercise of options exercisable currently or within 60 days.

(k) Includes (i) 10,481 shares owned outright and (ii) 3,144 shares held in the Company s employee stock ownership plan.

(l) Shares held in the Company s employee stock ownership plan.

Each of the individuals named in the preceding table has sole voting and investment power over shares listed as beneficially owned, except as indicated. Each of the directors and officers whose share ownership is reported above has indicated that no such shares are pledged as security.

The following persons have informed us that they were the beneficial owners of more than five percent of our outstanding shares of Class A Common Stock:

Name(s)[(a)]	**Reported Shares of Company s Class A Common Stock Beneficially Owned***	**Percent of Outstanding Class A Common Stock**
J. Spencer Standish	2,583,811[(b)]	8.51%
BlackRock, Inc.	2,169,068[(c)]	7.81%
Wellington Management Company, LLP	2,077,185[(d)]	7.48%
Vanguard Fiduciary Trust Company	1,595,894[(e)]	5.74%
Tocqueville Asset Management, LP	1,459,200[(f)]	5.25%
Columbia Wanger Asset Management, L.P.	1,433,000[(g)]	5.16%

* As of December 31, 2009, except for J. Spencer Standish, whose holdings are shown as of March 31, 2010.

(a) Addresses of the beneficial owners listed in the above table are as follows: J. Spencer Standish, 395 Llwyd s Lane, Vero Beach, FL 32963; BlackRock, Inc., 40 East 52nd Street, New York, NY 10022; Wellington Management Company, LLP, 75 State Street, Boston, MA 02109; Vanguard Fiduciary Trust Company, 500 Admiral Nelson Boulevard, Malvern, PA 19355; Tocqueville Asset Management, LP, 40 West 57th Street, 19th Floor, New York, NY 10019; Columbia Wanger Asset Management, L.P., 227 West Monroe Street, Suite 3000, Chicago, IL 60606; and FMR LLC, 82 Devonshire Street, Boston, MA 02109.

(b) Includes 2,583,811 shares issuable upon conversion of an equal number of shares of Class B Common Stock. 1,715,694 shares of Class B Common Stock are held by trusts as to which he has sole voting and investment power; the remaining 868,117 shares are held by J. S. Standish Company. (J. S. Standish Company is a corporation as to which J. Spencer Standish holds the power to elect all of the directors.) Current directors of J. S. Standish Company include J. Spencer Standish, John C. Standish (son of J. Spencer Standish), Christine L. Standish (daughter of J. Spencer Standish), and Thomas R. Beecher, Jr. Does not include (x) 6,912 shares of Class A Common Stock beneficially owned by his daughter, Christine L. Standish, a director of the Company, (y) 8,150 shares of Class A Common Stock beneficially owned by his son, John C. Standish, a director of the Company, or (z) 151,318 shares issuable upon conversion of an equal number of shares of Class B Common Stock held by the Standish Delta Trust. Mr. Standish disclaims beneficial ownership of such shares.

(c) Represents shares beneficially owned by BlackRock, Inc. and one or more affiliates, including Barclays Global Investors, Ltd. and various subsidiaries of Barclays Global Investors, Ltd. BlackRock, Inc. acquired Barclays Global Investors, Ltd. on December 1, 2009. BlackRock, Inc. and/or one or more of such entities has the sole power to vote or direct the vote of, and sole power to dispose or direct the disposition of, all such shares.

(d) Represents shares beneficially owned by investment advisory clients of Wellington Management Company, LLP. Wellington Management Company, LLP has shared power to vote or direct the vote of 1,492,482 such shares, and shared power to dispose or direct the disposition of all such shares.

(e) Represents shares reported as beneficially owned by Vanguard Fiduciary Trust Company, in its capacity as trustee for certain employee benefit plans, including the Company s ProsperityPlus Savings Plan. The plan trustee votes shares allocated to participant accounts as directed by participants subject to Section 404 of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

(f) Represents shares beneficially owned by Tocqueville Asset Management, LP as investment adviser. Tocqueville Asset Management, LP has sole power to vote or direct the vote of, and sole power to dispose or direct the disposition of, all such shares.

(g) Represents shares beneficially owned by investment advisory clients of Columbia Wanger Asset Management, L.P. Columbia Wanger Asset Management, L.P. has sole power to vote or direct the vote of, and shared power to dispose or direct the disposition of, all such shares.

The following persons have informed the Company that they are the beneficial owners of more than five percent of the Company s outstanding shares of Class B Common Stock as of March 31, 2010:

Name(s)[(a)]	**Shares of Company s Class B Common Stock Beneficially Owned**	**Percent of Outstanding Class B Common Stock**
J. Spencer Standish	2,583,811[(b)]	79.92%
J. S. Standish Company	868,117	26.85%
Thomas R. Beecher, Jr.	645,625[(c)]	19.97%

(a) Addresses of the beneficial owners listed in the above table are as follows: J. Spencer Standish, 395 Llwyd s Lane, Vero Beach, Florida 32963; J. S. Standish Company, c/o Barrantys LLC, 120 West Tupper Street, Buffalo, New York 14201; and Thomas R. Beecher, Jr., c/o Barrantys LLC, 120 West Tupper Street, Buffalo, New York 14201.

(b) Includes (i) 868,117 shares held by J. S. Standish Company, a corporation of which he is a director and as to which he holds the power to elect all of the directors, and (ii) 1,715,694 shares held by trusts as to which he has sole voting and investment power. Does not include (x) 1,704 shares of Class B Common Stock owned outright by his son, John C. Standish, (y) 1,704 shares of Class B Common Stock owned outright by his daughter, Christine L. Standish, or (z) 151,318 shares held by the Standish Delta Trust. Mr. Standish disclaims beneficial ownership of such shares.

(c) Includes (i) 247,154 shares held by a trust for the sole benefit of John C. Standish (son of J. Spencer Standish) and (ii) 247,153 shares held by a trust for the sole benefit of Christine L. Standish (daughter of J. Spencer Standish). Mr. Beecher is the sole trustee of such trusts with sole voting and investment power. Also includes 151,318 shares held by the Standish Delta Trust, of which he is trustee with shared voting and investment power. Does not include 868,117 shares held by J. S. Standish Company, of which he is a director.

Voting Power of Mr. Standish

As of March 31, 2010, J. Spencer Standish, related persons (including Christine L. Standish and John C. Standish, directors of the Company) and Thomas R. Beecher, Jr., as sole trustee of trusts for the benefit of descendants of J. Spencer Standish, now hold in the aggregate shares entitling them to cast approximately 53.79% of the combined votes entitled to be cast by all stockholders of the Company. Accordingly, if J. Spencer Standish, related persons, and Thomas R. Beecher, Jr., as such trustee, cast votes as expected, election of the director nominees listed above will be assured.

Compensation Committee Report

The Compensation Committee of the Board of Directors (the Committee) has reviewed the Compensation Discussion and Analysis following this report with management of the Company, and based on such review recommended to the Board of Directors that it be included in the Company s Annual Report on Form 10-K and this proxy statement.

John F. Cassidy, Jr., Chairman
Paula H. J. Cholmondeley
Juhani Pakkala
Christine L. Standish

COMPENSATION DISCUSSION AND ANALYSIS

The object of this discussion is the disclosure of the compensation given to the Company s named executive officers during 2009. We will also address compensation philosophies and practices that relate to compensation given in earlier years, as well as some compensation matters that may affect compensation in 2010. For the purposes of this proxy statement, the Company s named executive officers (NEOs) in 2009, as that term is defined according to SEC regulations, were President and CEO Joseph G. Morone, former Executive Vice President and CFO Michael C. Nahl, current Senior Vice President and CFO Michael K. Burke, President, PMC Daniel A. Halftermeyer, President, Applied Technologies Michael J. Joyce, and Senior Vice President Human Resources and Chief Administrative Officer Ralph M. Polumbo. However, as we describe the various elements of the Company s executive compensation program, it is important to bear in mind that they may also be applicable to other Company executives in addition to the NEOs. Thus, we shall refer to four groups of executives. Managers or management refers to approximately 500 managers worldwide who participate in the annual cash incentive bonus program described below. Top management refers to approximately 250 more senior managers who, in addition, are eligible to receive annual grants of Restricted Stock Units (RSUs) as described below. Executive officers refers to a still more senior group of 11 executives who are elected by the Board of Directors and are identified as executive officers in our Annual Report on Form 10-K. Finally, the term senior management team refers to the CEO and a core group of 7 to 9 top executives working most closely with him. The senior management team consists of both executive officers and non-officers. They receive Performance Awards described below. The six NEOs were all members of the senior management team during 2009.

Compensation Philosophy and Objectives

The principal objectives of our executive compensation program are (1) to enable the Company to attract and retain talented, well-qualified, experienced, and highly motivated managers whose performance will substantially enhance the Company s performance, (2) to structure elements of compensation so that performance consistent with delivering shareholder value and the Company s annual and long-term goals is suitably rewarded, and (3) in the case of top management, to align the interests of each manager with the interests of our stockholders.

Given these objectives, our compensation program is designed to recognize and reward:

1) success in attaining financial, operational, and/or strategic goals during the year;

2) success in responding to events, problems, challenges, and opportunities arising during the course of the year that were not anticipated in management s operating plan, or were otherwise not exclusively within management s control;

3) demonstrated competence, intelligence, and ethical business behavior and managerial skill; and

4) demonstrated loyalty and commitment to the Company in the form of continued voluntary employment (i.e., retention).

Although there are multiple elements to the Company s executive compensation program, the Committee believes that flexibility in the application of each discrete element allows the Committee the opportunity to respond to changes in market conditions. This flexibility is manifest in the Committee s differing allocation between long- and short-term compensation, and in its varying use of cash and non-cash elements, even within the same groups of executives. It is the philosophy of the Company (approved by the Board of Directors) to compensate individuals based on their individual importance to the Company in achieving strategic objectives, consistent with competitive market practices, and taking internal equity into account. Towers Watson (formerly Watson Wyatt Worldwide) provides consulting services to the Committee. They provide the Committee with data useful to determine both market compensation practices and the key elements of compensation. They also provide advice to the Committee on which compensation elements are appropriate for furthering its objectives. In addition, the Committee considers materials regarding compensation that are provided from time to time by the Company s Human Resources Department.

Final compensation decisions regarding executive officers are the purview of Committee. The Committee s decisions are based on Company or business unit performance, an executive s annual achievements, the Committee s review regarding the executive s abilities, experience and effectiveness, and the Company s long-term goals. In the specific case of the CEO, the Committee s Charter charges the Committee with the responsibility of reviewing and approving performance goals and objectives relevant to the determination of his compensation, evaluating performance in the light of such goals and objectives, and determining his compensation after taking such evaluation into account. In practice, the Committee reports to the full Board of Directors and solicits its comments prior to taking any action. Thus, although the decisions regarding the CEO s compensation are those of the Committee, they reflect the advice and input of the entire Board of Directors.

Elements of Compensation

During 2009 the Company again used four principal elements of compensation to achieve the foregoing objectives: (1) base (cash) salary; (2) annual cash incentive bonuses; (3) performance-based incentive grants (Performance Awards), denominated in shares of Company stock and payable in a combination of cash and shares, awarded pursuant to the Company s 2005 Incentive Plan; and (4) retention incentives in the form of RSUs granted pursuant to the Company s Restricted Stock Unit Plan (RSU Plan).

<u>Cash Compensation Salary</u>

Annual base salary constitutes the core cash portion of the compensation of every member of management, including the NEOs. Base salaries are reviewed and established annually.

Executive salaries are customarily reviewed and adjusted to become effective in April of each year. However, in response to the developing global recession, the Committee had already decided in 2008 to forgo merit salary increases for 2009, except in cases of promotion or other change in responsibilities. None of the NEOs received an increase for 2009. Thus, actual base salaries for the six NEOs in 2009 were as follows: Dr. Morone $717,000; Mr. Nahl $502,100; Mr. Burke $400,000; Mr. Halftermeyer $376,640; Mr. Joyce $376,640; and Mr. Polumbo $328,790. As a percentage of expected total cash compensation, these base salaries ranged from 44% (for the CEO) to 69%.

<u>Annual Incentive Plan</u>

The Company also provides each manager an opportunity to earn an annual cash incentive bonus. Although the amount of the incentive bonus actually paid to a manager (including each of the NEOs) is determined by the Committee in its sole discretion, it is generally based on Company, business unit, and individual performance against established targets during the previous year. For the 2009 incentive bonus (payable in early 2010 on the basis of 2009 performance) the Committee approved specific performance metrics proposed by management at the beginning of 2009. A bonus at the targeted level is paid only if the Committee determines that the performance levels that it considers appropriate for the particular fiscal year have been achieved. Lesser cash incentives will be paid if such performance levels are not achieved, and larger incentives will be paid if performance exceeds such levels. Threshold performance levels are also established. Performance below the threshold levels generally results in no bonus being earned. Maximum performance levels are also established, limiting a bonus to 200% of target. The threshold, target and maximum performance levels are set based upon the operating plan approved by the Board of Directors. The threshold level is established as an acceptable percentage of targeted performance and the slope of the resulting bonus curve line becomes increasingly steeper above the target performance level.

The Committee periodically reviews the target bonus opportunities as part of its review of total compensation. Target bonuses as a percentage of base salary were set for each of the NEOs in 2009 as follows: Joseph G. Morone, 125% (target bonus opportunity $896,2500); Michael C. Nahl, 44% ($220,294); Daniel A. Halftermeyer, 55% ($207,152); Michael J. Joyce, 55% ($207,152); Ralph M. Polumbo, 50% ($164,395); and Michael K. Burke, 55% ($220,000, but prorated to reflect his midyear hire date). These target bonus opportunities were unchanged from 2008.

2009 Performance Metrics for NEOs (except Mr. Halftermeyer and Mr. Joyce)

The performance measurement metrics established for Dr. Morone, Mr. Nahl, Mr. Burke and Mr. Polumbo were identical, and related to the Company s 2009 Adjusted Consolidated EBITDA, its accounts receivable and inventories as a percentage of net sales, and its accounts payable as a percentage of total costs. These three metrics were weighted to account for 75%, 20% and 5%, respectively, of their target bonus.

Adjusted Consolidated EBITDA

For the purposes of establishing goals, the Company s 2009 Adjusted Consolidated EBITDA was defined as operating income for 2009 as reported in the Company s Consolidated Statement of Income adjusted by adding back, to the extent that such expense reduced operating income:

(a) Depreciation and amortization expense;

(b) Costs to Reduce Costs as that term is defined in the Company s Credit Agreement and reported to the Administrative Agent and Lender Banks pursuant to such Agreement;

(c) restructuring costs;

(d) any expenses related to machinery and equipment relocations related to plant closings or the consolidation of manufacturing capacities; and

(e) any goodwill impairment;

provided, that the amount so determined would be further adjusted:

(1) to exclude the effect of any adjustments to the Company s financial statements required to reflect the effect of (i) discontinued operations, or (ii) newly effective accounting pronouncements, the effect of which were not incorporated into the Board-approved operating plan (in each case, without duplication, as defined by GAAP and as included in the Company s audited financial statements whether or not reflected as a separate line item in such audited financial statements);

(2) to exclude (i) any income (or loss), attributable to any business operations acquired during 2009, or (ii) the reallocation of any overhead costs that were otherwise attributable to any business operation divested during 2009; and

(3) to exclude the effect on earnings of any expenses, including consulting or professional fees, incurred in connection with any activities undertaken by management at the direction of the Board of Directors to investigate or pursue any strategic acquisitions, combinations, joint ventures or divestitures, regardless of whether such efforts result in the completion of such acquisition, combination, joint venture or divestiture in 2009 (collectively, the EBITDA Adjustments).

The goal established was Adjusted Consolidated EBITDA of $120 million.

Accounts Receivable and Inventory as a Percentage of Net Sales

Accounts Receivable and Inventory as a Percentage of Net Sales was defined as the aggregate sum of the Company s accounts receivable and inventories divided by net sales. For the purposes of the metric, accounts receivable and inventories were, in each case, to be the average of the amounts reported as Accounts receivable, net and Inventories , respectively in the Company s financial accounting systems as of July 31, 2009, August 31, 2009, September 30, 2009, October 31, 2009, November 30, 2009 and December 31, 2009, adjusted to exclude any accounts receivable or inventory attributable to any business operations acquired during 2009. The metric was focused on the second half of the year to allow time to become accustomed to, and prepare for, a newly adopted working capital metric. Net Sales were meant to be net sales, as set forth in the Company s financial accounting systems and reported in the Company s 2009 consolidated financial statements in accordance with GAAP, adjusted to exclude any consolidated net sales attributable to any business operations acquired during 2009. The goal established was a percentage of 39.4%.

Accounts Payable as a Percentage of Total Costs

Accounts Payable as a Percentage of Total Costs was defined as Accounts Payable divided by Total Costs. For the purposes of the metric, Accounts Payable was to be the average of the amounts reported as Accounts payable in the Company s financial accounting systems as of July 31, 2009, August 31, 2009, September 30, 2009, October 31, 2009, November 30, 2009 and December 31, 2009, adjusted to exclude any accounts payable attributable to any business operations acquired during 2009. Total Costs was defined as Net Sales less Adjusted Consolidated EBITDA, adjusted to exclude the amounts attributable to any business operations acquired during 2009. The goal established for this metric was a percentage of 9.8%.

2009 Performance Metrics for Mr. Halftermeyer and Mr. Joyce

Messrs. Halftermeyer and Joyce s performance measurement metrics were (1) 2009 Adjusted Global PMC EBITDA and (2) Global PMC Accounts Receivable and Inventory as a Percentage of Net Sales, weighted 75% and 25%, respectively. While Mr. Halftermeyer and Mr. Joyce were in charge of specific parts of the PMC business, the Committee felt it important that the two parts be managed in a coordinated manner; hence the goals for each individual were identical for purposes of the annual incentive plan.

2009 Adjusted Global PMC EBITDA

2009 Adjusted Global PMC EBITDA was defined as the amount reported as operating income from PMC Americas, PMC Eurasia and Process Belts for 2009 in the Company s Consolidated Statement of Income adjusted by making the same adjustments as to determine Adjusted Consolidated EBITDA described above. The goal established for both gentlemen was Adjusted Global PMC EBITDA of $161.7 million.

Global PMC Accounts Receivable and Inventory as a Percentage of Net Sales

Global PMC Accounts Receivable and Inventory as a Percentage of Net Sales was defined as the aggregate sum of Accounts Receivable and Inventories attributable to PMC Americas, PMC Eurasia, and Process Belts, divided by the Net Sales of such business segments using the same methodology described above under Accounts Receivable and Inventory as a Percentage of Net Sales (the Working Capital Methodology). The goal established for both gentlemen was a percentage of 40.8%.

Results and Earned Awards

Following the close of 2009, the Committee reviewed Company performance with respect to the performance metrics identified above and, based upon audited financial statement results, determined that the Company s Adjusted Consolidated EBITDA was $123.1 million; its Accounts Receivable and Inventory as a Percentage of Net Sales was 39.1%; and its Accounts Payable as a Percentage of Total Costs was 6.1%. It was also determined that Adjusted Global PMC EBITDA was $178.1 million and Global PMC Accounts Receivable and Inventory as a Percentage of Net Sales was 41.4%.

Applying these results, the six NEOs earned the following percentages of their target annual cash incentive bonus: Dr. Morone, 96% ($860,400); Mr. Halftermeyer, 112.2% ($232,400); Mr. Joyce, 112.2% ($232,400); Mr. Polumbo, 96% ($157,800); and Mr. Burke, 96% ($101,500).

<u>Performance Awards</u>

The Performance Awards were designed to award performance, but rather than paying out over one year, are paid out over multiple years. Because all awards, once earned, continue to be denominated in shares of Class A Common Stock until they are paid out, the value of the awards remains linked to the value of the Company s Class A Common Stock over the three-year distribution period. Thus, the executive s interests remain aligned with those of the shareholders over a longer period of time.

In determining the size of the 2009 Performance Awards, the Committee s primary intention was to establish incentives consistent with competitive best-practices at comparable companies and of sufficient size to motivate performance and encourage retention. The Committee also considered (1) the alignment between the performance goals and the Company s business objectives, (2) prior advice from Towers Watson as to the total value of the awards, as well as the ideal frequency of various award outcomes, and (3) the sizes of the Performance Awards actually earned during 2005, 2006, 2007 and 2008. In general, the Committee seeks to establish target criteria that would result in a 50% probability of a 100% payout. The Committee further intended that there be a rather high probability that threshold levels would be met, and a rather low probability that maximum levels would be met.

Since the adoption of the 2005 Incentive Plan, grants of Performance Awards have generally been made in February of each year to the members of the senior management team. Awards to the NEOs in 2009 again consisted of a target number of shares of the Company s Class A Common Stock. Each award entitled the recipient to be credited with a number of shares equal to from 0% to 200% of such target, based on the extent to which he or she attained certain performance goals during 2009. Once credited, awards are to be paid out as follows: (1) 25% in early 2010, in cash, (2) 50% in early 2011, half in cash and half in shares, and (3) the remaining 25% in early 2012, half in cash and half in shares. The awards are in cash and stock to facilitate the satisfaction of any tax obligations from these payments.

2009 Performance Metrics

The performance measurement metrics and goals for the 2009 Performance Awards were the same performance measurement metrics and goals established relative to the 2009 annual cash incentive bonuses described above for all NEOs except Mr. Joyce. For his Performance Award, Mr. Joyce was to be measured against two additional metrics reflecting his added responsibilities for the Company s Engineered Fabrics business. Thus, his performance measurement metrics were: (1) 2009 Adjusted Global PMC EBITDA, (2) Global PMC Accounts Receivable and Inventory as a Percentage of Net Sales, (3) 2009 Adjusted Global Engineered Fabrics EBITDA and (4) Global Engineered Fabrics Accounts Receivable and Inventory as a Percentage of Net Sales, weighted 56.25%, 18.75%, 18.75% and 6.25%, respectively. For the purposes of his award, 2009 Adjusted Global Engineered Fabrics EBITDA was defined as the amount reported as operating income from Global Engineered Fabrics for 2009 in the Company s Consolidated Statements of Income, adjusted by making the same adjustments as to determine Adjusted Consolidated EBITDA outlined above. The goal established was Adjusted Global Engineered Fabrics EBITDA of $19.5 million. Global Engineered Fabrics Accounts Receivable and Inventory as a Percentage of Net Sales was defined as the aggregate sum of accounts receivable and inventories attributable to Global Engineered Fabrics, divided by

the net sales of such business segment calculated using the Working Capital Methodology. The goal established for Mr. Joyce was a percentage of 42.5%.

The foregoing performance metrics and goals were drawn from management s operating plan approved by the Board of Directors.

Results and Earned Awards

Following the close of 2009, and again based upon audited financial statement results, the Committee determined that 2009 Adjusted Global Engineered Fabrics EBITDA was $18.9 million and Global Engineered Fabrics Accounts Receivable and Inventory as a Percentage of Net Sales was 44.0%. Consequently, Mr. Joyce earned 106.8% of his targeted Performance Award. The percentages earned by the other NEOs are the same as those stated above in relation to their annual cash incentive bonuses. The target share amount awarded to each NEO in February 2009 was: Dr. Morone, 42,000 shares; Mr. Nahl, 14,000 shares; and 9,000 shares each to Messrs. Halftermeyer, Joyce, and Polumbo. (Mr. Burke did not join the Company until July 2009.) Thus, based on performance, the final number of shares credited to each NEO was as follows: Dr. Morone, 40,305 shares; Mr. Halftermeyer, 10,096 shares; Mr. Joyce, 9,610 shares; and Mr. Polumbo, 8,637 shares. Mr. Nahl s award was forfeited when he retired prior to December 31, 2009.

Restricted Stock Units

RSU grants function primarily as retention incentives. The size of any grant to any single manager has typically been determined primarily on the basis of salary and grade level, years of service and internal equity. Consistent with the objective of executive retention, in granting awards the Committee has typically considered the manager s value to the Company, and whether the number and remaining term of any stock options previously given and RSUs already granted are a sufficient retention incentive. Since the adoption of the 2005 Incentive Plan, and with the exception of a special executive retention incentive adopted in February 2008 and grants made upon hiring, members of the senior management team have generally not participated in the annual RSU grants.

Other Plans and Programs

In addition to the foregoing compensation programs, the Company maintains a tax-qualified 401(k) defined contribution plan in which all U.S. employees are generally eligible to participate. Under the 401(k) plan, a participant is entitled to contribute up to 10% of his or her pre-tax income and up to 15% after tax; the Company will match (in shares of the Company s Class A Common Stock) contributions made by the employee under the Plan, up to a maximum of 5% of the employee s pre-tax income. The Company also maintains a profit-sharing plan for all salaried U.S. employees. Under the profit-sharing plan, employees can receive an amount generally determined using the same formula used to determine annual incentive bonuses for top-management executives employed in the U.S. The actual amount is determined by the Committee in its sole discretion, and typically amounts to between 1% and 2.5% of each participant s annual salary. Profit-sharing payments are generally made in the form of Class A Common Stock to the accounts of participants in the 401(k) plan.

The Company also maintains a tax-qualified defined benefit plan (i.e., a pension plan) in which all salaried and hourly U.S. employees (including any NEOs who are U.S. employees) who began their employment before October 1, 1998 participate. The Company also maintains a related supplemental executive retirement plan. NEOs who are U.S. employees and who were so employed before such date accrue retirement benefits under these plans in accordance with its terms. Effective February 28, 2009, the pension plan and supplemental executive retirement plan were both amended so that no additional benefits would be accrued by any plan participant after that date. This effectively froze the future benefits of any participant based on their years of service and highest earned salaries prior to February 28, 2009.

Finally, employees located outside of the United States may enjoy benefits under local government-mandated retirement or pension plans, as well as supplementary pension or retirement plans sponsored by a local affiliate of the Company. Mr. Halftermeyer is the only NEO employed outside of the United States. As a French citizen who serves as an employee of a Swiss subsidiary of the Company while on an international assignment, he accrues

benefits under both a private pension plan maintained by the Swiss subsidiary as a requirement under Swiss law, and as an expatriate under a French government-sponsored pension scheme. The Company pays both the employer and employee contributions to the French government-sponsored pension scheme in order to maintain Mr. Halftermeyer s participation during his expatriation. The amounts paid by the Company toward both pension plans during 2009 are reported in the Summary Compensation Table on page 24, and the present value of the benefits accumulated under the Swiss private pension plan are reported in the PENSION BENEFITS table on page 34.

The amounts to which executives are entitled under these plans are dictated by the terms of the plans themselves. These are tax-qualified, nondiscriminatory plans, which apply equally to all eligible employees of the Company. The Committee is made aware of the accrued value of these entitlements when making determinations regarding executive compensation (including the NEOs), but an executive s benefits under these plans have generally had no direct bearing on its determinations. The Committee believes that the accumulation of wealth under these plans should have no impact on its objective of compensating individuals based upon their individual importance to the Company in achieving annual and strategic objectives.

Timing of Awards and Grants

Annual cash incentive bonuses are determined by the Committee following the completion of the fiscal year at the first meeting when all relevant data is available. That meeting typically occurs in February. Base salary increases are also approved at this time. This is also the time when a special Performance Committee of the Board (intended to ensure the deductibility of these awards under Section 162(m) of the Internal Revenue Code) approves new grants of Performance Awards under the 2005 Incentive Plan. Although RSU grants are generally made in November, interim grants may be awarded to specific individuals at other times during the year or at the time of a new hiring or promotion. That was the case with the special executive retention incentive adopted in February 2008 and the RSUs granted to Mr. Burke upon his hire in July 2009.

The Effect of Prior or Accumulated Compensation

At the end of each year since 2005, the Committee, in approving each element of compensation, has reviewed tally sheets for each member of the senior management team. These tally sheets contained a summary of all material elements of annual and long-term compensation (including accrued pension and 401(k) benefits) actually earned by each NEO and every other executive officer in the immediate prior year and, depending on the executive s length of service, several years prior thereto. The information includes each executive officer s actual base salary, annual cash incentive bonus, payments under the Company s RSU plan, Performance Awards under the equity-based long-term incentive plan, pension accruals and other compensation paid by the Company. The tally sheets also show the outstanding balances of RSU grants and equity-based awards and the unrealized gains on those balances. The Committee considers this information before approving new Performance Awards, base salary increases, or final annual cash incentive bonuses for the prior year. The tally sheets are used to determine how well past compensation practices satisfy the Committee s objectives.

Although the tally sheets provide insight into an executive s accumulation of wealth, it is the Committee s philosophy that neither the historical data nor any perceived wealth accumulation justified a change in either the Committee s current compensation philosophy or the elements of compensation employed. It is the Committee s belief that an executive s accumulation of wealth is the result of his or her achievement of a series of objectives over time. Furthermore, it is the Company s philosophy that the perceived accumulated wealth by the NEOs was not so significant as to deter the Committee from its objective of compensating individuals based on their individual importance to the Company in achieving strategic objectives. The Committee views realizable future compensation as having been earned by the employee on the basis of employment and performance, and provided during the term of such employee s employment. As a result, such realizable future compensation has generally had little, if any, bearing on the amount or timing of new compensation approved or awarded. The Company does not believe that the compensation paid to its executives, including the NEOs, or any individual element of that compensation, is lavish or extraordinary.

The Impact of Accounting or Tax Considerations

Although accounting or tax treatments typically have had little direct impact on the compensation decisions of the Committee, if given the choice between two comparable forms of compensation, the Committee has in the past favored the form with the lower tax cost (to the employee and/or the Company), more favorable accounting treatment, or more favorable impact on the Company s borrowing cost pursuant to its primary revolving credit facility.

Equity Ownership Requirements or Guidelines

In early 2008 the Company s Board of Directors adopted stock ownership guidelines for the Company s CEO. Those guidelines provide that the CEO is expected to own and hold shares of the Company s Common Stock (Class A or Class B) equal in value to three (3) times current base salary. There is no deadline by which such target should be attained, but at any time that the value of the CEO s holdings is less than the applicable target, he or she will be expected to retain, in addition to all shares already owned, (1) all shares acquired upon the exercise of any stock options, and (2) all shares received upon a distribution of shares pursuant to the terms of any Performance Award (in each case, net of shares used, if any, to satisfy the exercise price, taxes or commissions). Currently, the 76,441 shares owned by Dr. Morone have a value that is less than three times his current base salary.

As for other executive officers, the Committee believes that adoption of share ownership guidelines is unwarranted. The Committee acknowledges that the adoption of such requirements is sometimes perceived as creating greater alignment of executive and shareholder interests, but the Board of Directors believes that substantial alignment already exists. A Company executive officer, with a significant portion of his or her net worth in the form of unexercised stock options, unvested RSUs and/or undistributed Performance Awards (all of which are denominated in shares), and Company common stock contributions to his or her 401(k) account, is already acutely dependent on the continued financial well-being of the Company.

Benchmarking and Use of Consultant

The Committee s compensation consultant, Towers Watson, provides benchmarking and comparative compensation analysis when requested. Its findings and recommendations form part of the input used in the ongoing design of the Company s executive compensation program. Towers Watson normally carries out such comparisons annually in the case of the Company s CEO, and periodically with respect to all members of the senior management team. However, no such comparisons were completed at the outset of 2009 for either the CEO or any other member of the senior management team because the Committee had already determined in late 2008 that it would forgo 2009 merit pay increases for all salaried employees, including the senior management team. Analyses were completed by Towers Watson in late 2009 and again in early 2010 relative to 2010 base salary increases.

In their various reports prior to 2007, Towers Watson benchmarked individual compensation against the Company s proxy peer group (i.e., the companies in the Dow Jones U.S. Paper Index, in each case as described in the stock performance chart set forth in the Company s proxy statement or Form 10-K for the relevant fiscal year, to the extent such data was available). Beginning in 2007, Towers Watson benchmarked individual compensation against a peer group of 15 publicly traded U.S. companies (identified below) in the same or related industries with comparable revenues, employees, and international operations. On occasion, where appropriate and when available, Towers Watson may be asked to benchmark compensation for specific executives against data for executives at other companies in charge of similar business units or operations of comparable revenues. No such request was made with respect to any of the NEOs relative to 2009 compensation.

The peer group of comparable publicly traded U.S. companies consisted of the following:

Aptargroup, Inc.	Actuant Corp.	Barnes Group, Inc.

Buckeye Technology	Chesapeake Corp.	Clarcor, Inc.
Crane Co.	Idex Corp.	Nordson Corp.
Enpro Industries, Inc.	Pall Corp.	Paxar Corp.
Schweitzer-Mauduit International, Inc.	Watts Water Technologies, Inc.	Xerium Technologies, Inc.

Representatives of Towers Watson are encouraged by the Committee Chairman to communicate directly with members of management as needed, particularly the Company s CEO and its Senior Vice President Human Resources and Chief Administrative Officer. Nevertheless, Towers Watson was retained by, instructed by, served for and reported to the Committee, and its main point of contact throughout 2009 remained the Chairman of the Committee. Notwithstanding the use of Towers Watson, the Committee is ultimately responsible for all compensation matters.

Towers Watson was formed when Towers Perrin and Watson Wyatt Worldwide merged as of January 1, 2010. Prior to that merger, the Company had used Towers Perrin for pension-related actuarial services and advice. Except for the services for which it is retained by the Committee, Watson Wyatt Worldwide did not provide any other services to the Company prior to the merger. During 2010 the Company expects that it will continue to retain Towers Watson to provide actuarial services previously provided by Towers Perrin.

The Role of Executive Officers in the Compensation Process

The Committee s Charter expressly indicates that input from management is both expected and in some instances required in connection with the Committee s exercise of its responsibilities. Consistent with this, Company management does in fact make recommendations to the Committee from time to time regarding modifications to benefit plans, as well as adoption of new benefit plans. In addition, although the Committee has traditionally been responsible for reviewing and approving salary ranges for senior management, and making any necessary changes in such ranges or in the Company s salary structure, such ranges and changes thereto are typically proposed by the Company s Senior Vice President Human Resources, working with the CEO.

In practice, certain members of the senior management team (specifically, the CEO, CFO, and Senior Vice President Human Resources and Chief Administrative Officer) make initial proposals to the Committee regarding the following annual compensation events: (1) the amount of the total budget for management salaries for the next fiscal year; (2) specific salary increases for each of the senior executive officers, excluding the CEO; (3) proposed aggregate annual management incentive bonus payments, as well as specific bonus payments proposed for each of the senior executive officers, excluding the CEO; (4) proposed annual management cash incentive bonus targets; (5) proposed RSU awards for each award recipient; and (6) proposed grants of performance-based incentive awards to the senior management team members, excluding the CEO. In addition, the senior management team may, under some circumstances, recommend discrete, special incentives intended to motivate performance or enhance retention in response to market conditions or competitive demands, or relative to the implementation of specific strategic initiatives.

EXECUTIVE COMPENSATION

Summary Compensation Table

The following table sets forth information concerning the compensation of the Named Executive Officers for 2007, 2008 and 2009.

Name and Principal Position	Year	Salary	Bonus	Stock Awards[1] ($)	Option Awards[2] ($)	Nonequity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings[3] ($)	All Other Compensation ($)	Total ($)

Joseph G. Morone,	2007	$684,825	$108,103[4]	$1,446,640	$739,675[5]	$0	$10,856[6]	$2,990,099
President and Chief	2008	711,000	0	4,886,220	812,675[8]	0	24,175[8]	6,434,070
Executive Officer	2009	717,000	0	361,200	865,104[10]	0	15,175[10]	1,958,479
Michael C. Nahl,	2007	479,325	48,952[4]	488,880	184,775[11]	188,000	30,707[12]	$1,420,639
Executive Vice President	2008	497,850	0	1,582,860	202,875[13]	223,000	23,543[14]	2,530,128
and Chief Financial Officer (former)	2009	334,733	0	120,400	4,704[15]	50,000	210,559[16]	720,396
Michael K. Burke, Senior Vice President and Chief Financial Officer (current)	2009	192,307	0	789,120	103,346[17]	0	3,680[18]	1,088,453
Daniel A.	2007	355,174[19]	0	314,280	90,200[20]	0	253,229[19,21]	1,012,883
Halftermeyer, Group	2008	425,409[22]	0	1,238,760	180,000[23]	8,554	310,467[22,24]	2,163,190
Vice President	2009	452,321[25]	0	77,400	232,400[26]	9,045	303,105[25,27]	1,074,271
Michael J. Joyce,	2007	261,000	0	314,280	73,360[28]	25,000	18,795[29]	692,435
Group Vice	2008	333,463	0	1,238,760	178,975[30]	57,000	26,235[31]	1,834,433
President	2009	376,640	0	77,400	237,104[32]	46,000	16,052[33]	753,196
Ralph M. Polumbo	2007	285,425	23,164	314,280	96,675[34]	0	27,539[35]	747,083
Senior Vice President	2008	306,338	0	1,238,760	115,300[36]	0	18,588[37]	1,678,986
Human Resources and Chief Admin. Officer	2009	328,790	0	77,400	157,504[38]	0	15,867[39]	579,561

(1) The figure provided for each year represents the grant date fair value, in dollars, of (a) all Performance Awards made during that year under the 2005 Incentive Plan, and (b) all RSUs granted in that year under the Company s RSU Plan. In all cases, the total presented is the aggregate grant date fair value computed in accordance with FASB ASC Item 718.

(2) No options were granted during 2009.

24

(3) The figure provided for each year represents the aggregate change in the actuarial present value of each NEO s (except Mr. Halftermeyer s) accumulated benefit under all defined benefit and actuarial pension plans (including supplemental plans) from the pension plan measurement date used for financial statement reporting purposes with respect to the Company s financial statements in the immediate prior year to the pension plan measurement date used for financial statement reporting purposes with respect to the Company s financial statements in that year. In the case of the figure provided for 2008 only, it shows an increase over a fifteen-month period as it represents the aggregate change in said actuarial present value from the pension plan measurement date used for financial statement reporting purposes with respect to the Company s 2007 financial statements (September 30, 2007) to the pension plan measurement date used for financial statement reporting purposes with respect to the Company s 2008 financial statements (December 31, 2008). The figure also reflects a change in actuarial assumptions. Reference is made to Note 3 of the Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2009, for a discussion of these assumptions. The figure provided for Mr. Halftermeyer represents the change in present value of the private pension purchased for Mr. Halftermeyer through a Swiss insurance company in accordance with Swiss law (see footnote 4 to the PENSION BENEFITS table on page 34). There were no above-market or preferential earnings during 2007, 2008 or 2009 for any of the NEOs under any deferred compensation plans.

(4)

The figure provided represents an additional discretionary bonus awarded during that year, for performance during that year, but which was actually paid in the subsequent year.

(5) Includes (a) profit-sharing of $3,375 under the Company s U.S. profit-sharing plan, and (b) the portion of his annual cash incentive bonus ($736,300) under the Company s annual cash incentive bonus program that is formula-based, in each case earned during 2007 and paid during 2008.

(6) Includes (a) Company-matching contributions of $6,600 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan, and (b) a premium of $4,256 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer.

(7) Includes (a) profit-sharing of $3,375 under the Company s U.S. profit-sharing plan, and (b) the portion of his annual cash incentive bonus ($809,300) under the Company s annual cash incentive bonus program that is formula-based, in each case earned during 2008 and paid during 2009.

(8) Includes (a) Company-matching contributions of $21,240 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan, and (b) a premium of $2,935 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer.

(9) Includes (a) profit-sharing of $4,704 under the Company s U.S. profit-sharing plan, and (b) the portion of his annual cash incentive bonus ($860,400) under the Company s annual cash incentive bonus program that is formula-based, in each case earned during 2009 and paid during 2010.

(10) Includes (a) Company-matching contributions of $12,250 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan and (b) a premium of $2,925 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer.

(11) Includes (a) profit-sharing of $3,375 under the Company s U.S. profit-sharing plan, and (b) the portion of his annual cash incentive bonus ($181,400) under the Company s annual cash incentive bonus program that is formula-based, in each case earned during 2007 and paid during 2008.

(12) Includes (a) Company-matching contributions of $14,267 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan, (b) a premium of $8,910 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer, and (c) perquisites of $7,530, valued on the basis of the aggregate incremental cost to the Company, consisting solely of country club dues.

(13) Includes (a) profit-sharing of $3,375 under the Company s U.S. profit-sharing plan, and (b) the portion of his annual cash incentive bonus ($199,500) under the Company s annual cash incentive bonus program that is formula-based, in each case earned during 2008 and paid during 2009.

(14) Includes (a) Company-matching contributions of $12,642 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan, (b) a premium of $2,050 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer, and (c) perquisites of $8,851, valued on the basis of the aggregate incremental cost to the Company, consisting solely of country club dues.

(15) Includes (a) profit-sharing of $4,704 under the Company s U.S. profit-sharing plan earned during 2009 and paid during 2010.

(16) Includes (a) Company-matching contributions of $10,460 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan, (b) a premium of $378 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer, (c) perquisites of $1,475, valued on the basis of the aggregate incremental cost to the Company, consisting solely of country club dues, (d) severance payments of $149,967, and (e) accrued vacation pay of $48,279.

(17) Includes (a) profit-sharing of $1,846 under the Company s U.S. profit-sharing plan, and (b) the portion of his annual cash incentive bonus ($101,500) under the Company s annual cash incentive bonus program that is formula-based, in each case earned during 2009 and paid during 2010.

(18)

Includes (a) Company-matching contributions of $3,000 to the officer s account under the Company s ProsperityPlus 401(k) defined contribution plan, and (b) a premium of $680 paid by the Company with respect to life insurance for the benefit of beneficiaries designated by the officer.

(19) Represents either the amount paid in euros, translated into U.S. dollars at the rate of 1.3padding-top:2px;padding-bottom:2px;background-color:#cceeff;"> $ 171.76 $173.48

- 34 -

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA

The selected consolidated statement of operations data for fiscal 2016, 2015, and 2014 and the consolidated balance sheet data as of July 31, 2016 and 2015 are derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The selected consolidated statement of operations data for fiscal 2013 and 2012 and the consolidated balance sheet data as of July 31, 2014, 2013, and 2012 are derived from audited financial statements not included in this Annual Report on Form 10-K. Our historical results are not necessarily indicative of the results that may be expected in the future. The selected consolidated financial data below should be read in conjunction with the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Part II, Item 7 of this Annual Report on Form 10-K and our consolidated financial statements and related notes included in Part II, Item 8 of this Annual Report on Form 10-K.

	Year Ended July 31,				
	2016	2015	2014	2013	2012
	(in millions)				
Selected Consolidated Statements of Operations Data:					
Revenue:					
Product	$670.8	$492.7	$340.1	$243.7	$174.5
Services	707.7	435.4	258.1	152.4	80.6
Total revenue	1,378.5	928.1	598.2	396.1	255.1
Cost of revenue:					
Product	175.4	131.1	85.5	63.4	44.6
Services	194.6	120.4	74.1	46.3	25.9
Total cost of revenue [(1)]	370.0	251.5	159.6	109.7	70.5
Total gross profit	1,008.5	676.6	438.6	286.4	184.6
Operating expenses:					
Research and development	284.2	185.8	104.8	62.5	38.6
Sales and marketing	776.0	522.7	334.8	199.8	115.9
General and administrative	138.4	101.6	73.1	42.7	26.2
Legal settlement	—	—	141.2	—	—
Total operating expenses [(1)]	1,198.6	810.1	653.9	305.0	180.7
Operating income (loss)	(190.1)	(133.5)	(215.3)	(18.6)	3.9
Interest expense	(23.4)	(22.3)	(1.9)	(0.1)	—
Other income (expense), net	8.4	0.2	(5.0)	—	(1.1)
Income (loss) before income taxes	(205.1)	(155.6)	(222.2)	(18.7)	2.8
Provision for income taxes	20.8	9.4	4.3	10.5	2.1
Net income (loss)	$(225.9)	$(165.0)	$(226.5)	$(29.2)	$0.7
Net income (loss) attributable to common stockholders, basic and diluted	$(225.9)	$(165.0)	$(226.5)	$(29.2)	$—
Net income (loss) per share attributable to common stockholders, basic and diluted	$(2.59)	$(2.02)	$(3.05)	$(0.43)	$0.00
Weighted-average shares used to compute net income (loss) per share attributable to common stockholders, basic and diluted	87.1	81.6	74.3	68.7	19.6

(1) Includes share-based compensation as follows:

- 35 -

Table of Contents

	Year Ended July 31,				
	2016	2015	2014	2013	2012
	(in millions)				
Cost of product revenue	$6.2	$3.9	$1.6	$0.8	$0.1
Cost of services revenue	40.9	20.4	9.4	3.6	0.7
Research and development	132.9	74.8	29.5	9.9	3.7
Sales and marketing	152.4	84.1	42.6	20.5	4.3
General and administrative	60.5	38.2	16.8	9.1	5.1
Total share-based compensation	$392.9	$221.4	$99.9	$43.9	$13.9

	July 31,				
	2016	2015	2014	2013	2012
	(in millions)				
Selected Consolidated Balance Sheet Data:					
Cash and cash equivalents	$734.4	$375.8	$653.8	$310.6	$322.6
Investments	1,204.0	952.0	320.6	126.3	—
Working capital [(1)]	872.3	41.8	610.1	323.6	259.7
Total assets	2,761.2	1,965.2	1,478.5	585.6	407.8
Total deferred revenue	1,240.8	713.7	422.6	249.2	135.8
Convertible senior notes, net [(1)]	508.2	487.1	466.9	—	—
Common stock and additional paid-in capital	1,515.5	988.7	804.4	381.6	309.1
Total stockholders' equity	$789.9	$487.9	$468.6	$272.4	$229.1

(1) As of July 31, 2015, the convertible senior notes, net balance was classified in current liabilities in our consolidated balance sheets. Refer to Note 7. Convertible Senior Notes of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information.

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

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

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

- Overview. A discussion of our business and overall analysis of financial and other highlights in order to provide context for the remainder of MD&A.
- Key Financial Metrics. A summary of our GAAP and non-GAAP key financial metrics, which management monitors to evaluate our performance.
- Results of Operations. A discussion of the nature and trends in our financial results and an analysis of our financial results comparing fiscal 2016 to 2015 and fiscal 2015 to 2014.
- Liquidity and Capital Resources. An analysis of changes in our balance sheets and cash flows, and a discussion of our financial condition and our ability to meet cash needs.
- Contractual Obligations and Commitments. An overview of our contractual obligations, contingent liabilities, commitments, and off-balance sheet arrangements outstanding as of July 31, 2016, including expected payment schedules.

Table of Contents

- Critical Accounting Estimates. A discussion of our 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.

Overview

We have pioneered the next generation of security through our innovative platform that allows enterprises, service providers, and government entities to secure their organizations by safely enabling applications running on their networks and by preventing breaches that stem from targeted cyber attacks. Our platform uses an innovative traffic classification engine that identifies network traffic by application, user, and content and provides consistent security across the network, endpoint, and cloud. Accordingly, our platform enables our end-customers to maintain the visibility and control needed to protect their valued data and critical control systems while pursuing technology initiatives, like cloud and mobility, that grow their business. We believe our platform offers superior performance compared to legacy approaches and reduces the total cost of ownership for organizations by simplifying their security infrastructure and eliminating the need for multiple, stand-alone security appliances and software products.

Our Next-Generation Security Platform consists of three major elements: our Next-Generation Firewall, our Advanced Endpoint Protection, and our Threat Intelligence Cloud. Our Next-Generation Firewall delivers application, user, and content visibility and control as well as protection against network-based cyber threats integrated within the firewall through our proprietary hardware and software architecture. Our Advanced Endpoint Protection prevents cyber attacks that aim to run malicious code or exploit software vulnerabilities on a broad variety of fixed and virtual endpoints and servers. Our Threat Intelligence Cloud provides central intelligence capabilities, security for SaaS applications, and automated delivery of preventative measures against cyber attacks.

For fiscal 2016, 2015, and 2014, total revenue was $1.4 billion, $928.1 million, and $598.2 million, respectively, representing year-over-year growth of 48.5% for fiscal 2016 and 55.1% for fiscal 2015. Our growth reflects the increased adoption of our hybrid SaaS revenue model, which consists of product, subscriptions, and support and maintenance. We believe this model will enable us to benefit from recurring revenues as we continue to grow our installed end-customer base. As of July 31, 2016, we had approximately 34,000 end-customers in over 140 countries. Our end-customers represent a broad range of industries including education, energy, financial services, government entities, healthcare, Internet and media, manufacturing, public sector, and telecommunications, and include some of the largest Fortune 100 and Global 2000 companies in the world.

Our product revenue grew to $670.8 million or 48.7% of total revenue for fiscal 2016, representing year-over-year growth of 36.2%. Product revenue is generated from sales of our appliances, primarily our Next-Generation Firewall, which is available in physical and virtualized form. Our Next-Generation Firewall incorporates our proprietary PAN-OS operating system, which provides a consistent set of capabilities across our entire product line. Our products are designed for different performance requirements throughout an organization, ranging from our PA-200, which is designed for enterprise remote offices, to our top-of-the-line PA-7080, which was released in August 2015 and is especially suited for very large enterprise deployments and service provider customers. The same firewall functionality that is delivered in our physical appliances is also available in our VM-Series virtual firewalls, which secure virtualized and cloud-based computing environments.

Our recurring services revenue grew to $707.7 million or 51.3% of total revenue for fiscal 2016, representing year-over-year growth of 62.5%, led by revenue from subscription services, which grew 67.8% to $357.0 million, and followed by support and maintenance services, which grew 57.5% to $350.7 million. Our subscriptions include two new services released during the first quarter of fiscal 2016: our Aperture subscription service, which provides added visibility and control within IT-sanctioned SaaS applications that are used to store and share end-customer’s data, and our AutoFocus cyber threat intelligence service, which provides prioritized actionable intelligence on targeted cyber attacks. Our subscriptions provide our end-customers with real-time access to the latest antivirus, intrusion prevention, web filtering, and modern malware prevention capabilities across fixed and mobile devices.

We maintain a field sales force that works closely with our channel partners in developing sales opportunities. We use a two-tier, indirect fulfillment model whereby we sell our products and services to our distributors, which, in turn, to our resellers, which then sell to our end-customers. 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 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, and focus on end-customer satisfaction. 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. While these areas present

Table of Contents

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. For additional information regarding the challenges and risks we face, see the “Risk Factors” section in Part I, Item 1A of this Annual Report on Form 10-K.

Key Financial Metrics

We monitor the key financial metrics set forth in the tables 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 “—Results of Operations.”

	July 31,	
	2016	2015
	(in millions)	
Total deferred revenue	$1,240.8	$713.7
Cash, cash equivalents, and investments	$1,938.4	$1,327.8

	Year Ended July 31,		
	2016	2015	2014
	(dollars in millions)		
Total revenue	$1,378.5	$928.1	$598.2
Total revenue year-over-year percentage increase	48.5 %	55.1 %	51.0 %
Gross margin percentage	73.2 %	72.9 %	73.3 %
Operating loss	$(190.1)	$(133.5)	$(215.3)
Operating margin percentage	(13.8)%	(14.4)%	(36.0)%
Billings	$1,905.6	$1,219.1	$771.4
Billings year-over-year percentage increase	56.3 %	58.0 %	51.4 %
Cash flow provided by operating activities	$658.1	$350.3	$88.4
Free cash flow (non-GAAP)	$585.6	$316.5	$52.3

- Deferred Revenue. Our deferred revenue consists of amounts that have been invoiced but have not been recognized as revenue as of the period end. The majority of our deferred revenue balance consists of subscription and support and maintenance revenue that is recognized ratably over the contractual service period. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods.
- Billings. We define billings as total revenue plus the change in total deferred revenue during the period. We consider billings to be a key measure used by management to manage our business given our hybrid SaaS revenue model, and believe billings provides investors with an important indicator of the health and visibility of our business because it includes services revenue, which is recognized ratably over the subscription period or the period in which the services are expected to be performed, as the case may be, and product revenue, which is recognized at the time of shipment, provided that all other revenue recognition criteria have been met. We consider billings to be a useful metric for management and investors, particularly if we continue to experience increased sales of subscriptions and strong renewal rates for subscriptions and support and maintenance services, and as we monitor our near term cash flows. While 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, 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. We calculate billings in the following manner:

Table of Contents

	Year Ended July 31,		
	2016	2015	2014
	(in millions)		
Billings:			
Total revenue	$1,378.5	$928.1	$598.2
Add: change in total deferred revenue, net of acquired deferred revenue	527.1	291.0	173.2
Billings	$1,905.6	$1,219.1	$771.4

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

	Year Ended July 31,		
	2016	2015	2014
	(in millions)		
Free cash flow (non-GAAP):			
Net cash provided by operating activities	$658.1	$350.3	$88.4
Less: purchases of property, equipment, and other assets	72.5	33.8	36.1
Free cash flow (non-GAAP) (1)	$585.6	$316.5	$52.3
Net cash used in investing activities	$(338.9)	$(679.0)	$(320.3)
Net cash provided by financing activities	$39.4	$50.7	$575.1

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

Table of Contents

Results of Operations

The following table summarizes our results of operations for the periods presented and as a percentage of our total revenue for those periods based on our consolidated statements of operations data. The period to period comparison of results is not necessarily indicative of results for future periods.

	Year Ended July 31,					
	2016		2015		2014	
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
	(dollars in millions)					
Revenue:						
Product	$670.8	48.7 %	$492.7	53.1 %	$340.1	56.9 %
Services	707.7	51.3 %	435.4	46.9 %	258.1	43.1 %
Total revenue	1,378.5	100.0 %	928.1	100.0 %	598.2	100.0 %
Cost of revenue:						
Product	175.4	12.7 %	131.1	14.1 %	85.5	14.3 %
Services	194.6	14.1 %	120.4	13.0 %	74.1	12.4 %
Total cost of revenue (1)	370.0	26.8 %	251.5	27.1 %	159.6	26.7 %
Total gross profit	1,008.5	73.2 %	676.6	72.9 %	438.6	73.3 %
Operating expenses:						
Research and development	284.2	20.6 %	185.8	20.0 %	104.8	17.5 %
Sales and marketing	776.0	56.3 %	522.7	56.3 %	334.8	56.0 %
General and administrative	138.4	10.1 %	101.6	11.0 %	73.1	12.2 %
Legal settlement	—	— %	—	— %	141.2	23.6 %
Total operating expenses (1)	1,198.6	87.0 %	810.1	87.3 %	653.9	109.3 %
Operating loss	(190.1)	(13.8)%	(133.5)	(14.4)%	(215.3)	(36.0)%
Interest expense	(23.4)	(1.7)%	(22.3)	(2.4)%	(1.9)	(0.3)%
Other income (expense), net	8.4	0.6 %	0.2	— %	(5.0)	(0.8)%
Loss before income taxes	(205.1)	(14.9)%	(155.6)	(16.8)%	(222.2)	(37.1)%
Provision for income taxes	20.8	1.5 %	9.4	1.0 %	4.3	0.8 %
Net loss	$(225.9)	(16.4)%	$(165.0)	(17.8)%	$(226.5)	(37.9)%

(1)Includes share-based compensation as follows:

Table of Contents

	Year Ended July 31,		
	2016	2015	2014
	(in millions)		
Cost of product revenue	$6.2	$3.9	$1.6
Cost of services revenue	40.9	20.4	9.4
Research and development	132.9	74.8	29.5
Sales and marketing	152.4	84.1	42.6
General and administrative	60.5	38.2	16.8
Total share-based compensation	$392.9	$221.4	$99.9

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. We expect our revenue to vary from quarter to quarter based on seasonal and cyclical factors.

Our total revenue is comprised of the following:

- Product Revenue. Product revenue is derived primarily from sales of our appliances. Product revenue also includes revenue derived from software licenses of Panorama and, to a lesser extent, the VM-Series. We recognize product revenue at the time of shipment, provided that all other revenue recognition criteria have been met.
- Services Revenue. Services revenue is derived primarily from sales of our subscriptions and support and maintenance. Our contractual subscription and support and maintenance terms are typically one 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, such as Aperture and AutoFocus, renew existing services contracts, and expand our installed end-customer base.

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Revenue:								
Product	$670.8	$492.7	$178.1	36.2%	$492.7	$340.1	$152.6	44.8%
Services								
Subscription	357.0	212.7	144.3	67.8%	212.7	123.2	89.5	72.6%
Support and maintenance	350.7	222.7	128.0	57.5%	222.7	134.9	87.8	65.2%
Total services	707.7	435.4	272.3	62.5%	435.4	258.1	177.3	68.7%
Total revenue	$1,378.5	$928.1	$450.4	48.5%	$928.1	$598.2	$329.9	55.1%
Revenue by geographic theater:								
Americas	$973.2	$639.4	$333.8	52.2%	$639.4	$396.7	$242.7	61.2%
EMEA	247.1	178.7	68.4	38.2%	178.7	126.9	51.8	40.8%
APAC	158.2	110.0	48.2	43.8%	110.0	74.6	35.4	47.4%
Total revenue	$1,378.5	$928.1	$450.4	48.5%	$928.1	$598.2	$329.9	55.1%

Product revenue increased year-over-year for both fiscal 2016 and fiscal 2015. The increases in both periods were driven by increased demand for our higher end appliances. The change in product revenue due to pricing was not significant for either period.

Services revenue increased year-over-year for both fiscal 2016 and fiscal 2015. The increases in both periods were due to the adoption of subscriptions and high renewal rates for both subscriptions and support and maintenance services. The mix between subscription revenue and support and maintenance revenue will fluctuate over time, depending on the introduction of new

Table of Contents

subscription offerings, renewals of support and maintenance services, and our ability to increase sales to new and existing customers. The change in services revenue due to pricing was not significant for either period.

With respect to geographic theaters, the Americas contributed the largest portion of the year-over-year increases in revenue for both fiscal 2016 and fiscal 2015 due to its larger and more established sales force compared to our other theaters. Revenue from both EMEA and APAC increased year-over-year for both fiscal 2016 and fiscal 2015 due to our investment in increasing the size of our sales force and number of channel partners in these theaters.

Cost of Revenue

Our cost of revenue consists of cost of product revenue and cost of services revenue.

Cost of Product Revenue

Cost of product revenue primarily includes costs paid to our third-party contract manufacturer. Our cost of product revenue also includes amortization of intellectual property licenses, product testing costs, shipping costs, personnel costs, which consist of salaries, benefits, bonuses, and share-based compensation associated with our operations organization, and allocated costs. Allocated costs consist of certain facilities, depreciation, benefits, recruiting, and information technology costs that we allocate based on headcount. We expect our cost of product revenue to increase as our product revenue increases.

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Cost of product revenue	$175.4	$ 131.1	$44.3	33.8%	$131.1	$ 85.5	$45.6	53.3%
Number of employees at period end	91	67	24	35.8%	67	50	17	34.0%

Cost of product revenue increased for fiscal 2016 compared to fiscal 2015 due to an increase in product unit volume for our higher end appliances.

Cost of product revenue increased for fiscal 2015 compared to fiscal 2014 due to an increase in product unit volume, as well as amortization of intellectual property licenses of $10.2 million.

Cost of Services Revenue

Cost of services revenue includes personnel costs for our global customer support and technical operations organizations, amortization of acquired intangible assets, third-party professional services costs, and allocated costs. We expect our cost of services revenue to increase as our installed end-customer base grows.

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Cost of services revenue	$194.6	$ 120.4	$74.2	61.7%	$120.4	$ 74.1	$46.3	62.4%
Number of employees at period end	539	357	182	51.0%	357	229	128	55.9%

Cost of services revenue increased year-over-year for both fiscal 2016 and fiscal 2015. The increases in both periods were driven by increases in personnel costs, which grew $42.1 million to $104.1 million for fiscal 2016 compared to fiscal 2015 and grew $25.8 million to $62.0 million for fiscal 2015 compared to fiscal 2014. The increases in personnel costs in both periods were due to headcount growth. The remaining increases in both periods were due to expansion of our customer service capabilities and infrastructure to support our growing installed end-customer base.

Gross Margin

Gross margin, or gross profit as a percentage of revenue, has been and will continue to be affected by a variety of factors, including the average sales price of our products, manufacturing costs, the mix of products sold, and the mix of revenue between products and services. For sales of our products, our higher end firewall products generally have higher gross margins than our lower end firewall products within each product series. For sales of our services, our subscriptions typically have higher gross

Table of Contents

margins than our support and maintenance. We expect our gross margins to fluctuate over time depending on the factors described above.

	Year Ended July 31,					
	2016		2015		2014	
	Amount	Gross Margin	Amount	Gross Margin	Amount	Gross Margin
	(dollars in millions)					
Gross profit:						
Product	$495.4	73.9 %	$361.6	73.4 %	$254.6	74.9 %
Services	513.1	72.5 %	315.0	72.3 %	184.0	71.3 %
Total gross profit	$1,008.5	73.2 %	$676.6	72.9 %	$438.6	73.3 %

Product gross margin increased for fiscal 2016 compared to fiscal 2015 due to our continued focus on material cost reductions. Product gross margin decreased for fiscal 2015 compared to fiscal 2014 due to increased amortization of intellectual property licenses as a result of the Settlement Agreement with Juniper in May 2014.

Services gross margin was flat for fiscal 2016 compared to fiscal 2015. Services gross margin increased for fiscal 2015 compared to fiscal 2014 due to contributions from our higher margin subscription services, partially offset by increased amortization of purchased intangible assets.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, general and administrative, and legal settlement expense. Personnel costs are the most significant component of operating expenses and consist of salaries, benefits, bonuses, share-based compensation, and with regard to sales and marketing expense, sales commissions. Our operating expenses also include allocated costs, which consist of certain facilities, depreciation, benefits, recruiting, and information technology costs that we allocate based on headcount. We expect operating expenses to increase in absolute dollars and decrease over the long term as a percentage of revenue as we continue to scale our business. As of July 31, 2016, we expect to recognize approximately $822.9 million of share-based compensation expense over a weighted-average period of approximately 2.4 years, excluding additional share-based compensation expense related to any future grants of share-based awards. Share-based compensation expense, net of forfeitures, is recognized on a straight-line basis over the requisite service periods of the awards.

Research and Development

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

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Research and development	$284.2	$ 185.8	$98.4	52.9%	$185.8	$ 104.8	$81.0	77.3%
Number of employees at period end	637	475	162	34.1%	475	312	163	52.2%

Research and development expense increased year-over-year for both fiscal 2016 and fiscal 2015. The increases in both periods were driven by increases in personnel costs, which grew $86.8 million to $236.4 million for fiscal 2016 compared to fiscal 2015 and grew $73.7 million to $149.6 million for fiscal 2015 compared to fiscal 2014. The increases in personnel costs in both periods were due to headcount growth.

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 thoughtfully invest in headcount and have substantially grown our sales presence internationally. We expect sales and marketing expense to continue to increase in absolute

Table of Contents

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.

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Sales and marketing	$776.0	$522.7	$253.3	48.5%	$522.7	$334.8	$187.9	56.1%
Number of employees at period end	2,092	1,443	649	45.0%	1,443	956	487	50.9%

Sales and marketing expense increased year-over-year for both fiscal 2016 and fiscal 2015. The increases in both periods were driven by increases in personnel costs, which grew $185.2 million to $553.0 million for fiscal 2016 compared to fiscal 2015 and grew $140.4 million to $367.8 million for fiscal 2015 compared to fiscal 2014. The increases in personnel costs in both periods were due to headcount growth.

General and Administrative

General and administrative expense consists of personnel costs for our executive, finance, human resources, legal, and information technology organizations, professional services costs, which consist primarily of legal, auditing, accounting, and other consulting costs, and certain non-recurring general expenses. Certain facilities, depreciation, benefits, recruiting, and information technology costs are allocated to other organizations based on headcount. 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.

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
General and administrative	$138.4	$101.6	$36.8	36.2%	$101.6	$73.1	$28.5	38.8%
Number of employees at period end	436	295	141	47.8%	295	175	120	68.6%

General and administrative expense increased year-over-year for both fiscal 2016 and fiscal 2015. The increases in both periods were driven by increases in personnel costs, which grew $32.9 million to $96.5 million for fiscal 2016 compared to fiscal 2015 and grew $31.4 million to $63.5 million for fiscal 2015 compared to fiscal 2014. The increases in personnel costs in both periods were due to headcount growth.

Legal Settlement

We incurred legal settlement expenses of $121.2 million and $20.0 million in fiscal 2014 related to the Settlement Agreement with Juniper and the Mutual Covenant Not to Sue and Release Agreement with Fortinet, respectively. Refer to the discussion under Note 9. Legal Settlement of Notes to Consolidated Financial Statements in Part II, Item 8 of this Annual Report on Form 10-K for information related to these matters.

Table of Contents

Interest Expense

Interest expense primarily consists of the amortization of the debt discount and debt issuance costs related to the 0.0% Convertible Seniors Notes due 2019 (the "Notes"). This interest expense is non-cash and will range from $24.5 million to $25.7 million per year through fiscal 2019.

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Interest expense	$23.4	$ 22.3	$1.1	4.8%	$22.3	$ 1.9	$20.4	NM

Interest expense was flat for fiscal 2016 compared to fiscal 2015. Interest expense increased for fiscal 2015 compared to fiscal 2014 due to the amortization of the debt discount and debt issuance costs related to the Notes, which were issued on June 30, 2014.

Other Income (Expense), Net

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

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Other income (expense), net	$8.4	$ 0.2	$8.2	NM	$0.2	$ (5.0)	$5.2	NM

Other income (expense), net increased for fiscal 2016 compared to fiscal 2015 due to an increase in interest income and higher foreign currency remeasurement gains. In fiscal 2014, we recorded an expense of $5.9 million in other income (expense), net to record the change in fair value of the warrant issued to Juniper in connection with the Settlement Agreement. The warrant was classified as a liability on our consolidated balance sheets and remeasured to fair value from June 3, 2014, the issuance date of the warrant, through July 1, 2014, the date the warrant was exercised.

Provision for Income Taxes

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

In recent years, we reorganized our corporate structure and intercompany relationships to more closely align with the international nature of our business activities. Our corporate structure has caused, and may continue to cause, disproportionate relationships between our overall effective tax rate and other jurisdictional measures.

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

	Year Ended July 31,				Year Ended July 31,			
	2016	2015	Change		2015	2014	Change	
	Amount	Amount	Amount	%	Amount	Amount	Amount	%
	(dollars in millions)							
Provision for income taxes	$20.8	$9.4	$11.4	121.4%	$ 9.4	$ 4.3	$5.1	119.1%
Effective tax rate	(10.2)%	(6.0)%			(6.0)%	(1.9)%		

We recorded an income tax provision for fiscal 2016 due to federal, state, and foreign income taxes, withholding taxes, and amortization of our deferred tax charges. The provision for income taxes increased for fiscal 2016 compared to fiscal 2015 primarily due to an increase in foreign taxes and amortization of our deferred tax charges.

Table of Contents

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

Liquidity and Capital Resources

	July 31,	
	2016	2015
	(in millions)	
Working capital [(1)]	$872.3	$41.8
Cash, cash equivalents, and investments:		
Cash and cash equivalents	$734.4	$375.8
Investments	1,204.0	952.0
Total cash, cash equivalents, and investments	$1,938.4	$1,327.8

____

(1) As of July 31, 2015, the net carrying amount of the Notes was classified in current liabilities in our consolidated balance sheets. Refer to Note 7. Convertible Senior Notes of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information.

At July 31, 2016, our total cash, cash equivalents, and investments of $1.9 billion were held for general corporate purposes, of which approximately $148.6 million was held outside of the United States. We do not provide for federal income taxes on the undistributed earnings of our foreign subsidiaries, all of which we expect to reinvest outside of the United States indefinitely. However, if these funds were needed for our domestic operations, we would be required to accrue and pay U.S. taxes on undistributed earnings of foreign subsidiaries. There are no other restrictions on the use of these funds. If we were to repatriate these earnings to the United States, any associated income tax liability would be insignificant.

As of July 31, 2016, all of the Notes remained outstanding. The Notes mature on July 1, 2019, however, prior to January 1, 2019, holders may surrender their Notes for early conversion under certain circumstances. Upon conversion, we will pay cash equal to the aggregate principal amount of the Notes to be converted, and, at our election, will pay or deliver cash and/or shares of our common stock for the amount of our conversion obligation in excess of the aggregate principal amount of the Notes being converted. Refer to Note 7. Convertible Senior Notes of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for information on the Notes.

On August 26, 2016, our board of directors authorized a $500.0 million share repurchase which will be funded from available working capital. Repurchases may be made at management's discretion from time to time on the open market, through privately negotiated transactions, transactions structured through investment banking institutions, block purchase techniques, 10b5-1 trading plans, or a combination of the foregoing. The repurchase authorization will expire on August 31, 2018, and may be suspended or discontinued at any time.

The following table summarizes our cash flows for the years ended July 31, 2016, 2015, and 2014.

	Year Ended July 31,		
	2016	2015	2014
	(in millions)		
Net cash provided by operating activities	$658.1	$350.3	$88.4
Net cash used in investing activities	(338.9)	(679.0)	(320.3)
Net cash provided by financing activities	39.4	50.7	575.1
Net increase (decrease) in cash and cash equivalents	$358.6	$(278.0)	$343.2

We believe that our cash flow from operations with existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for the foreseeable future. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to acquire or invest in complementary businesses and technologies, the costs to ensure access to adequate manufacturing capacity, the investments in our new corporate headquarters,

Table of Contents

and the continuing market acceptance of our products. In addition, from time to time we may incur additional tax liability in connection with certain tax structuring decisions.

We may also choose to seek additional equity or debt financing. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results, and financial condition may be adversely affected.

Operating Activities

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

Cash provided by operating activities in fiscal 2016 was $658.1 million, an increase of $307.8 million compared to fiscal 2015. The increase was due to growth of our business and changes in our assets and liabilities during fiscal 2016, which included an increase in sales of subscription and support and maintenance contracts to new and existing customers as reflected by an increase in deferred revenue, and was partially offset by an increase in accounts receivable due to an increase in sales near the end of the period.

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

Investing Activities

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

Cash used in investing activities during fiscal 2016 was $338.9 million, a decrease of $340.1 million compared to fiscal 2015, due to lower net purchases of available-for-sale investments and a payment of $15.1 million related to our acquisition of CirroSecure in fiscal 2015, partially offset by increased investment in infrastructure and facilities to support the growth of our business.

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

Financing Activities

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

Cash provided by financing activities during fiscal 2016 was $39.4 million, a decrease of $11.3 million compared to fiscal 2015, due to a payment of deferred consideration related to our acquisition of Cyvera, lower proceeds from the sale of shares through employee equity incentive plans, and a decrease in excess tax benefit from share-based compensation arrangements.

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

Contractual Obligations and Commitments

The following summarizes our contractual obligations and commitments as of July 31, 2016:

	Payments Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	3- 5 Years	More Than 5 Years
	(in millions)				
0.0% Convertible Senior Notes due 2019	$575.0	$—	$ 575.0	$ —	$ —
Operating lease obligations [1]	509.3	27.3	79.5	103.9	298.6
Purchase obligations [2]	54.2	54.2	—	—	—
Total [3]	$1,138.5	$81.5	$ 654.5	$ 103.9	$ 298.6

Table of Contents

(1) Consists of contractual obligations from our non-cancelable operating leases. Excludes contractual sublease proceeds of $5.1 million, of which $3.0 million will be received in less than one year and $2.1 million will be received in one to two years. Refer to Note 8. Commitments and Contingencies of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K for more information on our operating leases.

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

(3) No amounts related to income taxes are included. As of July 31, 2016, we had approximately $48.4 million of tax liabilities recorded related to uncertainty in income tax positions.

Off-Balance Sheet Arrangements

Through July 31, 2016, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Critical Accounting Estimates

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

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

Revenue Recognition

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

- Vendor-specific objective evidence (“VSOE”) of selling price, if available,
- Third-party evidence (“TPE”) of selling price, if VSOE of selling price is not available, or
- Best estimate of selling price (“BESP”), if neither VSOE of selling price nor TPE of selling price are available.

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

Share-Based Compensation

Compensation expense related to share-based transactions is measured and recognized in the financial statements based on fair value estimated on the grant date. The fair value of restricted stock units (“RSUs”) and restricted stock awards ("RSAs") is based on the closing market price of our common stock on the date of grant. The fair value of stock options and shares sold through our employee stock purchase plan (“ESPP”) are estimated on the grant date using the Black-Scholes option pricing model, which requires the use of subjective assumptions, including the expected term of the award and the expected volatility of the price of our common stock.

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

Income Taxes

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

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

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

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

Contract Manufacturer Liabilities

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

Loss Contingencies

We are subject to the possibility of various loss contingencies arising in the ordinary course of business. We accrue for loss contingencies when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. If we determine that a loss is possible and the range of the loss can be reasonably determined, then we disclose the range of the possible loss. We regularly evaluate current information available to us to determine whether an accrual is required, an accrual should be adjusted or a range of possible loss should be disclosed.

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

Table of Contents

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

Goodwill, Intangibles, and Other Long-Lived Assets

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

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

Under the two-step goodwill impairment test, we first compare the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of the reporting unit is estimated using significant judgment based on a combination of the income and the market approaches. If the fair value of the reporting unit does not exceed the carrying amount of the net assets assigned to the reporting unit, then we perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. When the carrying amount of a reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference.

Determining the fair value of a reporting unit is highly judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, operating trends, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates.

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

To date, we have not recognized any impairment losses on our goodwill, intangible assets, and long-lived assets.

Recent Accounting Pronouncements

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exchange Risk

Our sales contracts are primarily denominated in U.S. dollars. A portion of our operating expenses are incurred outside of the United States and are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the euro, British pound, Singapore dollar, Israeli shekel, and Japanese yen. Additionally, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in our statement of operations. The effect of an immediate 10% adverse change in foreign exchange rates on monetary assets and liabilities at July 31, 2016 would not be material to our financial condition or results of operations. As of July 31, 2016, foreign currency transaction gains and losses and exchange rate fluctuations have not been material to our financial statements. On August 30, 2016, in an effort to reduce our foreign currency exchange exposure related to our euro-dominated expenditures for the fiscal year ending July 31, 2017, we entered into forward contracts with a notional amount of €66.9 million. The effectiveness of our existing hedging transactions and the availability and

Table of Contents

effectiveness of any hedging transactions we may decide to enter into in the future may be limited and we may not be able to successfully hedge our exposure, which could adversely affect our financial condition and operating results.

As our international operations grow, our risks associated with fluctuation in currency rates will become greater, and we will continue to reassess our approach to managing this risk. In addition, a weakening U.S. dollar can increase the costs of our international expansion and a strengthening U.S. dollar can increase the real cost of our products to our end-customers outside of the United States, leading to delays in the purchase of our products and services. For additional information, see the risk factor entitled "We are exposed to fluctuations in currency exchange rates, which could negatively affect our financial condition and operating results" in Part 1, Item 1A of this Annual Report on Form 10-K.

Interest Rate Risk

The primary objectives of our investment activities are to preserve principal, provide liquidity, and maximize income without significantly increasing risk. Some of the securities we invest in are subject to interest risk. To minimize this risk, we maintain our portfolio of cash, cash equivalents, and short-term investments in a variety of securities, including commercial paper, money market funds, U.S. government and agency securities, and corporate debt securities. Due to the short duration and conservative nature of our investment portfolio, a movement of 10% in market interest rates would not have a material impact on our operating results and the total value of the portfolio. The effect of an immediate 10% change in interest rates at July 31, 2016 would not have been material to our operating results and the total value of the portfolio assuming consistent investment levels.

Market Risk and Market Interest Risk

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Palo Alto Networks, Inc. as of July 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended July 31, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Palo Alto Networks, Inc. at July 31, 2016 and 2015, and the consolidated results of its operations and its cash flows for each of the three years in the period ended July 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Palo Alto Networks, Inc.'s internal control over financial reporting as of July 31, 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated September 8, 2016 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
San Jose, California
September 8, 2016

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited Palo Alto Networks, Inc.'s internal control over financial reporting as of July 31, 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). Palo Alto Networks, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, Palo Alto Networks, Inc. maintained, in all material respects, effective internal control over financial reporting as of July 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Palo Alto Networks, Inc. as of July 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended July 31, 2016 of Palo Alto Networks, Inc. and our report dated September 8, 2016 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
San Jose, California
September 8, 2016

Table of Contents

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management's Report on Internal Control Over Financial Reporting

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

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

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

Management assessed the effectiveness of the Company's internal control over financial reporting as of July 31, 2016, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework (2013 framework). Based on that assessment, management concluded that, as of July 31, 2016, the Company's internal control over financial reporting was effective.

The effectiveness of the Company's internal control over financial reporting as of July 31, 2016, has been audited by Ernst & Young LLP, the independent registered public accounting firm that audits the Company's Consolidated Financial Statements, as stated in their report preceding this report, which expresses an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of July 31, 2016.

PALO ALTO NETWORKS, INC.

CONSOLIDATED BALANCE SHEETS
(In millions, except per share data)

	July 31, 2016	2015
Assets		
Current assets:		
Cash and cash equivalents	$734.4	$375.8
Short-term investments	551.2	413.2
Accounts receivable, net of allowance for doubtful accounts of $2.4 and $0.7 at July 31, 2016 and July 31, 2015, respectively	348.7	212.4
Prepaid expenses and other current assets	84.8	72.6
Total current assets	1,719.1	1,074.0
Property and equipment, net	117.2	62.9
Long-term investments	652.8	538.8
Goodwill	163.5	163.5
Intangible assets, net	44.0	52.7
Other assets	64.6	73.3
Total assets	$2,761.2	$1,965.2
Liabilities, temporary equity, and stockholders' equity		
Current liabilities:		
Accounts payable	$30.2	$13.2
Accrued compensation	73.5	79.8
Accrued and other liabilities	39.2	28.2
Deferred revenue	703.9	423.9
Convertible senior notes, net	—	487.1
Total current liabilities	846.8	1,032.2
Convertible senior notes, net	508.2	—
Long-term deferred revenue	536.9	289.8
Other long-term liabilities	79.4	67.4
Commitments and contingencies (Note 8)		
Temporary equity	—	87.9
Stockholders' equity:		
Preferred stock; $0.0001 par value; 100.0 shares authorized; none issued and outstanding at July 31, 2016 and July 31, 2015	—	—
Common stock and additional paid-in capital; $0.0001 par value; 1,000.0 shares authorized; 90.5 and 84.8 shares issued and outstanding at July 31, 2016 and July 31, 2015, respectively	1,515.5	988.7
Accumulated other comprehensive income (loss)	1.0	(0.1)
Accumulated deficit	(726.6)	(500.7)
Total stockholders' equity	789.9	487.9
Total liabilities, temporary equity, and stockholders' equity	$2,761.2	$1,965.2

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(In millions, except per share data)

	Year Ended July 31,		
	2016	2015	2014
Revenue:			
Product	$670.8	$492.7	$340.1
Services	707.7	435.4	258.1
Total revenue	1,378.5	928.1	598.2
Cost of revenue:			
Product	175.4	131.1	85.5
Services	194.6	120.4	74.1
Total cost of revenue	370.0	251.5	159.6
Total gross profit	1,008.5	676.6	438.6
Operating expenses:			
Research and development	284.2	185.8	104.8
Sales and marketing	776.0	522.7	334.8
General and administrative	138.4	101.6	73.1
Legal settlement (Note 9)	—	—	141.2
Total operating expenses	1,198.6	810.1	653.9
Operating loss	(190.1)	(133.5)	(215.3)
Interest expense	(23.4)	(22.3)	(1.9)
Other income (expense), net	8.4	0.2	(5.0)
Loss before income taxes	(205.1)	(155.6)	(222.2)
Provision for income taxes	20.8	9.4	4.3
Net loss	$(225.9)	$(165.0)	$(226.5)
Net loss per share, basic and diluted	$(2.59)	$(2.02)	$(3.05)
Weighted-average shares used to compute net loss per share, basic and diluted	87.1	81.6	74.3

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In millions)

	Year Ended July 31,		
	2016	2015	2014
Net loss	$(225.9)	$(165.0)	$(226.5)
Other comprehensive income (loss), net of tax:			
Change in unrealized gains (losses) on investments	1.1	—	(0.1)
Comprehensive loss	$(224.8)	$(165.0)	$(226.6)

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In millions)

	Common Stock and Additional Paid-In Capital		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount			
Balance as of July 31, 2013	71.6	$381.6	$ —	$ (109.2)	$ 272.4
Net loss	—	—	—	(226.5)	(226.5)
Other comprehensive loss	—	—	(0.1)	—	(0.1)
Issuance of common stock in connection with employee equity incentive plans and related excess tax benefit	4.8	48.0	—	—	48.0
Share-based compensation for equity based awards	—	99.8	—	—	99.8
Issuance of common stock in connection with legal settlement	1.5	113.3	—	—	113.3
Issuance of common stock in connection with acquisition	1.6	87.5	—	—	87.5
Equity component of convertible senior notes, net	—	106.9	—	—	106.9
Purchase of convertible senior note hedges	—	(111.0)	—	—	(111.0)
Issuance of warrants	—	78.3	—	—	78.3
Balance as of July 31, 2014	79.5	804.4	(0.1)	(335.7)	468.6
Net loss	—	—	—	(165.0)	(165.0)
Issuance of common stock in connection with employee equity incentive plans and related excess tax benefit	5.3	50.9	—	—	50.9
Share-based compensation for equity based awards	—	221.3	—	—	221.3
Temporary equity reclassification	—	(87.9)	—	—	(87.9)
Balance as of July 31, 2015	84.8	988.7	(0.1)	(500.7)	487.9
Net loss	—	—	—	(225.9)	(225.9)
Other comprehensive income	—	—	1.1	—	1.1
Issuance of common stock in connection with employee equity incentive plans and related excess tax benefit	5.7	45.8	—	—	45.8
Share-based compensation for equity based awards	—	393.1	—	—	393.1
Temporary equity reclassification	—	87.9	—	—	87.9
Balance as of July 31, 2016	90.5	$1,515.5	$ 1.0	$ (726.6)	$ 789.9

See notes to consolidated financial statements.

Table of Contents

PALO ALTO NETWORKS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)

	Year Ended July 31, 2016	2015	2014
Cash flows from operating activities			
Net loss	$(225.9)	$(165.0)	$(226.5)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Share-based compensation for equity based awards	392.8	221.3	99.8
Issuance of common stock for legal settlement	—	—	46.2
Depreciation and amortization	42.8	28.9	19.4
Amortization of investment premiums, net of accretion of purchase discounts	3.0	3.2	1.5
Amortization of debt discount and debt issuance costs	23.4	22.3	1.8
Change in fair value of common stock warrant	—	—	5.9
Excess tax benefit from share-based compensation arrangements	(0.5)	(2.5)	(1.0)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable, net	(136.4)	(76.8)	(47.9)
Prepaid expenses and other assets	2.6	(34.2)	(10.3)
Accounts payable	15.1	(3.5)	(1.1)
Accrued compensation	(6.3)	31.1	26.3
Accrued and other liabilities	20.4	34.5	1.1
Deferred revenue	527.1	291.0	173.2
Net cash provided by operating activities	658.1	350.3	88.4
Cash flows from investing activities			
Purchases of investments	(1,037.0)	(987.6)	(506.6)
Proceeds from sales of investments	141.9	18.5	74.6
Proceeds from maturities of investments	628.7	339.0	233.5
Business acquisitions, net of cash acquired	—	(15.1)	(85.7)
Purchases of property, equipment, and other assets	(72.5)	(33.8)	(36.1)
Net cash used in investing activities	(338.9)	(679.0)	(320.3)
Cash flows from financing activities			
Proceeds from borrowings on convertible senior notes, net	—	—	560.4
Proceeds from issuance of warrants	—	—	78.3
Purchase of convertible note hedges	—	—	(111.0)
Proceeds from sales of shares through employee equity incentive plans	45.3	48.2	46.4
Excess tax benefit from share-based compensation arrangements	0.5	2.5	1.0
Payment of deferred consideration related to prior year business acquisition	(6.4)	—	—
Net cash provided by financing activities	39.4	50.7	575.1
Net increase (decrease) in cash and cash equivalents	358.6	(278.0)	343.2
Cash and cash equivalents—beginning of period	375.8	653.8	310.6
Cash and cash equivalents—end of period	$734.4	$375.8	$653.8
Supplemental disclosures of cash flow information			
Cash paid for income taxes	$7.1	$17.5	$1.5
Cash paid for interest	$—	$0.1	$—
Non-cash investing and financing activities			
Issuance of common stock in connection with acquisition	$—	$—	$87.5

See notes to consolidated financial statements.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

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

Basis of Presentation

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

Principles of Consolidation

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

Use of Estimates

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

Concentrations

Financial instruments that subject us to concentrations of credit risk consist primarily of cash and cash equivalents, investments, and accounts receivable.

We invest only in high-quality credit instruments and maintain our cash and cash equivalents and available-for-sale investments in fixed income securities. Management believes that the financial institutions that hold our investments are financially sound and, accordingly, are subject to minimal credit risk. Deposits held with banks may exceed the amount of insurance provided on such deposits.

Our accounts receivables are primarily derived from our distributors representing various geographical locations. We perform ongoing credit evaluations and generally do not require collateral on accounts receivable. We maintain an allowance for doubtful accounts for estimated potential credit losses. As of July 31, 2016, four distributors represented 26.1%, 25.6%, 11.4%, and 11.0% of our gross accounts receivable. For fiscal 2016, two distributors represented 31.0% and 27.2% of our total revenue. We rely on an independent contract manufacturer to assemble most of our products and sole suppliers for a certain number of our components.

Comprehensive Loss

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

Foreign Currency Transactions

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

Table of Contents

Cash and Cash Equivalents

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

Fair Value

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

Investments

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

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

Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount, net of allowances for doubtful accounts. The allowance for doubtful accounts is based on our assessment of the collectability of accounts. Management regularly reviews the adequacy of the allowance for doubtful accounts by considering the age of each outstanding invoice, each channel partner’s expected ability to pay, and the collection history with each channel partner, when applicable, to determine whether a specific allowance is appropriate. Accounts receivable deemed uncollectible are charged against the allowance for doubtful accounts when identified. As of July 31, 2016 and 2015, the allowance for doubtful accounts activity was not significant.

Property and Equipment

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

Business Combinations

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

Amortization of Intangible Assets

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

Table of Contents

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

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

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

Through July 31, 2016, we have not recognized any impairment losses on our goodwill, intangible assets, and long-lived assets.

Contract Manufacturer Liabilities

We outsource most of our manufacturing, repair, and supply chain management operations to our independent contract manufacturer and payments to it are a significant portion of our product cost of revenues. Although we could be contractually obligated to purchase manufactured products, we generally do not own the manufactured products. Product title transfers from our independent contract manufacturer to us and immediately to our channel partners upon shipment. Our independent contract manufacturer assembles our products using design specifications, quality assurance programs, and standards that we establish and it procures components and assembles our products based on our demand forecasts. These forecasts represent our estimates of future demand for our products based upon historical trends and analysis from our sales and product management functions as adjusted for overall market conditions. If the actual component usage and product demand are significantly lower than forecast, we accrue for costs for contractual manufacturing commitments in excess of our forecasted demand including costs for excess components or for carrying costs incurred by our contract manufacturer. Through July 31, 2016, we have not accrued any significant costs associated with this exposure.

Convertible Senior Notes

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

When the Notes are convertible, the net carrying amount of the Notes and related debt issuance costs will be classified as current liabilities and current assets, respectively, in our consolidated balance sheets. In addition, a portion of the equity component representing the conversion option will be reclassified to temporary equity in our consolidated balance sheets.

Revenue Recognition

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

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

- Persuasive Evidence of an Arrangement Exists. We rely upon non-cancelable sales agreements and purchase orders to determine the existence of an arrangement.
- Delivery has Occurred. We use shipping documents or transmissions of product or service contract registration codes to determine delivery.

- The Fee is Fixed or Determinable. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction.
- Collectability is Reasonably Assured. We assess collectability based on credit analysis and payment history.

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

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

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

We account for multiple agreements with a single partner as one arrangement if the contractual terms and/or substance of those agreements indicate that they may be so closely related that they are, in effect, parts of a single arrangement.

Revenues are reported net of sales taxes. Shipping charges billed to channel partners are included in revenues and related costs are included in cost of revenue. Sales commissions and other incremental costs to acquire contracts are also expensed as incurred. After receipt of a partner order, any amounts billed in excess of revenue recognized are recorded as deferred revenue.

Advertising Costs

Advertising costs, which are expensed and included in sales and marketing expense when incurred, were $6.6 million, $4.8 million, and $3.7 million, during the years ended July 31, 2016, 2015, and 2014, respectively.

Software Development Costs

Internally developed software includes security software developed to meet our internal needs to provide cloud-based subscription services to our end-customers and business software that we customize to meet our specific operational needs. These capitalized costs consist of internal compensation related costs and external direct costs incurred during the application development stage and will be amortized over a useful life of three to five years.

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

Table of Contents

Share-Based Compensation

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

Leases

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

Income Taxes

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

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

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

Loss Contingencies

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

Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (“FASB”) issued new authoritative guidance addressing eight specific cash flow issues with the objective of reducing the existing diversity in practice in how certain transactions are presented and classified in the statement of cash flows. The standard is effective for us for our first quarter of fiscal 2019 and will be applied on a retrospective basis. Early adoption is permitted. We are currently evaluating whether this standard will have a material impact on our consolidated financial statements.

In June 2016, the FASB issued new authoritative guidance on the accounting for credit losses on most financial assets and certain financial instruments. The standard replaces the existing incurred loss model with an expected credit loss model for financial assets measured at amortized cost, including trade receivables, and requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down. The standard is effective for us for our first quarter of fiscal 2021 and will be applied on a modified-retrospective basis. Early adoption is permitted beginning our first quarter of fiscal 2020. We are currently evaluating whether this standard will have a material impact on our consolidated financial statements.

In March 2016, the FASB issued authoritative guidance simplifying several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, accounting for forfeitures, and classification of excess tax benefits on the statement of cash flows. The standard is effective for us for our first quarter of fiscal 2018, however, early adoption is permitted. We are currently evaluating whether this standard will have a material impact on our consolidated financial statements.

Table of Contents

In February 2016, the FASB issued new authoritative guidance on lease accounting. Among its provisions, the standard requires lessees to recognize right-of-use assets and lease liabilities on the balance sheet for operating leases and also requires additional qualitative and quantitative disclosures about lease arrangements. The standard is effective for us for our first quarter of fiscal 2020 and will be applied on a modified retrospective basis, with the option to elect certain practical expedients. Early adoption is permitted. We are currently evaluating whether this standard will have a material impact on our consolidated financial statements.

In April 2015, the FASB issued new authoritative guidance on fees paid in a cloud computing arrangement. The standard requires customers in a cloud computing arrangement to evaluate whether the arrangement includes a software license. If the arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If the arrangement does not include a software license, the customer should account for the arrangement as a service contract. The standard is effective for us for our first quarter of fiscal 2017 and will be applied on a prospective basis. We do not expect the adoption of the standard will have a material impact on our consolidated financial statements.

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

In May 2014, the FASB issued new authoritative guidance on revenue from contracts with customers. The new standard provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also requires significantly expanded disclosures about revenue recognition. The FASB subsequently delayed the effective date of the standard by one year and as a result, the standard is now effective for us for our first quarter of fiscal 2019 using either of two methods: (i) retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within the guidance; or (ii) retrospective with the cumulative effect of initially applying the guidance recognized at the date of initial application and providing certain additional disclosures as defined per the guidance. Early adoption as of the original effective date is permitted. We are currently evaluating adoption methods and whether this standard will have a material impact on our consolidated financial statements.

2. Fair Value Measurements

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

- Level 1—Inputs are unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2—Inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the assets or liabilities, either directly or indirectly through market corroboration, for substantially the full term of the financial instruments.
- Level 3—Inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. The inputs require significant management judgment or estimation.

Table of Contents

The following table presents the fair value of our financial assets and liabilities using the above input categories as of July 31, 2016 and July 31, 2015 (in millions):

	July 31, 2016				July 31, 2015			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Short-term investments:								
Certificates of deposit	$ —	$ —	$ —	$ —	$ —	$ 1.0	$ —	$ 1.0
Commercial paper	—	3.0	—	3.0	—	—	—	—
Corporate debt securities	—	121.4	—	121.4	—	97.8	—	97.8
U.S. government and agency securities	—	426.8	—	426.8	—	314.4	—	314.4
Total short-term investments	—	551.2	—	551.2	—	413.2	—	413.2
Long-term investments:								
Certificates of deposit	—	5.4	—	5.4	—	—	—	—
Corporate debt securities	—	166.1	—	166.1	—	92.9	—	92.9
U.S. government and agency securities	—	481.3	—	481.3	—	445.9	—	445.9
Total long-term investments	—	652.8	—	652.8	—	538.8	—	538.8
Total assets measured at fair value	$ —	$ 1,204.0	$ —	$ 1,204.0	$ —	$ 952.0	$ —	$ 952.0

Refer to Note 7. Convertible Senior Notes for the carrying amount and estimated fair value of our convertible senior notes as of July 31, 2016 and July 31, 2015.

3. Investments

The following tables summarize the amortized cost, unrealized gains and losses, and fair value of our available-for-sale investments as of July 31, 2016 and July 31, 2015 (in millions):

	July 31, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Certificates of deposit	$ 5.4	$ —	$ —	$ 5.4
Commercial paper	3.0	—	—	3.0
Corporate debt securities	286.7	0.8	—	287.5
U.S. government and agency securities	907.3	0.9	(0.1)	908.1
Total	$ 1,202.4	$ 1.7	$ (0.1)	$ 1,204.0

	July 31, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Certificates of deposit	$ 1.0	$ —	$ —	$ 1.0
Corporate debt securities	190.9	—	(0.2)	190.7
U.S. government and agency securities	760.2	0.3	(0.2)	760.3
Total	$ 952.1	$ 0.3	$ (0.4)	$ 952.0

Unrealized losses related to these investments are due to interest rate fluctuations as opposed to credit quality. In addition, we do not intend to sell and it is not likely that we would be required to sell these investments before recovery of their amortized cost basis, which may be at maturity. As a result, there were no other-than-temporary impairments for these investments at July 31, 2016 and 2015.

We received proceeds of $141.9 million, $18.5 million, and $74.6 million from sales of investments during the years ended July 31, 2016, 2015, and 2014, respectively. We use the specific identification method to determine the cost basis of investments sold.

Table of Contents

The following table summarizes the amortized cost and fair value of our available-for-sale investments as of July 31, 2016, by contractual years-to-maturity (in millions):

	Amortized Cost	Fair Value
Due within one year	$ 551.0	$ 551.2
Due between one and three years	651.4	652.8
Total	$ 1,202.4	$ 1,204.0

4. Acquisitions

Fiscal 2015

CirroSecure, Inc.

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

We allocated the purchase consideration to the assets acquired and liabilities assumed based on their estimated fair values and as a result, recorded a developed technology intangible asset of $11.0 million, goodwill of $8.1 million, and net liabilities of $3.8 million in our consolidated balance sheets as of the acquisition date. The developed technology is being amortized over an estimated useful life of seven years. The goodwill is attributable to the assembled workforce and expected post-acquisition synergies and is not deductible for income tax purposes.

Fiscal 2014

Cyvera Ltd.

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

	Amount
Cash	$ 90.1
Common stock (1.3 million shares)	87.5
Total	$ 177.6

As part of the acquisition, we agreed to replace Cyvera's unvested options with our restricted stock units with an estimated fair value of $6.4 million. Of the total estimated fair value, a portion was allocated to the purchase consideration and the remainder was allocated to future services and is being expensed over the remaining service periods on a straight-line basis as share-based compensation. In addition, we issued 0.3 million shares of restricted common stock with a total fair value of $17.6 million to certain Cyvera employees. The restriction on these shares will be released over a period of three years from the acquisition date, subject to continued employment. These shares were excluded from the purchase consideration and are being expensed over the remaining service periods on a straight-line basis as share-based compensation.

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

	Amount
Cash	$ 6.9
Goodwill	145.3
Identified intangible assets	42.3
Accrued and other liabilities, net	(7.0)
Long-term deferred tax liability, net	(9.9)
Total	$ 177.6

Table of Contents

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

	Fair Value	Estimated Useful Life
Developed technology	$ 34.5	7 years
In-process research and development	7.6	N/A
Other	0.2	2 years
Total	$ 42.3	

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

Morta Security, Inc.

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

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

	Amount
Goodwill	$ 10.1
Identified intangible assets	2.2
Net liabilities assumed	(2.0)
Total	$ 10.3

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

	Fair Value	Estimated Useful Life
In-process research and development held for defensive purposes	$ 1.9	3 years
Other	0.3	2 years
Total	$ 2.2	

Goodwill generated from this business combination is primarily attributable to human capital with threat intelligence experience and capabilities, and is not deductible for income tax purposes.

5. Intangible Assets

The following table presents details of our purchased intangible assets as of July 31, 2016 and July 31, 2015 (in millions):

	July 31, 2016			2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	$53.1	$ (15.4)	$ 37.7	$53.1	$ (7.7)	$ 45.4
Acquired intellectual property	8.9	(2.9)	6.0	8.2	(1.9)	6.3
In-process research and development held for defensive purposes	1.9	(1.6)	0.3	1.9	(1.0)	0.9
Other	0.5	(0.5)	—	0.5	(0.4)	0.1
Total purchased intangible assets	$64.4	$ (20.4)	$ 44.0	$63.7	$ (11.0)	$ 52.7

Table of Contents

We recognized amortization expense of $9.4 million, $7.9 million, and $2.9 million for the years ended July 31, 2016, 2015, and 2014, respectively.

The following table summarizes our estimated future amortization expense of intangible assets as of July 31, 2016 (in millions):

	Amount
Years ending July 31:	
2017	$ 8.7
2018	8.3
2019	8.2
2020	8.1
2021	6.5
2022 and thereafter	4.2
Total future amortization expense	$ 44.0

6. Property and Equipment

The following table presents details of our property and equipment, net as of July 31, 2016 and July 31, 2015 (in millions):

	July 31, 2016	2015
Computers, equipment, and software	$102.7	$62.6
Leasehold improvements	58.0	25.5
Demonstration units	20.1	16.0
Furniture and fixtures	14.6	6.6
Total property and equipment	195.4	110.7
Less: accumulated depreciation	(78.2)	(47.8)
Total property and equipment, net	$117.2	$62.9

We recognized depreciation expense of $33.1 million, $20.3 million, and $14.0 million related to property and equipment during the years ended July 31, 2016, 2015, and 2014, respectively.

7. Convertible Senior Notes

Convertible Senior Notes

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

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

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

- upon the occurrence of specified corporate events.

Table of Contents

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

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

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

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

The sale price condition was met during the fiscal quarter ended July 31, 2015, and as a result, holders could convert their Notes at any time during the fiscal quarter ending October 31, 2015. Accordingly, the net carrying amount of the Notes and related debit issuance costs were classified in current liabilities and current assets, respectively, and a portion of the equity component representing the conversion option was classified as temporary equity in our consolidated balance sheets as of July 31, 2015. The portion of the equity component classified as temporary equity was measured as the difference between the principal and net carrying amount of the Notes. The sale price condition was not met during the fiscal quarter ended July 31, 2016. Since the Notes were no longer convertible, the net carrying amount of the Notes and related debt issuance costs were reclassified into long-term liabilities and other assets, respectively, in our consolidated balance sheets as of July 31, 2016. In addition, the portion of the equity component classified as temporary equity was reclassified into additional paid-in capital in our consolidated balance sheets as of July 31, 2016.

The following table sets forth the components of the Notes as of July 31, 2016 and July 31, 2015 (in millions):

	July 31,	
	2016	2015
Liability:		
Principal	$575.0	$575.0
Less: debt discount, net of amortization	66.8	87.9
Net carrying amount	$508.2	$487.1
Equity (including temporary equity)	$109.8	$109.8

The total estimated fair value of the Notes was $761.9 million and $994.8 million at July 31, 2016 and July 31, 2015, respectively. The fair value was determined based on the closing trading price per $100 of the Notes as of the last day of trading for the period. We consider the fair value of the Notes at July 31, 2016 and July 31, 2015 to be a Level 2 measurement. The fair value of the Notes is primarily affected by the trading price of our common stock and market interest rates. As of July 31, 2016, the if-converted value of the Notes exceeded its principal amount by $80.0 million.

Table of Contents

The following table sets forth interest expense recognized related to the Notes (dollars in millions):

	Year Ended July 31,		
	2016	2015	2014
Amortization of debt discount	$21.1	$20.2	$1.6
Amortization of debt issuance costs	2.3	2.1	0.2
Total interest expense recognized	$23.4	$22.3	$1.8
Effective interest rate of the liability component	4.8 %	4.8 %	4.8 %

Note Hedges

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

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

Warrants

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

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

8. Commitments and Contingencies

Leases

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

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

In July 2013, we entered into a 51-month sub-lease agreement for our previous corporate headquarters with a commencement date of January 2014. Net proceeds from this sub-lease are approximately $10.7 million over the lease term.

In May 2015, we entered into three lease agreements for approximately 752,000 square feet of corporate office space in Santa Clara, California to serve as our future corporate headquarters. In October 2015, we entered into a fourth lease agreement for approximately 310,000 square feet of additional office space at the same location. The first lease commenced in February 2016 and will expire in April 2021. The remaining three leases will commence between May 2017 and December 2017 and expire in April 2028, however, the property is currently under construction and as a result, the lease commencement dates may change based on progress of the construction project. The leases contain a rent holiday period, scheduled rent increases, lease incentives, and renewal options which allow the lease terms to be extended through April 2046. Rental payments under the four lease agreements are approximately $376.7 million over the lease term.

We recognized rent expense of $20.2 million, $15.4 million, and $13.2 million for the years ended July 31, 2016, 2015, and 2014, respectively. Rent expense is recognized on a straight-line basis over the term of the lease.

Table of Contents

The following table presents details of the aggregate future non-cancelable minimum rental payments under our operating leases as of July 31, 2016 (in millions):

	Amount
Years ending July 31:	
2017	$ 27.3
2018	33.3
2019	46.2
2020	49.8
2021	54.1
2022 and thereafter	298.6
Committed gross lease payments	509.3
Less: proceeds from sublease rental	5.1
Net operating lease obligation	$ 504.2

Contract Manufacturer Commitments

Our independent contract manufacturer procures components and assembles our products based on our forecasts. These forecasts are based on estimates of demand for our products primarily for the next 12 months, which are in turn based on historical trends and an analysis from our sales and product marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate supply, we may issue forecasts and orders for components and products that are non-cancelable. As of July 31, 2016, our purchase commitments under such orders were $54.2 million, excluding obligations under contracts that we can cancel without a significant penalty.

Litigation

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

In addition to the above matter, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. We accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss.

To the extent there is a reasonable possibility that a loss exceeding amounts already recognized may be incurred and the amount of such additional loss would be material, we will either disclose the estimated additional loss or state that such an estimate cannot be made. As of July 31, 2016, we have not recorded any significant accruals for loss contingencies associated with such legal proceedings, determined that an unfavorable outcome is probable or reasonably possible, or determined that the amount or range of any possible loss is reasonably estimable.

Indemnification

Under the indemnification provisions of our standard sales related contracts, we agree to defend our end-customers against third-party claims asserting infringement of certain intellectual property rights, which may include patents, copyrights, trademarks, or trade secrets, and to pay judgments entered on such claims. Our exposure under these indemnification provisions is generally limited to payments made to us for the alleged infringing products over the preceding twelve months under the agreement. However, certain agreements include indemnification provisions that could potentially expose us to losses in excess of these payments. In addition, we indemnify our officers, directors, and certain key employees while they are serving in good faith in their company capacities. To date, we have not recorded any accruals for loss contingencies associated with indemnification claims or determined that an unfavorable outcome is probable or reasonably possible.

Table of Contents

9. Legal Settlement

Settlement, Release and Cross-License Agreement with Juniper

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

- Mutual dismissal with prejudice of all pending litigation between the parties and general release of all liability for Palo Alto Networks and Juniper,
- Cross-license between both parties for the patents-in-suit and associated family members and counterparts worldwide for the life of the patents, and
- Mutual covenant not to sue for infringement of any other patents for a period of eight years.

The fair value of the total consideration as of the settlement date was $182.5 million, which was comprised of $75.0 million in cash, $75.3 million in common stock, and $32.2 million in warrant. The fair values of the common stock and warrant were measured using the closing price of our common stock on the settlement date.

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

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

Mutual Covenant Not to Sue and Release Agreement

On January 27, 2014, we executed a Mutual Covenant Not to Sue and Release Agreement with Fortinet, Inc., thereby extending an existing covenant for six more years. We evaluated the transaction as a multiple-element arrangement and allocated the one-time payment that we made in the amount of $20.0 million to each identifiable element using its relative fair value. Based on our estimates of fair value, we determined that the primary benefit of the arrangement is avoided litigation cost and the release of any potential past claims, with no material value attributable to future use or benefit. Accordingly, we recorded a $20.0 million settlement charge within legal settlement expense in our consolidated statement of operations for the year ended July 31, 2014.

10. Equity Award Plans

Share-Based Compensation Plans

2012 Equity Incentive Plan

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

Awards granted under our 2012 Plan vest over the periods determined by the board of directors, generally three to four years from the date of grant, and our options expire no more than ten years after the date of grant. Since our IPO in 2012, awards granted under our 2012 Plan consist primarily of RSUs. Until vested, RSUs do not have the voting and dividend participation rights of common stock and the shares underlying the awards are not considered issued and outstanding.

A total of 16.8 million shares of our common stock are reserved for issuance pursuant to our 2012 Plan as of July 31, 2016. This includes shares that are (i) reserved but unissued under our 2005 Plan on the effective date of our 2012 Plan or (ii) returned to our 2005 Plan as a result of expiration or termination of options. On the first day of each fiscal year, the number of shares in the reserve

Table of Contents

may be increased by the lesser of (i) 8,000,000 shares, (ii) 4.5% of the outstanding shares of common stock on the last day of our immediately preceding fiscal year, or (iii) such other amount as determined by our board of directors.

2012 Employee Stock Purchase Plan

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

Our 2012 ESPP permits eligible employees to acquire shares of our common stock at 85% of the lower of the fair market value of our common stock on the first trading day of each offering period or on the exercise date. Each offering period will be approximately six months starting on the first trading date after March 15 and September 15 of each year. Participants may purchase shares of common stock through payroll deductions of up to 15% of their eligible compensation, subject to purchase limits of 625 shares during a six-month period or $25,000 worth of stock for each calendar year. During the year ended July 31, 2016, employees purchased 0.2 million shares of common stock under our 2012 ESPP at an average exercise price of $126.96 per share.

A total of 2.4 million shares of our common stock are available for sale under our 2012 ESPP as of July 31, 2016. On the first day of each fiscal year, the number of shares in the reserve may be increased by the lesser of (i) 2,000,000 shares, (ii) 1% of the outstanding shares of our common stock on the first day of the fiscal year, or (iii) such other amount as determined by our board of directors.

Stock Option Activities

The following table summarizes the stock option activity under our stock plans during the reporting period (in millions, except per share amounts):

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance—July 31, 2015	3.3	$ 13.74	6.2	$ 562.9
Options granted	—	—		
Options forfeited	—	—		
Options exercised	(1.2)	14.21		
Balance—July 31, 2016	2.1	$ 13.42	5.2	$ 244.9
Options vested and expected to vest—July 31, 2016	2.1	$ 13.42	5.2	$ 244.9
Options exercisable—July 31, 2016	2.1	$ 13.42	5.2	$ 244.9

The intrinsic value of options exercised during the years ended July 31, 2016, 2015, and 2014 was $176.1 million, $301.1 million, and $198.8 million, respectively. The grant-date fair value of options vested during the years ended July 31, 2016, 2015, and 2014 was $8.1 million, $14.6 million, and $17.1 million, respectively.

Table of Contents

Restricted Stock Unit ("RSU") and Restricted Stock Award ("RSA") Activities

The following table summarizes the RSU and RSA activity under our stock plans during the reporting period (in millions, except per share amounts):

	RSAs Outstanding		RSUs Outstanding			
	Number of Shares	Weighted-Average Grant-Date Fair Value Per Share	Number of Shares	Weighted-Average Grant-Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance—July 31, 2015	—	$ —	7.2	$ 95.66	1.2	$ 1,334.8
Granted	1.1	170.97	3.2	160.60		
Vested	—	—	(3.3)	89.76		
Forfeited	—	—	(0.6)	104.08		
Balance—July 31, 2016	1.1	$ 170.97	6.5	$ 130.14	1.1	$ 852.7
Expected to vest—July 31, 2016	1.0	$ 170.97	6.2	$ 129.64	1.1	$ 810.0

The weighted-average grant-date fair value of RSUs granted during the years ended July 31, 2016, 2015, and 2014 was $160.60, $122.36, and $61.00 per share, respectively. The aggregate fair value, as of the respective vesting dates, of RSUs vested during the years ended July 31, 2016, 2015, and 2014 was $513.0 million, $350.4 million, and $57.4 million, respectively.

Shares Available for Grant

The following table presents the stock activity and the total number of shares available for grant as of July 31, 2016 (in millions):

	Number of shares
Balance—July 31, 2015	8.1
Authorized	3.8
RSUs and RSAs granted	(4.3)
RSUs forfeited	0.6
Balance—July 31, 2016	8.2

Share-Based Compensation

We record share-based compensation awards based on estimated fair value as of the grant date. The fair value of RSUs and RSAs is based on the closing market price of our common stock on the date of grant. The fair value of shares sold through our 2012 ESPP are estimated on the grant date using the Black-Scholes option pricing model.

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

	Year Ended July 31,		
	2016	2015	2014
Cost of product revenue	$ 6.2	$ 3.9	$ 1.6
Cost of services revenue	40.9	20.4	9.4
Research and development	132.9	74.8	29.5
Sales and marketing	152.4	84.1	42.6
General and administrative	60.5	38.2	16.8
Total share-based compensation	$ 392.9	$ 221.4	$ 99.9

During the year ended July 31, 2014, we accelerated the vesting of certain share-based awards in connection with our acquisitions of Cyvera and Morta and as a result, we recorded $3.4 million of compensation expense within general and administrative expense. At July 31, 2016, total compensation cost related to unvested share-based awards not yet recognized was $822.9 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of approximately 2.4 years. Future grants will increase the amount of compensation expense to be recorded in these periods.

Table of Contents

11. Income Taxes

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

	Year Ended July 31,		
	2016	2015	2014
United States	$(216.2)	$(47.5)	$(149.3)
Foreign	11.1	(108.1)	(72.9)
Total	$(205.1)	$(155.6)	$(222.2)

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

	Year Ended July 31,		
	2016	2015	2014
Federal:			
Current	$1.9	$1.8	$0.8
Deferred	(0.6)	(3.0)	—
State:			
Current	1.1	0.7	0.2
Deferred	(0.1)	(0.4)	(0.3)
Foreign:			
Current	19.1	10.7	4.7
Deferred	(0.6)	(0.4)	(1.1)
Total	$20.8	$9.4	$4.3

For the year ended July 31, 2016, our provision for income taxes increased compared to the year ended July 31, 2015 primarily due to an increase in foreign taxes and amortization of our deferred tax charges.

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

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

	Year Ended July 31,		
	2016	2015	2014
Federal statutory rate	35.0 %	35.0 %	35.0 %
Effect of:			
State taxes, net of federal tax benefit	(1.5)	3.6	1.3
Foreign income at other than U.S. rates	(8.8)	(6.5)	(12.1)
Change in valuation allowance	(24.9)	(28.5)	(21.3)
Share-based compensation	(13.3)	(10.2)	(3.2)
Amortization of deferred tax charges	(2.8)	(2.2)	—
Research credits	9.5	6.7	1.3
Other, net	(3.4)	(3.9)	(2.9)
Total	(10.2)%	(6.0)%	(1.9)%

During the year ended July 31, 2016, we accounted for the outcome of The Gillette Company et al. v. California Franchise Tax Board which disallowed the election to use an evenly weighted, three factor apportionment formula utilized by us on our tax return for the year ended July 31, 2014. The impact for the change in apportionment is reflected in state taxes, net of federal tax benefit above and is fully offset by changes in our valuation allowance.

Table of Contents

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

The following table presents the components of our deferred tax assets and liabilities as of July 31, 2016 and July 31, 2015 (in millions):

	July 31, 2016	July 31, 2015
Deferred tax assets:		
Accruals and reserves	$43.5	$38.9
Deferred revenue	62.0	35.3
Research and development and foreign tax credits	41.4	20.1
Net operating loss carryforwards	5.4	18.4
Share-based compensation	55.2	35.9
Gross deferred tax assets	207.5	148.6
Valuation allowance	(189.4)	(138.4)
Total deferred tax assets	18.1	10.2
Deferred tax liabilities:		
Fixed assets and intangible assets	(14.2)	(7.9)
Other deferred tax liabilities	(2.5)	(1.6)
Total deferred tax liabilities	(16.7)	(9.5)
Total	$1.4	$0.7

A valuation allowance is provided when it is more likely than not that the deferred tax asset will not be realized. Realization of deferred tax assets is dependent upon future taxable income, if any, the amount and timing of which are uncertain. At such time, if it is determined that it is more likely than not that the deferred tax assets are realizable, the valuation allowance will be adjusted. As of July 31, 2016, we have provided a valuation allowance for our federal and state deferred tax assets that we believe will, more likely than not, be unrealizable. The net valuation allowance increased by approximately $51.0 million from the year ended July 31, 2015 to the year ended July 31, 2016, which was primarily attributable to an increase in deferred tax assets in our federal and state jurisdictions.

As of July 31, 2016, we had federal, state, and foreign NOL carryforwards of approximately $1.1 billion, $823.8 million, and $8.9 million, respectively as reported on our tax returns, available to reduce future taxable income, if any. If not utilized, our federal and state NOL carryforwards will expire in various amounts at various dates beginning in the years ending July 31, 2027 and July 31, 2017, respectively. Our foreign NOL will carry forward indefinitely.

As of July 31, 2016, we had federal and state research and development tax credit carryforwards of approximately $37.1 million and $37.2 million, respectively as reported on our tax returns. If not utilized, the federal credit carryforwards will expire in various amounts at various dates beginning in the year ending July 31, 2026. The state credit will carry forward indefinitely.

As of July 31, 2016, we had foreign tax credit carryforwards of $1.7 million as reported on our tax returns. If not utilized, the foreign tax credit carryforwards will expire in various amounts at various dates beginning in the year ending July 31, 2021.

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

We use the with-and-without approach to determine the recognition and measurement of excess tax benefits resulting from share-based awards. Accordingly, we have elected to recognize excess income tax benefits from share-based awards in additional paid-in capital only if an incremental income tax benefit would be realized after considering all other tax attributes presently available to us. As of July 31, 2016, we had excess tax benefits from share-based awards of $1.0 billion, $669.7 million, and $8.9 million included in federal, state, and foreign NOL, respectively. We also had

$5.3 million of excess tax benefits from share-based awards included in federal research and development tax credit. The impact of this excess tax benefit is recognized as additional paid-in capital when it reduces taxes payable. We have elected to account for the indirect effects of share-based awards on other tax attributes, such as the research, foreign and other tax credits, through the consolidated statements of operations.

Table of Contents

During the years ended July 31, 2016, 2015, and 2014, we recorded excess tax benefits that resulted from allocating certain tax effects related to exercises of stock options and vesting of RSUs directly to stockholders' equity in the amount of $0.5 million, $2.5 million, and $1.0 million, respectively.

In December 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") was signed into law. Among its provisions, the PATH Act retroactively extends the bonus depreciation and other corporate tax incentives through December 31, 2019, and permanently extends the federal research and development credit. Due to the valuation allowance against our domestic deferred tax assets, we did not recognize any discrete tax benefits during the year ended July 31, 2016 as a result of the legislation.

As of July 31, 2016, we had $127.7 million of unrecognized tax benefits, $21.9 million of which would affect income tax expense if recognized, after consideration of our valuation allowance in the United States and other assets. As of July 31, 2015, we had $67.2 million of unrecognized tax benefits, $10.8 million of which would affect income tax expense if recognized, after consideration of our valuation allowance in the United States. As of July 31, 2016, our federal, state, and foreign returns for the tax years 2008 through the current period remain subject to adjustment due to examination. Fiscal years outside the normal statute of limitation remain open to audit by tax authorities due to tax attributes generated in earlier years, which have been carried forward and may be audited in subsequent years when utilized. We do not expect the amount of unrecognized tax benefits as of July 31, 2016 to change significantly over the next 12 months. We recognize both interest and penalties associated with uncertain tax positions as a component of income tax expense. During the years ended July 31, 2016, 2015, and 2014, we recognized income tax expense related to interest and penalties of $1.6 million, $1.1 million, and $0.3 million, respectively. We had accrued interest and penalties on our consolidated balance sheets related to unrecognized tax benefits of $3.3 million and $1.8 million as of July 31, 2016 and 2015, respectively. The ultimate amount and timing of any future cash settlements cannot be predicted with reasonable certainty.

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

	Year Ended July 31,		
	2016	2015	2014
Unrecognized tax benefits at the beginning of the period	$67.2	$10.4	$6.6
Additions for tax positions taken in prior years	25.2	6.1	0.4
Reductions for tax positions taken in prior years	—	(0.6)	—
Additions for tax positions taken in the current year	35.3	51.3	3.4
Unrecognized tax benefits at the end of the period	$127.7	$67.2	$10.4

During the year ended July 31, 2016, our additions for tax positions taken in prior years and additions for tax positions taken in the current year were primarily attributable to uncertain tax positions relating to federal and state research and development credits, adjustments for California apportionment, and transfer pricing methodologies.

As of July 31, 2016, we had approximately $9.7 million of undistributed earnings in foreign subsidiaries. We expect to permanently reinvest these earnings outside of the United States to fund future foreign operations. We project that we will have sufficient cash flow in the United States and will not need to repatriate the foreign earnings to finance our domestic operations. If we were to distribute these earnings to the United States, we would be subject to U.S. income taxes, an adjustment for foreign tax credits, and foreign withholding taxes. We have not recorded a deferred tax liability on any portion of our undistributed earnings in foreign subsidiaries. If we were to repatriate these earnings to the United States, any associated income tax liability would be insignificant.

12. Net Income (Loss) Per Share

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

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

	Year Ended July 31,		
	2016	2015	2014

Net loss	$(225.9)	$(165.0)	$(226.5)
Weighted-average shares used to compute net loss per share, basic and diluted	87.1	81.6	74.3
Net loss per share, basic and diluted	$(2.59)	$(2.02)	$(3.05)

Table of Contents

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

	Year Ended July 31,		
	2016	2015	2014
RSUs	6.5	7.2	6.0
Convertible senior notes	5.2	5.2	5.2
Warrants related to the issuance of convertible senior notes	5.2	5.2	5.2
Options to purchase common stock	2.1	3.3	5.8
RSAs	1.1	—	—
ESPP shares	0.1	0.1	0.1
Total	20.2	21.0	22.3

13. Employee Benefit Plan

We have established a 401(k) tax-deferred savings plan which permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code. In fiscal 2016, we began to make matching contributions based upon the amount of employees’ contributions, subject to certain limitations. Our matching contributions to the plan were immaterial for the year ended July 31, 2016.

14. Segment Information

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

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

	Year Ended July 31,		
	2016	2015	2014
Revenue:			
Americas			
United States	$901.8	$593.8	$363.2
Other Americas	71.4	45.6	33.5
Total Americas	973.2	639.4	396.7
Europe, the Middle East, and Africa (“EMEA”)	247.1	178.7	126.9
Asia Pacific and Japan (“APAC”)	158.2	110.0	74.6
Total revenue	$1,378.5	$928.1	$598.2

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

	Year Ended July 31,		
	2016	2015	2014
Revenue:			
Product	$670.8	$492.7	$340.1
Services			
Subscription	357.0	212.7	123.2
Support and maintenance	350.7	222.7	134.9
Total services	707.7	435.4	258.1
Total revenue	$1,378.5	$928.1	$598.2

Substantially all of our assets were attributable to our U.S. operations as of July 31, 2016 and 2015.

Table of Contents

15. Selected Quarterly Financial Data (Unaudited)

The following tables set forth selected unaudited quarterly financial data for the years ended July 31, 2016 and 2015 (in millions, except per share amounts):

	Three Months Ended			
	Oct. 31, 2015	Jan. 31, 2016	Apr. 30, 2016	Jul. 31, 2016
Revenue:				
Product	$147.7	$169.9	$162.1	$191.1
Services	149.5	164.8	183.7	209.7
Total revenue	297.2	334.7	345.8	400.8
Cost of revenue:				
Product	38.8	44.9	43.2	48.5
Services	40.4	49.3	51.7	53.2
Total cost of revenue	79.2	94.2	94.9	101.7
Total gross profit	218.0	240.5	250.9	299.1
Operating expenses:				
Research and development	59.7	74.0	74.0	76.5
Sales and marketing	158.3	187.6	202.0	228.1
General and administrative	30.8	34.2	33.5	39.9
Total operating expenses	248.8	295.8	309.5	344.5
Operating loss	(30.8)	(55.3)	(58.6)	(45.4)
Interest expense	(5.8)	(5.8)	(5.8)	(6.0)
Other income, net	2.2	2.5	1.0	2.7
Loss before income taxes	(34.4)	(58.6)	(63.4)	(48.7)
Provision for income taxes	4.3	3.9	6.8	5.8
Net loss	$(38.7)	$(62.5)	$(70.2)	$(54.5)
Net loss per share, basic and diluted	$(0.45)	$(0.72)	$(0.80)	$(0.61)

Table of Contents

	Three Months Ended			
	Oct. 31, 2014	Jan. 31, 2015	Apr. 30, 2015	Jul. 31, 2015
Revenue:				
Product	$101.5	$115.6	$121.5	$154.1
Services	90.8	102.1	112.7	129.8
Total revenue	192.3	217.7	234.2	283.9
Cost of revenue:				
Product	29.1	30.7	32.8	38.5
Services	24.3	28.7	31.6	35.8
Total cost of revenue	53.4	59.4	64.4	74.3
Total gross profit	138.9	158.3	169.8	209.6
Operating expenses:				
Research and development	37.3	47.0	48.4	53.1
Sales and marketing	106.4	122.8	131.1	162.4
General and administrative	19.0	27.0	27.0	28.6
Total operating expenses	162.7	196.8	206.5	244.1
Operating loss	(23.8)	(38.5)	(36.7)	(34.5)
Interest expense	(5.5)	(5.5)	(5.7)	(5.6)
Other income (expense), net	0.4	0.3	—	(0.5)
Loss before income taxes	(28.9)	(43.7)	(42.4)	(40.6)
Provision for (benefit from) income taxes	1.2	(0.7)	3.5	5.4
Net loss	$(30.1)	$(43.0)	$(45.9)	$(46.0)
Net loss per share, basic and diluted	$(0.38)	$(0.53)	$(0.56)	$(0.55)

16. Subsequent Events

Share Repurchase

On August 26, 2016, our board of directors authorized a $500.0 million share repurchase which will be funded from available working capital. Repurchases may be made at management's discretion from time to time on the open market, through privately negotiated transactions, transactions structured through investment banking institutions, block purchase techniques, 10b5-1 trading plans, or a combination of the foregoing. The repurchase authorization will expire on August 31, 2018, and may be suspended or discontinued at any time.

Hedging

On August 30, 2016, we entered into forward contracts with a notional amount of €66.9 million to hedge the foreign currency exposure related to our euro-denominated expenditures for the fiscal year ending July 31, 2017. These forward contracts have been designated as hedging instruments for hedge accounting purposes.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control

Table of Contents

objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our chief executive officer and chief financial officer concluded that, as of July 31, 2016, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission (SEC) rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Management’s Annual Report on Internal Control Over Financial Reporting

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

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

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the quarter ended July 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

Table of Contents

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Executive Officers and Directors

The information required by this item will be contained in our definitive proxy statement to be filed with the SEC in connection with our 2016 annual meeting of stockholders (the “Proxy Statement”), which is expected to be filed not later than 120 days after the end of our fiscal year ended July 31, 2016, and is incorporated in this report by reference.

ITEM 11. EXECUTIVE COMPENSATION

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

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

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

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

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

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

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

Table of Contents

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

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

1. Consolidated Financial Statements

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

2. Financial Statement Schedules

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

3. Exhibits

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

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on September 8, 2016.

PALO ALTO NETWORKS, INC.
By: /s/ MARK D. MCLAUGHLIN
Mark D. McLaughlin
Chief Executive Officer

Table of Contents

POWER OF ATTORNEY

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

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

Signature	Title	Date
/s/ MARK D. MCLAUGHLIN Mark D. McLaughlin	Chief Executive Officer and Director (Principal Executive Officer)	September 8, 2016
/s/ STEFFAN C. TOMLINSON Steffan C. Tomlinson	Chief Financial Officer (Principal Accounting and Financial Officer)	September 8, 2016
/s/ NIR ZUK Nir Zuk	Chief Technical Officer and Director	September 8, 2016
/s/ FRANK CALDERONI Frank Calderoni	Director	September 8, 2016
/s/ ASHEEM CHANDNA Asheem Chandna	Director	September 8, 2016
/s/ JOHN M. DONOVAN John M. Donovan	Director	September 8, 2016
/s/ CARL ESCHENBACH Carl Eschenbach	Director	September 8, 2016
/s/ JAMES J. GOETZ James J. Goetz	Director	September 8, 2016
/s/ STANLEY J. MERESMAN Stanley J. Meresman	Director	September 8, 2016
/s/ DANIEL J. WARMENHOVEN Daniel J. Warmenhoven	Director	September 8, 2016

Table of Contents

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference			
		Form	File No.	Exhibit	Filing Date
3.1	Restated Certificate of Incorporation of the Registrant.	10-K	001-35594	3.1	October 4, 2012
3.2	Amended and Restated Bylaws of the Registrant.	10-K	001-35594	3.2	October 4, 2012
4.1	Warrant to Purchase Stock by Juniper Networks, Inc.	8-K	001-35594	4.1	June 4, 2014
4.2	Indenture between the Registrant and U.S. Bank National Association, dated as of June 30, 2014.	8-K	001-35594	4.1	July 1, 2014
10.1*	Form of Indemnification Agreement between the Registrant and its directors and officers.	S-1/A	333-180620	10.1	July 9, 2012
10.2*	2005 Equity Incentive Plan and related form agreements under 2005 Equity Incentive Plan.	S-1/A	333-180620	10.2	July 9, 2012
10.3*	2012 Equity Incentive Plan and related form agreements under 2012 Equity Incentive Plan, as amended.	10-K	001-35594	10.3	September 18, 2014
10.4*	2012 Employee Stock Purchase Plan and related form agreements under 2012 Employee Stock Purchase Plan, as amended and restated.	10-Q	001-35594	10.3	November 25, 2014
10.5*	Employee Incentive Compensation Plan, as amended and restated.	10-Q	001-35594	10.2	November 25, 2014
10.6*	Offer Letter between the Registrant and Mark D. McLaughlin, dated July 21, 2011, as amended.	S-1	333-180620	10.6	April 6, 2012
10.7*	Offer Letter between the Registrant and Steffan C. Tomlinson, dated January 17, 2012.	S-1	333-180620	10.7	April 6, 2012
10.8*	Letter Agreement between the Registrant and Nir Zuk, dated December 19, 2011.	S-1	333-180620	10.8	April 6, 2012
10.9*	Letter Agreement between the Registrant and René Bonvanie, dated December 19, 2011.	S-1	333-180620	10.10	April 6, 2012
10.10*	Offer Letter between the Registrant and Stanley J. Meresman, dated September 8, 2014.	8-K	001-35594	10.1	September 22, 2014
10.11*	Offer Letter between the Registrant and Daniel J. Warmenhoven, dated February 14, 2012.	S-1	333-180620	10.13	April 6, 2012
10.12*	Offer Letter between the Registrant and Mark F. Anderson, dated May 23, 2012.	S-1/A	333-180620	10.16	July 9, 2012

10.13*	Offer Letter between the Registrant and John M. Donovan, dated September 14, 2012.	8-K	001-35594	10.1	September 20, 2012
10.14*	Offer Letter between the Registrant and Carl Eschenbach, dated May 9, 2013.	8-K	001-35594	10.1	May 30, 2013
10.15*	Offer Letter between the Registrant and Frank Calderoni, dated February 24, 2016.	8-K	001-35594	10.1	February 25, 2016
10.16	Lease between the Registrant and Santa Clara Office Partners LLC, dated October 20, 2010, as amended.	S-1	333-180620	10.14	April 6, 2012
10.17	Amendment No. 2 to Lease between the Registrant and Santa Clara Office Partners LLC, dated July 2, 2013.	10-K	001-35594	10.17	September 25, 2013
10.18	Lease between the Registrant and SI 34 LLC, dated September 17, 2012.	10-K	001-35594	10.16	October 4, 2012
10.19	Lease between the Registrant and SI 34 LLC, dated September 17, 2012.	10-K	001-35594	10.16	October 4, 2012

Table of Contents

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Exhibit	Filing Date
10.20**	Amended and Restated Flextronics Manufacturing Services Agreement, by and between the Registrant and Flextronics Telecom Systems Ltd., dated December 8, 2015.	8-K	001-35594	10.1	December 14, 2015
10.21	Settlement, Release and Cross-License Agreement, dated May 27, 2014, by and between the Registrant and Juniper Networks, Inc.	8-K	001-35594	10.1	May 28, 2014
10.22	Share Purchase Agreement between the Registrant, Cyvera Ltd., Palo Alto Networks Holding B.V., the shareholders of Cyvera Ltd. and Shareholder Representative Services LLC, dated March 22, 2014.	10-Q	001-35594	10.1	June 3, 2014
10.23	Amendment No. 1 to the Share Purchase Agreement between the Registrant, Cyvera Ltd., Palo Alto Networks Holding B.V., the shareholders of Cyvera Ltd. and Shareholder Representative Services LLC, dated April 9, 2014.	10-Q	001-35594	10.2	June 3, 2014
10.24	Purchase Agreement, dated June 24, 2014, by and among the Registrant and J.P. Morgan Securities LLC, RBC Capital Markets, LLC and Citigroup Global Markets Inc., as representatives of the initial purchasers named therein.	8-K	001-35594	10.1	June 26, 2014
10.25	Form of Convertible Note Hedge Confirmation.	8-K	001-35594	10.2	June 26, 2014
10.26	Form of Warrant Confirmation.	8-K	001-35594	10.3	June 26, 2014
10.27	Lease between the Registrant and Santa Clara Campus Property Owner I LLC, dated May 28, 2015.	10-K	001-35594	10.29	September 17, 2015
10.28	Lease between the Registrant and Santa Clara Campus Property Owner I LLC, dated May 28, 2015.	10-K	001-35594	10.30	September 17, 2015
10.29	Lease between the Registrant and Santa Clara Campus Property Owner I LLC, dated May 28, 2015.	10-K	001-35594	10.31	September 17, 2015
10.30	Lease by and between the Registrant and Santa Clara Campus Property Owner I LLC, dated October 7, 2015.	8-K	001-35594	10.1	October 19, 2015
10.31	Amendment No. 1 to Lease by and between the Registrant and Santa Clara Phase I Property LLC, dated November 9, 2015.	10-Q	001-35594	10.2	November 24, 2015
10.32	Amendment No. 1 to Lease by and between the Registrant and Santa Clara Campus Property Owner I LLC, dated November 9, 2015.	10-Q	001-35594	10.3	November 24, 2015

21.1	List of subsidiaries of the Registrant.
23.1	Consent of Independent Registered Public Accounting Firm.
24.1	Power of Attorney (contained in the signature page to this Annual Report on Form 10-K).
31.1	Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1†	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

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

* Indicates a management contract or compensatory plan or arrangement.

** Registrant has omitted portions of the relevant exhibit and filed such exhibit separately with the Securities and Exchange Commission pursuant to a request for confidential treatment under Rule 406 under the Securities Act of 1933, as amended.

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

- 90 -