

CISCO SYSTEMS, INC.  
Form 10-Q  
November 20, 2014  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

(Mark one)

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

For the quarterly period ended October 25, 2014

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 0-18225

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CISCO SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

California

(State or other jurisdiction of  
incorporation or organization)

170 West Tasman Drive

San Jose, California 95134

(Address of principal executive office and zip code)

(408) 526-4000

(Registrant's telephone number, including area code)

77-0059951

(I.R.S. Employer

Identification Number)

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

No ☐

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

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

Large accelerated filer ☒

Accelerated filer

☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

Number of shares of the registrant's common stock outstanding as of November 14, 2014: 5,113,588,147



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Form 10-Q for the Quarter Ended October 25, 2014

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

## CISCO SYSTEMS, INC.

## CONSOLIDATED BALANCE SHEETS

(in millions, except par value)

(Unaudited)

	October 25, 2014	July 26, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$4,387	\$6,726
Investments	47,720	45,348
Accounts receivable, net of allowance for doubtful accounts of \$276 at October 25, 2014 and \$265 at July 26, 2014	4,375	5,157
Inventories	1,676	1,591
Financing receivables, net	4,265	4,153
Deferred tax assets	2,689	2,808
Other current assets	1,284	1,331
Total current assets	66,396	67,114
Property and equipment, net	3,233	3,252
Financing receivables, net	3,691	3,918
Goodwill	24,364	24,239
Purchased intangible assets, net	3,066	3,280
Other assets	3,228	3,331
<b>TOTAL ASSETS</b>	<b>\$103,978</b>	<b>\$105,134</b>
<b>LIABILITIES AND EQUITY</b>		
Current liabilities:		
Short-term debt	\$1,357	\$508
Accounts payable	1,022	1,032
Income taxes payable	94	159
Accrued compensation	2,638	3,181
Deferred revenue	9,449	9,478
Other current liabilities	5,496	5,451
Total current liabilities	20,056	19,809
Long-term debt	19,615	20,401
Income taxes payable	1,504	1,851
Deferred revenue	4,295	4,664
Other long-term liabilities	1,793	1,748
Total liabilities	47,263	48,473
Commitments and contingencies (Note 12)		
Equity:		
Cisco shareholders' equity:		
Preferred stock, no par value: 5 shares authorized; none issued and outstanding	—	—
Common stock and additional paid-in capital, \$0.001 par value: 20,000 shares authorized; 5,109 and 5,107 shares issued and outstanding at October 25, 2014 and July 26, 2014, respectively	41,984	41,884
Retained earnings	14,273	14,093
Accumulated other comprehensive income	451	677
<b>Total Cisco shareholders' equity</b>	<b>56,708</b>	<b>56,654</b>

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Noncontrolling interests	7	7
Total equity	56,715	56,661
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>\$103,978</b>	<b>\$105,134</b>
See Notes to Consolidated Financial Statements.		

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CISCO SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in millions, except per-share amounts)  
(Unaudited)

	Three Months Ended	
	October 25, 2014	October 26, 2013
REVENUE:		
Product	\$9,435	\$9,397
Service	2,810	2,688
Total revenue	12,245	12,085
COST OF SALES:		
Product	3,919	3,747
Service	993	931
Total cost of sales	4,912	4,678
GROSS MARGIN	7,333	7,407
OPERATING EXPENSES:		
Research and development	1,583	1,724
Sales and marketing	2,515	2,411
General and administrative	504	515
Amortization of purchased intangible assets	71	65
Restructuring and other charges	318	237
Total operating expenses	4,991	4,952
OPERATING INCOME	2,342	2,455
Interest income	179	169
Interest expense	(139)	(140)
Other income (loss), net	(22)	56
Interest and other income (loss), net	18	85
INCOME BEFORE PROVISION FOR INCOME TAXES	2,360	2,540
Provision for income taxes	532	544
NET INCOME	\$1,828	\$1,996
Net income per share:		
Basic	\$0.36	\$0.37
Diluted	\$0.35	\$0.37
Shares used in per-share calculation:		
Basic	5,112	5,378
Diluted	5,156	5,430
Cash dividends declared per common share	\$0.19	\$0.17
See Notes to Consolidated Financial Statements.		

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## CISCO SYSTEMS, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(Unaudited)

	Three Months Ended	
	October 25, 2014	October 26, 2013
Net income	\$1,828	\$1,996
Available-for-sale investments:		
Change in net unrealized gains, net of tax benefit (expense) of \$14 and \$(53) for the three months ended October 25, 2014 and October 26, 2013, respectively	(22)	) 121
Net gains reclassified into earnings, net of tax expense of \$2 and \$31 for the three months ended October 25, 2014 and October 26, 2013, respectively	(5)	) (52)
	(27)	) 69
Cash flow hedging instruments:		
Change in unrealized gains and losses, net of tax benefit (expense) of \$3 and \$(3) for the three months ended October 25, 2014 and October 26, 2013, respectively	(53)	) 35
Net (gains) losses reclassified into earnings	4	(9)
	(49)	) 26
Net change in cumulative translation adjustment and other, net of tax benefit (expense) of \$11 and \$(3) for the three months ended October 25, 2014 and October 26, 2013, respectively	(150)	) 73
Other comprehensive income (loss)	(226)	) 168
Comprehensive income	1,602	2,164
Comprehensive (income) loss attributable to noncontrolling interests	—	(4)
Comprehensive income attributable to Cisco Systems, Inc.	\$1,602	\$2,160
See Notes to Consolidated Financial Statements.		

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CISCO SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in millions)  
(Unaudited)

	Three Months Ended	
	October 25, 2014	October 26, 2013
Cash flows from operating activities:		
Net income	\$1,828	\$1,996
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization, and other	596	591
Share-based compensation expense	369	309
Provision for receivables	43	23
Deferred income taxes	236	130
Excess tax benefits from share-based compensation	(71)	(55)
(Gains) losses on investments and other, net	29	(108)
Change in operating assets and liabilities, net of effects of acquisitions and divestitures:		
Accounts receivable	723	361
Inventories	(107)	22
Financing receivables	(2)	(37)
Other assets	5	28
Accounts payable	(5)	(29)
Income taxes, net	(398)	(389)
Accrued compensation	(495)	(460)
Deferred revenue	(328)	(307)
Other liabilities	68	574
Net cash provided by operating activities	2,491	2,649
Cash flows from investing activities:		
Purchases of investments	(9,761)	(8,835)
Proceeds from sales of investments	3,450	4,733
Proceeds from maturities of investments	3,906	4,058
Acquisition of businesses, net of cash and cash equivalents acquired	(184)	(2,447)
Purchases of investments in privately held companies	(50)	(134)
Return of investments in privately held companies	42	33
Acquisition of property and equipment	(285)	(315)
Proceeds from sales of property and equipment	3	156
Other	2	(4)
Net cash used in investing activities	(2,877)	(2,755)
Cash flows from financing activities:		
Issuances of common stock	353	444
Repurchases of common stock - repurchase program	(1,088)	(1,898)
Shares repurchased for tax withholdings on vesting of restricted stock units	(342)	(286)
Short-term borrowings, original maturities less than 90 days, net	(4)	(2)
Issuances of debt	—	4
Repayments of debt	(3)	—
Excess tax benefits from share-based compensation	71	55
Dividends paid	(973)	(914)



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Other	33	32	
Net cash used in financing activities	(1,953	) (2,565	)
Net (decrease) increase in cash and cash equivalents	(2,339	) (2,671	)
Cash and cash equivalents, beginning of period	6,726	7,925	
Cash and cash equivalents, end of period	\$4,387	\$5,254	
Supplemental cash flow information:			
Cash paid for interest	\$263	\$221	
Cash paid for income taxes, net	\$694	\$803	
See Notes to Consolidated Financial Statements.			

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CISCO SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF EQUITY  
(in millions, except per-share amounts)  
(Unaudited)

Three Months Ended October 25, 2014	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Cisco Shareholders' Equity	Non-controlling Interests	Total Equity
BALANCE AT JULY 26, 2014	5,107	\$ 41,884	\$ 14,093	\$ 677	\$ 56,654	\$ 7	\$56,661
Net income			1,828		1,828		1,828
Other comprehensive income (loss)				(226 )	(226 )	—	(226 )
Issuance of common stock	57	353			353		353
Repurchase of common stock	(41 )	(338 )	(675 )		(1,013 )		(1,013 )
Shares repurchased for tax withholdings on vesting of restricted stock units	(14 )	(342 )			(342 )		(342 )
Cash dividends declared (\$0.19 per common share)			(973 )		(973 )		(973 )
Tax effects from employee stock incentive plans		55			55		55
Share-based compensation expense		369			369		369
Purchase acquisitions and other		3			3		3
BALANCE AT OCTOBER 25, 2014	5,109	\$ 41,984	\$ 14,273	\$ 451	\$ 56,708	\$ 7	\$56,715

  

Three Months Ended October 26, 2013	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Cisco Shareholders' Equity	Non-controlling Interests	Total Equity
BALANCE AT JULY 27, 2013	5,389	\$ 42,297	\$ 16,215	\$ 608	\$ 59,120	\$ 8	\$59,128
Net income			1,996		1,996		1,996
Other comprehensive income (loss)				164	164	4	168
Issuance of common stock	58	444			444		444
Repurchase of common stock	(84 )	(662 )	(1,338 )		(2,000 )		(2,000 )
Shares repurchased for tax withholdings on vesting of restricted stock units	(12 )	(286 )			(286 )		(286 )
Cash dividends declared (\$0.17 per common share)			(914 )		(914 )		(914 )
Tax effects from employee stock incentive plans		35			35		35
Share-based compensation expense		309			309		309
Purchase acquisitions and other		29			29		29
	5,351	\$ 42,166	\$ 15,959	\$ 772	\$ 58,897	\$ 12	\$58,909

BALANCE AT OCTOBER 26,  
2013

Supplemental Information

In September 2001, the Company's Board of Directors authorized a stock repurchase program. As of October 25, 2014, the Company's Board of Directors had authorized an aggregate repurchase of up to \$97 billion of common stock under this program with no termination date. The stock repurchases since the inception of this program and the related impacts on Cisco shareholders' equity are summarized in the following table (in millions):

	Shares of Common Stock	Common Stock and Additional Paid-In Capital	Retained Earnings	Total Cisco Shareholders' Equity
Repurchases of common stock under the repurchase program	4,329	\$21,662	\$67,796	\$89,458

See Notes to Consolidated Financial Statements.

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CISCO SYSTEMS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. Basis of Presentation

The fiscal year for Cisco Systems, Inc. (the “Company” or “Cisco”) is the 52 or 53 weeks ending on the last Saturday in July. Fiscal 2015 and fiscal 2014 are each 52-week fiscal years. The Consolidated Financial Statements include the accounts of Cisco and its subsidiaries. All intercompany accounts and transactions have been eliminated. The Company conducts business globally and is primarily managed on a geographic basis in the following three geographic segments: the Americas; Europe, Middle East, and Africa (EMEA); and Asia Pacific, Japan, and China (APJC).

The accompanying financial data as of October 25, 2014 and for the three months ended October 25, 2014 and October 26, 2013 has been prepared by the Company, without audit, pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. The July 26, 2014 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended July 26, 2014.

The Company consolidates its investments in a venture fund managed by SOFTBANK Corp. and its affiliates (“SOFTBANK”) as this is a variable interest entity and the Company is the primary beneficiary. The noncontrolling interests attributed to SOFTBANK are presented as a separate component from the Company’s equity in the equity section of the Consolidated Balance Sheets. SOFTBANK’s share of the earnings in the venture fund are not presented separately in the Consolidated Statements of Operations as these amounts are not material for any of the fiscal periods presented.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to present fairly the consolidated balance sheet as of October 25, 2014; the results of operations; statements of comprehensive income, cash flows, and equity for the three months ended October 25, 2014 and October 26, 2013, as applicable, have been made. The results of operations for the three months ended October 25, 2014 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Certain reclassifications have been made to the amounts in prior periods in order to conform to the current period’s presentation. The Company has evaluated subsequent events through the date that the financial statements were issued.

2. Recent Accounting Pronouncements

(a) New Accounting Updates Recently Adopted

In March 2013, the FASB issued an accounting standard update requiring an entity to release into net income the entire amount of a cumulative translation adjustment related to its investment in a foreign entity when as a parent it sells either a part or all of its investment in the foreign entity or no longer holds a controlling financial interest in a subsidiary or group of assets within the foreign entity. This accounting standard update became effective for the Company beginning in the first quarter of fiscal 2015. The application of this accounting standard update did not have any impact to the Company’s Consolidated Financial Statements.

In July 2013, the FASB issued an accounting standard update that provides explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward or a tax credit carryforward exists. Under the new standard update, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, is to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss

carryforward or a tax credit carryforward. This accounting standard update became effective for the Company beginning in the first quarter of fiscal 2015 and applied prospectively. The application of this accounting standard update did not have a material impact to the Company's Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (b)Recent Accounting Standards or Updates Not Yet Effective

In April 2014, the FASB issued an accounting standard update that changes the criteria for reporting discontinued operations. This accounting standard update raises the threshold for a disposal transaction to qualify as a discontinued operation and requires additional disclosures about discontinued operations and disposals of individually significant components that do not qualify as discontinued operations. This accounting standard update will be effective for the Company beginning in the first quarter of fiscal 2016. Early adoption is permitted, but only for disposals that have not been reported in financial statements previously issued. The Company is currently evaluating the impact of this accounting standard update on its Consolidated Financial Statements.

In May 2014, the FASB issued an accounting standard update related to revenue from contracts with customers, which will supersede nearly all current U.S. GAAP guidance on this topic and eliminate industry-specific guidance. The underlying principle is to recognize revenue when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. This accounting standard update will be effective for the Company beginning in the first quarter of fiscal 2018. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. Early adoption is not permitted. The Company is currently evaluating the impact of this accounting standard update on its Consolidated Financial Statements.

## 3. Business Combinations

The Company completed two business combinations during the three months ended October 25, 2014. A summary of the allocation of the total purchase consideration is presented as follows (in millions):

	Purchase Consideration	Net Liabilities Assumed	Purchased Intangible Assets	Goodwill
Metacloud, Inc.	\$ 149	\$(7 )	\$29	\$127
Other	38	(10 )	29	19
Total acquisitions	\$ 187	\$(17 )	\$58	\$146

On September 29, 2014, the Company completed its acquisition of Metacloud, Inc. ("Metacloud"), a provider of private clouds for global organizations. With its acquisition of Metacloud, the Company aims to advance its Intercloud strategy to deliver a globally distributed, highly secure cloud platform capable of meeting customer demands.

The total purchase consideration related to the Company's business combinations completed during the three months ended October 25, 2014 consisted of cash consideration along with vested share-based awards assumed. The total cash and cash equivalents acquired from these business combinations was approximately \$3 million. Total transaction costs related to the Company's business combination activities were \$2 million and \$6 million for the three months ended October 25, 2014 and October 26, 2013, respectively. These transaction costs were expensed as incurred in general and administrative (G&A) expenses in the Consolidated Statements of Operations.

The Company's purchase price allocation for business combinations completed during recent periods is preliminary and subject to revision as additional information about fair value of assets and liabilities becomes available.

Additional information, which existed as of the acquisition date but at that time was unknown to the Company may become known to the Company during the remainder of the measurement period, a period not to exceed 12 months from the acquisition date. Adjustments in the purchase price allocation may require a recasting of the amounts allocated to goodwill retroactive to the period in which the acquisition occurred.

The goodwill generated from the Company's business combinations completed during the three months ended October 25, 2014 is primarily related to expected synergies. The goodwill is generally not deductible for income tax purposes.

The Consolidated Financial Statements include the operating results of each business combination from the date of acquisition. Pro forma results of operations for the acquisitions completed during the three months ended October 25, 2014 have not been presented because the effects of the acquisitions, individually and in the aggregate, were not

material to the Company's financial results.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 4. Goodwill and Purchased Intangible Assets

## (a) Goodwill

The following table presents the goodwill allocated to the Company's reportable segments as of and during the three months ended October 25, 2014 (in millions):

	Balance at July 26, 2014	Acquisitions	Other	Balance at October 25, 2014
Americas	\$15,080	\$75	\$(11)	) \$15,144
EMEA	5,715	60	(6)	) 5,769
APJC	3,444	11	(4)	) 3,451
Total	\$24,239	\$146	\$(21)	) \$24,364

The column entitled "Other" primarily includes purchase accounting adjustments.

## (b) Purchased Intangible Assets

The following table presents details of the Company's intangible assets acquired through business combinations completed during the three months ended October 25, 2014 (in millions, except years):

	FINITE LIVES		INDEFINITE LIVES		TOTAL
	TECHNOLOGY	CUSTOMER RELATIONSHIPS	IPR&D		
	Weighted-Average Useful Life (in Years)	Weighted-Average Useful Life (in Years)	Amount	Amount	Amount
Metacloud, Inc.	3.0	5.0	\$24	\$3	\$29
Other	5.0	5.0	21	4	29
Total			\$45	\$7	\$58

The following tables present details of the Company's purchased intangible assets (in millions):

October 25, 2014	Gross	Accumulated Amortization	Net
Purchased intangible assets with finite lives:			
Technology	\$4,150	\$(2,166)	) \$1,984
Customer relationships	1,713	(788)	) 925
Other	51	(16)	) 35
Total purchased intangible assets with finite lives	5,914	(2,970)	) 2,944
In-process research and development, with indefinite lives	122	—	122
Total	\$6,036	\$(2,970)	) \$3,066

July 26, 2014	Gross	Accumulated Amortization	Net
Purchased intangible assets with finite lives:			
Technology	\$4,100	\$(1,976)	) \$2,124
Customer relationships	1,706	(720)	) 986
Other	51	(13)	) 38
Total purchased intangible assets with finite lives	5,857	(2,709)	) 3,148
In-process research and development, with indefinite lives	132	—	132



Total \$5,989 \$(2,709 ) \$3,280

Purchased intangible assets include intangible assets acquired through business combinations as well as through direct purchases or licenses.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table presents the amortization of purchased intangible assets (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Amortization of purchased intangible assets:		
Cost of sales	\$189	\$174
Operating expenses	71	65
Total	\$260	\$239

There were no impairment charges related to purchased intangible assets during the periods presented.

The estimated future amortization expense of purchased intangible assets with finite lives as of October 25, 2014 is as follows (in millions):

Fiscal Year	Amount
2015 (remaining nine months)	\$728
2016	754
2017	580
2018	421
2019	315
Thereafter	146
Total	\$2,944

## 5. Restructuring and Other Charges

## Fiscal 2015 Plan

In connection with a restructuring action announced in August 2014, the Company incurred cumulative charges of \$318 million for the first quarter of fiscal 2015. The Company estimates that it will recognize aggregate pre-tax charges pursuant to the restructuring action in an amount not expected to exceed \$600 million, consisting of severance and other one-time termination benefits and other associated costs. These charges are primarily cash-based and the Company expects the remaining amount to be recognized during the remainder of fiscal 2015.

## Fiscal 2014 Plan

The Fiscal 2014 Plan is a workforce reduction plan the Company announced in August 2013. In connection with this restructuring action, the Company incurred cumulative charges of approximately \$418 million, of which \$237 million was incurred during the three months ended October 26, 2013. The Company completed the Fiscal 2014 Plan at the end of fiscal 2014.

The following table summarizes the activities related to the restructuring and other charges as discussed above (in millions):

	Fiscal 2014 and Prior Plans		Fiscal 2015 Plan		
	Employee Severance	Other	Employee Severance	Other	Total
Liability as of July 26, 2014	\$40	\$29	\$—	\$—	\$69
Gross charges in fiscal 2015	—	—	322	(4	) 318
Cash payments	(13	) —	(142	) —	(155 )
Non-cash items	—	(4	) —	4	—
Liability as of October 25, 2014	\$27	\$25	\$180	\$—	\$232

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 6. Balance Sheet Details

The following tables provide details of selected balance sheet items (in millions):

	October 25, 2014	July 26, 2014
Inventories:		
Raw materials	\$ 173	\$ 77
Work in process	3	5
Finished goods:		
Distributor inventory and deferred cost of sales	654	595
Manufactured finished goods	535	606
Total finished goods	1,189	1,201
Service-related spares	275	273
Demonstration systems	36	35
Total	\$ 1,676	\$ 1,591
Property and equipment, net:		
Land, buildings, and building and leasehold improvements	\$ 4,471	\$ 4,468
Computer equipment and related software	1,423	1,425
Production, engineering, and other equipment	5,728	5,756
Operating lease assets	349	362
Furniture and fixtures	498	509
	12,469	12,520
Less accumulated depreciation and amortization	(9,236	) (9,268
Total	\$ 3,233	\$ 3,252
Other assets:		
Deferred tax assets	\$ 1,553	\$ 1,700
Investments in privately held companies	886	899
Other	789	732
Total	\$ 3,228	\$ 3,331
Deferred revenue:		
Service	\$ 9,029	\$ 9,640
Product:		
Unrecognized revenue on product shipments and other deferred revenue	4,056	3,924
Cash receipts related to unrecognized revenue from two-tier distributors	659	578
Total product deferred revenue	4,715	4,502
Total	\$ 13,744	\$ 14,142
Reported as:		
Current	\$ 9,449	\$ 9,478
Noncurrent	4,295	4,664
Total	\$ 13,744	\$ 14,142

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 7. Financing Receivables and Operating Leases

## (a) Financing Receivables

Financing receivables primarily consist of lease receivables, loan receivables, and financed service contracts and other. Lease receivables represent sales-type and direct-financing leases resulting from the sale of the Company's and complementary third-party products and are typically collateralized by a security interest in the underlying assets. Loan receivables represent financing arrangements related to the sale of the Company's products and services, which may include additional funding for other costs associated with network installation and integration of the Company's products and services. Lease receivables consist of arrangements with terms of four years on average, while loan receivables generally have terms of up to three years. The financed service contracts and other category includes financing receivables related to technical support and advanced services, as well as receivables related to financing of certain indirect costs associated with leases. Revenue related to the technical support services is typically deferred and included in deferred service revenue and is recognized ratably over the period during which the related services are to be performed, which typically ranges from one to three years.

A summary of the Company's financing receivables is presented as follows (in millions):

October 25, 2014	Lease Receivables	Loan Receivables	Financed Service Contracts and Other	Total	
Gross	\$3,498	\$1,744	\$ 3,071	\$8,313	
Residual value	234	—	—	234	
Unearned income	(223	) —	—	(223	)
Allowance for credit loss	(248	) (84	) (36	) (368	)
Total, net	\$3,261	\$1,660	\$ 3,035	\$7,956	
Reported as:					
Current	\$1,496	\$827	\$ 1,942	\$4,265	
Noncurrent	1,765	833	1,093	3,691	
Total, net	\$3,261	\$1,660	\$ 3,035	\$7,956	
			Financed		
July 26, 2014	Lease Receivables	Loan Receivables	Service Contracts and Other	Total	
Gross	\$3,532	\$1,683	\$3,210	\$8,425	
Residual value	233	—	—	233	
Unearned income	(238	) —	—	(238	)
Allowance for credit loss	(233	) (98	) (18	) (349	)
Total, net	\$3,294	\$1,585	\$3,192	\$8,071	
Reported as:					
Current	\$1,476	\$728	\$1,949	\$4,153	
Noncurrent	1,818	857	1,243	3,918	
Total, net	\$3,294	\$1,585	\$3,192	\$8,071	

As of October 25, 2014 and July 26, 2014, the deferred service revenue related to the financed service contracts and other was \$1,672 million and \$1,843 million, respectively.

Future minimum lease payments at October 25, 2014 are summarized as follows (in millions):

Fiscal Year	Amount
2015 (remaining nine months)	\$1,303
2016	1,144
2017	681

2018	281
2019	87
Thereafter	2
Total	\$3,498

Actual cash collections may differ from the contractual maturities due to early customer buyouts, refinancings, or defaults.

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## (b) Credit Quality of Financing Receivables

Gross receivables less unearned income categorized by the Company's internal credit risk rating as of October 25, 2014 and July 26, 2014 are summarized as follows (in millions):

	INTERNAL CREDIT RISK RATING			
	1 to 4	5 to 6	7 and Higher	Total
October 25, 2014				
Lease receivables	\$1,665	\$1,482	\$128	\$3,275
Loan receivables	953	637	154	1,744
Financed service contracts and other	1,677	1,296	98	3,071
Total	\$4,295	\$3,415	\$380	\$8,090

	INTERNAL CREDIT RISK RATING			
	1 to 4	5 to 6	7 and Higher	Total
July 26, 2014				
Lease receivables	\$1,615	\$1,538	\$141	\$3,294
Loan receivables	953	593	137	1,683
Financed service contracts and other	1,744	1,367	99	3,210
Total	\$4,312	\$3,498	\$377	\$8,187

The Company determines the adequacy of its allowance for credit loss by assessing the risks and losses inherent in its financing receivables by portfolio segment. The portfolio segment is based on the types of financing offered by the Company to its customers, which consist of the following: lease receivables, loan receivables, and financed service contracts and other.

The Company's internal credit risk ratings of 1 through 4 correspond to investment-grade ratings, while credit risk ratings of 5 and 6 correspond to non-investment grade ratings. Credit risk ratings of 7 and higher correspond to substandard ratings.

In circumstances when collectibility is not deemed reasonably assured, the associated revenue is deferred in accordance with the Company's revenue recognition policies, and the related allowance for credit loss, if any, is included in deferred revenue. The Company also records deferred revenue associated with financing receivables when there are remaining performance obligations, as it does for financed service contracts. Total allowances for credit loss and deferred revenue as of October 25, 2014 and July 26, 2014 were \$2,054 million and \$2,220 million, respectively, and they were associated with total financing receivables before allowance for credit loss of \$8,324 million and \$8,420 million as of their respective period ends.

The following tables present the aging analysis of gross receivables less unearned income as of October 25, 2014 and July 26, 2014 (in millions):

	DAYS PAST DUE (INCLUDES BILLED AND UNBILLED)							
October 25, 2014	31-60	61-90	91+	Total Past Due	Current	Total	Nonaccrual Financing Receivables	Impaired Financing Receivables
Lease receivables	\$80	\$54	\$196	\$330	\$2,945	\$3,275	\$ 47	\$39
Loan receivables	17	41	89	147	1,597	1,744	41	37
Financed service contracts and other	144	163	532	839	2,232	3,071	12	7
Total	\$241	\$258	\$817	\$1,316	\$6,774	\$8,090	\$ 100	\$83

	DAYS PAST DUE (INCLUDES BILLED AND UNBILLED)							
July 26, 2014	31-60	61-90	91+	Total Past Due	Current	Total	Nonaccrual Financing Receivables	Impaired Financing Receivables
Lease receivables	\$104	\$43	\$165	\$312	\$2,982	\$3,294	\$ 48	\$41

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Loan receivables	2	1	16	19	1,664	1,683	19	19
Financed service contracts and other	301	238	230	769	2,441	3,210	12	9
Total	\$407	\$282	\$411	\$1,100	\$7,087	\$8,187	\$ 79	\$69

Past due financing receivables are those that are 31 days or more past due according to their contractual payment terms. The data in the preceding tables are presented by contract, and the aging classification of each contract is based on the oldest outstanding receivable, and therefore past due amounts also include unbilled and current receivables within the same contract. The balances

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of either unbilled or current financing receivables included in the category of 91 days plus past due for financing receivables were \$661 million and \$296 million as of October 25, 2014 and July 26, 2014, respectively.

As of October 25, 2014, the Company had financing receivables of \$111 million, net of unbilled or current receivables from the same contract, that were in the category of 91 days plus past due but remained on accrual status. Such balance was \$78 million as of July 26, 2014. A financing receivable may be placed on nonaccrual status earlier if, in management's opinion, a timely collection of the full principal and interest becomes uncertain.

## (c) Allowance for Credit Loss Rollforward

The allowances for credit loss and the related financing receivables are summarized as follows (in millions):

	CREDIT LOSS ALLOWANCES				
Three Months Ended October 25, 2014	Lease Receivables	Loan Receivables	Financed Service Contracts and Other	Total	
Allowance for credit loss as of July 26, 2014	\$233	\$98	\$ 18	\$349	
Provisions	22	(13	) 19	28	
Recoveries (write-offs), net	(4	) 1	—	(3	)
Foreign exchange and other	(3	) (2	) (1	(6	)
Allowance for credit loss as of October 25, 2014	\$248	\$84	\$ 36	\$368	
Financing receivables as of October 25, 2014 <sup>(1)</sup>	\$3,509	\$1,744	\$ 3,071	\$8,324	
	CREDIT LOSS ALLOWANCES				
Three Months Ended October 26, 2013	Lease Receivables	Loan Receivables	Financed Service Contracts and Other	Total	
Allowance for credit loss as of July 27, 2013	\$238	\$86	\$ 20	\$344	
Provisions	(3	) 6	—	3	
Foreign exchange and other	2	1	—	3	
Allowance for credit loss as of October 26, 2013	\$237	\$93	\$ 20	\$350	
Financing receivables as of October 26, 2013 <sup>(1)</sup>	\$3,549	\$1,808	\$ 3,018	\$8,375	

<sup>(1)</sup> Total financing receivables before allowance for credit loss.

The Company assesses the allowance for credit loss related to financing receivables on either an individual or a collective basis. The Company considers various factors in evaluating lease and loan receivables and the earned portion of financed service contracts for possible impairment on an individual basis. These factors include the Company's historical experience, credit quality and age of the receivable balances, and economic conditions that may affect a customer's ability to pay. When the evaluation indicates that it is probable that all amounts due pursuant to the contractual terms of the financing agreement, including scheduled interest payments, are unable to be collected, the financing receivable is considered impaired. All such outstanding amounts, including any accrued interest, will be assessed and fully reserved at the customer level. The Company's internal credit risk ratings are categorized as 1 through 10, with the lowest credit risk rating representing the highest quality financing receivables.

Typically, the Company also considers receivables with a risk rating of 8 or higher to be impaired and will include them in the individual assessment for allowance. These balances, as of October 25, 2014 and July 26, 2014, are presented under "(b) Credit Quality of Financing Receivables" above.

The Company evaluates the remainder of its financing receivables portfolio for impairment on a collective basis and records an allowance for credit loss at the portfolio segment level. When evaluating the financing receivables on a collective basis, the Company uses expected default frequency rates published by a major third-party credit-rating agency as well as its own historical loss rate in the event of default, while also systematically giving effect to economic conditions, concentration of risk, and correlation.



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## (d) Operating Leases

The Company provides financing of certain equipment through operating leases, and the amounts are included in property and equipment in the Consolidated Balance Sheets. Amounts relating to equipment on operating lease assets and the associated accumulated depreciation are summarized as follows (in millions):

	October 25, 2014	July 26, 2014
Operating lease assets	\$349	\$362
Accumulated depreciation	(197)	(202)
Operating lease assets, net	\$152	\$160

Minimum future rentals on noncancelable operating leases at October 25, 2014 were approximately \$0.2 billion for the remaining nine months of fiscal 2015, \$0.1 billion for fiscal 2016, and less than \$0.1 billion per year for each of fiscal 2017 through fiscal 2019.

## 8. Investments

## (a) Summary of Available-for-Sale Investments

The following tables summarize the Company's available-for-sale investments (in millions):

October 25, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government securities	\$32,343	\$71	\$—	\$32,414
U.S. government agency securities	1,338	3	—	1,341
Non-U.S. government and agency securities	1,049	2	—	1,051
Corporate debt securities	10,170	73	(10)	10,233
U.S. agency mortgage-backed securities	875	9	—	884
Total fixed income securities	45,775	158	(10)	45,923
Publicly traded equity securities	1,263	545	(11)	1,797
Total	\$47,038	\$703	\$(21)	\$47,720

July 26, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed income securities:				
U.S. government securities	\$31,717	\$29	\$(12)	\$31,734
U.S. government agency securities	1,062	1	—	1,063
Non-U.S. government and agency securities	860	2	(1)	861
Corporate debt securities	9,092	74	(7)	9,159
U.S. agency mortgage-backed securities	574	5	—	579
Total fixed income securities	43,305	111	(20)	43,396
Publicly traded equity securities	1,314	648	(10)	1,952
Total	\$44,619	\$759	\$(30)	\$45,348

Non-U.S. government and agency securities include agency and corporate debt securities that are guaranteed by non-U.S. governments.

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## (b) Gains and Losses on Available-for-Sale Investments

The following table presents the gross realized gains and gross realized losses related to the Company's available-for-sale investments (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Gross realized gains	\$21	\$95
Gross realized losses	(14	) (12
Total	\$7	\$83

The following table presents the realized net gains (losses) related to the Company's available-for-sale investments by security type (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Net gains (losses) on investments in publicly traded equity securities	\$(4	) \$75
Net gains on investments in fixed income securities	11	8
Total	\$7	\$83

There were no impairment charges on available-for-sale investments for the periods presented.

The following tables present the breakdown of the available-for-sale investments with gross unrealized losses and the duration that those losses had been unrealized at October 25, 2014 and July 26, 2014 (in millions):

	UNREALIZED LOSSES LESS THAN 12 MONTHS		UNREALIZED LOSSES 12 MONTHS OR GREATER		TOTAL	
October 25, 2014	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fixed income securities:						
Corporate debt securities	\$2,491	\$(8	) \$ 383	\$(2	) \$2,874	\$(10
Total fixed income securities	2,491	(8	) 383	(2	) 2,874	(10
Publicly traded equity securities	131	(11	) 1	—	132	(11
Total	\$2,622	\$(19	) \$ 384	\$(2	) \$3,006	\$(21

	UNREALIZED LOSSES LESS THAN 12 MONTHS		UNREALIZED LOSSES 12 MONTHS OR GREATER		TOTAL	
July 26, 2014	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fixed income securities:						
U.S. government securities	\$7,676	\$(12	) \$ 45	\$ —	\$7,721	\$(12
Non-U.S. government and agency securities	361	(1	) 22	—	383	(1
Corporate debt securities	1,875	(3	) 491	(4	) 2,366	(7
Total fixed income securities	9,912	(16	) 558	(4	) 10,470	(20
Publicly traded equity securities	132	(10	) —	—	132	(10
Total	\$10,044	\$(26	) \$ 558	\$(4	) \$10,602	\$(30

As of October 25, 2014, for fixed income securities that were in unrealized loss positions, the Company has determined that (i) it does not have the intent to sell any of these investments, and (ii) it is not more likely than not that it will be required to sell any of these investments before recovery of the entire amortized cost basis. In addition, as of October 25, 2014, the Company anticipates that it will recover the entire amortized cost basis of such fixed income securities and has determined that no other-than-temporary impairments associated with credit losses were required to

be recognized during the three months ended October 25, 2014.

The Company has evaluated its publicly traded equity securities as of October 25, 2014 and has determined that there was no indication of other-than-temporary impairments in the respective categories of unrealized losses. This determination was based on several factors, which include the length of time and extent to which fair value has been less than the cost basis, the financial

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condition and near-term prospects of the issuer, and the Company's intent and ability to hold the publicly traded equity securities for a period of time sufficient to allow for any anticipated recovery in market value.

## (c) Maturities of Fixed Income Securities

The following table summarizes the maturities of the Company's fixed income securities at October 25, 2014 (in millions):

	Amortized Cost	Fair Value
Less than 1 year	\$16,643	\$16,656
Due in 1 to 2 years	14,222	14,270
Due in 2 to 5 years	13,884	13,957
Due after 5 years	1,026	1,040
Total	\$45,775	\$45,923

Actual maturities may differ from the contractual maturities because borrowers may have the right to call or prepay certain obligations. The remaining contractual principal maturities for mortgage-backed securities were allocated assuming no prepayments.

## (d) Securities Lending

The Company periodically engages in securities lending activities with certain of its available-for-sale investments. These transactions are accounted for as a secured lending of the securities, and the securities are typically loaned only on an overnight basis. The average daily balance of securities lending for the three months ended October 25, 2014 and October 26, 2013 was \$1.0 billion and \$0.6 billion, respectively. The Company requires collateral equal to at least 102% of the fair market value of the loaned security and that the collateral be in the form of cash or liquid, high-quality assets. The Company engages in these secured lending transactions only with highly creditworthy counterparties, and the associated portfolio custodian has agreed to indemnify the Company against collateral losses. The Company did not experience any losses in connection with the secured lending of securities during the periods presented. As of October 25, 2014 and July 26, 2014, the Company had no outstanding securities lending transactions.

## (e) Investments in Privately Held Companies

The carrying value of the Company's investments in privately held companies was included in other assets. For such investments that were accounted for under the equity and cost method as of October 25, 2014 and July 26, 2014, the amounts are summarized in the following table (in millions):

	October 25, 2014	July 26, 2014
Equity method investments	\$559	\$630
Cost method investments	327	269
Total	\$886	\$899

## Variable Interest Entities

**VCE Joint Venture** VCE is a joint venture that the Company formed in fiscal 2010 with EMC Corporation ("EMC"), with investments from VMware, Inc. ("VMware") and Intel Capital Corporation ("Intel"). VCE helps organizations leverage best-in-class technologies and disciplines from Cisco, EMC, and VMware to enable the transformation to cloud computing.

As of October 25, 2014, the Company's cumulative gross investment in VCE was approximately \$716 million, inclusive of accrued interest on convertible notes, and its ownership percentage was approximately 35%. The Company did not make any investments in VCE during the three months ended October 25, 2014. As of October 25, 2014, the Company had recorded cumulative losses from VCE under the equity method of \$691 million since inception, of which losses of \$47 million and \$53 million were recorded for the three months ended October 25, 2014 and October 26, 2013, respectively. The Company's carrying value in VCE as of October 25, 2014 was \$25 million.

EMC and the Company have entered into guarantee agreements on behalf of VCE to indemnify certain customers (the "Guarantees") for monetary damages. Such Guarantees were not material as of October 25, 2014.

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In October 2014, the Company, EMC, VMware, and Intel agreed to restructure the VCE joint venture. Under the terms of the agreement, VCE will undergo a reorganization and recapitalization whereby VCE will pay approximately \$150 million to the Company for a portion of the outstanding principal balance of the convertible notes and accrued interest on such notes. The Company also agreed to cancel the remaining principal balance of the convertible notes held by it and the accrued interest on such notes, and to have VCE redeem a portion of the Company's equity interest in VCE. EMC also agreed to indemnify the Company for any liabilities incurred by the Company under the Guarantees. Following this reorganization and recapitalization, the Company's ownership interest in VCE will be approximately 10%. The transaction is expected to close in the second quarter of the Company's fiscal year 2015, subject to customary regulatory approvals.

**Other Variable Interest Entities** In the ordinary course of business, the Company has investments in other privately held companies and provides financing to certain customers. These other privately held companies and customers may be considered to be variable interest entities. The Company evaluates on an ongoing basis its investments in these other privately held companies and its customer financings, and has determined that as of October 25, 2014 there were no other variable interest entities required to be consolidated in the Company's Consolidated Financial Statements.

**9. Fair Value**

Fair value is defined 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 required or permitted to be either recorded or disclosed at fair value, the Company considers the principal or most advantageous market in which it would transact, and it also considers assumptions that market participants would use when pricing the asset or liability.

**(a) Fair Value Hierarchy**

The accounting guidance for fair value measurement requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard establishes a fair value hierarchy based on the level of independent, objective evidence surrounding the inputs used to measure fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The fair value hierarchy is as follows:

Level 1 applies to assets or liabilities for which there are quoted prices in active markets for identical assets or liabilities.

Level 2 applies to assets or liabilities for which there are inputs other than quoted prices that are observable for the asset or liability, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.

Level 3 applies to assets or liabilities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value of the assets or liabilities.

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## (b) Assets and Liabilities Measured at Fair Value on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis as of October 25, 2014 and July 26, 2014 were as follows (in millions):

	OCTOBER 25, 2014 FAIR VALUE MEASUREMENTS			JULY 26, 2014 FAIR VALUE MEASUREMENTS			
	Level 1	Level 2	Total Balance	Level 1	Level 2	Level 3	Total Balance
Assets:							
Cash equivalents:							
Money market funds	\$2,461	\$—	\$2,461	\$4,935	\$—	\$—	\$4,935
Available-for-sale investments:							
U.S. government securities	—	32,414	32,414	—	31,734	—	31,734
U.S. government agency securities	—	1,341	1,341	—	1,063	—	1,063
Non-U.S. government and agency securities	—	1,051	1,051	—	861	—	861
Corporate debt securities	—	10,233	10,233	—	9,159	—	9,159
U.S. agency mortgage-backed securities	—	884	884	—	579	—	579
Publicly traded equity securities	1,797	—	1,797	1,952	—	—	1,952
Derivative assets	—	227	227	—	158	2	160
Total	\$4,258	\$46,150	\$50,408	\$6,887	\$43,554	\$2	\$50,443
Liabilities:							
Derivative liabilities	\$—	\$99	\$99	\$—	\$67	\$—	\$67
Total	\$—	\$99	\$99	\$—	\$67	\$—	\$67

Level 1 publicly traded equity securities are determined by using quoted prices in active markets for identical assets. Level 2 fixed income securities are priced using quoted market prices for similar instruments or nonbinding market prices that are corroborated by observable market data. The Company uses inputs such as actual trade data, benchmark yields, broker/dealer quotes, and other similar data, which are obtained from quoted market prices, independent pricing vendors, or other sources, to determine the ultimate fair value of these assets and liabilities. The Company uses such pricing data as the primary input to make its assessments and determinations as to the ultimate valuation of its investment portfolio and has not made, during the periods presented, any material adjustments to such inputs. The Company is ultimately responsible for the financial statements and underlying estimates. The Company's derivative instruments are primarily classified as Level 2, as they are not actively traded and are valued using pricing models that use observable market inputs. The Company did not have any transfers between Level 1 and Level 2 fair value measurements during the periods presented.

Level 3 assets include certain derivative instruments, the values of which are determined based on discounted cash flow models using inputs that the Company could not corroborate with market data.

## (c) Assets Measured at Fair Value on a Nonrecurring Basis

The Company recognized \$1 million of losses related to the impairment of privately held investments for each of the three months ended October 25, 2014 and October 26, 2013. These assets were measured at fair value due to events or circumstances the Company identified as having significant impact on their fair value during the respective periods. To arrive at the valuation of these assets, the Company considers any significant changes in the financial metrics and economic variables and also uses third-party valuation reports to assist in the valuation as necessary.

The fair value measurement of the impaired investments was classified as Level 3 because significant unobservable inputs were used in the valuation due to the absence of quoted market prices and inherent lack of liquidity. Significant

unobservable inputs, which included financial metrics of comparable private and public companies, financial condition and near-term prospects of the investees, recent financing activities of the investees, and the investees' capital structure as well as other economic variables, reflected the assumptions market participants would use in pricing these assets. The impairment charges, representing the difference between the net book value and the fair value as a result of the evaluation, were recorded to other income (loss), net.



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## (d) Other Fair Value Disclosures

The carrying value of the Company's investments in privately held companies that were accounted for under the cost method was \$327 million and \$269 million as of October 25, 2014 and July 26, 2014, respectively. It was not practicable to estimate the fair value of this portfolio.

The fair value of the Company's short-term loan receivables and financed service contracts approximates their carrying value due to their short duration. The aggregate carrying value of the Company's long-term loan receivables and financed service contracts and other as of October 25, 2014 and July 26, 2014 was \$1.9 billion and \$2.1 billion, respectively. The estimated fair value of the Company's long-term loan receivables and financed service contracts and other approximates their carrying value. The Company uses significant unobservable inputs in determining discounted cash flows to estimate the fair value of its long-term loan receivables and financed service contracts, and therefore they are categorized as Level 3.

As of October 25, 2014, the estimated fair value of the short-term debt approximates its carrying value due to the short maturities. As of October 25, 2014, the fair value of the Company's senior notes and other long-term debt was \$22.4 billion with a carrying amount of \$21.0 billion. This compares to a fair value of \$22.4 billion and a carrying amount of \$20.9 billion as of July 26, 2014. The fair value of the senior notes and other long-term debt was determined based on observable market prices in a less active market and was categorized as Level 2 in the fair value hierarchy.

## 10. Borrowings

## (a) Short-Term Debt

The following table summarizes the Company's short-term debt (in millions, except percentages):

	October 25, 2014		July 26, 2014		
	Amount	Effective Rate	Amount	Effective Rate	
Current portion of long-term debt	\$1,350	1.38	% \$500	3.11	%
Other short-term debt	7	2.76	% 8	2.67	%
Total short-term debt	\$1,357		\$508		

In fiscal 2011, the Company established a short-term debt financing program of up to \$3.0 billion through the issuance of commercial paper notes. The Company uses the proceeds from the issuance of commercial paper notes for general corporate purposes. The Company had no commercial paper notes outstanding as of each of October 25, 2014 and July 26, 2014.

The effective interest rate on the current portion of long-term debt includes the impact of interest rate swaps, as discussed further in "(b) Long-Term Debt." Other notes and borrowings consist of the short-term portion of secured borrowings associated with customer financing arrangements. These notes and credit facilities were subject to various terms and foreign currency market interest rates pursuant to individual financial arrangements between the financing institution and the applicable foreign subsidiary.

On November 17, 2014, upon the maturity of the Company's 2014 Fixed-Rate Notes (2.90%), the Company repaid an aggregate principal amount of \$500 million.

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## (b) Long-Term Debt

The following table summarizes the Company's long-term debt (in millions, except percentages):

	Maturity Date	October 25, 2014		July 26, 2014	
		Amount	Effective Rate	Amount	Effective Rate
Senior notes:					
Floating-rate notes:					
Three-month LIBOR plus 0.05%	September 3, 2015	\$850	0.36%	\$850	0.35%
Three-month LIBOR plus 0.28%	March 3, 2017	1,000	0.57%	1,000	0.56%
Three-month LIBOR plus 0.50%	March 1, 2019	500	0.79%	500	0.78%
Fixed-rate notes:					
2.90%	November 17, 2014	500	3.11%	500	3.11%
5.50%	February 22, 2016	3,000	3.05%	3,000	3.04%
1.10%	March 3, 2017	2,400	0.55%	2,400	0.56%
3.15%	March 14, 2017	750	0.80%	750	0.79%
4.95%	February 15, 2019	2,000	4.69%	2,000	4.69%
2.125%	March 1, 2019	1,750	0.77%	1,750	0.77%
4.45%	January 15, 2020	2,500	2.98%	2,500	2.98%
2.90%	March 4, 2021	500	0.93%	500	0.93%
3.625%	March 4, 2024	1,000	1.04%	1,000	1.05%
5.90%	February 15, 2039	2,000	6.11%	2,000	6.11%
5.50%	January 15, 2040	2,000	5.67%	2,000	5.67%
Other long-term debt		2	2.08%	4	2.39%
Total		20,752		20,754	
Unaccreted discount		(62 )		(63 )	
Hedge accounting fair value adjustments		275		210	
Total		\$20,965		\$20,901	

## Reported as:

Current portion of long-term debt	\$1,350	\$500
Long-term debt	19,615	20,401
Total	\$20,965	\$20,901

To achieve its interest rate risk management objectives, the Company entered into interest rate swaps in prior periods with an aggregate notional amount of \$10.4 billion designated as fair value hedges of certain of its fixed-rate senior notes. In effect, these swaps convert the fixed interest rates of the fixed-rate notes to floating interest rates based on the London InterBank Offered Rate (LIBOR). The gains and losses related to changes in the fair value of the interest rate swaps substantially offset changes in the fair value of the hedged portion of the underlying debt that are attributable to the changes in market interest rates. For additional information, see Note 11.

The effective rates for the fixed-rate debt include the interest on the notes, the accretion of the discount, and, if applicable, adjustments related to hedging. Interest is payable semiannually on each class of the senior fixed-rate notes and payable quarterly on the floating-rate notes. Each of the senior fixed-rate notes is redeemable by the Company at any time, subject to a make-whole premium.

The senior notes rank at par with the commercial paper notes that may be issued in the future pursuant to the Company's short-term debt financing program, as discussed above under "(a) Short-Term Debt." As of October 25, 2014, the Company was in compliance with all debt covenants.



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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of October 25, 2014, future principal payments for long-term debt, including the current portion, are summarized as follows (in millions):

Fiscal Year	Amount
2015 (remaining nine months)	\$500
2016	3,851
2017	4,151
2018	—
2019	4,250
Thereafter	8,000
Total	\$20,752

## (c) Credit Facility

On February 17, 2012, the Company entered into a credit agreement with certain institutional lenders that provides for a \$3.0 billion unsecured revolving credit facility that is scheduled to expire on February 17, 2017. Any advances under the credit agreement will accrue interest at rates that are equal to, based on certain conditions, either (i) the higher of the Federal Funds rate plus 0.50%, Bank of America's "prime rate" as announced from time to time, or one-month LIBOR plus 1.00% or (ii) LIBOR plus a margin that is based on the Company's senior debt credit ratings as published by Standard & Poor's Financial Services, LLC and Moody's Investors Service, Inc. The credit agreement requires the Company to comply with certain covenants, including that it maintain an interest coverage ratio as defined in the agreement. As of October 25, 2014, the Company was in compliance with the required interest coverage ratio and the other covenants, and the Company had not borrowed any funds under the credit facility.

The Company may also, upon the agreement of either the existing lenders or additional lenders not currently parties to the agreement, increase the commitments under the credit facility by up to an additional \$2.0 billion and/or extend the expiration date of the credit facility by up to two additional years, or up to February 17, 2019.

## 11. Derivative Instruments

## (a) Summary of Derivative Instruments

The Company uses derivative instruments primarily to manage exposures to foreign currency exchange rate, interest rate, and equity price risks. The Company's primary objective in holding derivatives is to reduce the volatility of earnings and cash flows associated with changes in foreign currency exchange rates, interest rates, and equity prices. The Company's derivatives expose it to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. The Company does, however, seek to mitigate such risks by limiting its counterparties to major financial institutions. In addition, the potential risk of loss with any one counterparty resulting from this type of credit risk is monitored. Management does not expect material losses as a result of defaults by counterparties.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The fair values of the Company's derivative instruments and the line items on the Consolidated Balance Sheets to which they were recorded are summarized as follows (in millions):

	DERIVATIVE ASSETS			DERIVATIVE LIABILITIES		
	Balance Sheet Line Item	October 25, 2014	July 26, 2014	Balance Sheet Line Item	October 25, 2014	July 26, 2014
Derivatives designated as hedging instruments:						
Foreign currency derivatives	Other current assets	\$8	\$7	Other current liabilities	\$46	\$6
Interest rate derivatives	Other assets	217	148	Other long-term liabilities	—	3
Equity derivatives	Other current assets	—	—	Other current liabilities	50	56
Total		225	155		96	65
Derivatives not designated as hedging instruments:						
Foreign currency derivatives	Other current assets	2	3	Other current liabilities	3	2
Equity derivatives	Other assets	—	2	Other long-term liabilities	—	—
Total		2	5		3	2
Total		\$227	\$160		\$99	\$67

The effects of the Company's cash flow and net investment hedging instruments on other comprehensive income (OCI) and the Consolidated Statements of Operations are summarized as follows (in millions):

GAINS (LOSSES) RECOGNIZED IN OCI ON DERIVATIVES FOR THE THREE MONTHS ENDED (EFFECTIVE PORTION)			GAINS (LOSSES) RECLASSIFIED FROM AOCI INTO INCOME FOR THE THREE MONTHS ENDED (EFFECTIVE PORTION)		
	October 25, 2014	October 26, 2013	Line Item in Statements of Operations	October 25, 2014	October 26, 2013
Derivatives designated as cash flow hedging instruments:					
Foreign currency derivatives	\$(56	) \$38	Operating expenses	\$(3	) \$7
			Cost of sales—service	(1	) 2
Total	\$(56	) \$38		\$(4	) \$9
Derivatives designated as net investment hedging instruments:					
Foreign currency derivatives	\$20	\$(19	Other income (loss), net	\$—	\$—

Derivatives designated as  
net investment hedging  
instruments:

Foreign currency derivatives	\$20	\$(19	Other income (loss), net	\$—	\$—
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As of October 25, 2014, the Company estimates that approximately \$52 million of net derivative losses related to its cash flow hedges included in accumulated other comprehensive income (AOCI) will be reclassified into earnings within the next 12 months.

The effect on the Consolidated Statements of Operations of derivative instruments designated as fair value hedges and the underlying hedged items is summarized as follows (in millions):

GAINS (LOSSES) ON DERIVATIVE INSTRUMENTS FOR THE	GAINS (LOSSES) RELATED TO HEDGED
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		THREE MONTHS ENDED		ITEMS FOR THE THREE MONTHS ENDED	
Derivatives Designated as Fair Value Hedging Instruments	Line Item in Statements of Operations	October 25, 2014	October 26, 2013	October 25, 2014	October 26, 2013
Equity derivatives	Other income (loss), net	\$6	\$(35)	\$(6)	\$35
Interest rate derivatives	Interest expense	70	18	(73)	(20)
Total		\$76	\$(17)	\$(79)	\$15

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The effect on the Consolidated Statements of Operations of derivative instruments not designated as hedges is summarized as follows (in millions):

Derivatives Not Designated as Hedging Instruments	Line Item in Statements of Operations	GAINS (LOSSES) FOR THE THREE MONTHS ENDED	
		October 25, 2014	October 26, 2013
Foreign currency derivatives	Other income (loss), net	\$ (58 )	\$ 43
Total return swaps—deferred compensation	Operating expenses	(13 )	17
Equity derivatives	Other income (loss), net	(4 )	11
Total		\$ (75 )	\$ 71

The notional amounts of the Company's outstanding derivatives are summarized as follows (in millions):

	October 25, 2014	July 26, 2014
Derivatives designated as hedging instruments:		
Foreign currency derivatives—cash flow hedges	\$2,614	\$1,618
Interest rate derivatives	10,400	10,400
Net investment hedging instruments	372	345
Equity derivatives	238	238
Derivatives not designated as hedging instruments:		
Foreign currency derivatives	2,445	2,528
Total return swaps—deferred compensation	438	428
Total	\$16,507	\$15,557

**(b) Offsetting of Derivative Instruments**

The Company presents its derivative instruments at gross fair values in the Consolidated Balance Sheets. However, the Company's master netting and other similar arrangements with the respective counterparties allow for net settlement under certain conditions, which are designed to reduce credit risk by permitting net settlement with the same counterparty. To further limit credit risk, the Company also enters into collateral security arrangements related to certain derivative instruments whereby cash is posted as collateral between the counterparties based on the fair market value of the derivative instrument. Information related to these offsetting arrangements is summarized as follows (in millions):

**OFFSETTING OF DERIVATIVE ASSETS**

October 25, 2014	Gross Amounts Offset in Consolidated Balance Sheets			Gross Amounts Not Offset in the Consolidated Balance Sheets, but with Legal Rights to Offset		
	Gross Amount of Recognized Assets	Gross Amounts Offset in Consolidated Balance Sheets	Net Amount Presented on Consolidated Balance Sheets	Gross Derivative Amounts with Legal Rights to Offset	Cash Collateral Received	Net Amount
Derivatives	\$227	\$—	\$227	\$(59 )	\$(115 )	\$53

**OFFSETTING OF DERIVATIVE LIABILITIES**

October 25, 2014	Gross Amounts Offset in Consolidated Balance Sheets			Gross Amounts Not Offset in the Consolidated Balance Sheets, but with Legal Rights to Offset		
	Gross Amount of Recognized Liabilities	Gross Amounts Offset in Consolidated Balance Sheets	Net Amount Presented on Consolidated Balance Sheets	Gross Derivative Amounts with Legal Rights to Offset	Cash Collateral Pledged	Net Amount

Derivatives	\$99	\$—	\$99	\$(59	) \$—	\$40
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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## OFFSETTING OF DERIVATIVE ASSETS

	Gross Amounts Offset in Consolidated Balance Sheets			Gross Amounts Not Offset in the Consolidated Balance Sheets, but with Legal Rights to Offset		
	Gross Amount of Recognized Assets	Gross Amounts Offset in Consolidated Balance Sheets	Net Amount Presented on Consolidated Balance Sheets	Gross Derivative Amounts with Legal Rights to Offset	Cash Collateral Received	Net Amount
July 26, 2014						
Derivatives	\$160	\$—	\$160	\$(39 )	\$(60 )	\$61

## OFFSETTING OF DERIVATIVE LIABILITIES

	Gross Amounts Offset in Consolidated Balance Sheets			Gross Amounts Not Offset in the Consolidated Balance Sheets, but with Legal Rights to Offset		
	Gross Amount of Recognized Liabilities	Gross Amounts Offset in Consolidated Balance Sheets	Net Amount Presented on Consolidated Balance Sheets	Gross Derivative Amounts with Legal Rights to Offset	Cash Collateral Pledged	Net Amount
July 26, 2014						
Derivatives	\$67	\$—	\$67	\$(39 )	\$(1 )	\$27

## (c) Foreign Currency Exchange Risk

The Company conducts business globally in numerous currencies. Therefore, it is exposed to adverse movements in foreign currency exchange rates. To limit the exposure related to foreign currency changes, the Company enters into foreign currency contracts. The Company does not enter into such contracts for trading purposes.

The Company hedges forecasted foreign currency transactions related to certain operating expenses and service cost of sales with currency options and forward contracts. These currency options and forward contracts, designated as cash flow hedges, generally have maturities of less than 18 months. The Company assesses effectiveness based on changes in total fair value of the derivatives. The effective portion of the derivative instrument's gain or loss is initially reported as a component of AOCI and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion, if any, of the gain or loss is reported in earnings immediately. During the periods presented, the Company did not discontinue any cash flow hedges for which it was probable that a forecasted transaction would not occur.

The Company enters into foreign exchange forward and option contracts to reduce the short-term effects of foreign currency fluctuations on assets and liabilities such as foreign currency receivables, including long-term customer financings, investments, and payables. These derivatives are not designated as hedging instruments. Gains and losses on the contracts are included in other income (loss), net, and substantially offset foreign exchange gains and losses from the remeasurement of intercompany balances or other current assets, investments, or liabilities denominated in currencies other than the functional currency of the reporting entity.

The Company hedges certain net investments in its foreign operations with forward contracts to reduce the effects of foreign currency fluctuations on the Company's net investment in those foreign subsidiaries. These derivative instruments generally have maturities of up to six months.

## (d) Interest Rate Risk

**Interest Rate Derivatives, Investments** The Company's primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, the Company may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. As of October 25, 2014 and July 26, 2014, the Company did not have any outstanding interest rate derivatives related to its fixed income securities.

**Interest Rate Derivatives Designated as Fair Value Hedge, Long-Term Debt** In fiscal 2014 and 2013, the Company entered into interest rate swaps designated as fair value hedges related to fixed-rate senior notes that are due on various dates from 2017 through 2024. In the periods prior to fiscal 2013, the Company entered into interest rate swaps designated as fair value hedges related to fixed-rate senior notes that are due in 2016 and 2017. Under these interest rate swaps, the Company receives fixed-rate interest payments and makes interest payments based on LIBOR plus a fixed number of basis points. The effect of such swaps is to convert the fixed interest rates of the senior fixed-rate notes to floating interest rates based on LIBOR. The gains and losses related to changes in the fair value of the interest rate swaps are included in interest expense and substantially offset changes in the fair value of the hedged portion of the underlying debt that are attributable to the changes in market interest rates. The fair value of the interest rate swaps was reflected in other assets and other long-term liabilities.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (e) Equity Price Risk

The Company may hold equity securities for strategic purposes or to diversify its overall investment portfolio. The publicly traded equity securities in the Company's portfolio are subject to price risk. To manage its exposure to changes in the fair value of certain equity securities, the Company has entered into equity derivatives that are designated as fair value hedges. The changes in the value of the hedging instruments are included in other income (loss), net, and offset the change in the fair value of the underlying hedged investment. In addition, the Company periodically enters into equity derivatives that are not designated as accounting hedges. The changes in the fair value of these derivatives are also included in other income (loss), net.

The Company is also exposed to variability in compensation charges related to certain deferred compensation obligations to employees. Although not designated as accounting hedges, the Company utilizes derivatives such as total return swaps to economically hedge this exposure.

## (f) Hedge Effectiveness

For the periods presented, amounts excluded from the assessment of hedge effectiveness were not material for fair value, cash flow, and net investment hedges. In addition, hedge ineffectiveness for fair value, cash flow, and net investment hedges was not material for any of the periods presented.

## (g) Collateral and Credit-Risk-Related Contingent Features

For certain derivative instruments, the Company and its counterparties have entered into arrangements requiring the party that is in a liability position from a mark-to-market standpoint to post cash collateral to the other party. See further discussion under "(b) Offsetting of Derivative Instruments" above.

In addition, certain derivative instruments are executed under agreements that have provisions requiring the Company and the counterparty to maintain a specified credit rating from certain credit-rating agencies. Under such agreements, if the Company's or the counterparty's credit rating falls below a specified credit rating, either party has the right to request collateral on the derivatives' net liability position. No such derivatives were in a net liability position as of October 25, 2014. The fair market value of such derivatives was \$3 million as of July 26, 2014.

## 12. Commitments and Contingencies

## (a) Operating Leases

The Company leases office space in many U.S. locations. Outside the United States, larger leased sites include sites in Belgium, Canada, China, France, Germany, India, Israel, Japan, Norway, and the United Kingdom. The Company also leases equipment and vehicles. Future minimum lease payments under all noncancelable operating leases with an initial term in excess of one year as of October 25, 2014 are as follows (in millions):

Fiscal Year	Amount
2015 (remaining nine months)	\$292
2016	282
2017	185
2018	132
2019	65
Thereafter	183
Total	\$1,139

## (b) Purchase Commitments with Contract Manufacturers and Suppliers

The Company purchases components from a variety of suppliers and uses several contract manufacturers to provide manufacturing services for its products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, the Company enters into agreements with contract manufacturers and suppliers that allow them to either procure inventory based upon criteria as defined by the Company or establish the parameters defining the Company's requirements. A significant portion of the Company's reported purchase commitments arising from these agreements consists of firm, noncancelable, and unconditional commitments. In

certain instances, these agreements allow the Company the option to cancel, reschedule, and adjust the Company's requirements based on its business needs prior to firm orders being placed. As of October 25, 2014 and July 26, 2014, the Company had total purchase commitments for inventory of \$4,299 million and \$4,169 million, respectively.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company records a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of its future demand forecasts consistent with the valuation of the Company's excess and obsolete inventory. As of October 25, 2014 and July 26, 2014, the liability for these purchase commitments was \$169 million and \$162 million, respectively, and was included in other current liabilities.

## (c) Other Commitments

In connection with the Company's business combinations, the Company has agreed to pay certain additional amounts contingent upon the achievement of certain agreed-upon technology, development, product, or other milestones or upon the continued employment with the Company of certain employees of the acquired entities.

The following table summarizes the compensation expense related to acquisitions (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Compensation expense related to acquisitions	\$98	\$304

As of October 25, 2014, the Company estimated that future cash compensation expense of up to \$528 million may be required to be recognized pursuant to the applicable business combination agreements, which included the remaining potential compensation expense related to Insieme Networks, Inc., as more fully discussed immediately below.

Insieme Networks, Inc. In the third quarter of fiscal 2012, the Company made an investment in Insieme Networks, Inc. ("Insieme"), an early stage company focused on research and development in the data center market. As set forth in the agreement between the Company and Insieme, this investment included \$100 million of funding and a license to certain of the Company's technology. Immediately prior to the call option exercise and acquisition described below, the Company owned approximately 83% of Insieme as a result of these investments and consolidated the results of Insieme in its Consolidated Financial Statements. In connection with this investment, the Company and Insieme entered into a put/call option agreement that provided the Company with the right to purchase the remaining interests in Insieme. In addition, the noncontrolling interest holders could require the Company to purchase their shares upon the occurrence of certain events.

During the first quarter of fiscal 2014, the Company exercised its call option and entered into an agreement to purchase the remaining interests in Insieme. The acquisition closed in the second quarter of fiscal 2014, at which time the former noncontrolling interest holders became eligible to receive up to two milestone payments, which will be determined using agreed-upon formulas based primarily on revenue for certain of Insieme's products. During the three months ended October 25, 2014 and October 26, 2013, the Company recorded compensation expense of \$53 million and \$257 million, respectively, related to the fair value of the vested portion of amounts that are expected to be earned by the former noncontrolling interest holders. Continued vesting and changes to the fair value of the amounts probable of being earned will result in adjustments to the recorded compensation expense in future periods. Based on the terms of the agreement, the Company has determined that the maximum amount that could be recorded as compensation expense by the Company is approximately \$853 million, net of forfeitures and including the \$469 million that has been expensed to date. The milestone payments, if earned, are expected to be paid primarily during fiscal 2016 and fiscal 2017.

The Company also has certain funding commitments, primarily related to its investments in privately held companies and venture funds, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The funding commitments were \$252 million and \$255 million as of October 25, 2014 and July 26, 2014, respectively.

## (d) Product Warranties

The following table summarizes the activity related to the product warranty liability (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Balance at beginning of period	\$446	\$402
Provision for warranties issued	143	196

Payments	(153	) (169	)
Balance at end of period	\$436	\$429	

The Company accrues for warranty costs as part of its cost of sales based on associated material product costs, labor costs for technical support staff, and associated overhead. The Company's products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products the Company provides a limited lifetime warranty.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (e) Financing and Other Guarantees

In the ordinary course of business, the Company provides financing guarantees for various third-party financing arrangements extended to channel partners and end-user customers. Payments under these financing guarantee arrangements were not material for the periods presented.

**Channel Partner Financing Guarantees** The Company facilitates arrangements for third-party financing extended to channel partners, consisting of revolving short-term financing, generally with payment terms ranging from 60 to 90 days. These financing arrangements facilitate the working capital requirements of the channel partners, and, in some cases, the Company guarantees a portion of these arrangements. The volume of channel partner financing was \$6.3 billion for each of the three months ended October 25, 2014 and October 26, 2013. The balance of the channel partner financing subject to guarantees was \$1.3 billion and \$1.2 billion as of October 25, 2014 and July 26, 2014, respectively.

**End-User Financing Guarantees** The Company also provides financing guarantees for third-party financing arrangements extended to end-user customers related to leases and loans, which typically have terms of up to three years. The volume of financing provided by third parties for leases and loans as to which the Company had provided guarantees was \$26 million and \$25 million for the three months ended October 25, 2014 and October 26, 2013.

**Financing Guarantee Summary** The aggregate amounts of financing guarantees outstanding at October 25, 2014 and July 26, 2014, representing the total maximum potential future payments under financing arrangements with third parties along with the related deferred revenue, are summarized in the following table (in millions):

	October 25, 2014	July 26, 2014
Maximum potential future payments relating to financing guarantees:		
Channel partner	\$285	\$263
End user	161	202
Total	\$446	\$465
Deferred revenue associated with financing guarantees:		
Channel partner	\$(126)	\$(127)
End user	(130)	(166)
Total	\$(256)	\$(293)
Maximum potential future payments relating to financing guarantees, net of associated deferred revenue	\$190	\$172

**Other Guarantees** The Company's other guarantee arrangements as of October 25, 2014 and July 26, 2014 that were subject to recognition and disclosure requirements were not material.

## (f) Supplier Component Remediation Liability

The Company has recorded in other current liabilities a liability for the expected remediation cost for certain products sold in prior fiscal years containing memory components manufactured by a single supplier between 2005 and 2010. These components are widely used across the industry and are included in a number of the Company's products. Defects in some of these components have caused products to fail after a power cycle event. Defect rates due to this issue have been and are expected to be low. However, the Company has seen a small number of its customers experience a growing number of failures in their networks as a result of this component problem. Although the majority of these products are beyond the Company's warranty terms, the Company is proactively working with customers on mitigation. Prior to the second quarter of fiscal 2014, the Company had a liability of \$63 million related to this issue for expected remediation costs based on the intended approach at that time. In February 2014, on the basis of the growing number of failures described above, the Company decided to expand its approach, which resulted in an additional charge to product cost of sales of \$655 million being recorded for the second quarter of fiscal 2014. The remaining supplier component remediation liability as of October 25, 2014 and July 26, 2014 was \$639 million and \$670 million, respectively.

## (g) Indemnifications

In the normal course of business, the Company indemnifies other parties, including customers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold such parties harmless against losses arising from a breach of representations or covenants or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim.



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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company has an obligation to indemnify certain expenses pursuant to such agreements in a case involving certain of the Company's service provider customers that are subject to patent infringement claims asserted by Sprint Communications Company, L.P. ("Sprint") in the United States District Court for the District of Kansas filed on December 19, 2011 (including one case that was later transferred to the District of Delaware). Sprint alleges that the service providers infringe Sprint's patents by offering Voice over Internet Protocol-based telephone services utilizing products provided by the Company and other manufacturers. Sprint is seeking monetary damages. Trial dates have been set for the first half of calendar year 2015. The parties intend to conduct a mediation process later this calendar year, and the Company may be asked to participate. The mediation could result in a resolution of the case for some or all of the Company's service provider customers. The Company believes that the service providers have strong defenses and that its products do not infringe the patents subject to the claims. Due to the uncertainty surrounding the litigation process, which involves numerous defendants, the Company is unable to reasonably estimate the ultimate outcome of this litigation at this time. Should the plaintiff prevail in litigation, mediation, or settlement, the Company may have an obligation to indemnify its service provider customers for damages, mediation awards, or settlement amounts arising from their use of Cisco products.

In addition, the Company has entered into indemnification agreements with its officers and directors, and the Company's Amended and Restated Bylaws contain similar indemnification obligations to the Company's agents. It is not possible to determine the maximum potential amount under these indemnification agreements due to the Company's limited history with prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on the Company's operating results, financial position, or cash flows.

(h) Legal Proceedings

**Brazil** Brazilian authorities have investigated the Company's Brazilian subsidiary and certain of its current and former employees, as well as a Brazilian importer of the Company's products, and its affiliates and employees, relating to alleged evasion of import taxes and alleged improper transactions involving the subsidiary and the importer. Brazilian tax authorities have assessed claims against the Company's Brazilian subsidiary based on a theory of joint liability with the Brazilian importer for import taxes, interest, and penalties. In addition to claims asserted by the Brazilian federal tax authorities in prior fiscal years, tax authorities from the Brazilian state of Sao Paulo have asserted similar claims on the same legal basis in prior fiscal years. In the first quarter of fiscal 2013, the Brazilian federal tax authorities asserted an additional claim against the Company's Brazilian subsidiary based on a theory of joint liability with respect to an alleged underpayment of income taxes, social taxes, interest, and penalties by a Brazilian distributor.

The asserted claims by Brazilian federal tax authorities are for calendar years 2003 through 2008, and the asserted claims by the tax authorities from the state of Sao Paulo are for calendar years 2005 through 2007. The total asserted claims by Brazilian state and federal tax authorities aggregate to approximately \$348 million for the alleged evasion of import and other taxes, approximately \$1.3 billion for interest, and approximately \$1.5 billion for various penalties, all determined using an exchange rate as of October 25, 2014. The Company has completed a thorough review of the matters and believes the asserted claims against the Company's Brazilian subsidiary are without merit, and the Company is defending the claims vigorously. While the Company believes there is no legal basis for the alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil and the nature of the claims asserting joint liability with the importer, the Company is unable to determine the likelihood of an unfavorable outcome against its Brazilian subsidiary and is unable to reasonably estimate a range of loss, if any. The Company does not expect a final judicial determination for several years.

**Russia and the Commonwealth of Independent States** At the request of the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice, the Company is conducting an investigation into allegations which the Company and those agencies received regarding possible violations of the U.S. Foreign Corrupt Practices Act involving business activities of the Company's operations in Russia and certain of the Commonwealth of

Independent States, and by certain resellers of the Company's products in those countries. The Company takes any such allegations very seriously and is fully cooperating with and sharing the results of its investigation with the SEC and the Department of Justice. While the outcome of the Company's investigation is currently not determinable, the Company does not expect that it will have a material adverse effect on its consolidated financial position, results of operations, or cash flows. The countries that are the subject of the investigation collectively comprise less than 2% of the Company's revenues.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**Rockstar** The Company and some of its service provider customers are subject to patent claims asserted in December 2013 in the Eastern District of Texas and the District of Delaware by subsidiaries of the Rockstar Consortium ("Rockstar"). Rockstar, whose members include Apple, Microsoft, LM Ericsson, Sony, and Blackberry, purchased a portfolio of patents out of the Nortel Networks' bankruptcy proceedings (the "Nortel Portfolio"). Rockstar's subsidiaries allege that some of the Company's NGN Routing, Switching and Collaboration products, as well as video solutions deployed by its service provider customers, infringe some of the patents in the Nortel Portfolio. A binding letter of intent has been executed with Rockstar regarding the Nortel Portfolio. The transaction, which is subject to various closing conditions, will result in various technology companies, including but not limited to the Company and the various service provider customers described above, obtaining a license to that portfolio. The parties agreed to stay the litigation pending negotiation of agreements, and when the transaction closes, Rockstar will dismiss all litigation brought against the participating companies. In connection with this matter, during the first quarter of fiscal 2015 the Company recorded a charge to product cost of sales of \$188 million.

In addition, the Company is subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

**13. Shareholders' Equity****(a) Cash Dividends on Shares of Common Stock**

During the three months ended October 25, 2014, the Company declared and paid cash dividends of \$0.19 per common share, or \$973 million, on the Company's outstanding common stock. During the three months ended October 26, 2013, the Company declared and paid cash dividends of \$0.17 per common share, or \$914 million, on the Company's outstanding common stock.

Any future dividends will be subject to the approval of the Company's Board of Directors.

**(b) Stock Repurchase Program**

In September 2001, the Company's Board of Directors authorized a stock repurchase program. As of October 25, 2014, the Company's Board of Directors had authorized an aggregate repurchase of up to \$97 billion of common stock under this program, and the remaining authorized repurchase amount was \$7.5 billion, with no termination date. A summary of the stock repurchase activity under the stock repurchase program, reported based on the trade date, is summarized as follows (in millions, except per-share amounts):

	Shares Repurchased	Weighted- Average Price per Share	Amount Repurchased
Cumulative balance at July 26, 2014	4,288	\$20.63	\$88,445
Repurchase of common stock under the stock repurchase program <sup>(1)</sup>	41	24.58	1,013
Cumulative balance at October 25, 2014	4,329	\$20.66	\$89,458

<sup>(1)</sup> Includes stock repurchases of \$51 million, which were pending settlement as of October 25, 2014. There were \$126 million of stock repurchases that were pending settlement as of July 26, 2014.

The purchase price for the shares of the Company's stock repurchased is reflected as a reduction to shareholders' equity. The Company is required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings and (ii) a reduction of common stock and additional paid-in capital. Issuance of common stock and the tax benefit related to employee stock incentive plans are recorded as an increase to common stock and additional paid-in capital.

**(c) Restricted Stock Unit Withholdings**

For the three months ended October 25, 2014 and October 26, 2013, the Company repurchased approximately 14 million and 12 million shares, or \$342 million and \$286 million, of common stock, respectively, in settlement of

employee tax withholding obligations due upon the vesting of restricted stock or stock units.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

14. Employee Benefit Plans

(a) Employee Stock Incentive Plans

**Stock Incentive Plan Program Description** As of October 25, 2014, the Company had four stock incentive plans: the 2005 Stock Incentive Plan (the “2005 Plan”); the 1996 Stock Incentive Plan (the “1996 Plan”); the Cisco Systems, Inc. SA Acquisition Long-Term Incentive Plan (the “SA Acquisition Plan”); and the Cisco Systems, Inc. WebEx Acquisition Long-Term Incentive Plan (the “WebEx Acquisition Plan”). In addition, the Company has, in connection with the acquisitions of various companies, assumed the share-based awards granted under stock incentive plans of the acquired companies or issued share-based awards in replacement thereof. Share-based awards are designed to reward employees for their long-term contributions to the Company and provide incentives for them to remain with the Company. The number and frequency of share-based awards are based on competitive practices, operating results of the Company, government regulations, and other factors. Since the inception of the stock incentive plans, the Company has granted share-based awards to a significant percentage of its employees, and the majority has been granted to employees below the vice president level. The Company’s primary stock incentive plans are summarized as follows:

**2005 Plan** As of October 25, 2014, the maximum number of shares issuable under the 2005 Plan over its term was 694 million shares, plus the number of any shares underlying awards outstanding on November 15, 2007 under the 1996 Plan, the SA Acquisition Plan, and the WebEx Acquisition Plan that are forfeited or are terminated for any other reason before being exercised or settled. If any awards granted under the 2005 Plan are forfeited or are terminated for any other reason before being exercised or settled, the unexercised or unsettled shares underlying the awards will again be available under the 2005 Plan. Starting November 19, 2013, shares withheld by the Company from an award other than a stock option or stock appreciation right to satisfy withholding tax liabilities resulting from such award will again be available for issuance, based on the fungible share ratio in effect on the date of grant.

Pursuant to an amendment approved by the Company’s shareholders on November 12, 2009, the number of shares available for issuance under the 2005 Plan is reduced by 1.5 shares for each share awarded as a stock grant or a stock unit, and any shares underlying awards outstanding under the 1996 Plan, the SA Acquisition Plan, and the WebEx Acquisition Plan that expire unexercised at the end of their maximum terms become available for reissuance under the 2005 Plan. The 2005 Plan permits the granting of stock options, restricted stock, and restricted stock units (RSUs), the vesting of which may be performance-based or market-based along with the requisite service requirement, and stock appreciation rights to employees (including employee directors and officers), consultants of the Company and its subsidiaries and affiliates, and non-employee directors of the Company. Stock options and stock appreciation rights granted under the 2005 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and prior to November 12, 2009 have an expiration date no later than nine years from the grant date. The expiration date for stock options and stock appreciation rights granted subsequent to the amendment approved on November 12, 2009 shall be no later than 10 years from the grant date.

The stock options will generally become exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 months or 36 months, respectively. Time-based stock grants and time-based RSUs will generally vest with respect to 20% or 25% of the shares or share units covered by the grant on each of the first through fifth or fourth anniversaries of the date of the grant, respectively. Performance-based and market-based RSUs typically vest at the end of the three-year requisite service period or earlier if the award recipient meets certain retirement eligibility conditions. The Compensation and Management Development Committee of the Board of Directors has the discretion to use different vesting schedules. Stock appreciation rights may be awarded in combination with stock options or stock grants, and such awards shall provide that the stock appreciation rights will not be exercisable unless the related stock options or stock grants are forfeited. Stock grants may be awarded in combination with non-statutory stock options, and such awards may provide that the stock grants will be forfeited in the event that the related non-statutory stock options are exercised.

1996 Plan The 1996 Plan expired on December 31, 2006, and the Company can no longer make equity awards under the 1996 Plan. The maximum number of shares issuable over the term of the 1996 Plan was 2.5 billion shares. Stock options granted under the 1996 Plan have an exercise price of at least 100% of the fair market value of the underlying stock on the grant date and expire no later than nine years from the grant date. The stock options generally became exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 months or 36 months, respectively. Certain other grants utilized a 60-month ratable vesting schedule. In addition, the Board of Directors, or other committees administering the 1996 Plan, had the discretion to use a different vesting schedule and did so from time to time.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Acquisition Plans In connection with the Company's acquisitions of Scientific-Atlanta, Inc. ("Scientific-Atlanta") and WebEx Communications, Inc. ("WebEx"), the Company adopted the SA Acquisition Plan and the WebEx Acquisition Plan, respectively, each effective upon completion of the applicable acquisition. These plans constitute assumptions, amendments, restatements, and renamings of the 2003 Long-Term Incentive Plan of Scientific-Atlanta and the WebEx Communications, Inc. Amended and Restated 2000 Stock Incentive Plan, respectively. The plans permit the grant of stock options, stock, stock units, and stock appreciation rights to certain employees of the Company and its subsidiaries and affiliates who had been employed by Scientific-Atlanta or its subsidiaries or WebEx or its subsidiaries, as applicable. As a result of the shareholder approval of the amendment and extension of the 2005 Plan, as of November 15, 2007, the Company will no longer make stock option grants or direct share issuances under either the SA Acquisition Plan or the WebEx Acquisition Plan.

## (b) Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan, which includes its subplan named the International Employee Stock Purchase Plan (together, the "Purchase Plan"), under which 471.4 million shares of the Company's common stock have been reserved for issuance as of October 25, 2014. Eligible employees are offered shares through a 24-month offering period, which consists of four consecutive 6-month purchase periods. Employees may purchase a limited number of shares of the Company's stock at a discount of up to 15% of the lesser of the market value at the beginning of the offering period or the end of each 6-month purchase period. The Purchase Plan is scheduled to terminate on January 3, 2020. No shares were issued under the Purchase Plan during either of the three months ended October 25, 2014 and October 26, 2013. As of October 25, 2014, 25 million shares were available for issuance under the Purchase Plan.

## (c) Summary of Share-Based Compensation Expense

Share-based compensation expense consists primarily of expenses for stock options, stock purchase rights, restricted stock, and restricted stock units granted to employees. The following table summarizes share-based compensation expense (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Cost of sales—product	\$11	\$10
Cost of sales—service	37	33
Share-based compensation expense in cost of sales	48	43
Research and development	119	92
Sales and marketing	147	123
General and administrative	59	54
Restructuring and other charges	(4	) (3
Share-based compensation expense in operating expenses	321	266
Total share-based compensation expense	\$369	\$309
Income tax benefit for share-based compensation	\$94	\$78

As of October 25, 2014, the total compensation cost related to unvested share-based awards not yet recognized was \$2.3 billion, which is expected to be recognized over approximately 2.4 years on a weighted-average basis.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (d) Share-Based Awards Available for Grant

A summary of share-based awards available for grant is as follows (in millions):

	Share-Based Awards Available for Grant
BALANCE AT July 27, 2013	228
Restricted stock, stock units, and other share-based awards granted	(98 )
Share-based awards canceled/forfeited/expired	36
Additional shares reserved	135
Shares withheld for taxes and not issued	6
Other	3
BALANCE AT July 26, 2014	310
Restricted stock, stock units, and other share-based awards granted	(27 )
Share-based awards canceled/forfeited/expired	16
Shares withheld for taxes and not issued	20
BALANCE AT October 25, 2014	319

As reflected in the preceding table, for each share awarded as restricted stock or subject to a restricted stock unit award under the 2005 Plan, an equivalent of 1.5 shares was deducted from the available share-based award balance. For restricted stock units that were awarded with vesting contingent upon the achievement of future financial performance or market-based metrics, the maximum awards that can be achieved upon full vesting of such awards were reflected in the preceding table.

## (e) Restricted Stock and Stock Unit Awards

A summary of the restricted stock and stock unit activity, which includes time-based and performance-based or market-based restricted stock units, is as follows (in millions, except per-share amounts):

	Restricted Stock/ Stock Units	Weighted-Average Grant Date Fair Value per Share	Aggregated Fair Market Value
UNVESTED BALANCE AT JULY 27, 2013	143	\$ 18.80	
Granted and assumed	72	20.85	
Vested	(53 )	19.55	\$1,229
Canceled/forfeited	(13 )	18.61	
UNVESTED BALANCE AT JULY 26, 2014	149	19.54	
Granted and assumed	15	23.17	
Vested	(38 )	19.51	\$968
Canceled/forfeited	(6 )	19.48	
UNVESTED BALANCE AT OCTOBER 25, 2014	120	\$ 20.02	



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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (f) Stock Option Awards

A summary of the stock option activity is as follows (in millions, except per-share amounts):

	STOCK OPTIONS OUTSTANDING	
	Number Outstanding	Weighted-Average Exercise Price per Share
BALANCE AT JULY 27, 2013	276	\$ 24.44
Assumed from acquisitions	6	3.60
Exercised	(78)	) 18.30
Canceled/forfeited/expired	(17)	) 27.53
BALANCE AT JULY 26, 2014	187	26.03
Assumed from acquisitions	1	2.72
Exercised	(19)	) 18.66
Canceled/forfeited/expired	(6)	) 29.05
BALANCE AT OCTOBER 25, 2014	163	\$ 26.63

The following table summarizes significant ranges of outstanding and exercisable stock options as of October 25, 2014 (in millions, except years and share prices):

Range of Exercise Prices	STOCK OPTIONS OUTSTANDING				STOCK OPTIONS EXERCISABLE		
	Number Outstanding	Weighted-Average Remaining Contractual Life (in Years)	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value	Number Exercisable	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value
\$ 0.01 – 15.00	7	5.3	\$4.07	\$145	4	\$5.41	\$74
15.01 – 18.00	1	1.0	17.32	7	1	17.32	7
18.01 – 20.00	2	0.5	19.60	9	2	19.60	9
20.01 – 25.00	55	1.0	22.87	51	54	22.87	51
25.01 – 30.00	26	1.7	26.59	—	26	26.59	—
30.01 – 35.00	72	1.8	32.16	—	72	32.16	—
Total	163	1.6	\$26.63	\$212	159	\$27.13	\$141

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$23.78 as of October 24, 2014, that would have been received by the option holders had those option holders exercised their stock options as of that date. The total number of in-the-money stock options exercisable as of October 25, 2014 was 61 million. As of July 26, 2014, 183 million outstanding stock options were exercisable and the weighted-average exercise price was \$26.50.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (g) Valuation of Employee Share-Based Awards

Time-based restricted stock units and performance-based restricted stock units (PRSUs) that are based on the Company's financial performance metrics or non-financial operating goals are valued using the market value of the Company's common stock on the date of grant, discounted for the present value of expected dividends. On the date of grant, the Company estimated the fair value of the total shareholder return (TSR) component of the PRSUs using a Monte Carlo simulation model. The assumptions for the valuation of time-based RSUs and PRSUs are summarized as follows:

	RESTRICTED STOCK UNITS		PERFORMANCE RESTRICTED STOCK UNITS	
Three Months Ended	October 25, 2014	October 26, 2013	October 25, 2014	October 26, 2013
Number of shares granted (in millions)	9	10	6	4
Grant date fair value per share	\$23.10	\$23.11	\$23.31	\$22.70
Weighted-average assumptions/inputs:				
Expected dividend yield	3.0	% 2.7	% 3.0	% 2.3
Range of risk-free interest rates	0.0% – 1.8%	0.0% – 1.4%	0.0% – 1.8%	0.0% – 1.4%
Range of expected volatilities for index	N/A	N/A	15.1% – 70.0%	17.4% – 70.5%

The PRSUs granted during the first quarter of each of fiscal 2015 and fiscal 2014 are contingent on the achievement of the Company's financial performance metrics, its comparative market-based returns, or the achievement of non-financial operating goals. For the awards based on financial performance metrics or comparative market-based returns, generally 50% of the PRSUs are earned based on the average of annual operating cash flow and earnings per share goals established at the beginning of each fiscal year over a three-year performance period. Generally, the remaining 50% of the PRSUs are earned based on the Company's TSR measured against the benchmark TSR of a peer group over the same period. Each PRSU recipient could vest in 0% to 150% of the target shares granted contingent on the achievement of the Company's financial performance metrics or its comparative market-based returns, and 0% or 100% of the target shares granted contingent on the achievement of non-financial operating goals.

## 15. Comprehensive Income

The components of AOCI, net of tax, and the other comprehensive income (loss), excluding noncontrolling interest, for the three months ended October 25, 2014 and October 26, 2013 are summarized as follows (in millions):

	Net Unrealized Gains on Investments	Net Unrealized Gains (Losses) Cash Flow Hedging Instruments	Cumulative Translation Adjustment and Other	Accumulated Other Comprehensive Income
October 25, 2014				
BALANCE AT JULY 26, 2014	\$424	\$(12)	) \$265	\$ 677
Other comprehensive income (loss) before reclassifications attributable to Cisco Systems, Inc.	(36)	) (56)	) (161)	) (253)
(Gains) losses reclassified out of other comprehensive income	(7)	) 4	—	(3)
Tax benefit (expense)	16	3	11	30
BALANCE AT OCTOBER 25, 2014	\$397	\$(61)	) \$115	\$ 451

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

October 26, 2013	Net Unrealized Gains on Investments	Net Unrealized Gains (Losses) Cash Flow Hedging Instruments	Cumulative Translation Adjustment and Other	Accumulated Other Comprehensive Income	
BALANCE AT JULY 27, 2013	\$379	\$8	\$221	\$ 608	
Other comprehensive income (loss) before reclassifications attributable to Cisco Systems, Inc.	170	38	76	284	
(Gains) losses reclassified out of other comprehensive income	(83	) (9	) —	(92	)
Tax benefit (expense)	(22	) (3	) (3	) (28	)
BALANCE AT OCTOBER 26, 2013	\$444	\$34	\$294	\$ 772	

The net gains (losses) reclassified out of other comprehensive income into the Consolidated Statements of Operations, with line item location, during each period were as follows (in millions):

Comprehensive Income Components	Three Months Ended		Line Item in Statements of Operations
	October 25, 2014	October 26, 2013	
Income Before Taxes			
Net unrealized gains on available-for-sale investments	\$ 7	\$ 83	Other income (loss), net
Net unrealized gains and (losses) on cash flow hedging instruments:			
Foreign currency derivatives	(3	) 7	Operating expenses
Foreign currency derivatives	(1	) 2	Cost of sales—service
	(4	) 9	
Total amounts reclassified out of other comprehensive income	\$ 3	\$ 92	

## 16. Income Taxes

The following table provides details of income taxes (in millions, except percentages):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Income before provision for income taxes	\$ 2,360	\$ 2,540
Provision for income taxes	\$ 532	\$ 544
Effective tax rate	22.5	% 21.4

As of October 25, 2014, the Company had \$2.0 billion of unrecognized tax benefits, of which \$1.7 billion, if recognized, would favorably impact the effective tax rate. The Company regularly engages in discussions and negotiations with tax authorities regarding tax matters in various jurisdictions. The Company believes it is reasonably possible that certain federal, foreign, and state tax matters may be concluded in the next 12 months. Specific positions that may be resolved include issues involving transfer pricing and various other matters. Accordingly, the Company estimates that it is reasonably possible that the unrecognized tax benefits at October 25, 2014 could be reduced by

\$300 million in the next 12 months.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 17. Segment Information and Major Customers

## (a) Revenue and Gross Margin by Segment

The Company conducts business globally and is primarily managed on a geographic basis consisting of three segments: the Americas, EMEA, and APJC. The Company's management makes financial decisions and allocates resources based on the information it receives from its internal management system. Sales are attributed to a segment based on the ordering location of the customer. The Company does not allocate research and development, sales and marketing, or general and administrative expenses to its segments in this internal management system because management does not include the information in its measurement of the performance of the operating segments. In addition, the Company does not allocate amortization and impairment of acquisition-related intangible assets, share-based compensation expense, significant litigation and other contingencies, impacts to cost of sales from purchase accounting adjustments to inventory, charges related to asset impairments and restructurings, and certain other charges to the gross margin for each segment because management does not include this information in its measurement of the performance of the operating segments.

Summarized financial information by segment for the three months ended October 25, 2014 and October 26, 2013, based on the Company's internal management system and as utilized by the Company's Chief Operating Decision Maker ("CODM"), is as follows (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Revenue:		
Americas	\$7,501	\$7,316
EMEA	3,002	2,933
APJC	1,742	1,836
Total	\$12,245	\$12,085
Gross margin:		
Americas	\$4,810	\$4,650
EMEA	1,915	1,888
APJC	1,025	1,079
Segment total	7,750	7,617
Unallocated corporate items	(417)	(210)
Total	\$7,333	\$7,407

Revenue in the United States was \$6.6 billion and \$6.4 billion for the three months ended October 25, 2014 and October 26, 2013, respectively.

## (b) Revenue for Groups of Similar Products and Services

The Company designs, manufactures, and sells Internet Protocol (IP)-based networking and other products related to the communications and IT industry and provides services associated with these products and their use. The Company groups its products and technologies into the following categories: Switching, NGN Routing, Collaboration, Service Provider Video, Data Center, Wireless, Security, and Other Products. These products, primarily integrated by Cisco IOS Software, link geographically dispersed local-area networks (LANs), metropolitan-area networks (MANs), and wide-area networks (WANs).

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

	Three Months Ended	
	October 25, 2014	October 26, 2013
Revenue:		
Switching	\$3,846	\$3,740
NGN Routing	1,949	2,026
Collaboration	949	1,051
Service Provider Video	871	987
Data Center	693	601
Wireless	605	547
Security	455	365
Other	67	80
Product	9,435	9,397
Service	2,810	2,688
Total	\$12,245	\$12,085

The Company has made certain reclassifications to the product revenue amounts for prior periods to conform to the current period's presentation.

## (c) Additional Segment Information

The majority of the Company's assets, excluding cash and cash equivalents and investments, as of October 25, 2014 and July 26, 2014 were attributable to its U.S. operations. The Company's total cash and cash equivalents and investments held by various foreign subsidiaries were \$48.3 billion and \$47.4 billion as of October 25, 2014 and July 26, 2014, respectively, and the remaining \$3.8 billion and \$4.7 billion at the respective period ends were available in the United States.

Property and equipment information is based on the physical location of the assets. The following table presents property and equipment information for geographic areas (in millions):

	October 25, 2014	July 26, 2014
Property and equipment, net:		
United States	\$2,687	\$2,697
International	546	555
Total	\$3,233	\$3,252

## 18. Net Income per Share

The following table presents the calculation of basic and diluted net income per share (in millions, except per-share amounts):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Net income	\$1,828	\$1,996
Weighted-average shares—basic	5,112	5,378
Effect of dilutive potential common shares	44	52
Weighted-average shares—diluted	5,156	5,430
Net income per share—basic	\$0.36	\$0.37
Net income per share—diluted	\$0.35	\$0.37
Antidilutive employee share-based awards, excluded	114	174

Employee equity share options, unvested shares, and similar equity instruments granted by the Company are treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options, unvested restricted stock, and restricted stock units. The dilutive effect of such

equity awards is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are collectively assumed to be used to repurchase shares.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations  
Forward-Looking Statements

This Quarterly Report on Form 10-Q, including this Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). All statements other than statements of historical facts are statements that could be deemed forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "continues," "may," variations of such words, and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, under "Part II, Item 1A. Risk Factors," and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

**OVERVIEW**

We design, manufacture, and sell Internet Protocol (IP) based networking products and services related to the communications and information technology (IT) industry. Our customers include businesses of all sizes, public institutions, telecommunications companies, other service providers and individuals. We connect people, process, data and things with products that transport data, voice, and video within buildings, across campuses, and around the world. We are a key strategic partner to companies that helps them as they seek to make the most of the Internet of Everything (IoE) and connect the unconnected.

A summary of our results is as follows (in millions, except percentages and per-share amounts):

	Three Months Ended			
	October 25, 2014	October 26, 2013	Variance	
Revenue	\$12,245	\$12,085	1.3	%
Gross margin percentage	59.9	% 61.3	(1.4	) pts
Research and development	\$1,583	\$1,724	(8.2	)%
Sales and marketing	\$2,515	\$2,411	4.3	%
General and administrative	\$504	\$515	(2.1	)%
Total R&D, sales and marketing, general and administrative	\$4,602	\$4,650	(1.0	)%
Total as a percentage of revenue	37.6	% 38.5	(0.9	) pts
Amortization of purchased intangible assets	\$71	\$65	9.2	%
Restructuring and other charges	\$318	\$237	34.2	%
Operating income as a percentage of revenue	19.1	% 20.3	(1.2	) pts
Income tax percentage	22.5	% 21.4	1.1	pts
Net income	\$1,828	\$1,996	(8.4	)%
Net income as a percentage of revenue	14.9	% 16.5	(1.6	) pts
Earnings per share—diluted	\$0.35	\$0.37	(5.4	)%



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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

In the first quarter of fiscal 2015, revenue increased by 1% as compared with the first quarter of fiscal 2014. Within the total revenue change, product revenue was flat while service revenue increased 5%. Total gross margin decreased by 1.4 percentage points, driven by unfavorable impacts from pricing and the \$188 million Rockstar patent portfolio charge partially offset by productivity improvement and the favorable impact of mix. As a percentage of revenue, research and development, sales and marketing, and general and administrative expenses, collectively, decreased by 0.9 percentage points. Operating income as a percentage of revenue decreased by 1.2 percentage points, primarily as a result of the increase in restructuring and other charges. Diluted earnings per share decreased by 5% from the prior year, driven by an 8% decrease in net income.

In the first quarter of fiscal 2015, total revenue increased by \$0.2 billion as compared to the first quarter of fiscal 2014. Revenue from the Americas increased by \$0.2 billion, reflecting higher product revenue in the United States. EMEA revenue increased by \$0.1 billion, led by higher product revenue in the United Kingdom. Revenue in our APJC segment decreased by \$0.1 billion, led by a product revenue decline in China. The weakness we encountered in emerging countries in fiscal 2014 continued in certain of the emerging countries in the first quarter of fiscal 2015. We experienced mixed results in the emerging countries of Brazil, Russia, India, China, and Mexico ("BRICM"), which in the aggregate, experienced a 7% product revenue decline, as product revenue declines in China and Russia were only partially offset by increases in the other three countries. We believe that the product revenue declines in various emerging countries were driven by the impact of economic and geopolitical challenges in these countries.

From a customer market standpoint, in the first quarter of fiscal 2015, while the service provider market continued to experience a decline in product revenue, we had solid product revenue growth in the public sector and commercial markets, and modest growth in the enterprise market. The product revenue increase in the public sector market was led by higher spending from the U.S. federal government.

From a product category perspective, product revenue was flat year over year. Overall, our product revenue from our core product areas was relatively flat as the increase in product revenue from our Switching products was substantially offset by the decrease in revenue from our NGN Routing products. Our other major product categories experienced revenue changes ranging from a 12% decrease in Service Provider Video to a 25% increase in Security. Service revenue increased by 5% year over year.

In summary, in the first quarter of fiscal 2015, we continued to see some improved business momentum. We also continued to experience several of the challenges we have encountered in recent quarters including reduced spending by our service provider customers and weakness in certain emerging countries. We did see our product transitions in certain areas start to improve. We are not expecting the challenges in service provider and emerging countries to improve for at least a few quarters.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Strategy and Focus Areas

Our strategy is to deliver the integrated architectures, solutions, and outcomes to help our customers grow, manage costs, and mitigate risk. We see our customers, in almost every industry, becoming increasingly reliant on technology—and specifically the network—to meet their business objectives and compete successfully in the market. Our focus continues to be on capitalizing on market transitions to maintain leadership in our core markets and to enter new markets where the network is foundational. We believe this focus best positions us to become a more relevant and trusted partner to our customers and to expand our share of our customers' IT spending. We are focused on driving the innovation, speed, agility, and efficiencies in our company required to deliver leading technology solutions for our customers and shareholder value for our investors.

Over the last few years, we have been working to transform our business to move from selling individual products and services to selling products and services integrated into architectures and solutions, as well as to meet customers' business outcomes. As a part of this transformation, we are making changes to how we are organized and how we deliver our technology. We believe these changes enable us to better meet our customers' requirements and help them stay ahead of market transitions.

For a full discussion of our strategy and focus areas, see Item 1. Business in our Annual Report on Form 10-K for the year ended July 26, 2014.

## Other Key Financial Measures

The following is a summary of our other key financial measures for the first quarter of fiscal 2015 (in millions, except days sales outstanding in accounts receivable (DSO) and annualized inventory turns):

	October 25, 2014	July 26, 2014
Cash and cash equivalents and investments	\$52,107	\$52,074
Deferred revenue	\$13,744	\$14,142
DSO	33 days	38 days
Inventories	\$1,676	\$1,591
Annualized inventory turns	12.0	12.7
Three Months Ended		
	October 25, 2014	October 26, 2013
Cash provided by operating activities	\$2,491	\$2,649
Repurchases of common stock—stock repurchase program	\$1,013	\$2,000
Dividends	\$973	\$914

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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended July 26, 2014, as updated as applicable in Note 2 to the Consolidated Financial Statements herein, describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The accounting policies described below are significantly affected by critical accounting estimates. Such accounting policies require significant judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements, and actual results could differ materially from the amounts reported based on these policies.

Revenue Recognition

Revenue is recognized when all of the following criteria have been met:

- Persuasive evidence of an arrangement exists. Contracts, Internet commerce agreements, and customer purchase orders are generally used to determine the existence of an arrangement.
- Delivery has occurred. Shipping documents and customer acceptance, when applicable, are used to verify 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 and whether the sales price is subject to refund or adjustment.
- Collectibility is reasonably assured. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history.

In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met. When a sale involves multiple deliverables, such as sales of products that include services, the multiple deliverables are evaluated to determine the unit of accounting, and the entire fee from the arrangement is allocated to each unit of accounting based on the relative selling price. Revenue is recognized when the revenue recognition criteria for each unit of accounting are met. For hosting arrangements, we recognize subscription revenue ratably over the subscription period, while usage revenue is recognized based on utilization. Software subscription revenue is deferred and recognized ratably over the subscription term upon delivery of the first product and commencement of the term.

The amount of product and service revenue recognized in a given period is affected by our judgment as to whether an arrangement includes multiple deliverables and, if so, our valuation of the units of accounting for multiple deliverables. According to the accounting guidance prescribed in Accounting Standards Codification (ASC) 605, Revenue Recognition, we use vendor-specific objective evidence of selling price (VSOE) for each of those units, when available. We determine VSOE based on our normal pricing and discounting practices for the specific product or service when sold separately. In determining VSOE, we require that a substantial majority of the historical standalone transactions have the selling prices for a product or service fall within a reasonably narrow pricing range, generally evidenced by approximately 80% of such historical standalone transactions falling within plus or minus 15% of the median rates. When VSOE does not exist, we apply the selling price hierarchy to applicable multiple-deliverable arrangements. Under the selling price hierarchy, third-party evidence of selling price (TPE) will be considered if VSOE does not exist, and estimated selling price (ESP) will be used if neither VSOE nor TPE is available. Generally, we are not able to determine TPE because our go-to-market strategy differs from that of others in our markets, and the extent of our proprietary technology varies among comparable products or services from those of our peers. In determining ESP, we apply significant judgment as we weigh a variety of factors, based on the facts and circumstances of the arrangement. We typically arrive at an ESP for a product or service that is not sold separately by considering company-specific factors such as geographies, competitive landscape, internal costs, profitability objectives, pricing practices used to establish bundled pricing, and existing portfolio pricing and discounting. Some of our sales arrangements have multiple deliverables containing software and related software support components. Such sales arrangements are subject to the accounting guidance in ASC 985-605, Software-Revenue

Recognition.

As our business and offerings evolve over time, our pricing practices may be required to be modified accordingly, which could result in changes in selling prices, including both VSOE and ESP, in subsequent periods. There were no material impacts during the first quarter of fiscal 2015, nor do we currently expect a material impact in the next 12 months on our revenue recognition due to any changes in our VSOE, TPE, or ESP.

Revenue deferrals relate to the timing of revenue recognition for specific transactions based on financing arrangements, service, support, and other factors. Financing arrangements may include sales-type, direct-financing, and operating leases, loans, and guarantees of third-party financing. Our deferred revenue for products was \$4.7 billion and \$4.5 billion as of October 25, 2014 and July 26, 2014, respectively. Technical support services revenue is deferred and recognized ratably over the period during which the services are to be performed, which typically is from one to three years. Advanced services revenue is recognized upon delivery

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

or completion of performance. Our deferred revenue for services was \$9.0 billion and \$9.6 billion as of October 25, 2014 and July 26, 2014, respectively.

We make sales to distributors which we refer to as two-tier systems of sales to the end customer. Revenue from distributors is recognized based on a sell-through method using information provided by them. Our distributors participate in various cooperative marketing and other programs, and we maintain estimated accruals and allowances for these programs. If actual credits received by our distributors under these programs were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

## Allowances for Receivables and Sales Returns

The allowances for receivables were as follows (in millions, except percentages):

	October 25, 2014	July 26, 2014	
Allowance for doubtful accounts	\$276	\$265	
Percentage of gross accounts receivable	5.9	% 4.9	%
Allowance for credit loss—lease receivables	\$248	\$233	
Percentage of gross lease receivables <sup>(1)</sup>	6.6	% 6.2	%
Allowance for credit loss—loan receivables	\$84	\$98	
Percentage of gross loan receivables	4.8	% 5.8	%

<sup>(1)</sup> Calculated as allowance for credit loss on lease receivables as a percentage of gross lease receivables before unearned income.

The allowance for doubtful accounts is based on our assessment of the collectibility of customer accounts. We regularly review the adequacy of these allowances by considering internal factors such as historical experience, credit quality and age of the receivable balances as well as external factors such as economic conditions that may affect a customer's ability to pay and expected default frequency rates, which are published by major third-party credit-rating agencies and are generally updated on a quarterly basis. We also consider the concentration of receivables outstanding with a particular customer in assessing the adequacy of our allowances for doubtful accounts. If a major customer's creditworthiness deteriorates, if actual defaults are higher than our historical experience, or if other circumstances arise, our estimates of the recoverability of amounts due to us could be overstated, and additional allowances could be required, which could have an adverse impact on our operating results.

The allowance for credit loss on financing receivables is also based on the assessment of collectibility of customer accounts. We regularly review the adequacy of the credit allowances determined either on an individual or a collective basis. When evaluating the financing receivables on an individual basis, we consider historical experience, credit quality and age of receivable balances, and economic conditions that may affect a customer's ability to pay. When evaluating financing receivables on a collective basis, we use expected default frequency rates published by a major third-party credit-rating agency as well as our own historical loss rate in the event of default, while also systematically giving effect to economic conditions, concentration of risk and correlation. Determining expected default frequency rates and loss factors associated with internal credit risk ratings, as well as assessing factors such as economic conditions, concentration of risk, and correlation, are complex and subjective. Our ongoing consideration of all these factors could result in an increase in our allowance for credit loss in the future, which could adversely affect our operating results. Both accounts receivable and financing receivables are charged off at the point when they are considered uncollectible.

A reserve for future sales returns is established based on historical trends in product return rates. The reserve for future sales returns as of October 25, 2014 and July 26, 2014 was \$123 million and \$135 million, respectively, and was recorded as a reduction of our accounts receivable. If the actual future returns were to deviate from the historical data on which the reserve had been established, our revenue could be adversely affected.

## Inventory Valuation and Liability for Purchase Commitments with Contract Manufacturers and Suppliers

Our inventory balance was \$1.7 billion and \$1.6 billion as of October 25, 2014 and July 26, 2014, respectively.

Inventory is written down based on excess and obsolete inventories, determined primarily by future demand forecasts.

Inventory write-downs are measured as the difference between the cost of the inventory and market, based upon assumptions about future demand, and are charged to the provision for inventory, which is a component of our cost of sales. At the point of the loss recognition, a new, lower cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis. We record a liability for firm, noncancelable, and unconditional purchase commitments with contract manufacturers and suppliers for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory. As of

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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

October 25, 2014, the liability for these purchase commitments was \$169 million, compared with \$162 million as of July 26, 2014, and was included in other current liabilities.

Our provision for inventory was \$11 million and \$18 million for the first quarter of fiscal 2015 and 2014, respectively. The provision for the liability related to purchase commitments with contract manufacturers and suppliers was \$32 million and \$30 million for the first quarter of fiscal 2015 and 2014, respectively. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory write-downs, and our liability for purchase commitments with contract manufacturers and suppliers, and accordingly our profitability, could be adversely affected. We regularly evaluate our exposure for inventory write-downs and the adequacy of our liability for purchase commitments. Inventory and supply chain management remain areas of focus as we balance the need to maintain supply chain flexibility to help ensure competitive lead times with the risk of inventory obsolescence, particularly in light of current macroeconomic uncertainties and conditions and the resulting potential for changes in future demand forecast.

**Loss Contingencies and Product Warranties**

We are subject to the possibility of various losses arising in the ordinary course of business. We consider the likelihood of impairment of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss, in determining loss contingencies. 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. We regularly evaluate information available to us to determine whether such accruals should be made or adjusted and whether new accruals are required.

Third parties, including customers, have in the past and may in the future assert claims or initiate litigation related to exclusive patent, copyright, trademark, and other intellectual property rights to technologies and related standards that are relevant to us. These assertions have increased over time as a result of our growth and the general increase in the pace of patent claims assertions, particularly in the United States. If any infringement or other intellectual property claim made against us by any third party is successful, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results, and financial condition could be materially and adversely affected.

We have recorded a liability for the expected remediation cost for certain products sold in prior fiscal years containing memory components manufactured by a single supplier between 2005 and 2010. In February 2014, on the basis of the growing number of failures as described in Note 12 (f) to the Consolidated Financial Statements, we decided to expand our approach, which resulted in an additional charge to product cost of sales of \$655 million being recorded for the second quarter of fiscal 2014. Estimating this liability is complex and subjective, and if we experience changes in a number of underlying assumptions and estimates such as a change in claims compared with our expectations, or if the cost of servicing these claims is different than expected, our estimated liability may be impacted.

Our liability for product warranties, included in other current liabilities, was \$436 million as of October 25, 2014, compared with \$446 million as of July 26, 2014. Our products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products we provide a limited lifetime warranty. We accrue for warranty costs as part of our cost of sales based on associated material costs, technical support labor costs, and associated overhead. Material cost is estimated based primarily upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is estimated based primarily upon historical trends in the rate of customer cases and the cost to support the customer cases within the warranty period. Overhead cost is applied based on estimated time to support warranty activities.

The provision for product warranties during the first quarter of fiscal 2015 and 2014 was \$143 million and \$196 million, respectively. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our profitability could be adversely affected.

**Fair Value Measurements**

Our fixed income and publicly traded equity securities, collectively, are reflected in the Consolidated Balance Sheets at a fair value of \$47.7 billion as of October 25, 2014, compared with \$45.3 billion as of July 26, 2014. Our fixed income investment portfolio as of October 25, 2014 consisted primarily of high quality investment-grade securities. See Note 8 to the Consolidated Financial Statements.

As described more fully in Note 9 to the Consolidated Financial Statements, a valuation hierarchy is based on the level of independent, objective evidence available regarding the value of the investments. It encompasses three classes of investments: Level 1 consists of securities for which there are quoted prices in active markets for identical securities; Level 2 consists of securities for which observable inputs other than Level 1 inputs are used, such as quoted prices for similar securities in active markets or quoted prices for identical securities in less active markets and model-derived valuations for which the variables are derived from,



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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

or corroborated by, observable market data; and Level 3 consists of securities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value.

Our Level 2 securities are valued using quoted market prices for similar instruments or nonbinding market prices that are corroborated by observable market data. We use inputs such as actual trade data, benchmark yields, broker/dealer quotes, and other similar data, which are obtained from independent pricing vendors, quoted market prices, or other sources to determine the ultimate fair value of our assets and liabilities. We use such pricing data as the primary input, to which we have not made any material adjustments during the periods presented, to make our assessments and determinations as to the ultimate valuation of our investment portfolio. We are ultimately responsible for the financial statements and underlying estimates.

The inputs and fair value are reviewed for reasonableness, may be further validated by comparison to publicly available information, and could be adjusted based on market indices or other information that management deems material to its estimate of fair value. The assessment of fair value can be difficult and subjective. However, given the relative reliability of the inputs we use to value our investment portfolio, and because substantially all of our valuation inputs are obtained using quoted market prices for similar or identical assets, we do not believe that the nature of estimates and assumptions affected by levels of subjectivity and judgment was material to the valuation of the investment portfolio as of October 25, 2014. We had no Level 3 assets measured at fair value on a recurring basis as of October 25, 2014.

**Other-than-Temporary Impairments**

We recognize an impairment charge when the declines in the fair values of our fixed income or publicly traded equity securities below their cost basis are judged to be other than temporary. The ultimate value realized on these securities, to the extent unhedged, is subject to market price volatility until they are sold.

If the fair value of a debt security is less than its amortized cost, we assess whether the impairment is other than temporary. An impairment is considered other than temporary if (i) we have the intent to sell the security, (ii) it is more likely than not that we will be required to sell the security before recovery of its entire amortized cost basis, or (iii) we do not expect to recover the entire amortized cost of the security. If an impairment is considered other than temporary based on (i) or (ii) described in the prior sentence, the entire difference between the amortized cost and the fair value of the security is recognized in earnings. If an impairment is considered other than temporary based on condition (iii), the amount representing credit loss, defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis of the debt security, will be recognized in earnings, and the amount relating to all other factors will be recognized in other comprehensive income (OCI). In estimating the amount and timing of cash flows expected to be collected, we consider all available information, including past events, current conditions, the remaining payment terms of the security, the financial condition of the issuer, expected defaults, and the value of underlying collateral.

For publicly traded equity securities, we consider various factors in determining whether we should recognize an impairment charge, including the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the issuer, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

There were no impairment charges on our investments in publicly traded equity securities and fixed income securities in the first quarters of fiscal 2015 and 2014. Our ongoing consideration of all the factors described previously could result in additional impairment charges in the future, which could adversely affect our net income.

We also have investments in privately held companies, some of which are in the startup or development stages. Our investments in privately held companies as of October 25, 2014 were \$886 million, compared with \$899 million as of July 26, 2014, and were included in other assets. We monitor these investments for events or circumstances indicative of potential impairment, and we make appropriate reductions in carrying values if we determine that an impairment charge is required, based primarily on the financial condition and near-term prospects of these companies. These investments are inherently risky because the markets for the technologies or products these companies are developing

are typically in the early stages and may never materialize. Our impairment charge on investments in privately held companies was \$1 million for the first quarter of each of fiscal 2015 and 2014.

#### Goodwill and Purchased Intangible Asset Impairments

Our methodology for allocating the purchase price relating to purchase acquisitions is determined through established valuation techniques. Goodwill represents a residual value as of the acquisition date, which in most cases results in measuring goodwill as an excess of the purchase consideration transferred plus the fair value of any noncontrolling interest in the acquired company over the fair value of net assets acquired, including contingent consideration. We perform goodwill impairment tests on an annual basis in the fourth fiscal quarter and between annual tests in certain circumstances for each reporting unit. The assessment of fair value for goodwill and purchased intangible assets is based on factors that market participants would use in an orderly transaction in accordance with the new accounting guidance for the fair value measurement of nonfinancial assets.

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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The goodwill recorded in the Consolidated Balance Sheets as of October 25, 2014 and July 26, 2014 was \$24.4 billion and \$24.2 billion, respectively. In response to changes in industry and market conditions, we could be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses, which could result in an impairment of goodwill. There was no impairment of goodwill in the first quarters of fiscal 2015 and 2014.

We make judgments about the recoverability of purchased intangible assets with finite lives whenever events or changes in circumstances indicate that an impairment may exist. Recoverability of purchased intangible assets with finite lives is measured by comparing the carrying amount of the asset to the future undiscounted cash flows the asset is expected to generate. We review indefinite-lived intangible assets for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. If the asset is considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset. Assumptions and estimates about future values and remaining useful lives of our purchased intangible assets are complex and subjective. They can be affected by a variety of factors, including external factors such as industry and economic trends, and internal factors such as changes in our business strategy and our internal forecasts. There were no impairment charges related to purchased intangible assets for the first quarters of fiscal 2015 and 2014. Our ongoing consideration of all the factors described previously could result in additional impairment charges in the future, which could adversely affect our net income.

Income Taxes

We are subject to income taxes in the United States and numerous foreign jurisdictions. Our effective tax rates differ from the statutory rate, primarily due to the tax impact of state taxes, foreign operations, R&D tax credits, domestic manufacturing deductions, tax audit settlements, nondeductible compensation, international realignments, and transfer pricing adjustments. Our effective tax rate was 22.5% and 21.4% in the first quarter of fiscal 2015 and 2014, respectively.

Significant judgment is 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 will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest and penalties.

Significant judgment is also 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.

Our provision for income taxes is subject to volatility and could be adversely impacted by earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates; by changes in the valuation of our deferred tax assets and liabilities; by expiration of or lapses in the R&D tax credit or domestic manufacturing deduction laws; by expiration of or lapses in tax incentives; by transfer pricing adjustments, including the effect of acquisitions on our intercompany R&D cost-sharing arrangement and legal structure; by tax effects of nondeductible compensation; by tax costs related to intercompany realignments; by changes in accounting principles; or by changes in tax laws and regulations, treaties, or interpretations thereof, including possible changes to the taxation of earnings of our foreign subsidiaries, the deductibility of expenses attributable to foreign income, or the foreign tax credit rules. Significant judgment is required to determine the recognition and measurement attributes prescribed in the accounting guidance for uncertainty in income taxes. The Organisation for Economic Co-operation

and Development (OECD), an international association comprised of 34 countries, including the United States, is contemplating changes to numerous long-standing tax principles. These contemplated changes, if finalized and adopted by countries, will increase tax uncertainty and may adversely affect our provision for income taxes. As a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service (IRS) and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse impact on our operating results and financial condition.

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## CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## RESULTS OF OPERATIONS

## Revenue

The following table presents the breakdown of revenue between product and service (in millions, except percentages):

	Three Months Ended				
	October 25, 2014	October 26, 2013	Variance in Dollars	Variance in Percent	
Revenue:					
Product	\$9,435	\$9,397	\$38	0.4	%
Percentage of revenue	77.1	% 77.8	%		
Service	2,810	2,688	122	4.5	%
Percentage of revenue	22.9	% 22.2	%		
Total	\$12,245	\$12,085	\$160	1.3	%

We manage our business primarily on a geographic basis, organized into three geographic segments. Our revenue, which includes product and service for each segment, is summarized in the following table (in millions, except percentages):

	Three Months Ended				
	October 25, 2014	October 26, 2013	Variance in Dollars	Variance in Percent	
Revenue:					
Americas	\$7,501	\$7,316	\$185	2.5	%
Percentage of revenue	61.3	% 60.5	%		
EMEA	3,002	2,933	69	2.4	%
Percentage of revenue	24.5	% 24.3	%		
APJC	1,742	1,836	(94)	(5.1)	)%
Percentage of revenue	14.2	% 15.2	%		
Total	\$12,245	\$12,085	\$160	1.3	%

## Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

For the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, total revenue increased by 1%.

Product revenue was flat, while service revenue increased by 5%. Our total revenue reflected growth in our Americas and EMEA geographic segments, while revenue declined in the APJC segment. The emerging countries of BRICM, in the aggregate, experienced a 7% product revenue decline, with declines in China and Russia only partially offset by increases in the other three countries.

We conduct business globally in numerous currencies. The direct effect of foreign currency fluctuations on revenue has not been material because our revenue is primarily denominated in U.S. dollars. However, if the U.S. dollar strengthens relative to other currencies, such strengthening could have an indirect effect on our revenue to the extent it raises the cost of our products to non-U.S. customers and thereby reduces demand. A weaker U.S. dollar could have the opposite effect. However, the precise indirect effect of currency fluctuations is difficult to measure or predict because our revenue is influenced by many factors in addition to the impact of such currency fluctuations. Our revenue in first quarter of fiscal 2015 may have been adversely affected by the depreciation of the local currency relative to the U.S. dollar in certain emerging countries, although as noted above, such indirect effects are difficult to measure.

In addition to the impact of macroeconomic factors, such as a reduced IT spending environment and budget-driven reductions in spending by government entities, revenue by segment in a particular period may be significantly impacted by several factors related to revenue recognition, including the complexity of transactions such as multiple-element arrangements; the mix of financing arrangements provided to our channel partners and customers; and final acceptance of the product, system, or solution, among other factors. In addition, certain customers tend to

make large and sporadic purchases, and the revenue related to these transactions may also be affected by the timing of revenue recognition, which in turn would impact the revenue of the relevant segment. As has been the case in certain of our emerging countries from time to time, customers require greater levels of financing arrangements, service, and support, and these activities may occur in future periods, which may also impact the timing of the recognition of revenue.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Product Revenue by Segment

The following table presents the breakdown of product revenue by segment (in millions, except percentages):

	Three Months Ended		Variance in Dollars	Variance in Percent	
	October 25, 2014	October 26, 2013			
Product revenue:					
Americas	\$5,684	\$5,533	\$151	2.7	%
Percentage of product revenue	60.2	% 58.9	%		
EMEA	2,396	2,381	15	0.6	%
Percentage of product revenue	25.4	% 25.3	%		
APJC	1,355	1,483	(128)	(8.6)	)%
Percentage of product revenue	14.4	% 15.8	%		
Total	\$9,435	\$9,397	\$38	0.4	%

Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

## Americas

Product revenue in the Americas segment increased by 3%, led by solid growth in the public sector market and, to a lesser extent, growth in the commercial and enterprise markets. Product revenue increased in the U.S. public sector market, led by higher sales to the U.S. federal government. Within the Americas segment, we continued to experience a product revenue decline in the service provider market. From a country perspective, product revenue increased by 3% in the United States, 1% in Canada, 12% in Mexico and 8% in Brazil, partially offset by product revenue declines in certain countries within Latin America.

## EMEA

Product revenue in the EMEA segment increased by 1%, led by growth in the commercial market and, to a lesser extent, growth in the service provider market. We experienced product revenue declines in the enterprise and public sector markets. Product revenue from emerging countries within EMEA decreased by 5%, led by a 22% decrease in Russia. Product revenue for the remainder of EMEA, which primarily comprises countries in western Europe, grew by 3%.

## APJC

Product revenue in the APJC segment decreased by 9%. The decrease in product revenue was across all customer markets, led by a significant decline in the service provider market. From a country perspective, product revenue decreased in China, Australia, and Japan by 24%, 13%, and 4%, respectively. These decreases were partially offset by an increase in product revenue of 27% in India.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Product Revenue by Groups of Similar Products

In addition to the primary view on a geographic basis, we also prepare financial information related to groups of similar products and customer markets for various purposes. Our product categories consist of the following categories (with subcategories in parentheses): Switching (fixed switching, modular switching, and storage); NGN Routing (high-end routers, mid-range and low-end routers, and other NGN Routing products); Collaboration (unified communications, Cisco TelePresence, and conferencing); Service Provider Video (infrastructure, video software and solutions); Data Center; Wireless; Security; and Other Products. The Other Products category consists primarily of emerging technology products and other networking products.

The following table presents revenue for groups of similar products (in millions, except percentages):

	Three Months Ended				
	October 25, 2014	October 26, 2013	Variance in Dollars	Variance in Percent	
Product revenue:					
Switching	\$3,846	\$3,740	\$106	2.8	%
Percentage of product revenue	40.8	% 39.8	%		
NGN Routing	1,949	2,026	(77)	(3.8)	)%
Percentage of product revenue	20.7	% 21.6	%		
Collaboration	949	1,051	(102)	(9.7)	)%
Percentage of product revenue	10.1	% 11.2	%		
Service Provider Video	871	987	(116)	(11.8)	)%
Percentage of product revenue	9.2	% 10.5	%		
Data Center	693	601	92	15.3	%
Percentage of product revenue	7.3	% 6.4	%		
Wireless	605	547	58	10.6	%
Percentage of product revenue	6.4	% 5.8	%		
Security	455	365	90	24.7	%
Percentage of product revenue	4.8	% 3.9	%		
Other	67	80	(13)	(16.3)	)%
Percentage of product revenue	0.7	% 0.8	%		
Total	\$9,435	\$9,397	\$38	0.4	%

Certain reclassifications have been made to the prior period amounts to conform to the current period's presentation.

Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

## Switching

Revenue in our Switching product category increased by 3%, or \$106 million, driven by a 7%, or \$170 million, increase in revenue from our LAN fixed-configuration switches. Revenue from our LAN fixed-configuration switches increased due to the continued adoption of Cisco Catalyst 3650 Series Switches and Cisco Catalyst 3850 Series Switches. Higher revenue from fixed-configuration Cisco Nexus Series Switches also contributed to the increase. We also experienced a 63%, or \$60 million, increase in sales of storage products within this category. Partially offsetting these increases was a decrease in revenue from our modular switches of 9%, or \$124 million, due primarily to lower sales of Cisco Catalyst 6500-E Series Switches.

## NGN Routing

The decrease in revenue in our NGN Routing product category of 4%, or \$77 million, was driven by a 39%, or \$70 million, decrease in revenue from what we categorize as other NGN Routing products and a 7%, or \$49 million, decrease in revenue from our midrange and low-end router products. These decreases were partially offset by a 4%, or \$42 million, increase in revenue from our high-end products. Revenue from other NGN Routing products decreased due to lower sales of certain optical networking products. The decrease in revenue from our midrange and low-end



router products was due to lower sales of our Cisco Integrated Services Routers products. Within the high-end router product category, we experienced increased sales of mobility products within our Cisco Aggregation Services Routers category and the adoption of our Cisco Network Convergence System platform partially offset by lower sales of Cisco Carrier Routing System products and our legacy high-end router products.

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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Collaboration

Overall, revenue in our Collaboration product category decreased by 10%, or \$102 million, primarily due to decreased revenue from our Cisco TelePresence and Unified Communications products, driven by lower revenue in endpoint products such as phones. These decreases were partially offset by higher revenue from our conferencing products. We continue to increase the amount of deferred revenue related to our Collaboration product category.

Service Provider Video

Revenue in our Service Provider Video product category decreased by 12%, or \$116 million, driven by a decrease in sales of our Service Provider Video infrastructure products. The revenue decline in Service Provider Video infrastructure products was due to a decrease in revenue from connected devices and cable access products. The decrease in revenue from connected devices products was due primarily to lower sales of set-top boxes.

Data Center

We continue to experience solid growth in our Data Center product category, which grew by 15%, or \$92 million, with sales growth of our Cisco Unified Computing System products occurring across most geographic segments and customer markets. The increase was due in large part to the continued momentum we are experiencing in both data center and cloud environments, as current customers increase their data center build-outs and as new customers deploy these offerings.

Wireless

Revenue in our Wireless product category increased by 11%, or \$58 million, driven by continued growth in our 802.11ac portfolio and an increase in sales of Meraki products. We continue to increase the proportion of recurring revenue in our Wireless product category.

Security

Revenue in our Security product category experienced growth of 25%, or \$90 million, driven by higher network security sales as we combined products from Sourcefire, which we acquired in the first quarter of fiscal 2014, more closely with our other products. We continue to increase the proportion of recurring revenue in our Security product category.

Other Products

We experienced a year-over-year decrease in revenue in our Other Products category, due in large part to the decrease in sales of our other networking products.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Service Revenue by Segment

The following table presents the breakdown of service revenue by segment (in millions, except percentages):

	Three Months Ended				
	October 25, 2014	October 26, 2013	Variance in Dollars	Variance in Percent	
Service revenue:					
Americas	\$1,817	\$1,783	\$34	1.9	%
Percentage of service revenue	64.6	% 66.4	%		
EMEA	606	552	54	9.8	%
Percentage of service revenue	21.6	% 20.5	%		
APJC	387	353	34	9.6	%
Percentage of service revenue	13.8	% 13.1	%		
Total	\$2,810	\$2,688	\$122	4.5	%

## Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

Service revenue experienced growth across all of our geographic segments. Worldwide technical support services revenue increased by 5% while worldwide advanced services revenue increased by 3% driven by growth in subscription revenues. Technical support service revenue experienced growth across all geographic segments, led by solid growth in our APJC segment. Renewals and technical support service contract initiations associated with product sales provided an installed base of equipment being serviced which, in concert with new service offerings, were the primary factors driving the revenue increases. Advanced services revenue, which relates to consulting support services for specific customer network needs, experienced strong growth in our EMEA segment, increased slightly in our APJC segment, and decreased slightly in our Americas segment.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Gross Margin

The following table presents the gross margin for products and services (in millions, except percentages):

	Three Months Ended					
	AMOUNT		PERCENTAGE			
	October 25, 2014	October 26, 2013	October 25, 2014		October 26, 2013	
Gross margin:						
Product	\$5,516	\$5,650	58.5	%	60.1	%
Service	1,817	1,757	64.7	%	65.4	%
Total	\$7,333	\$7,407	59.9	%	61.3	%

## Product Gross Margin

The following table summarizes the key factors that contributed to the change in product gross margin percentage for the first quarter of fiscal 2015 as compared with the corresponding prior year period:

	Product Gross Margin Percentage	
First Quarter of Fiscal 2014	60.1	%
Product pricing	(2.5	)%
Rockstar patent portfolio charge	(2.0	)%
Amortization of purchased intangible assets	(0.1	)%
Mix of products sold	0.9	%
Productivity <sup>(1)</sup>	2.1	%
First Quarter of Fiscal 2015	58.5	%

<sup>(1)</sup> Productivity includes overall manufacturing-related costs, shipment volume, and other items not categorized elsewhere.

Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

Product gross margin decreased by 1.6 percentage points compared with the first quarter of fiscal 2014.

The decrease in product gross margin was driven by unfavorable impacts from product pricing, which were driven by typical market factors and impacted each of our geographic segments and customer markets. The decrease was also due to a charge of \$188 million to product cost of sales recorded in the first quarter fiscal 2015 related to the Rockstar patent portfolio. Our product gross margin for the first quarter of fiscal 2015 was also negatively impacted by higher amortization expense from purchased intangible assets.

These amounts were partially offset by benefits from productivity and the mix of products sold. The productivity benefits we experienced in the first quarter of fiscal 2015 were driven by value engineering efforts; favorable component pricing; continued operational efficiency in manufacturing operations; and lower warranty expense. Value engineering is the process by which production costs are reduced through component redesign, board configuration, test processes, and transformation processes. The shift in the mix of products sold increased our product gross margin, primarily as a result of a revenue increase from certain of our higher margin core products and decreased revenue from our relatively lower margin Service Provider Video products, partially offset by a revenue increase in our relatively lower margin Cisco Unified Computing System products.

Our future gross margins could be impacted by our product mix and could be adversely affected by further growth in sales of products that have lower gross margins, such as Cisco Unified Computing System products. Our gross margins may also be impacted by the geographic mix of our revenue and may be adversely affected by product pricing attributable to competitive factors. Additionally, our manufacturing-related costs may be negatively impacted by constraints in our supply chain, which in turn could negatively affect gross margin. If any of the preceding factors that in the past have negatively impacted our gross margins arise in future periods, our gross margins could continue to

decline.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Service Gross Margin

Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

Our service gross margin percentage decreased by 0.7 percentage points for the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, driven by increased cost impacts such as partner delivery costs and headcount-related costs. These cost impacts were partially offset by the resulting benefit to gross margin of higher sales volume in both advanced services and technical support services.

Our service gross margin normally experiences some fluctuations due to various factors such as the timing of contract initiations in our renewals, our strategic investments in headcount, and the resources we deploy to support the overall service business. Other factors include the mix of service offerings, as the gross margin from our advanced services is typically lower than the gross margin from technical support services.

## Gross Margin by Segment

The following table presents the total gross margin for each segment (in millions, except percentages):

	Three Months Ended		PERCENTAGE		
	AMOUNT				
	October 25,	October 26,	October 25,	October 26,	
	2014	2013	2014	2013	
Gross margin:					
Americas	\$4,810	\$4,650	64.1	% 63.6	%
EMEA	1,915	1,888	63.8	% 64.4	%
APJC	1,025	1,079	58.8	% 58.8	%
Segment total	7,750	7,617	63.3	% 63.0	%
Unallocated corporate items <sup>(1)</sup>	(417)	(210)			
Total	\$7,333	\$7,407	59.9	% 61.3	%

<sup>(1)</sup> The unallocated corporate items for the periods presented include the effects of amortization and impairments of acquisition-related intangible assets, share-based compensation expense, significant litigation and other contingencies, and certain other charges. We do not allocate these items to the gross margin for each segment because management does not include such information in measuring the performance of the operating segments.

Three Months Ended October 25, 2014 Compared with Three Months Ended October 26, 2013

The Americas segment experienced a gross margin percentage increase due to productivity improvements from lower overall manufacturing costs and, to a lesser extent, a favorable mix impact. The favorable mix impact in this geographic segment was driven by lower sales of our relatively lower margin Service Provider Video products and an increase in revenue from certain of our higher margin core products, partially offset by an increase in revenue from our relatively lower margin Cisco Unified Computing System products. Partially offsetting these favorable impacts to gross margin were negative impacts from pricing.

The gross margin percentage decrease in our EMEA segment was due primarily to the unfavorable impacts from pricing, as well as an unfavorable mix impact, partially offset by productivity improvements in this geographic segment. The unfavorable mix impact was driven by an increase in revenue from our lower margin Cisco Unified Computing System products.

Our APJC segment gross margin percentage was unchanged, as a favorable impact of mix and productivity improvements offset the unfavorable impacts from pricing. The favorable mix impact was driven by an increase in revenue from certain of our higher margin core products and a decrease in revenue from our relatively lower margin Service Provider Video products.

The gross margin percentage for a particular segment may fluctuate, and period-to-period changes in such percentages may or may not be indicative of a trend for that segment. Our product and service gross margins may be impacted by economic downturns or uncertain economic conditions as well as our movement into new market opportunities, and could decline if any of the factors that impact our gross margins are adversely affected in future periods.



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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Factors That May Impact Revenue and Gross Margin

Product revenue may continue to be affected by factors, including global economic downturns and related market uncertainty, that have resulted in reduced IT-related capital spending in certain segments within our enterprise, service provider, public sector, and commercial markets; changes in the geopolitical environment and global economic conditions; competition, including price-focused competitors from Asia, especially from China; new product introductions; sales cycles and product implementation cycles; changes in the mix of our customers between service provider and enterprise markets; changes in the mix of direct sales and indirect sales; variations in sales channels; and final acceptance criteria of the product, system, or solution as specified by the customer. Sales to the service provider market have been and may be in the future characterized by large and sporadic purchases, especially relating to our router sales and sales of certain products within our Collaboration, Data Center, and Service Provider Video product categories. In addition, service provider customers typically have longer implementation cycles; require a broader range of services, including network design services; and often have acceptance provisions that can lead to a delay in revenue recognition. Certain of our customers in certain emerging countries also tend to make large and sporadic purchases, and the revenue related to these transactions may similarly be affected by the timing of revenue recognition. As we focus on new market opportunities, customers may require greater levels of financing arrangements, service, and support, especially in certain emerging countries, which in turn may result in a delay in the timing of revenue recognition. To improve customer satisfaction, we continue to focus on managing our manufacturing lead-time performance, which may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter revenue and operating results.

Product revenue may also be adversely affected by fluctuations in demand for our products, especially with respect to telecommunications service providers and Internet businesses, whether or not driven by any slowdown in capital expenditures in the service provider market; price and product competition in the communications and information technology industry; introduction and market acceptance of new technologies and products; adoption of new networking standards; and financial difficulties experienced by our customers. We may, from time to time, experience manufacturing issues that create a delay in our suppliers' ability to provide specific components, resulting in delayed shipments. To the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods when we and our suppliers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters are not remediated within the same quarter. For additional factors that may impact product revenue, see "Part II, Item 1A. Risk Factors."

Our distributors participate in various cooperative marketing and other programs. Increased sales to our distributors generally result in greater difficulty in forecasting the mix of our products and, to a certain degree, the timing of orders from our customers. We recognize revenue for sales to our distributors generally based on a sell-through method using information provided by them, and we maintain estimated accruals and allowances for all cooperative marketing and other programs.

Product gross margin may be adversely affected in the future by changes in the mix of products sold, including periods of increased growth of some of our lower margin products; introduction of new products, including products with price-performance advantages and new business models for our offerings such as other-as-a-service ("XaaS"); our ability to reduce production costs; entry into new markets, including markets with different pricing structures and cost structures, as a result of internal development or through acquisitions; changes in distribution channels; price competition, including competitors from Asia, especially those from China; changes in geographic mix of our product revenue; the timing of revenue recognition and revenue deferrals; sales discounts; increases in material or labor costs, including share-based compensation expense; excess inventory and obsolescence charges; warranty costs; changes in shipment volume; loss of cost savings due to changes in component pricing; effects of value engineering; inventory holding charges; and the extent to which we successfully execute on our strategy and operating plans. Additionally, our manufacturing-related costs may be negatively impacted by constraints in our supply chain. Service gross margin



may be impacted by various factors such as the change in mix between technical support services and advanced services; the timing of technical support service contract initiations and renewals; share-based compensation expense; and the timing of our strategic investments in headcount and resources to support this business.

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## CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Research and Development ("R&D"), Sales and Marketing, and General and Administrative ("G&A") Expenses  
R&D, sales and marketing, and G&A expenses are summarized in the following table (in millions, except percentages):

	Three Months Ended				
	October 25, 2014	October 26, 2013	Variance in Dollars	Variance in Percent	
Research and development	\$1,583	\$1,724	\$(141)	(8.2)	%
Percentage of revenue	12.9	% 14.3	%		
Sales and marketing	2,515	2,411	104	4.3	%
Percentage of revenue	20.5	% 20.0	%		
General and administrative	504	515	(11)	(2.1)	%
Percentage of revenue	4.1	% 4.3	%		
Total	\$4,602	\$4,650	\$(48)	(1.0)	%
Percentage of revenue	37.6	% 38.5	%		

**R&D Expenses**

R&D expenses decreased for the first quarter of fiscal 2015, as compared with the corresponding period in fiscal 2014, primarily due to compensation expense recorded in the first quarter of fiscal 2014 in connection with our acquisition of the remaining interest in Insieme. See Note 12 to the Consolidated Financial Statements. Efficiencies related to our restructuring actions also contributed to the decrease.

We continue to invest in R&D in order to bring a broad range of products to market in a timely fashion. If we believe that we are unable to enter a particular market in a timely manner with internally developed products, we may purchase or license technology from other businesses, or we may partner with or acquire businesses as an alternative to internal R&D.

**Sales and Marketing Expenses**

Sales and marketing expenses increased for the first quarter of fiscal 2015, as compared with the corresponding period in fiscal 2014, due to higher discretionary spending, higher headcount-related expenses and higher share-based compensation expense.

**G&A Expenses**

G&A expenses decreased in the first quarter of fiscal 2015, as compared with the corresponding period in fiscal 2014, primarily due to compensation expense recorded in the first quarter of fiscal 2014 in connection with our acquisition of the remaining interest in Insieme and due to lower discretionary spending and lower contracted services in the first quarter of fiscal 2015. Lower headcount-related expenses also contributed to the decrease in G&A expenses. The lower headcount-related expenses were due to efficiencies related to our restructuring actions.

**Effect of Foreign Currency**

In the first quarter of fiscal 2015, foreign currency fluctuations, net of hedging, increased the combined R&D, sales and marketing, and G&A expenses by \$4 million, or approximately 0.1%, compared with the first quarter of fiscal 2014. In the first quarter of fiscal 2014, foreign currency fluctuations, net of hedging, decreased the combined R&D, sales and marketing, and G&A expenses by \$44 million, or approximately 1.0%, compared with the first quarter of fiscal 2013.

**Headcount**

Our headcount decreased by approximately 1,800 employees in the first quarter of fiscal 2015 as compared with the total headcount at the end of fiscal 2014. The decrease was due to headcount reductions from our workforce reduction

under the Fiscal 2015 Plan. These headcount reductions were partially offset by headcount additions from targeted hiring in engineering, services and sales, and also by headcount additions from our recent acquisitions.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Share-Based Compensation Expense

The following table presents share-based compensation expense (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Cost of sales—product	\$11	\$10
Cost of sales—service	37	33
Share-based compensation expense in cost of sales	48	43
Research and development	119	92
Sales and marketing	147	123
General and administrative	59	54
Restructuring and other charges	(4)	(3)
Share-based compensation expense in operating expenses	321	266
Total share-based compensation expense	\$369	\$309

The increase in share-based compensation expense for the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, was due primarily to share-based compensation expense attributable to equity awards assumed with respect to our acquisitions and higher expense associated with the ESPP and PRSUs.

## Amortization of Purchased Intangible Assets

The following table presents the amortization of purchased intangible assets (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Amortization of purchased intangible assets:		
Cost of sales	\$189	\$174
Operating expenses	71	65
Total	\$260	\$239

Amortization of purchased intangible assets increased for the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, due to amortization of purchased intangible assets from our recent acquisitions partially offset by certain purchased intangible assets having become fully amortized.

The fair value of acquired technology and patents, as well as acquired technology under development, is determined at acquisition date primarily using the income approach, which discounts expected future cash flows to present value.

The discount rates used in the present value calculations are typically derived from a weighted-average cost of capital analysis and then adjusted to reflect risks inherent in the development lifecycle as appropriate. We consider the pricing model for products related to these acquisitions to be standard within the high-technology communications industry, and the applicable discount rates represent the rates that market participants would use for valuation of such intangible assets.

## Restructuring and Other Charges

In the first quarter of fiscal 2015, we incurred within operating expenses restructuring and other charges of approximately \$318 million which were related primarily to employee severance charges for employees impacted by our workforce reduction under the Fiscal 2015 Plan. We expect the remaining charges under this plan to be incurred within the remainder of fiscal 2015. We plan to reinvest substantially all of the cost savings from the restructuring actions in key growth areas of our business such as data center, software, security, and cloud.

In the first quarter of fiscal 2014, we incurred within operating expenses net restructuring and other charges of \$237 million, which were related primarily to employee severance charges for employees impacted by our workforce reduction under the Fiscal 2014 Plan. See Note 5 to the Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Operating Income

The following table presents our operating income and our operating income as a percentage of revenue (in millions, except percentages):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Operating income	\$2,342	\$2,455
Operating income as a percentage of revenue	19.1	% 20.3

For the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, operating income decreased by 5%, and as a percentage of revenue operating income decreased by 1.2 percentage points. The decrease resulted from a gross margin percentage decline, driven in part by the Rockstar patent portfolio charge of \$188 million (or 1.5 percentage points) and an increase in restructuring and other charges related to the workforce reduction under the Fiscal 2015 Plan.

## Interest and Other Income (Loss), Net

Interest Income (Expense), Net The following table summarizes interest income and interest expense (in millions):

	Three Months Ended		
	October 25, 2014	October 26, 2013	Variance
Interest income	\$179	\$169	\$10
Interest expense	(139	) (140	) 1
Interest income (expense), net	\$40	\$29	\$11

Interest income increased in the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, primarily due to the increase in our portfolio of cash, cash equivalents, and fixed income investments. Interest expense in the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, was relatively flat.

Other Income (Loss), Net The components of other income (loss), net, are summarized as follows (in millions):

	Three Months Ended		
	October 25, 2014	October 26, 2013	Variance
Gains (losses) on investments, net:			
Publicly traded equity securities	\$(4	) \$75	\$(79
Fixed income securities	11	8	3
Total available-for-sale investments	7	83	(76
Privately held companies	(33	) (31	) (2
Net gains (losses) on investments	(26	) 52	(78
Other gains (losses), net	4	4	—
Other income (loss), net	\$(22	) \$56	\$(78

The decrease in total net gains on available-for-sale investments in the first quarter of fiscal 2015, compared with the first quarter of fiscal 2014, was primarily attributable to losses on publicly traded equity securities in the current period as a result of market conditions and the timing of sales of these securities.

The change in net losses on investments in privately held companies for the first quarter of fiscal 2015, as compared with the first quarter of fiscal 2014, was primarily due to higher net losses recognized from our equity method investments, partially offset by higher realized gains from various investments in privately held companies.

Other gains (losses), net was flat in the first quarter of fiscal 2015 as compared with the first quarter of fiscal 2014, as favorable foreign exchange impacts were offset by unfavorable impacts from equity derivatives.

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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Provision for Income Taxes

Our provision for income taxes is subject to volatility and could be adversely impacted by earnings being lower than anticipated in countries that have lower tax rates, higher than anticipated in countries that have higher tax rates, and expiration of or lapses in tax incentives. Our provision for income taxes does not include provisions for U.S. income taxes and foreign withholding taxes associated with the repatriation of undistributed earnings of certain foreign subsidiaries that we intend to reinvest indefinitely in our foreign subsidiaries. If these earnings were distributed from the foreign subsidiaries to the United States in the form of dividends or otherwise, or if the shares of the relevant foreign subsidiaries were sold or otherwise transferred, we would be subject to additional U.S. income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. The provision for income taxes resulted in an effective tax rate of 22.5% for the first quarter of fiscal 2015, compared with 21.4% for the first quarter of fiscal 2014. The net 1.1 percentage point increase in the effective tax rate for the first quarter of fiscal 2015 was primarily due to expiration of the U.S. federal R&D tax credit and a decrease in foreign income taxed at other than U.S. tax rates.

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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## LIQUIDITY AND CAPITAL RESOURCES

The following sections discuss the effects of changes in our balance sheet, our capital allocation strategy including stock repurchase program and dividends, our contractual obligations, and certain other commitments and activities on our liquidity and capital resources.

## Balance Sheet and Cash Flows

Cash and Cash Equivalents and Investments The following table summarizes our cash and cash equivalents and investments (in millions):

	October 25, 2014	July 26, 2014	Increase (Decrease)	
Cash and cash equivalents	\$4,387	\$6,726	\$(2,339)	)
Fixed income securities	45,923	43,396	2,527	
Publicly traded equity securities	1,797	1,952	(155)	)
Total	\$52,107	\$52,074	\$33	

The slight net increase in cash and cash equivalents and investments in the first quarter of fiscal 2015 was primarily the result of cash provided by operating activities of \$2.5 billion and proceeds from the issuance of common stock of \$0.4 billion pursuant to employee stock incentive plans. These sources of cash were substantially offset by the repurchase of common stock of \$1.1 billion under the stock repurchase program, cash dividends paid of \$1.0 billion, capital expenditures of \$0.3 billion, and net cash paid for acquisitions of \$0.2 billion.

Our total in cash and cash equivalents and investments held by various foreign subsidiaries was \$48.3 billion and \$47.4 billion as of October 25, 2014 and July 26, 2014, respectively. Under current tax laws and regulations, if these assets were to be distributed from the foreign subsidiaries to the United States in the form of dividends or otherwise, we would be subject to additional U.S. income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes. The balance of cash and cash equivalents and investments available in the United States as of October 25, 2014 and July 26, 2014 was \$3.8 billion and \$4.7 billion, respectively.

We maintain an investment portfolio of various holdings, types, and maturities. We classify our investments as short-term investments based on their nature and their availability for use in current operations. We believe the overall credit quality of our portfolio is strong, with our cash equivalents and our fixed income investment portfolio consisting primarily of high quality investment-grade securities. We believe that our strong cash and cash equivalents and investments position allows us to use our cash resources for strategic investments to gain access to new technologies, for acquisitions, for customer financing activities, for working capital needs, and for the repurchase of shares of common stock and payment of dividends as discussed below.

Free Cash Flow and Capital Allocation As part of our capital allocation strategy, we intend to return a minimum of 50% of our free cash flow annually to our shareholders through cash dividends and repurchases of common stock.

We define free cash flow as net cash provided by operating activities less cash used to acquire property and equipment. The following table reconciles our net cash provided by operating activities to free cash flow (in millions):

	Three Months Ended	
	October 25, 2014	October 26, 2013
Net cash provided by operating activities	\$2,491	\$2,649
Acquisition of property and equipment	(285)	(315)
Free cash flow	\$2,206	\$2,334

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, the rate at which products are shipped during the quarter (which we refer to as shipment linearity), the timing and collection of accounts receivable and financing receivables, inventory and supply chain management, deferred revenue, excess tax benefits resulting from share-based compensation, and the timing and amount of tax and other payments. For additional discussion, see "Part II, Item 1A. Risk Factors" in this report.

We consider free cash flow to be a liquidity measure that provides useful information to management and investors because of our intent to return a stated percentage of free cash flow to shareholders in the form of dividends and stock repurchases. We further regard free cash flow as a useful measure because it reflects cash that can be used to, among other things, invest in our business,

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## CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

make strategic acquisitions, repurchase common stock, and pay dividends on our common stock, after deducting capital investments. A limitation of the utility of free cash flow as a measure of financial performance and liquidity is that the free cash flow does not represent the total increase or decrease in our cash balance for the period. In addition, we have other required uses of cash, including repaying the principal of our outstanding indebtedness. Free cash flow is not a measure calculated in accordance with U.S. generally accepted accounting principles and should not be regarded in isolation or as an alternative for net income provided by operating activities or any other measure calculated in accordance with such principles, and other companies may calculate free cash flow in a different manner than we do.

The following table summarizes the dividends paid and stock repurchases (in millions, except per-share amounts):

	DIVIDENDS		STOCK REPURCHASE PROGRAM			
Quarter Ended	Per Share	Amount	Shares	Weighted-Average Price per Share	Amount	TOTAL
Fiscal 2015						
October 25, 2014	\$0.19	\$973	41	\$ 24.58	\$1,013	\$1,986
Fiscal 2014						
July 26, 2014	\$0.19	\$974	61	\$ 25.11	\$1,514	\$2,488
April 26, 2014	\$0.19	\$974	90	\$ 22.24	\$2,005	\$2,979
January 25, 2014	\$0.17	\$896	185	\$ 21.73	\$4,020	\$4,916
October 26, 2013	\$0.17	\$914	84	\$ 23.65	\$2,000	\$2,914

Any future dividends will be subject to the approval of our Board of Directors.

Accounts Receivable, Net The following table summarizes our accounts receivable, net (in millions), and DSO:

	October 25, 2014	July 26, 2014	Increase (Decrease)
Accounts receivable, net	\$4,375	\$5,157	\$(782)
DSO	33	38	(5)

Our accounts receivable net, as of October 25, 2014 decreased by approximately 15% compared with the end of fiscal 2014. Our DSO as of October 25, 2014 was lower by 5 days compared with the end of fiscal 2014, primarily due to service and product billings being more linear in the first quarter of fiscal 2015 compared with the fourth quarter of fiscal 2014.

Inventory Supply Chain The following table summarizes our inventories and purchase commitments with contract manufacturers and suppliers (in millions, except annualized inventory turns):

	October 25, 2014	July 26, 2014	Increase (Decrease)
Inventories	\$1,676	\$1,591	\$85
Annualized inventory turns	12.0	12.7	(0.7)
Purchase commitments with contract manufacturers and suppliers	\$4,299	\$4,169	\$130

Inventory as of October 25, 2014 increased by 5% from our inventory balance at the end of fiscal 2014, and for the same period purchase commitments with contract manufacturers and suppliers increased by approximately 3%. On a combined basis, inventories and purchase commitments with contract manufacturers and suppliers increased by 4% compared with the end of fiscal 2014. We believe our inventory and purchase commitments levels are in line with our current demand forecasts.

Our finished goods consist of distributor inventory and deferred cost of sales and manufactured finished goods.

Distributor inventory and deferred cost of sales are related to unrecognized revenue on shipments to distributors and retail partners as well as shipments to customers. Manufactured finished goods consist primarily of build-to-order and

build-to-stock products.

We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements and our commitment to securing manufacturing capacity. A significant portion of our reported purchase commitments arising from these agreements are firm,

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

noncancelable, and unconditional commitments. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. Our purchase commitments are for short-term product manufacturing requirements as well as for commitments to suppliers to secure manufacturing capacity.

We record a liability, included in other current liabilities, for firm, noncancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory. The purchase commitments for inventory are expected to be primarily fulfilled within one year. Inventory and supply chain management remain areas of focus as we balance the need to maintain supply chain flexibility to help ensure competitive lead times with the risk of inventory obsolescence because of rapidly changing technology and customer requirements. We believe the amount of our inventory and purchase commitments is appropriate for our revenue levels.

**Financing Receivables and Guarantees** We measure our net balance sheet exposure position related to our financing receivables and financing guarantees by reducing the total of gross financing receivables and financing guarantees by the associated allowances for credit loss and deferred revenue. As of October 25, 2014, our net balance sheet exposure position related to financing receivables and financing guarantees was as follows (in millions):

	FINANCING RECEIVABLES				FINANCING GUARANTEES			
	Lease Receivables	Loan Receivables	Financed Service Contracts and Other	Total	Channel Partner	End-User Customers	Total	TOTAL
October 25, 2014								
Financing receivables less unearned income	\$3,509	\$ 1,744	\$ 3,071	\$8,324	\$285	\$ 161	\$446	\$8,770
Allowance for credit loss	(248 )	(84 )	(36 )	(368 )	—	—	—	(368 )
Deferred revenue	(10 )	(4 )	(1,672 )	(1,686 )	(126 )	(130 )	(256 )	(1,942 )
Net balance sheet exposure	\$3,251	\$ 1,656	\$ 1,363	\$6,270	\$159	\$ 31	\$190	\$6,460

**Financing Receivables** Financing receivables less unearned income decreased by 1% compared with the end of fiscal 2014. The change was primarily due to a 1% decrease in lease receivables and 4% decrease in financed service contracts and other, partially offset by a 4% increase in loan receivables. We provide financing to certain end-user customers and channel partners to enable sales of our products, services, and networking solutions. These financing arrangements include leases, financed service contracts, and loans. Arrangements related to leases are generally collateralized by a security interest in the underlying assets. Lease receivables include sales-type and direct-financing leases. We also provide certain qualified customers financing for long-term service contracts, which primarily relate to technical support services and advanced services. Our loan financing arrangements may include not only financing the acquisition of our products and services but also providing additional funds for other costs associated with network installation and integration of our products and services. We expect to continue to expand the use of our financing programs in the near term.

**Financing Guarantees** In the normal course of business, third parties may provide financing arrangements to our customers and channel partners under financing programs. The financing arrangements to customers provided by third parties are related to leases and loans and typically have terms of up to three years. In some cases, we provide guarantees to third parties for these lease and loan arrangements. The financing arrangements to channel partners consist of revolving short-term financing provided by third parties, generally with payment terms ranging from 60 to 90 days. In certain instances, these financing arrangements result in a transfer of our receivables to the third party. The receivables are derecognized upon transfer, as these transfers qualify as true sales, and we receive payments for the receivables from the third party based on our standard payment terms. These financing arrangements facilitate the working capital requirements of the channel partners, and in some cases, we guarantee a portion of these arrangements. We could be called upon to make payments under these guarantees in the event of nonpayment by the

channel partners or end-user customers. Historically, our payments under these arrangements have been immaterial. Where we provide a guarantee, we defer the revenue associated with the channel partner and end-user financing arrangement in accordance with revenue recognition policies, or we record a liability for the fair value of the guarantees. In either case, the deferred revenue is recognized as revenue when the guarantee is removed.

**Deferred Revenue Related to Financing Receivables and Guarantees** The majority of the deferred revenue in the preceding table is related to financed service contracts. The majority of the revenue related to financed service contracts, which primarily relates to technical support services, is deferred as the revenue related to financed service contracts is recognized ratably over the period during which the related services are to be performed. A portion of the revenue related to lease and loan receivables is also deferred and included in deferred product revenue based on revenue recognition criteria not currently having been met.

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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Borrowings

Senior Notes The following table summarizes the principal amount of our senior notes (in millions):

	Maturity Date	October 25, 2014	July 26, 2014
Senior notes:			
Floating-rate notes:			
Three-month LIBOR plus 0.05%	September 3, 2015	\$850	\$850
Three-month LIBOR plus 0.28%	March 3, 2017	1,000	1,000
Three-month LIBOR plus 0.50%	March 1, 2019	500	500
Fixed-rate notes:			
2.90%	November 17, 2014	500	500
5.50%	February 22, 2016	3,000	3,000
1.10%	March 3, 2017	2,400	2,400
3.15%	March 14, 2017	750	750
4.95%	February 15, 2019	2,000	2,000
2.125%	March 1, 2019	1,750	1,750
4.45%	January 15, 2020	2,500	2,500
2.90%	March 4, 2021	500	500
3.625%	March 4, 2024	1,000	1,000
5.90%	February 15, 2039	2,000	2,000
5.50%	January 15, 2040	2,000	2,000
Total		\$20,750	\$20,750

Interest is payable semiannually on each class of the senior fixed-rate notes, each of which is redeemable by us at any time, subject to a make-whole premium. Interest is payable quarterly on the floating-rate notes. We were in compliance with all debt covenants as of October 25, 2014.

On November 17, 2014, upon the maturity of our 2014 Fixed-Rate Notes (2.90%), we repaid an aggregate principal amount of \$500 million.

**Other Debt** Other debt as of October 25, 2014 and July 26, 2014 included secured borrowings associated with customer financing arrangements. The amount of borrowings outstanding under these arrangements was \$9 million and \$12 million as of October 25, 2014 and July 26, 2014, respectively.

**Commercial Paper** In fiscal 2011, we established a short-term debt financing program of up to \$3.0 billion through the issuance of commercial paper notes. We use the proceeds from the issuance of commercial paper notes for general corporate purposes. We had no commercial paper notes outstanding as of each of October 25, 2014 and July 26, 2014.

**Credit Facility** On February 17, 2012, we entered into a credit agreement with certain institutional lenders that provides for a \$3.0 billion unsecured revolving credit facility that is scheduled to expire on February 17, 2017. Any advances under the credit agreement will accrue interest at rates that are equal to, based on certain conditions, either (i) the higher of the Federal Funds rate plus 0.50%, Bank of America's "prime rate" as announced from time to time, or one-month LIBOR plus 1.00% or (ii) LIBOR plus a margin that is based on our senior debt credit ratings as published by Standard & Poor's Financial Services, LLC and Moody's Investors Service, Inc. The credit agreement requires that we comply with certain covenants, including that we maintain an interest coverage ratio as defined in the agreement. As of October 25, 2014, we were in compliance with the required interest coverage ratio and the other covenants, and we had not borrowed any funds under the credit facility.

We may also, upon the agreement of either the existing lenders or additional lenders not currently parties to the agreement, increase the commitments under the credit facility by up to an additional \$2.0 billion and/or extend the expiration date of the credit facility by up to two additional years, or up to February 17, 2019.



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CISCO SYSTEMS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Deferred Revenue The following table presents the breakdown of deferred revenue (in millions):

	October 25, 2014	July 26, 2014	Increase (Decrease)	
Service	\$9,029	\$9,640	\$(611)	)
Product	4,715	4,502	213	)
Total	\$13,744	\$14,142	\$(398)	)
Reported as:				
Current	\$9,449	\$9,478	\$(29)	)
Noncurrent	4,295	4,664	(369)	)
Total	\$13,744	\$14,142	\$(398)	)

The 6% decrease in deferred service revenue in the first quarter of fiscal 2015 as compared with the fourth quarter of fiscal 2014 reflects what, in our view, is a typical seasonal decline as we tend to experience higher service initiations as well as renewals in our fourth quarter. The 5% increase in deferred product revenue was primarily due to increased deferrals related to subscription revenue arrangements and, to a lesser extent, also due to an increase in shipments not having met revenue recognition criteria as of October 25, 2014.

## Contractual Obligations

## Operating Leases

We lease office space in many U.S. locations. Outside the United States, larger leased sites include sites in Belgium, Canada, China, France, Germany, India, Israel, Japan, Norway, and the United Kingdom. We also lease equipment and vehicles. The future minimum lease payments under all of our noncancelable operating leases with an initial term in excess of one year as of October 25, 2014 were \$1.1 billion.

## Other Commitments

In connection with our business combinations and asset purchases, we have agreed to pay certain additional amounts contingent upon the achievement of certain agreed-upon technology, development, product, or other milestones or the continued employment with us of certain employees of the acquired entities. See Note 12 to the Consolidated Financial Statements.

**Insieme Networks, Inc.** In the third quarter of fiscal 2012, we made an investment in Insieme, an early stage company focused on research and development in the data center market. As set forth in the agreement between Cisco and Insieme, this investment included \$100 million of funding and a license to certain of our technology. Immediately prior to the call option exercise and acquisition described below, we owned approximately 83% of Insieme as a result of these investments and have consolidated the results of Insieme in our Consolidated Financial Statements. In connection with this investment, we entered into a put/call option agreement that provided us with the right to purchase the remaining interests in Insieme. In addition, the noncontrolling interest holders could require us to purchase their shares upon the occurrence of certain events.

During the first quarter of fiscal 2014, we exercised our call option and entered into an agreement to purchase the remaining interests in Insieme. The acquisition closed in the second quarter of fiscal 2014, at which time the former noncontrolling interest holders became eligible to receive up to two milestone payments, which will be determined using agreed-upon formulas based primarily on revenue for certain of Insieme's products. During the three months ended October 25, 2014 and October 26, 2013, we recorded compensation expense of \$53 million and \$257 million, respectively, related to the fair value of the vested portion of amounts that are expected to be earned by the former noncontrolling interest holders. Continued vesting and changes to the fair value of the amounts probable of being earned will result in adjustments to the recorded compensation expense in future periods. Based on the terms of the agreement, we have determined that the maximum amount that could be recorded as compensation expense by us is approximately \$853 million, net of forfeitures and including the \$469 million that has been expensed to date. The milestone payments, if earned, are expected to be paid primarily during fiscal 2016 and fiscal 2017.

**Other Funding Commitments** We also have certain funding commitments primarily related to our investments in privately held companies and venture funds, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The funding commitments were \$252 million as of October 25, 2014, compared with \$255 million as of July 26, 2014.



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CISCO SYSTEMS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Off-Balance Sheet Arrangements

We consider our investments in unconsolidated variable interest entities to be off-balance sheet arrangements. In the ordinary course of business, we have investments in privately held companies and provide financing to certain customers. These privately held companies and customers may be considered to be variable interest entities. We evaluate on an ongoing basis our investments in these privately held companies and customer financings, and we have determined that as of October 25, 2014 there were no material unconsolidated variable interest entities.

VCE is a joint venture that we formed in fiscal 2010 with EMC Corporation ("EMC"), with investments from VMware, Inc. ("VMware") and Intel Capital Corporation ("Intel"). VCE helps organizations leverage best-in-class technologies and disciplines from Cisco, EMC, and VMware to enable the transformation to cloud computing. As of October 25, 2014, our cumulative gross investment in VCE was approximately \$716 million, inclusive of accrued interest on convertible notes, and our ownership percentage was approximately 35%. We did not make any investments in VCE during the three months ended October 25, 2014. As of October 25, 2014, we have recorded cumulative losses from VCE under the equity method of \$691 million since inception. Our carrying value in VCE as of October 25, 2014 was \$25 million.

EMC and Cisco have entered into guarantee agreements on behalf of VCE to indemnify certain customers (the "Guarantees"), for monetary damages. Such Guarantees were not material as of October 25, 2014.

In October 2014, Cisco, EMC, VMware and Intel agreed to restructure the VCE joint venture. Under the terms of the agreement, VCE will undergo a reorganization and recapitalization whereby VCE will pay approximately \$150 million to us for a portion of the outstanding principal balance of the convertible notes and accrued interest on such notes. We also agreed to cancel the remaining principal balance of the convertible notes held by us and the accrued interest on such notes, and to have VCE redeem a portion of our equity interest in VCE. EMC also agreed to indemnify Cisco for any liabilities incurred by us under the Guarantees. Following this reorganization and recapitalization, our ownership interest in VCE will be approximately 10%. The transaction is expected to close in the second quarter of our fiscal year 2015, subject to customary regulatory approvals.

On an ongoing basis, we reassess our investments in privately held companies and customer financings to determine if they are variable interest entities and if we would be regarded as the primary beneficiary pursuant to the applicable accounting guidance. As a result of this ongoing assessment, we may be required to make additional disclosures or consolidate these entities. Because we may not control these entities, we may not have the ability to influence these events.

We provide financing guarantees, which are generally for various third-party financing arrangements extended to our channel partners and end-user customers. We could be called upon to make payments under these guarantees in the event of nonpayment by the channel partners or end-user customers. See the previous discussion of these financing guarantees under "Financing Receivables and Guarantees."

Securities Lending

We periodically engage in securities lending activities with certain of our available-for-sale investments. These transactions are accounted for as a secured lending of the securities, and the securities are typically loaned only on an overnight basis. The average daily balance of securities lending for the three months ended October 25, 2014 and October 26, 2013 was \$1.0 billion and \$0.6 billion, respectively. We require collateral equal to at least 102% of the fair market value of the loaned security and that the collateral be in the form of cash or liquid, high-quality assets. We engage in these secured lending transactions only with highly creditworthy counterparties, and the associated portfolio custodian has agreed to indemnify us against collateral losses. As of October 25, 2014 and July 26, 2014, we had no outstanding securities lending transactions. We believe these arrangements do not present a material risk or impact to our liquidity requirements.

Liquidity and Capital Resource Requirements

Based on past performance and current expectations, we believe our cash and cash equivalents, investments, cash generated from operations, and ability to access capital markets and committed credit lines will satisfy, through at

least the next 12 months, our liquidity requirements, both in total and domestically, including the following: working capital needs, capital expenditures, investment requirements, stock repurchases, cash dividends, contractual obligations, commitments, principal and interest payments on debt, future customer financings, and other liquidity requirements associated with our operations. There are no other transactions, arrangements, or relationships with unconsolidated entities or other persons that are reasonably likely to materially affect the liquidity and the availability of, as well as our requirements for, capital resources.

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## Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our financial position is exposed to a variety of risks, including interest rate risk, equity price risk, and foreign currency exchange risk.

## Interest Rate Risk

**Fixed Income Securities** We maintain an investment portfolio of various holdings, types, and maturities. Our primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. At any time, a sharp rise in market interest rates could have a material adverse impact on the fair value of our fixed income investment portfolio. Conversely, declines in interest rates, including the impact from lower credit spreads, could have a material adverse impact on interest income for our investment portfolio. We may utilize derivative instruments designated as hedging instruments to achieve our investment objectives. We had no outstanding hedging instruments for our fixed income securities as of October 25, 2014. Our fixed income investments are held for purposes other than trading. Our fixed income investments are not leveraged as of October 25, 2014. We monitor our interest rate and credit risks, including our credit exposures to specific rating categories and to individual issuers. As of October 25, 2014, approximately 74% of our fixed income securities balance consisted of U.S. government and U.S. government agency securities. We believe the overall credit quality of our portfolio is strong.

**Financing Receivables** As of October 25, 2014, our financing receivables had a carrying value of \$8.0 billion, compared with \$8.1 billion as of July 26, 2014. As of October 25, 2014, a hypothetical 50 basis points (“BPS”) increase or decrease in market interest rates would change the fair value of our financing receivables by a decrease or increase of approximately \$0.1 billion, respectively.

**Debt** As of October 25, 2014, we had \$20.8 billion in principal amount of senior notes outstanding, which consisted of \$2.4 billion floating-rate notes and \$18.4 billion fixed-rate notes. The carrying amount of the senior notes was \$21.0 billion, and the related fair value based on market prices was \$22.4 billion. As of October 25, 2014, a hypothetical 50 BPS increase or decrease in market interest rates would change the fair value of the fixed-rate debt, excluding the \$10.4 billion of hedged debt, by a decrease or increase of approximately \$0.4 billion, respectively. However, this hypothetical change in interest rates would not impact the interest expense on the fixed-rate debt that is not hedged.

## Equity Price Risk

The fair value of our equity investments in publicly traded companies is subject to market price volatility. We may hold equity securities for strategic purposes or to diversify our overall investment portfolio. Our equity portfolio consists of securities with characteristics that most closely match the Standard & Poor’s 500 Index or NASDAQ Composite Index. These equity securities are held for purposes other than trading. To manage our exposure to changes in the fair value of certain equity securities, we may enter into equity derivatives designated as hedging instruments.

**Publicly Traded Equity Securities** The following tables present the hypothetical fair values of publicly traded equity securities as a result of selected potential decreases and increases in the price of each equity security in the portfolio, excluding hedged equity securities, if any. Potential fluctuations in the price of each equity security in the portfolio of plus or minus 10%, 20%, and 30% were selected based on potential near-term changes in those security prices. The hypothetical fair values as of October 25, 2014 and July 26, 2014 are as follows (in millions):

	VALUATION OF SECURITIES GIVEN AN X% DECREASE IN EACH STOCK’S PRICE			FAIR VALUE AS OF OCTOBER 25, 2014	VALUATION OF SECURITIES GIVEN AN X% INCREASE IN EACH STOCK’S PRICE		
	(30)%	(20)%	(10)%		10%	20%	30%
Publicly traded equity securities	\$1,040	\$1,188	\$1,337	\$ 1,485	\$1,634	\$1,782	\$1,931
	VALUATION OF SECURITIES			FAIR VALUE	VALUATION OF SECURITIES		

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	GIVEN AN X% DECREASE IN EACH STOCK'S PRICE			AS OF JULY 26, 2014	GIVEN AN X% INCREASE IN EACH STOCK'S PRICE		
	(30)%	(20)%	(10)%		10%	20%	30%
Publicly traded equity securities	\$1,144	\$1,307	\$1,471	\$ 1,634	\$1,797	\$1,961	\$2,124

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**Investments in Privately Held Companies** We have also invested in privately held companies. These investments are recorded in other assets in our Consolidated Balance Sheets and are accounted for using primarily either the cost or the equity method. As of October 25, 2014, the total carrying amount of our investments in privately held companies was \$886 million, compared with \$899 million at July 26, 2014. Some of the privately held companies in which we invested are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. We could lose our entire investment in these companies. Our evaluation of investments in privately held companies is based on the fundamentals of the businesses invested in, including, among other factors, the nature of their technologies and potential for financial return.

**Foreign Currency Exchange Risk**

Our foreign exchange forward and option contracts outstanding as of respective period-ends are summarized in U.S. dollar equivalents as follows (in millions):

	October 25, 2014		July 26, 2014	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Forward contracts:				
Purchased	\$2,651	\$(25 )	\$2,635	\$(3 )
Sold	\$813	\$5	\$896	\$2
Option contracts:				
Purchased	\$1,076	\$3	\$494	\$5
Sold	\$891	\$(22 )	\$466	\$(2 )

We conduct business globally in numerous currencies. The direct effect of foreign currency fluctuations on revenue has not been material because our sales are primarily denominated in U.S. dollars. However, if the U.S. dollar strengthens relative to other currencies, such strengthening could have an indirect effect on our revenue to the extent it raises the cost of our products to non-U.S. customers and thereby reduces demand. A weaker U.S. dollar could have the opposite effect. However, the precise indirect effect of currency fluctuations is difficult to measure or predict because our sales are influenced by many factors in addition to the impact of such currency fluctuations.

Approximately 65% of our operating expenses are U.S.-dollar denominated. In the first quarter of fiscal 2015, foreign currency fluctuations, net of hedging, increased our combined R&D, sales and marketing, and G&A expenses by \$4 million, or approximately 0.1%, compared with the first quarter of fiscal 2014. In the first quarter of fiscal 2014, foreign currency fluctuations, net of hedging, decreased our combined R&D, sales and marketing, and G&A expenses by \$44 million, or approximately 1.0%, as compared with the first quarter of fiscal 2013. To reduce variability in operating expenses and service cost of sales caused by non-U.S.-dollar denominated operating expenses and costs, we hedge certain forecasted foreign currency transactions with currency options and forward contracts. These hedging programs are not designed to provide foreign currency protection over long time horizons. In designing a specific hedging approach, we consider several factors, including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument, and potential effectiveness of the hedge. The gains and losses on foreign exchange contracts mitigate the effect of currency movements on our operating expenses and service cost of sales.

We also enter into foreign exchange forward and option contracts to reduce the short-term effects of foreign currency fluctuations on receivables and payables that are denominated in currencies other than the functional currencies of the entities. The market risks associated with these foreign currency receivables, investments, and payables relate primarily to variances from our forecasted foreign currency transactions and balances. Our forward and option contracts generally have the following maturities:

	Maturities
Forward and option contracts—forecasted transactions related to operating expenses and service cost of sales	Up to 18 months
Forward contracts—current assets and liabilities	Up to 3 months

Forward contracts—net investments in foreign subsidiaries

Up to 6 months

Forward contracts—long-term customer financings

Up to 2 years

We do not enter into foreign exchange forward or option contracts for trading purposes.

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### Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the "Exchange Act")) are effective to ensure that information required to be disclosed by us 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 rules and forms and is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our first quarter of fiscal 2015 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

**Brazil** Brazilian authorities have investigated our Brazilian subsidiary and certain of its current and former employees, as well as a Brazilian importer of our products, and its affiliates and employees, relating to alleged evasion of import taxes and alleged improper transactions involving the subsidiary and the importer. Brazilian tax authorities have assessed claims against our Brazilian subsidiary based on a theory of joint liability with the Brazilian importer for import taxes, interest, and penalties. In addition to claims asserted by the Brazilian federal tax authorities in prior fiscal years, tax authorities from the Brazilian state of Sao Paulo have asserted similar claims on the same legal basis in prior fiscal years. In the first quarter of fiscal 2013, the Brazilian federal tax authorities asserted an additional claim against our Brazilian subsidiary based on a theory of joint liability with respect to an alleged underpayment of income taxes, social taxes, interest, and penalties by a Brazilian distributor.

The asserted claims by Brazilian federal tax authorities are for calendar years 2003 through 2008, and the asserted claims by the tax authorities from the state of Sao Paulo are for calendar years 2005 through 2007. The total asserted claims by Brazilian state and federal tax authorities aggregate to approximately \$348 million for the alleged evasion of import and other taxes, approximately \$1.3 billion for interest, and approximately \$1.5 billion for various penalties, all determined using an exchange rate as of October 25, 2014. We have completed a thorough review of the matters and believe the asserted claims against our Brazilian subsidiary are without merit, and we are defending the claims vigorously. While we believe there is no legal basis for the alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil and the nature of the claims asserting joint liability with the importer, we are unable to determine the likelihood of an unfavorable outcome against our Brazilian subsidiary and are unable to reasonably estimate a range of loss, if any. We do not expect a final judicial determination for several years.

**Russia and the Commonwealth of Independent States** At the request of the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice, we are conducting an investigation into allegations which we and those agencies received regarding possible violations of the U.S. Foreign Corrupt Practices Act involving business activities of Cisco's operations in Russia and certain of the Commonwealth of Independent States, and by certain resellers of our products in those countries. We take any such allegations very seriously and are fully cooperating with and sharing the results of our investigation with the SEC and the Department of Justice. While the outcome of our investigation is currently not determinable, we do not expect that it will have a material adverse effect on our consolidated financial position, results of operations, or cash flows. The countries that are the subject of the investigation collectively comprise less than 2% of our revenues.

**Rockstar** We and some of our service provider customers are subject to patent claims asserted in December 2013 in the Eastern District of Texas and the District of Delaware by subsidiaries of the Rockstar Consortium ("Rockstar"). Rockstar, whose members include Apple, Microsoft, LM Ericsson, Sony, and Blackberry, purchased a portfolio of

patents out of the Nortel Networks' bankruptcy proceedings (the "Nortel Portfolio"). Rockstar's subsidiaries allege that some of our NGN Routing, Switching and Collaboration products, as well as video solutions deployed by our service provider customers, infringe some of the patents in the Nortel Portfolio. A binding letter of intent has been executed with Rockstar regarding the Nortel Portfolio. The transaction, which is subject to various closing conditions, will result in various technology companies, including but not limited to Cisco and the various service provider customers described above, obtaining a license to that portfolio. The parties agreed to stay the litigation pending negotiation of agreements, and when the transaction closes, Rockstar will dismiss all litigation brought against the participating companies. In connection with this matter, during the first quarter of fiscal 2015 we recorded a charge to product cost of sales of \$188 million.



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In addition, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations, or cash flows. For additional information regarding intellectual property litigation, see “Part II, Item 1A. Risk Factors-We may be found to infringe on intellectual property rights of others” herein.

### Item 1A.

#### Risk Factors

Set forth below and elsewhere in this report and in other documents we file with the SEC are descriptions of the risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in “Part I, Item 1A. Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended July 26, 2014.

#### OUR OPERATING RESULTS MAY FLUCTUATE IN FUTURE PERIODS, WHICH MAY ADVERSELY AFFECT OUR STOCK PRICE

Our operating results have been in the past, and will continue to be, subject to quarterly and annual fluctuations as a result of numerous factors, some of which may contribute to more pronounced fluctuations in an uncertain global economic environment. These factors include:

- Fluctuations in demand for our products and services, especially with respect to telecommunications service providers and Internet businesses, in part due to changes in the global economic environment
- Changes in sales and implementation cycles for our products and reduced visibility into our customers’ spending plans and associated revenue
- Our ability to maintain appropriate inventory levels and purchase commitments
- Price and product competition in the communications and networking industries, which can change rapidly due to technological innovation and different business models from various geographic regions
- The overall movement toward industry consolidation among both our competitors and our customers
- The introduction and market acceptance of new technologies and products and our success in new and evolving markets, including in our newer product categories such as data center and collaboration and in emerging technologies, as well as the adoption of new standards
- New business models for our offerings, such as XaaS, where costs are borne up front while revenue is recognized over time
- Variations in sales channels, product costs, or mix of products sold
- The timing, size, and mix of orders from customers
- Manufacturing and customer lead times
- Fluctuations in our gross margins, and the factors that contribute to such fluctuations, as described below
- The ability of our customers, channel partners, contract manufacturers and suppliers to obtain financing or to fund capital expenditures, especially during a period of global credit market disruption or in the event of customer, channel partner, contract manufacturer or supplier financial problems
- Share-based compensation expense
- Actual events, circumstances, outcomes, and amounts differing from judgments, assumptions, and estimates used in determining the values of certain assets (including the amounts of related valuation allowances), liabilities, and other items reflected in our Consolidated Financial Statements
- How well we execute on our strategy and operating plans and the impact of changes in our business model that could result in significant restructuring charges

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- Our ability to achieve targeted cost reductions
- Benefits anticipated from our investments in engineering, sales, service, and marketing
- Changes in tax laws or accounting rules, or interpretations thereof

As a consequence, operating results for a particular future period are difficult to predict, and, therefore, prior results are not necessarily indicative of results to be expected in future periods. Any of the foregoing factors, or any other factors discussed elsewhere herein, could have a material adverse effect on our business, results of operations, and financial condition that could adversely affect our stock price.

### **OUR OPERATING RESULTS MAY BE ADVERSELY AFFECTED BY UNFAVORABLE ECONOMIC AND MARKET CONDITIONS AND THE UNCERTAIN GEOPOLITICAL ENVIRONMENT**

Challenging economic conditions worldwide have from time to time contributed, and may continue to contribute, to slowdowns in the communications and networking industries at large, as well as in specific segments and markets in which we operate, resulting in:

- Reduced demand for our products as a result of continued constraints on IT-related capital spending by our customers, particularly service providers, and other customer markets as well
- Increased price competition for our products, not only from our competitors but also as a consequence of customers disposing of unutilized products
- Risk of excess and obsolete inventories
- Risk of supply constraints
- Risk of excess facilities and manufacturing capacity
- Higher overhead costs as a percentage of revenue and higher interest expense

The global macroeconomic environment and recovery from the downturn has been challenging and inconsistent. Instability in the global credit markets, the impact of uncertainty regarding the U.S. federal budget including the effect of the sequestration beginning in 2013, global central bank monetary policy, the instability in the geopolitical environment in many parts of the world and other disruptions may continue to put pressure on global economic conditions. If global economic and market conditions, or economic conditions in key markets, remain uncertain or deteriorate further, we may experience material impacts on our business, operating results, and financial condition. Our operating results in one or more segments may also be affected by uncertain or changing economic conditions particularly germane to that segment or to particular customer markets within that segment. For example, sales in several of our emerging countries decreased in recent periods, including the first quarter of fiscal 2015, and we expect that this weakness will continue for at least several quarters.

In addition, reports of certain intelligence gathering methods of the U.S. government could affect customers' perception of the products of IT companies which design and manufacture products in the United States. Trust and confidence in us as an IT supplier is critical to the development and growth of our markets. Impairment of that trust, or foreign regulatory actions taken in response to reports of certain intelligence gathering methods of the U.S. government, could affect the demand for our products from customers outside of the United States and could have an adverse effect on our operating results.

### **WE HAVE BEEN INVESTING AND EXPECT TO CONTINUE TO INVEST IN KEY GROWTH AREAS AS WELL AS MAINTAINING LEADERSHIP IN ROUTING, SWITCHING AND SERVICES, AND IF THE RETURN ON THESE INVESTMENTS IS LOWER OR DEVELOPS MORE SLOWLY THAN WE EXPECT, OUR OPERATING RESULTS MAY BE HARMED**

We expect to realign and dedicate resources into key growth areas, such as data center virtualization, software, security, and cloud, while also focusing on maintaining leadership in routing, switching and services. However, the return on our investments may be lower, or may develop more slowly, than we expect. If we do not achieve the benefits anticipated from these investments (including if our selection of areas for investment does not play out as we expect), or if the achievement of these benefits is delayed, our operating results may be adversely affected.

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**OUR REVENUE FOR A PARTICULAR PERIOD IS DIFFICULT TO PREDICT, AND A SHORTFALL IN REVENUE MAY HARM OUR OPERATING RESULTS**

As a result of a variety of factors discussed in this report, our revenue for a particular quarter is difficult to predict, especially in light of a challenging and inconsistent global macroeconomic environment and related market uncertainty.

Our revenue may grow at a slower rate than in past periods, or decline as it did in fiscal 2014 on a year-over-year basis. Our ability to meet financial expectations could also be adversely affected if the nonlinear sales pattern seen in some of our past quarters recurs in future periods. We have experienced periods of time during which shipments have exceeded net bookings or manufacturing issues have delayed shipments, leading to nonlinearity in shipping patterns. In addition to making it difficult to predict revenue for a particular period, nonlinearity in shipping can increase costs, because irregular shipment patterns result in periods of underutilized capacity and periods in which overtime expenses may be incurred, as well as in potential additional inventory management-related costs. In addition, to the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods in which our contract manufacturers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters occur and are not remediated within the same quarter.

The timing of large orders can also have a significant effect on our business and operating results from quarter to quarter, primarily in the United States and in emerging countries. From time to time, we receive large orders that have a significant effect on our operating results in the period in which the order is recognized as revenue. The timing of such orders is difficult to predict, and the timing of revenue recognition from such orders may affect period to period changes in revenue. As a result, our operating results could vary materially from quarter to quarter based on the receipt of such orders and their ultimate recognition as revenue.

Inventory management remains an area of focus. We have experienced longer than normal manufacturing lead times in the past which have caused some customers to place the same order multiple times within our various sales channels and to cancel the duplicative orders upon receipt of the product, or to place orders with other vendors with shorter manufacturing lead times. Such multiple ordering (along with other factors) or risk of order cancellation may cause difficulty in predicting our revenue and, as a result, could impair our ability to manage parts inventory effectively. In addition, our efforts to improve manufacturing lead-time performance may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter revenue and operating results. In addition, when facing component supply-related challenges, we have increased our efforts in procuring components in order to meet customer expectations which in turn contribute to an increase in purchase commitments. Increases in our purchase commitments to shorten lead times could also lead to excess and obsolete inventory charges if the demand for our products is less than our expectations.

We plan our operating expense levels based primarily on forecasted revenue levels. These expenses and the impact of long-term commitments are relatively fixed in the short term. A shortfall in revenue could lead to operating results being below expectations because we may not be able to quickly reduce these fixed expenses in response to short-term business changes.

Any of the above factors could have a material adverse impact on our operations and financial results.

**WE EXPECT GROSS MARGIN TO VARY OVER TIME, AND OUR LEVEL OF PRODUCT GROSS MARGIN MAY NOT BE SUSTAINABLE**

Our level of product gross margins declined in recent periods and may continue to decline and be adversely affected by numerous factors, including:

- Changes in customer, geographic, or product mix, including mix of configurations within each product group
- Introduction of new products, including products with price-performance advantages, and new business models for our offerings such as XaaS
- Our ability to reduce production costs
- Entry into new markets or growth in lower margin markets, including markets with different pricing and cost structures, through acquisitions or internal development

- Sales discounts
- Increases in material, labor or other manufacturing-related costs, which could be significant especially during periods of supply constraints
- Excess inventory and inventory holding charges

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- Obsolescence charges
- Changes in shipment volume
- The timing of revenue recognition and revenue deferrals
- Increased cost, loss of cost savings or dilution of savings due to changes in component pricing or charges
- incurred due to inventory holding periods if parts ordering does not correctly anticipate product demand or if the financial health of either contract manufacturers or suppliers deteriorates
- Lower than expected benefits from value engineering
- Increased price competition, including competitors from Asia, especially from China
- Changes in distribution channels
- Increased warranty costs
- Increased amortization of purchased intangible assets, especially from acquisitions
- How well we execute on our strategy and operating plans

Changes in service gross margin may result from various factors such as changes in the mix between technical support services and advanced services, as well as the timing of technical support service contract initiations and renewals and the addition of personnel and other resources to support higher levels of service business in future periods.

**SALES TO THE SERVICE PROVIDER MARKET ARE ESPECIALLY VOLATILE, AND WEAKNESS IN SALES ORDERS FROM THIS INDUSTRY MAY HARM OUR OPERATING RESULTS AND FINANCIAL CONDITION**

Sales to the service provider market have been characterized by large and sporadic purchases, especially relating to our router sales and sales of certain products in our newer product categories such as Data Center, Collaboration, and Service Provider Video, in addition to longer sales cycles. At various times in the past including fiscal 2014 and the first quarter of fiscal 2015, we experienced significant weakness in sales to service providers, sometimes lasting over extended periods of time as market conditions have fluctuated. We expect that the weakness we experienced in fiscal 2014 and the first quarter of fiscal 2015 will continue for at least several quarters. Sales activity in this industry depends upon the stage of completion of expanding network infrastructures; the availability of funding; and the extent to which service providers are affected by regulatory, economic, and business conditions in the country of operations. Weakness in orders from this industry, including as a result of any slowdown in capital expenditures by service providers (which may be more prevalent during a global economic downturn or periods of economic uncertainty), could have a material adverse effect on our business, operating results, and financial condition. Such slowdowns may continue or recur in future periods. Orders from this industry could decline for many reasons other than the competitiveness of our products and services within their respective markets. For example, in the past, many of our service provider customers have been materially and adversely affected by slowdowns in the general economy, by overcapacity, by changes in the service provider market, by regulatory developments, and by constraints on capital availability, resulting in business failures and substantial reductions in spending and expansion plans. These conditions have materially harmed our business and operating results in the past, and some of these or other conditions in the service provider market could affect our business and operating results in any future period. Finally, service provider customers typically have longer implementation cycles; require a broader range of services, including design services; demand that vendors take on a larger share of risks; often require acceptance provisions, which can lead to a delay in revenue recognition; and expect financing from vendors. All these factors can add further risk to business conducted with service providers.

**DISRUPTION OF OR CHANGES IN OUR DISTRIBUTION MODEL COULD HARM OUR SALES AND MARGINS**

If we fail to manage distribution of our products and services properly, or if our distributors' financial condition or operations weaken, our revenue and gross margins could be adversely affected.

A substantial portion of our products and services is sold through our channel partners, and the remainder is sold through direct sales. Our channel partners include systems integrators, service providers, other resellers, and distributors. Systems integrators and service providers typically sell directly to end users and often provide system installation, technical support, professional services, and other support services in addition to network equipment

sales. Systems integrators also typically integrate our products into an overall solution, and a number of service providers are also systems integrators. Distributors stock inventory and typically sell to systems integrators, service providers, and other resellers. We refer to sales through distributors as our two-tier system of

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sales to the end customer. Revenue from distributors is generally recognized based on a sell-through method using information provided by them. These distributors are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. If sales through indirect channels increase, this may lead to greater difficulty in forecasting the mix of our products and, to a degree, the timing of orders from our customers.

Historically, we have seen fluctuations in our gross margins based on changes in the balance of our distribution channels. Although variability to date has not been significant, there can be no assurance that changes in the balance of our distribution model in future periods would not have an adverse effect on our gross margins and profitability. Some factors could result in disruption of or changes in our distribution model, which could harm our sales and margins, including the following:

- We compete with some of our channel partners, including through our direct sales, which may lead these channel partners to use other suppliers that do not directly sell their own products or otherwise compete with them
- Some of our channel partners may demand that we absorb a greater share of the risks that their customers may ask them to bear
- Some of our channel partners may have insufficient financial resources and may not be able to withstand changes and challenges in business conditions
- Revenue from indirect sales could suffer if our distributors' financial condition or operations weaken

In addition, we depend on our channel partners globally to comply with applicable regulatory requirements. To the extent that they fail to do so, that could have a material adverse effect on our business, operating results, and financial condition. Further, sales of our products outside of agreed territories can result in disruption to our distribution channels.

### THE MARKETS IN WHICH WE COMPETE ARE INTENSELY COMPETITIVE, WHICH COULD ADVERSELY AFFECT OUR ACHIEVEMENT OF REVENUE GROWTH

The markets in which we compete are characterized by rapid change, converging technologies, and a migration to networking and communications solutions that offer relative advantages. These market factors represent a competitive threat to us. We compete with numerous vendors in each product category. The overall number of our competitors providing niche product solutions may increase. Also, the identity and composition of competitors may change as we increase our activity in newer product categories such as data center and collaboration and in key growth areas. For example, as products related to network programmability, such as software-defined-networking products, become more prevalent, we expect to face increased competition from companies who develop networking products based on commoditized hardware, referred to as "white box" hardware, to the extent customers decide to purchase those product offerings instead of ours. In addition, the growth in demand for technology delivered as a service enables new competitors to enter the market.

As we continue to expand globally, we may see new competition in different geographic regions. In particular, we have experienced price-focused competition from competitors in Asia, especially from China, and we anticipate this will continue. Our competitors include Alcatel-Lucent; Amazon Web Services LLC; Arista Networks, Inc.; ARRIS Group, Inc.; Aruba Networks, Inc.; Avaya Inc.; Brocade Communications Systems, Inc.; Check Point Software Technologies Ltd.; Citrix Systems, Inc.; Dell Inc.; LM Ericsson Telephone Company; Extreme Networks, Inc.; F5 Networks, Inc.; FireEye, Inc.; Fortinet, Inc.; Hewlett-Packard Company; Huawei Technologies Co., Ltd.; International Business Machines Corporation; Juniper Networks, Inc.; Microsoft Corporation; Palo Alto Networks, Inc.; Polycom, Inc.; Riverbed Technology, Inc.; Ruckus Wireless, Inc.; Symantec Corporation; and VMware, Inc.; among others. Some of these companies compete across many of our product lines, while others are primarily focused in a specific product area. Barriers to entry are relatively low, and new ventures to create products that do or could compete with our products are regularly formed. In addition, some of our competitors may have greater resources, including technical and engineering resources, than we do. As we expand into new markets, we will face competition not only from our existing competitors but also from other competitors, including existing companies with strong technological, marketing, and sales positions in those markets. We also sometimes face competition from resellers and

distributors of our products. Companies with whom we have strategic alliances in some areas may be competitors in other areas, and in our view this trend may increase.

For example, the enterprise data center is undergoing a fundamental transformation arising from the convergence of technologies, including computing, networking, storage, and software, that previously were segregated. Due to several factors, including the availability of highly scalable and general purpose microprocessors, application-specific integrated circuits offering advanced services, standards based protocols, cloud computing and virtualization, the convergence of technologies within the enterprise



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data center is spanning multiple, previously independent, technology segments. Also, some of our current and potential competitors for enterprise data center business have made acquisitions, or announced new strategic alliances, designed to position them to provide end-to-end technology solutions for the enterprise data center. As a result of all of these developments, we face greater competition in the development and sale of enterprise data center technologies, including competition from entities that are among our long-term strategic alliance partners. Companies that are strategic alliance partners in some areas of our business may acquire or form alliances with our competitors, thereby reducing their business with us.

The principal competitive factors in the markets in which we presently compete and may compete in the future include:

- The ability to provide a broad range of networking and communications products and services
- Product performance
- Price
- The ability to introduce new products, including products with price-performance advantages
- The ability to reduce production costs
- The ability to provide value-added features such as security, reliability, and investment protection
- Conformance to standards
- Market presence
- The ability to provide financing
- Disruptive technology shifts and new business models

We also face competition from customers to which we license or supply technology and suppliers from which we transfer technology. The inherent nature of networking requires interoperability. As such, we must cooperate and at the same time compete with many companies. Any inability to effectively manage these complicated relationships with customers, suppliers, and strategic alliance partners could have a material adverse effect on our business, operating results, and financial condition and accordingly affect our chances of success.

### **OUR INVENTORY MANAGEMENT RELATING TO OUR SALES TO OUR TWO-TIER DISTRIBUTION CHANNEL IS COMPLEX, AND EXCESS INVENTORY MAY HARM OUR GROSS MARGINS**

We must manage our inventory relating to sales to our distributors effectively, because inventory held by them could affect our results of operations. Our distributors may increase orders during periods of product shortages, cancel orders if their inventory is too high, or delay orders in anticipation of new products. They also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them, and in response to seasonal fluctuations in end-user demand. Revenue to our distributors generally is recognized based on a sell-through method using information provided by them, and they are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling price, and participate in various cooperative marketing programs. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times against the risk of inventory obsolescence because of rapidly changing technology and customer requirements. When facing component supply-related challenges, we have increased our efforts in procuring components in order to meet customer expectations. If we ultimately determine that we have excess inventory, we may have to reduce our prices and write down inventory, which in turn could result in lower gross margins.

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SUPPLY CHAIN ISSUES, INCLUDING FINANCIAL PROBLEMS OF CONTRACT MANUFACTURERS OR COMPONENT SUPPLIERS, OR A SHORTAGE OF ADEQUATE COMPONENT SUPPLY OR MANUFACTURING CAPACITY THAT INCREASED OUR COSTS OR CAUSED A DELAY IN OUR ABILITY TO FULFILL ORDERS, COULD HAVE AN ADVERSE IMPACT ON OUR BUSINESS AND OPERATING RESULTS, AND OUR FAILURE TO ESTIMATE CUSTOMER DEMAND PROPERLY MAY RESULT IN EXCESS OR OBSOLETE COMPONENT SUPPLY, WHICH COULD ADVERSELY AFFECT OUR GROSS MARGINS

The fact that we do not own or operate the bulk of our manufacturing facilities and that we are reliant on our extended supply chain could have an adverse impact on the supply of our products and on our business and operating results:

- Any financial problems of either contract manufacturers or component suppliers could either limit supply or increase costs
- Reservation of manufacturing capacity at our contract manufacturers by other companies, inside or outside of our industry, could either limit supply or increase costs

A reduction or interruption in supply; a significant increase in the price of one or more components; a failure to adequately authorize procurement of inventory by our contract manufacturers; a failure to appropriately cancel, reschedule, or adjust our requirements based on our business needs; or a decrease in demand for our products could materially adversely affect our business, operating results, and financial condition and could materially damage customer relationships. Furthermore, as a result of binding price or purchase commitments with suppliers, we may be obligated to purchase components at prices that are higher than those available in the current market. In the event that we become committed to purchase components at prices in excess of the current market price when the components are actually used, our gross margins could decrease. We have experienced longer than normal lead times in the past. Although we have generally secured additional supply or taken other mitigation actions when significant disruptions have occurred, if similar situations occur in the future, they could have a material adverse effect on our business, results of operations, and financial condition. See the risk factor above entitled “Our revenue for a particular period is difficult to predict, and a shortfall in revenue may harm our operating results.”

Our growth and ability to meet customer demands depend in part on our ability to obtain timely deliveries of parts from our suppliers and contract manufacturers. We have experienced component shortages in the past, including shortages caused by manufacturing process issues, that have affected our operations. We may in the future experience a shortage of certain component parts as a result of our own manufacturing issues, manufacturing issues at our suppliers or contract manufacturers, capacity problems experienced by our suppliers or contract manufacturers, or strong demand in the industry for those parts. Growth in the economy is likely to create greater pressures on us and our suppliers to accurately project overall component demand and component demands within specific product categories and to establish optimal component levels and manufacturing capacity, especially for labor-intensive components, components for which we purchase a substantial portion of the supply, or the re-ramping of manufacturing capacity for highly complex products. During periods of shortages or delays the price of components may increase, or the components may not be available at all, and we may also encounter shortages if we do not accurately anticipate our needs. We may not be able to secure enough components at reasonable prices or of acceptable quality to build new products in a timely manner in the quantities or configurations needed. Accordingly, our revenue and gross margins could suffer until other sources can be developed. Our operating results would also be adversely affected if, anticipating greater demand than actually develops, we commit to the purchase of more components than we need, which is more likely to occur in a period of demand uncertainties such as we are currently experiencing. There can be no assurance that we will not encounter these problems in the future. Although in many cases we use standard parts and components for our products, certain components are presently available only from a single source or limited sources, and a global economic downturn and related market uncertainty could negatively impact the availability of components from one or more of these sources, especially during times such as we have recently seen when there are supplier constraints based on labor and other actions taken during economic downturns. We may not be able to diversify sources in a timely manner, which could harm our ability to deliver products to customers and seriously impact present and future sales.

We believe that we may be faced with the following challenges in the future:

- New markets in which we participate may grow quickly, which may make it difficult to quickly obtain significant component capacity
- As we acquire companies and new technologies, we may be dependent, at least initially, on unfamiliar supply chains or relatively small supply partners
- We face competition for certain components that are supply-constrained, from existing competitors, and companies in other markets

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Manufacturing capacity and component supply constraints could continue to be significant issues for us. We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to improve manufacturing lead-time performance and to help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our requirements. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. When facing component supply-related challenges, we have increased our efforts in procuring components in order to meet customer expectations which in turn contributes to an increase in purchase commitments. Increases in our purchase commitments to shorten lead times could also lead to excess and obsolete inventory charges if the demand for our products is less than our expectations. If we fail to anticipate customer demand properly, an oversupply of parts could result in excess or obsolete components that could adversely affect our gross margins. For additional information regarding our purchase commitments with contract manufacturers and suppliers, see Note 12 to the Consolidated Financial Statements.

**WE DEPEND UPON THE DEVELOPMENT OF NEW PRODUCTS AND ENHANCEMENTS TO EXISTING PRODUCTS, AND IF WE FAIL TO PREDICT AND RESPOND TO EMERGING TECHNOLOGICAL TRENDS AND CUSTOMERS' CHANGING NEEDS, OUR OPERATING RESULTS AND MARKET SHARE MAY SUFFER**

The markets for our products are characterized by rapidly changing technology, evolving industry standards, new product introductions, and evolving methods of building and operating networks. Our operating results depend on our ability to develop and introduce new products into existing and emerging markets and to reduce the production costs of existing products. Many of our strategic initiatives and investments are aimed at meeting the requirements that a network capable of multiple-party, collaborative interaction would demand, and the investments we have made and our architectural approach are designed to enable the increased use of the network as the platform for all forms of communications and IT. For example, in fiscal 2009 we launched our Cisco Unified Computing System (UCS), our next-generation enterprise data center platform architected to unite computing, network, storage access and virtualization resources in a single system, which is designed to address the fundamental transformation occurring in the enterprise data center. While our Cisco UCS offering remains a significant focus area for us, several market transitions are also shaping our strategies and investments.

One such market transition we are focusing on is the move towards more programmable, flexible and virtual networks. In our view, this evolution is in its very early stages, and we believe the successful products and solutions in this market will combine application-specific integrated circuits (ASICs), hardware and software elements together. Other examples include our focus on the IoE market transition, a potentially significant transition in the IT industry, and a transition in cloud where we have announced plans to architect the Cisco Intercloud solution.

The process of developing new technology, including technology related to more programmable, flexible and virtual networks and technology related to other market transitions, including IoE and cloud, is complex and uncertain, and if we fail to accurately predict customers' changing needs and emerging technological trends our business could be harmed. We must commit significant resources, including the investments we have been making in our priorities to developing new products before knowing whether our investments will result in products the market will accept. In particular, if our model of the evolution of networking does not emerge as we believe it will, or if the industry does not evolve as we believe it will, or if our strategy for addressing this evolution is not successful, many of our strategic initiatives and investments may be of no or limited value. For example, if we do not introduce products related to network programmability, such as software-defined-networking products, in a timely fashion, or if product offerings in this market that ultimately succeed are based on technology, or an approach to technology, that differs from ours, such as, for example, networking products based on "white box" hardware, our business could be harmed. Similarly, our business could be harmed if we fail to develop, or fail to develop in a timely fashion, offerings to address other transitions, or if the offerings addressing these other transitions that ultimately succeed are based on technology, or an approach to technology, different from ours.

Furthermore, we may not execute successfully on our vision or strategy because of challenges with regard to product planning and timing, technical hurdles that we fail to overcome in a timely fashion, or a lack of appropriate resources.

This could result in competitors, some of which may also be our strategic alliance partners, providing those solutions before we do and loss of market share, revenue, and earnings. In addition, the growth in demand for technology delivered as a service enables new competitors to enter the market. The success of new products depends on several factors, including proper new product definition, component costs, timely completion and introduction of these products, differentiation of new products from those of our competitors, and market acceptance of these products. There can be no assurance that we will successfully identify new product opportunities, develop and bring new products to market in a timely manner, or achieve market acceptance of our products or that products and technologies developed by others will not render our products or technologies obsolete or noncompetitive. The products and technologies in our other product categories and key growth areas may not prove to have the market success we anticipate, and we may not successfully identify and invest in other emerging or new products.

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**CHANGES IN INDUSTRY STRUCTURE AND MARKET CONDITIONS COULD LEAD TO CHARGES RELATED TO DISCONTINUANCES OF CERTAIN OF OUR PRODUCTS OR BUSINESSES, ASSET IMPAIRMENTS AND WORKFORCE REDUCTIONS OR RESTRUCTURINGS**

In response to changes in industry and market conditions, we may be required to strategically realign our resources and to consider restructuring, disposing of, or otherwise exiting businesses. Any resource realignment, or decision to limit investment in or dispose of or otherwise exit businesses, may result in the recording of special charges, such as inventory and technology-related write-offs, workforce reduction or restructuring costs, charges relating to consolidation of excess facilities, or claims from third parties who were resellers or users of discontinued products. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such assessments and decisions. Although in certain instances our supply agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed, our loss contingencies may include liabilities for contracts that we cannot cancel with contract manufacturers and suppliers. Further, our estimates relating to the liabilities for excess facilities are affected by changes in real estate market conditions. Additionally, we are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances, and future goodwill impairment tests may result in a charge to earnings.

In August 2014, as part of our strategy of continuing to invest in growth, innovation and talent, while also managing costs and driving efficiencies, we announced a restructuring plan. We began taking action under this plan in the first quarter of fiscal 2015. The implementation of this restructuring plan may be disruptive to our business, and following completion of the restructuring plan our business may not be more efficient or effective than prior to implementation of the plan. Our restructuring activities, including any related charges and the impact of the related headcount restructurings, could have a material adverse effect on our business, operating results, and financial condition. **OVER THE LONG TERM WE INTEND TO INVEST IN ENGINEERING, SALES, SERVICE AND MARKETING ACTIVITIES, AND THESE INVESTMENTS MAY ACHIEVE DELAYED, OR LOWER THAN EXPECTED, BENEFITS WHICH COULD HARM OUR OPERATING RESULTS**

While we intend to focus on managing our costs and expenses, over the long term, we also intend to invest in personnel and other resources related to our engineering, sales, service and marketing functions as we realign and dedicate resources on key growth areas, such as data center virtualization, software, security, and cloud, and we also intend to focus on maintaining leadership in routing, switching and services. We are likely to recognize the costs associated with these investments earlier than some of the anticipated benefits, and the return on these investments may be lower, or may develop more slowly, than we expect. If we do not achieve the benefits anticipated from these investments, or if the achievement of these benefits is delayed, our operating results may be adversely affected. **OUR BUSINESS SUBSTANTIALLY DEPENDS UPON THE CONTINUED GROWTH OF THE INTERNET AND INTERNET-BASED SYSTEMS**

A substantial portion of our business and revenue depends on growth and evolution of the Internet, including the continued development of the Internet and the anticipated transition to IoE, and on the deployment of our products by customers who depend on such continued growth and evolution. To the extent that an economic slowdown or uncertainty and related reduction in capital spending adversely affect spending on Internet infrastructure, including spending or investment related to IoE, we could experience material harm to our business, operating results, and financial condition.

Because of the rapid introduction of new products and changing customer requirements related to matters such as cost-effectiveness and security, we believe that there could be performance problems with Internet communications in the future, which could receive a high degree of publicity and visibility. Because we are a large supplier of networking products, our business, operating results, and financial condition may be materially adversely affected, regardless of whether or not these problems are due to the performance of our own products. Such an event could also result in a material adverse effect on the market price of our common stock independent of direct effects on our business. **WE HAVE MADE AND EXPECT TO CONTINUE TO MAKE ACQUISITIONS THAT COULD DISRUPT OUR OPERATIONS AND HARM OUR OPERATING RESULTS**

Our growth depends upon market growth, our ability to enhance our existing products, and our ability to introduce new products on a timely basis. We intend to continue to address the need to develop new products and enhance existing products through acquisitions of other companies, product lines, technologies, and personnel. Acquisitions involve numerous risks, including the following:

Difficulties in integrating the operations, systems, technologies, products, and personnel of the acquired

- companies, particularly companies with large and widespread operations and/or complex products, such as Scientific-Atlanta, WebEx, Starent, Tandberg and NDS Group Limited

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- Diversion of management's attention from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions
- Potential difficulties in completing projects associated with in-process research and development intangibles
- Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions
- Initial dependence on unfamiliar supply chains or relatively small supply partners
- Insufficient revenue to offset increased expenses associated with acquisitions
- The potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans

Acquisitions may also cause us to:

- Issue common stock that would dilute our current shareholders' percentage ownership
- Use a substantial portion of our cash resources, or incur debt, as we did in fiscal 2006 when we issued and sold \$6.5 billion in senior unsecured notes to fund our acquisition of Scientific-Atlanta
- Significantly increase our interest expense, leverage and debt service requirements if we incur additional debt to pay for an acquisition
- Assume liabilities
- Record goodwill and intangible assets that are subject to impairment testing on a regular basis and potential periodic impairment charges
- Incur amortization expenses related to certain intangible assets
- Incur tax expenses related to the effect of acquisitions on our intercompany R&D cost sharing arrangement and legal structure
- Incur large and immediate write-offs and restructuring and other related expenses
- Become subject to intellectual property or other litigation

Mergers and acquisitions of high-technology companies are inherently risky and subject to many factors outside of our control, and no assurance can be given that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results, or financial condition. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. Prior acquisitions have resulted in a wide range of outcomes, from successful introduction of new products and technologies to a failure to do so. Even when an acquired company has already developed and marketed products, there can be no assurance that product enhancements will be made in a timely fashion or that pre-acquisition due diligence will have identified all possible issues that might arise with respect to such products.

From time to time, we have made acquisitions that resulted in charges in an individual quarter. These charges may occur in any particular quarter, resulting in variability in our quarterly earnings. In addition, our effective tax rate for future periods is uncertain and could be impacted by mergers and acquisitions. Risks related to new product development also apply to acquisitions. Please see the risk factors above, including the risk factor entitled "We depend upon the development of new products and enhancements to existing products, and if we fail to predict and respond to emerging technological trends and customers' changing needs, our operating results and market share may suffer" for additional information.

### **ENTRANCE INTO NEW OR DEVELOPING MARKETS EXPOSES US TO ADDITIONAL COMPETITION AND WILL LIKELY INCREASE DEMANDS ON OUR SERVICE AND SUPPORT OPERATIONS**

As we focus on new market opportunities and key growth areas, we will increasingly compete with large telecommunications equipment suppliers as well as startup companies. Several of our competitors may have greater resources, including technical and engineering resources, than we do. Additionally, as customers in these markets complete infrastructure deployments, they may require greater levels of service, support, and financing than we have provided in the past, especially in emerging countries. Demand



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for these types of service, support, or financing contracts may increase in the future. There can be no assurance that we can provide products, service, support, and financing to effectively compete for these market opportunities. Further, provision of greater levels of services, support and financing by us may result in a delay in the timing of revenue recognition. In addition, entry into other markets has subjected and will subject us to additional risks, particularly to those markets, including the effects of general market conditions and reduced consumer confidence. For example, as we add direct selling capabilities globally to meet changing customer demands, we will face increased legal and regulatory requirements.

**INDUSTRY CONSOLIDATION MAY LEAD TO INCREASED COMPETITION AND MAY HARM OUR OPERATING RESULTS**

There has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. For example, some of our current and potential competitors for enterprise data center business have made acquisitions, or announced new strategic alliances, designed to position them with the ability to provide end-to-end technology solutions for the enterprise data center. Companies that are strategic alliance partners in some areas of our business may acquire or form alliances with our competitors, thereby reducing their business with us. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This could lead to more variability in our operating results and could have a material adverse effect on our business, operating results, and financial condition. Furthermore, particularly in the service provider market, rapid consolidation will lead to fewer customers, with the effect that loss of a major customer could have a material impact on results not anticipated in a customer marketplace composed of more numerous participants.

**PRODUCT QUALITY PROBLEMS COULD LEAD TO REDUCED REVENUE, GROSS MARGINS, AND NET INCOME**

We produce highly complex products that incorporate leading-edge technology, including both hardware and software. Software typically contains bugs that can unexpectedly interfere with expected operations. There can be no assurance that our pre-shipment testing programs will be adequate to detect all defects, either ones in individual products or ones that could affect numerous shipments, which might interfere with customer satisfaction, reduce sales opportunities, or affect gross margins. From time to time, we have had to replace certain components and provide remediation in response to the discovery of defects or bugs in products that we had shipped. There can be no assurance that such remediation, depending on the product involved, would not have a material impact. An inability to cure a product defect could result in the failure of a product line, temporary or permanent withdrawal from a product or market, damage to our reputation, inventory costs, or product reengineering expenses, any of which could have a material impact on our revenue, margins, and net income. For example, in the second quarter of fiscal 2014, we recorded a pre-tax charge of \$655 million related to the expected remediation costs for certain products sold in prior fiscal years containing memory components manufactured by a single supplier between 2005 and 2010.

**DUE TO THE GLOBAL NATURE OF OUR OPERATIONS, POLITICAL OR ECONOMIC CHANGES OR OTHER FACTORS IN A SPECIFIC COUNTRY OR REGION COULD HARM OUR OPERATING RESULTS AND FINANCIAL CONDITION**

We conduct significant sales and customer support operations in countries around the world. As such, our growth depends in part on our increasing sales into emerging countries. We also depend on non-U.S. operations of our contract manufacturers, component suppliers and distribution partners. Although sales in several of our emerging countries decreased in recent periods, including in fiscal 2014, several of our emerging countries generally have been relatively fast growing, and we have announced plans to expand our commitments and expectations in certain of those countries. We expect that the weakness we experienced in recent periods in several emerging countries will continue for at least several quarters. Our future results could be materially adversely affected by a variety of political, economic or other factors relating to our operations inside and outside the United States, including impacts from the U.S. federal budget including the effect of the sequestration beginning in 2013; global central bank monetary policy;

issues related to the political relationship between the United States and other countries which can affect the willingness of customers in those countries to purchase products from companies headquartered in the United States; and the challenging and inconsistent global macroeconomic environment, any or all of which could have a material adverse effect on our operating results and financial condition, including, among others, the following:

- Foreign currency exchange rates
- Political or social unrest
- Economic instability or weakness or natural disasters in a specific country or region; environmental and trade protection measures and other legal and regulatory requirements, some of which may affect our ability to import our products, to export our products from, or sell our products in various countries

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- Political considerations that affect service provider and government spending patterns
- Health or similar issues, such as a pandemic or epidemic
- Difficulties in staffing and managing international operations
- Adverse tax consequences, including imposition of withholding or other taxes on our global operations

**WE ARE EXPOSED TO THE CREDIT RISK OF SOME OF OUR CUSTOMERS AND TO CREDIT EXPOSURES IN WEAKENED MARKETS, WHICH COULD RESULT IN MATERIAL LOSSES**

Most of our sales are on an open credit basis, with typical payment terms of 30 days in the United States and, because of local customs or conditions, longer in some markets outside the United States. We monitor individual customer payment capability in granting such open credit arrangements, seek to limit such open credit to amounts we believe the customers can pay, and maintain reserves we believe are adequate to cover exposure for doubtful accounts.

Beyond our open credit arrangements, we have also experienced demands for customer financing and facilitation of leasing arrangements. We expect demand for customer financing to continue, and recently we have been experiencing an increase in this demand as the credit markets have been impacted by the challenging and inconsistent global macroeconomic environment, including increased demand from customers in certain emerging countries.

We believe customer financing is a competitive factor in obtaining business, particularly in serving customers involved in significant infrastructure projects. Our loan financing arrangements may include not only financing the acquisition of our products and services but also providing additional funds for other costs associated with network installation and integration of our products and services.

Our exposure to the credit risks relating to our financing activities described above may increase if our customers are adversely affected by a global economic downturn or periods of economic uncertainty. Although we have programs in place that are designed to monitor and mitigate the associated risk, including monitoring of particular risks in certain geographic areas, there can be no assurance that such programs will be effective in reducing our credit risks.

In the past, there have been significant bankruptcies among customers both on open credit and with loan or lease financing arrangements, particularly among Internet businesses and service providers, causing us to incur economic or financial losses. There can be no assurance that additional losses will not be incurred. Although these losses have not been material to date, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition. A portion of our sales is derived through our distributors. These distributors are generally given business terms that allow them to return a portion of inventory, receive credits for changes in selling prices, and participate in various cooperative marketing programs. We maintain estimated accruals and allowances for such business terms. However, distributors tend to have more limited financial resources than other resellers and end-user customers and therefore represent potential sources of increased credit risk, because they may be more likely to lack the reserve resources to meet payment obligations. Additionally, to the degree that turmoil in the credit markets makes it more difficult for some customers to obtain financing, those customers' ability to pay could be adversely impacted, which in turn could have a material adverse impact on our business, operating results, and financial condition.

**WE ARE EXPOSED TO FLUCTUATIONS IN THE MARKET VALUES OF OUR PORTFOLIO INVESTMENTS AND IN INTEREST RATES; IMPAIRMENT OF OUR INVESTMENTS COULD HARM OUR EARNINGS**

We maintain an investment portfolio of various holdings, types, and maturities. These securities are generally classified as available-for-sale and, consequently, are recorded on our Consolidated Balance Sheets at fair value with unrealized gains or losses reported as a component of accumulated other comprehensive income, net of tax. Our portfolio includes fixed income securities and equity investments in publicly traded companies, the values of which are subject to market price volatility to the extent unhedged. If such investments suffer market price declines, as we experienced with some of our investments in the past, we may recognize in earnings the decline in the fair value of our investments below their cost basis when the decline is judged to be other than temporary. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, refer to the section titled "Quantitative and Qualitative Disclosures About Market Risk." Our investments in private companies are subject to risk of loss of investment capital. These investments are inherently risky because the markets for the technologies or products they have under development are typically in the early stages and may never

materialize. We could lose our entire investment in these companies.

**WE ARE EXPOSED TO FLUCTUATIONS IN CURRENCY EXCHANGE RATES THAT COULD NEGATIVELY IMPACT OUR FINANCIAL RESULTS AND CASH FLOWS**

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Historically, our primary exposures have related to nondollar-

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denominated sales in Japan, Canada, and Australia and certain nondollar-denominated operating expenses and service cost of sales in Europe, Latin America, and Asia, where we sell primarily in U.S. dollars. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. An increase in the value of the dollar could increase the real cost to our customers of our products in those markets outside the United States where we sell in dollars, and a weakened dollar could increase the cost of local operating expenses and procurement of raw materials to the extent that we must purchase components in foreign currencies.

Currently, we enter into foreign exchange forward contracts and options to reduce the short-term impact of foreign currency fluctuations on certain foreign currency receivables, investments, and payables. In addition, we periodically hedge anticipated foreign currency cash flows. Our attempts to hedge against these risks may result in an adverse impact on our net income.

### **OUR PROPRIETARY RIGHTS MAY PROVE DIFFICULT TO ENFORCE**

We generally rely on patents, copyrights, trademarks, and trade secret laws to establish and maintain proprietary rights in our technology and products. Although we have been issued numerous patents and other patent applications are currently pending, there can be no assurance that any of these patents or other proprietary rights will not be challenged, invalidated, or circumvented or that our rights will, in fact, provide competitive advantages to us.

Furthermore, many key aspects of networking technology are governed by industrywide standards, which are usable by all market entrants. In addition, there can be no assurance that patents will be issued from pending applications or that claims allowed on any patents will be sufficiently broad to protect our technology. In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as do the laws of the United States. The outcome of any actions taken in these foreign countries may be different than if such actions were determined under the laws of the United States. Although we are not dependent on any individual patents or group of patents for particular segments of the business for which we compete, if we are unable to protect our proprietary rights to the totality of the features (including aspects of products protected other than by patent rights) in a market, we may find ourselves at a competitive disadvantage to others who need not incur the substantial expense, time, and effort required to create innovative products that have enabled us to be successful.

### **WE MAY BE FOUND TO INFRINGE ON INTELLECTUAL PROPERTY RIGHTS OF OTHERS**

Third parties, including customers, have in the past and may in the future assert claims or initiate litigation related to exclusive patent, copyright, trademark, and other intellectual property rights to technologies and related standards that are relevant to us. These assertions have increased over time as a result of our growth and the general increase in the pace of patent claims assertions, particularly in the United States. Because of the existence of a large number of patents in the networking field, the secrecy of some pending patents, and the rapid rate of issuance of new patents, it is not economically practical or even possible to determine in advance whether a product or any of its components infringes or will infringe on the patent rights of others. The asserted claims and/or initiated litigation can include claims against us or our manufacturers, suppliers, or customers, alleging infringement of their proprietary rights with respect to our existing or future products or components of those products. Regardless of the merit of these claims, they can be time-consuming, result in costly litigation and diversion of technical and management personnel, or require us to develop a non-infringing technology or enter into license agreements. Where claims are made by customers, resistance even to unmeritorious claims could damage customer relationships. There can be no assurance that licenses will be available on acceptable terms and conditions, if at all, or that our indemnification by our suppliers will be adequate to cover our costs if a claim were brought directly against us or our customers. Furthermore, because of the potential for high court awards that are not necessarily predictable, it is not unusual to find even arguably unmeritorious claims settled for significant amounts. If any infringement or other intellectual property claim made against us by any third party is successful, if we are required to indemnify a customer with respect to a claim against the customer, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results, and financial condition could be materially and adversely affected. For additional information regarding our indemnification obligations, see Note 12(g) to the Consolidated Financial Statements.

Our exposure to risks associated with the use of intellectual property may be increased as a result of acquisitions, as we have a lower level of visibility into the development process with respect to such technology or the care taken to safeguard against infringement risks. Further, in the past, third parties have made infringement and similar claims after we have acquired technology that had not been asserted prior to our acquisition.

**WE RELY ON THE AVAILABILITY OF THIRD-PARTY LICENSES**

Many of our products are designed to include software or other intellectual property licensed from third parties. It may be necessary in the future to seek or renew licenses relating to various aspects of these products. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other

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intellectual property licensed from third parties on a nonexclusive basis could limit our ability to protect our proprietary rights in our products.

**OUR OPERATING RESULTS MAY BE ADVERSELY AFFECTED AND DAMAGE TO OUR REPUTATION MAY OCCUR DUE TO PRODUCTION AND SALE OF COUNTERFEIT VERSIONS OF OUR PRODUCTS**

As is the case with leading products around the world, our products are subject to efforts by third parties to produce counterfeit versions of our products. While we work diligently with law enforcement authorities in various countries to block the manufacture of counterfeit goods and to interdict their sale, and to detect counterfeit products in customer networks, and have succeeded in prosecuting counterfeiters and their distributors, resulting in fines, imprisonment and restitution to us, there can be no guarantee that such efforts will succeed. While counterfeiters often aim their sales at customers who might not have otherwise purchased our products due to lack of verifiability of origin and service, such counterfeit sales, to the extent they replace otherwise legitimate sales, could adversely affect our operating results.

**OUR OPERATING RESULTS AND FUTURE PROSPECTS COULD BE MATERIALLY HARMED BY UNCERTAINTIES OF REGULATION OF THE INTERNET**

Currently, few laws or regulations apply directly to access or commerce on the Internet. We could be materially adversely affected by regulation of the Internet and Internet commerce in any country where we operate. Such regulations could include matters such as voice over the Internet or using IP, encryption technology, sales or other taxes on Internet product or service sales, and access charges for Internet service providers. The adoption of regulation of the Internet and Internet commerce could decrease demand for our products and, at the same time, increase the cost of selling our products, which could have a material adverse effect on our business, operating results, and financial condition.

**CHANGES IN TELECOMMUNICATIONS REGULATION AND TARIFFS COULD HARM OUR PROSPECTS AND FUTURE SALES**

Changes in telecommunications requirements, or regulatory requirements in other industries in which we operate, in the United States or other countries could affect the sales of our products. In particular, we believe that there may be future changes in U.S. telecommunications regulations that could slow the expansion of the service providers' network infrastructures and materially adversely affect our business, operating results, and financial condition.

Future changes in tariffs by regulatory agencies or application of tariff requirements to currently untariffed services could affect the sales of our products for certain classes of customers. Additionally, in the United States, our products must comply with various requirements and regulations of the Federal Communications Commission and other regulatory authorities. In countries outside of the United States, our products must meet various requirements of local telecommunications and other industry authorities. Changes in tariffs or failure by us to obtain timely approval of products could have a material adverse effect on our business, operating results, and financial condition.

**FAILURE TO RETAIN AND RECRUIT KEY PERSONNEL WOULD HARM OUR ABILITY TO MEET KEY OBJECTIVES**

Our success has always depended in large part on our ability to attract and retain highly skilled technical, managerial, sales, and marketing personnel. Competition for these personnel is intense, especially in the Silicon Valley area of Northern California. Stock incentive plans are designed to reward employees for their long-term contributions and provide incentives for them to remain with us. Volatility or lack of positive performance in our stock price or equity incentive awards, or changes to our overall compensation program, including our stock incentive program, resulting from the management of share dilution and share-based compensation expense or otherwise, may also adversely affect our ability to retain key employees. As a result of one or more of these factors, we may increase our hiring in geographic areas outside the United States, which could subject us to additional geopolitical and exchange rate risk. The loss of services of any of our key personnel; the inability to retain and attract qualified personnel in the future; or delays in hiring required personnel, particularly engineering and sales personnel, could make it difficult to meet key objectives, such as timely and effective product introductions. In addition, companies in our industry whose employees accept positions with competitors frequently claim that competitors have engaged in improper hiring practices. We have received these claims in the past and may receive additional claims to this effect in the future.

**ADVERSE RESOLUTION OF LITIGATION OR GOVERNMENTAL INVESTIGATIONS MAY HARM OUR OPERATING RESULTS OR FINANCIAL CONDITION**

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. For example, Brazilian authorities have investigated our Brazilian subsidiary and certain of its current and former employees, as well as a Brazilian importer of our products, and its affiliates and employees, relating to alleged evasion of import taxes and alleged improper transactions involving the subsidiary and the importer. Brazilian tax authorities have assessed claims against our Brazilian subsidiary based on a theory



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of joint liability with the Brazilian importer for import taxes, interest, and penalties. In the first quarter of fiscal 2013, the Brazilian federal tax authorities asserted an additional claim against our Brazilian subsidiary based on a theory of joint liability with respect to an alleged underpayment of income taxes, social taxes, interest, and penalties by a Brazilian distributor. The asserted claims by Brazilian federal tax authorities are for calendar years 2003 through 2008 and the related asserted claims by the tax authorities from the state of Sao Paulo are for calendar years 2005 through 2007. The total asserted claims by Brazilian state and federal tax authorities aggregate to approximately \$348 million for the alleged evasion of import and other taxes, approximately \$1.3 billion for interest, and approximately \$1.5 billion for various penalties, all determined using an exchange rate as of October 25, 2014. We have completed a thorough review of the matters and believe the asserted claims against our Brazilian subsidiary are without merit, and we are defending the claims vigorously. While we believe there is no legal basis for the alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil and the nature of the claims asserting joint liability with the importer, we are unable to determine the likelihood of an unfavorable outcome against our Brazilian subsidiary and are unable to reasonably estimate a range of loss, if any. We do not expect a final judicial determination for several years. An unfavorable resolution of lawsuits or governmental investigations could have a material adverse effect on our business, operating results, or financial condition. For additional information regarding certain of the matters in which we are involved, see Item 1, "Legal Proceedings," contained in Part II of this report.

#### CHANGES IN OUR PROVISION FOR INCOME TAXES OR ADVERSE OUTCOMES RESULTING FROM EXAMINATION OF OUR INCOME TAX RETURNS COULD ADVERSELY AFFECT OUR RESULTS

Our provision for income taxes is subject to volatility and could be adversely affected by earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates; by changes in the valuation of our deferred tax assets and liabilities; by expiration of or lapses in the R&D tax credit or domestic manufacturing deduction laws; by expiration of or lapses in tax incentives; by transfer pricing adjustments, including the effect of acquisitions on our intercompany R&D cost sharing arrangement and legal structure; by tax effects of nondeductible compensation; by tax costs related to intercompany realignments; by changes in accounting principles; or by changes in tax laws and regulations, treaties, or interpretations thereof, including possible changes to the taxation of earnings of our foreign subsidiaries, the deductibility of expenses attributable to foreign income, or the foreign tax credit rules. Significant judgment is required to determine the recognition and measurement attribute prescribed in the accounting guidance for uncertainty in income taxes. The Organisation for Economic Co-operation and Development (OECD), an international association of 34 countries including the United States, is contemplating changes to numerous long-standing tax principles. These contemplated changes, if finalized and adopted by countries, will increase tax uncertainty and may adversely affect our provision for income taxes. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial condition.

#### OUR BUSINESS AND OPERATIONS ARE ESPECIALLY SUBJECT TO THE RISKS OF EARTHQUAKES, FLOODS, AND OTHER NATURAL CATASTROPHIC EVENTS

Our corporate headquarters, including certain of our research and development operations are located in the Silicon Valley area of Northern California, a region known for seismic activity. Additionally, a certain number of our facilities are located near rivers that have experienced flooding in the past. Also certain of our suppliers and logistics centers are located in regions that have or may be affected by earthquake, tsunami and flooding activity which in the past has disrupted, and in the future could disrupt, the flow of components and delivery of products. A significant natural disaster, such as an earthquake, a hurricane, volcano, or a flood, could have a material adverse impact on our business, operating results, and financial condition.

**MAN-MADE PROBLEMS SUCH AS COMPUTER VIRUSES OR TERRORISM MAY DISRUPT OUR OPERATIONS AND HARM OUR OPERATING RESULTS**

Despite our implementation of network security measures our servers are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems. Any such event could have a material adverse effect on our business, operating results, and financial condition. Efforts to limit the ability of malicious third parties to disrupt the operations of the Internet or undermine our own security efforts may meet with resistance. In addition, the continued threat of terrorism and heightened security and military action in response to this threat, or any future acts of terrorism, may cause further disruptions to the economies of the United States and other countries and create further uncertainties or otherwise materially harm our business, operating results, and financial condition. Likewise, events such as widespread blackouts could have similar negative impacts. To the extent that such disruptions or uncertainties result in delays or cancellations of customer orders or the manufacture or shipment of our products, our business, operating results, and financial condition could be materially and adversely affected.

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**IF WE DO NOT SUCCESSFULLY MANAGE OUR STRATEGIC ALLIANCES, WE MAY NOT REALIZE THE EXPECTED BENEFITS FROM SUCH ALLIANCES AND WE MAY EXPERIENCE INCREASED COMPETITION OR DELAYS IN PRODUCT DEVELOPMENT**

We have several strategic alliances with large and complex organizations and other companies with which we work to offer complementary products and services and have established a joint venture to market services associated with our Cisco Unified Computing System products. These arrangements are generally limited to specific projects, the goal of which is generally to facilitate product compatibility and adoption of industry standards. There can be no assurance we will realize the expected benefits from these strategic alliances or from the joint venture. If successful, these relationships may be mutually beneficial and result in industry growth. However, alliances carry an element of risk because, in most cases, we must compete in some business areas with a company with which we have a strategic alliance and, at the same time, cooperate with that company in other business areas. Also, if these companies fail to perform or if these relationships fail to materialize as expected, we could suffer delays in product development or other operational difficulties. Joint ventures can be difficult to manage, given the potentially different interests of joint venture partners.

**OUR STOCK PRICE MAY BE VOLATILE**

Historically, our common stock has experienced substantial price volatility, particularly as a result of variations between our actual financial results and the published expectations of analysts and as a result of announcements by our competitors and us. Furthermore, speculation in the press or investment community about our strategic position, financial condition, results of operations, business, security of our products, or significant transactions can cause changes in our stock price. In addition, the stock market has experienced extreme price and volume fluctuations that have affected the market price of many technology companies, in particular, and that have often been unrelated to the operating performance of these companies. These factors, as well as general economic and political conditions and the announcement of proposed and completed acquisitions or other significant transactions, or any difficulties associated with such transactions, by us or our current or potential competitors, may materially adversely affect the market price of our common stock in the future. Additionally, volatility, lack of positive performance in our stock price or changes to our overall compensation program, including our stock incentive program, may adversely affect our ability to retain key employees, virtually all of whom are compensated, in part, based on the performance of our stock price.

**THERE CAN BE NO ASSURANCE THAT OUR OPERATING RESULTS AND FINANCIAL CONDITION WILL NOT BE ADVERSELY AFFECTED BY OUR INCURRENCE OF DEBT**

As of the end of the first quarter of fiscal 2015, we have senior unsecured notes outstanding in an aggregate principal amount of \$20.8 billion that mature at specific dates from calendar year 2014 through 2040. We have also established a commercial paper program under which we may issue short-term, unsecured commercial paper notes on a private placement basis up to a maximum aggregate amount outstanding at any time of \$3.0 billion, and we had no commercial paper notes outstanding under this program as of October 25, 2014. The outstanding senior unsecured notes bear fixed-rate interest payable semiannually, except \$2.35 billion of the notes which bears interest at a floating rate payable quarterly. The fair value of the long-term debt is subject to market interest rate volatility. The instruments governing the senior unsecured notes contain certain covenants applicable to us and our wholly-owned subsidiaries that may adversely affect our ability to incur certain liens or engage in certain types of sale and leaseback transactions. In addition, we will be required to have available in the United States sufficient cash to service the interest on our debt and repay all of our notes on maturity. There can be no assurance that our incurrence of this debt or any future debt will be a better means of providing liquidity to us than would our use of our existing cash resources, including cash currently held offshore. Further, we cannot be assured that our maintenance of this indebtedness or incurrence of future indebtedness will not adversely affect our operating results or financial condition. In addition, changes by any rating agency to our credit rating can negatively impact the value and liquidity of both our debt and equity securities, as well as the terms upon which we may borrow under our commercial paper program or future debt issuances.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

(b) None.

(c) Issuer Purchases of Equity Securities (in millions, except per-share amounts):

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
July 27, 2014 to August 23, 2014	7	\$ 24.75	7	\$ 8,373
August 24, 2014 to September 20, 2014	17	\$ 24.96	17	\$ 7,949
September 21, 2014 to October 25, 2014	17	\$ 24.13	17	\$ 7,542
Total	41	\$ 24.58	41	

On September 13, 2001, we announced that our Board of Directors had authorized a stock repurchase program. As of October 25, 2014, our Board of Directors had authorized the repurchase of up to \$97 billion of common stock under this program. As of October 25, 2014, we had repurchased and retired 4.3 billion shares of our common stock at an average price of \$20.66 per share for an aggregate purchase price of \$89.5 billion since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was \$7.5 billion with no termination date.

For the majority of restricted stock units granted, the number of shares issued on the date the restricted stock units vest is net of shares withheld to meet applicable tax withholding requirements. Although these withheld shares are not issued or considered common stock repurchases under our stock repurchase program and therefore are not included in the preceding table, they are treated as common stock repurchases in our financial statements as they reduce the number of shares that would have been issued upon vesting (see Note 13 to the Consolidated Financial Statements).

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Item 3. Defaults Upon Senior Securities  
None.

Item 4. Mine Safety Disclosures  
Not Applicable.

Item 5. Other Information  
None.

Item 6. Exhibits

The following documents are filed as Exhibits to this report:

31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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Pursuant to the requirements 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.

Cisco Systems, Inc.

Date: November 20, 2014

By /s/ Frank A. Calderoni  
Frank A. Calderoni  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer and duly authorized signatory)

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EXHIBIT INDEX

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