GENERAL DYNAMICS CORP
Form 10-K
February 09, 2015

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)
[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2014
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _______ to _______

Commission File Number 1-3671

GENERAL DYNAMICS CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	13-1673581
State or other jurisdiction of incorporation or organization	IRS Employer Identification No.
2941 Fairview Park Drive, Suite 100 Falls Church, Virginia	22042-4513
Address of principal executive offices	Zip code

Registrant’s telephone number, including area code:
(703) 876-3000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of exchange on which registered
Common stock, par value $1 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ü No ___
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ___ No ü
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 ü 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 ü No ___

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K ___

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 ü Accelerated Filer __ Non-Accelerated Filer __ 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 ü

The aggregate market value of the voting common equity held by non-affiliates of the registrant was $37,171,450,405 as of June 29, 2014 (based on the closing price of the shares on the New York Stock Exchange).

331,704,599 shares of the registrant’s common stock, $1 par value per share, were outstanding on February 1, 2015.

DOCUMENTS INCORPORATED BY REFERENCE:

Part III incorporates by reference information from certain portions of the registrant’s definitive proxy statement for the 2015 annual meeting of shareholders to be filed with the Securities and Exchange Commission within 120 days after the close of the fiscal year.

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PART I

ITEM 1. BUSINESS

BUSINESS OVERVIEW

General Dynamics is an aerospace and defense company that offers a broad portfolio of products and services in business aviation; combat vehicles, weapons systems and munitions; communications and information technology systems and solutions; and shipbuilding. Our management team delivers shareholder returns through disciplined execution of backlog, efficient cash-flow conversion and prudent capital deployment. We manage costs, undertake continuous-improvement initiatives and collaborate across our businesses to achieve our goals of maximizing earnings and cash and creating value for our shareholders.

Incorporated in Delaware in 1952, General Dynamics grew organically and through acquisitions until the early 1990s when we sold nearly all of our divisions except Electric Boat and Land Systems. Starting in the mid-1990s, we began expanding by acquiring combat vehicle-related businesses, information technology product and service companies, additional shipyards and Gulfstream Aerospace Corporation.

We operate globally through four business groups: Aerospace, Combat Systems, Information Systems and Technology and Marine Systems. For selected financial information regarding each of our business groups, see Note Q to the Consolidated Financial Statements in Item 8.

AEROSPACE

Our Aerospace group designs, manufactures and outfits a family of Gulfstream business-jet aircraft, provides aircraft services (including maintenance and repair work, fixed-based operations (FBO) and aircraft management services) and performs aircraft completions for aircraft produced by other original equipment manufacturers (OEMs). With more than 50 years of experience at the forefront of the business-jet market, the Aerospace group is known for:

- superior aircraft design, quality, performance, safety and reliability;
- technologically advanced cockpit and cabin systems; and
- industry-leading product service and support.

The Gulfstream product line includes aircraft across a spectrum of price and performance options in the large- and mid-cabin business-jet market. The varying ranges, speeds and cabin dimensions are well-suited for the needs of a diverse and global customer base. The large-cabin models are manufactured at Gulfstream’s headquarters in Savannah, Georgia, while the mid-cabin models are constructed by a non-U.S. partner. All models are outfitted in the group’s U.S. facilities.

Demand for Gulfstream aircraft is strong across geographic regions and customer types, generating orders from public and private companies, individuals and governments around the world. The Gulfstream brand is recognized globally with non-U.S. customers representing approximately 60 percent of the group’s backlog on December 31, 2014.

We are committed to research and development (R&D) activities that facilitate the introduction of new products and first-to-market enhancements that broaden customer choice, improve aircraft performance and set new standards for customer safety, comfort and in-flight productivity. In 2014, we introduced three new large-cabin business jets, the G500, the G600 and the G650ER. The G500 and G600 are clean-sheet next-generation business jets that optimize the speed, wide-cabin comfort, efficiency and advanced safety technology of the aircraft. At Mach 0.85, the G500 can fly 5,000 nautical miles, and the G600 can fly 6,200

nautical miles. The G500 and G600 are expected to enter into service in 2018 and 2019, respectively. The G650ER is the extended-range sister-ship to the ultra-long range, ultra-large cabin G650. This new aircraft flies farther at faster speeds than any other business jet on the market and can travel 7,500 nautical miles at Mach 0.85. The first G650ER was delivered in the fourth quarter of 2014, ahead of the original 2015 estimate. These three new aircraft demonstrate the success of consistent and disciplined investment in Gulfstream's product development.

In addition to the new aircraft models, current product enhancement and development efforts include initiatives in advanced avionics, composites, renewable fuels, flight-control systems, acoustics, cabin technologies and vision systems. One recent innovation introduced with the G500 and G600 is the Symmetry Flight Deck that includes 10 touchscreens and active control sidesticks. The active control sidesticks allow the pilot and co-pilot to see and feel each other's control inputs, enhancing their situational awareness and safety of the flight. We have also introduced several service and support applications including the PlaneBook application, which provides pilots easy and immediate digital access to critical flight information and aircraft-specific documents.

In support of Gulfstream's growing aircraft portfolio and international customer base, we have invested in a multi-year facilities project at our Savannah campus, which is scheduled to continue through 2017. This expansion consists of constructing new facilities, including the completed purpose-built manufacturing facilities for production of the G500 and G600, and renovating existing infrastructure. This effort follows earlier projects that included a purpose-built G650 manufacturing facility, increased aircraft-service capacity, an improved customer sales and design center and a state-of-the-art paint facility.

The group offers extensive support of the nearly 2,500 Gulfstream aircraft in service with professionals located around the globe. The service network for Gulfstream aircraft continues to evolve to address the demands of the group's growing international customer base. We operate 11 company-owned service centers, maintain 15 authorized warranty centers and maintenance facilities on six continents, and offer on-call Gulfstream aircraft technicians ready to deploy for urgent customer-service requirements in the Americas. This commitment to superior product support continues to receive industry recognition, including the number-one ranking for the 12th consecutive year in the annual Aviation International News Product Support Survey, as well as the top ranking in the annual Professional Pilot Survey.

Jet Aviation augments our Aerospace portfolio with completions (avionics, interior outfitting and paint) for business-jet customers, as well as custom, complex completions of single- and double-aisle aircraft requiring advanced engineering, design and manufacturing capabilities. In addition, Jet Aviation provides superior maintenance, repair, aircraft management and FBO services to a broad global customer base through a network of facilities across four continents.

A market leader in the business-aviation industry, the Aerospace group is focused on developing innovative first-to-market technologies and products; providing exemplary and timely service to customers globally; and driving efficiencies and reducing costs in the aircraft production, outfitting and service processes.

Revenues for the Aerospace group were 28 percent of our consolidated revenues in 2014, 26 percent in 2013 and 22 percent in 2012. Revenues by major products and services were as follows:

Year Ended December 31	2014	2013	2012
Aircraft manufacturing, outfitting and completions	$6,983	$6,378	$5,317
Aircraft services	1,599	1,530	1,491
Pre-owned aircraft	67	210	104
Total Aerospace	$8,649	$8,118	$6,912

COMBAT SYSTEMS

Our Combat Systems group is a global leader in systems engineering, spanning design, development, manufacture and support of military vehicles, weapons systems and munitions for the United States and its allies. The group's product lines include:

- wheeled combat and tactical vehicles,
- main battle tanks and tracked combat vehicles,
- weapons systems and munitions, and
- maintenance and logistics support and sustainment services.

The group's backlog, which reached a historic high in 2014, includes a diverse mix of products supporting domestic and non-U.S. customers. We pursue continuous process improvements to enhance our productivity and improve our operating performance as we deliver on this backlog. We apply our systems-level engineering expertise to develop improvements that advance the utility, safety and mission-effectiveness of our products.

Our portfolio of military vehicles, produced at our operations in North America and Europe, includes heavy, medium and light wheeled vehicles and heavy and medium tracked vehicles. This extensive product line allows us to be agile in providing tailored solutions to our customers.

The group has a market-leading position in the light armored vehicle (LAV) market. We have a $10 billion contract with an international customer to provide wheeled armored vehicles through 2028. This contract includes vehicle production and contractor logistics support.

We offer several products in the medium wheeled vehicle segment, including the Stryker combat vehicle. Stryker has proven itself as one of the most versatile combat-tested vehicles in the U.S. Army inventory, combining agility and firepower into a deployable and responsive combat support vehicle. There are currently 10 variants of the Stryker, including the M1127 Reconnaissance Vehicle and the M1133 Medical Evacuation Vehicle. The Army is planning to convert all nine of its Stryker Brigade Combat Teams to the double-V-hulled configuration, which significantly improves protection for soldiers from improvised explosive devices (IEDs). In addition to the Stryker program, we are modernizing approximately 600 LAV III combat vehicles for the Canadian government and have delivered numerous Piranha and Pandur armored vehicles to various foreign governments.

Leveraging our prior experience in the light wheeled vehicle market, the group is under contract with U.S. Special Operations Command to produce the Ground Mobility Vehicle (GMV) and the Internally-Transportable Vehicle (ITV), a narrow version of the GMV. We are also delivering the Foxhound vehicle to the U.K. Ministry of Defence (MoD), and the Eagle vehicle to Germany.

We continue to support the evolving needs of the U.S. Army and Marine Corps with technology upgrades to the Abrams main battle tank family of vehicles. The group is currently upgrading Abrams tanks with the System Enhancement Package (SEP) that provides a digital platform with an enhanced command-and-control system, new power generation and distribution systems, second-generation thermal sights and improved armor.

Our position in the medium tracked vehicle segment grew in 2014 with a 10-year contract to build the Specialist Vehicle (SV) for the U.K. MoD. SV is the next generation of armoured fighting vehicles in the United Kingdom. The contract positions us as a leading provider of the U.K.'s combat vehicles.
With our large installed base of vehicles worldwide, we are positioned for future modernization programs, as well as opportunities for support and sustainment services. For example, we are under contract with the Marine Corps to reset Cougar vehicles. In addition, with the expertise gained from our engineering and production programs across our product portfolio, we are well-qualified to participate in future combat vehicle development programs.
Complementing these military-vehicle offerings, the group designs, develops and produces a comprehensive array of weapons systems across the battle spectrum. For ground forces, we manufacture M2/M2-A1 heavy machine guns and MK19/ MK47 grenade launchers. The group also produces legacy and next-generation weapons systems for shipboard applications, including the Navy's Phalanx Close-In Weapon System (CIWS), multiple subsystems for the Littoral Combat Ship (LCS), and DDG-1000 destroyer firepower mission modules. For airborne platforms, we produce weapons for U.S. and non-U.S. fighter aircraft, including high-speed Gatling guns for all U.S. fixed-wing military aircraft. The group is also a significant supplier of composite structures and aircraft components.
Our munitions portfolio covers the full breadth of naval, air and ground forces applications across all calibers and weapons platforms for the U.S. government and its allies. The group maintains a market-leading position in the supply of Hydra-70 rockets, large-caliber tank ammunition, medium-caliber ammunition, mortar and artillery projectiles, tactical missile aerostructures and high-performance warheads, military propellants, and conventional bombs and bomb cases.
The Combat Systems group emphasizes operational execution and business optimization initiatives as the group delivers on our backlog. As part of these efforts, the group has undertaken restructuring activities to ensure we remain competitively positioned for the future. In an environment of dynamic threats and evolving customer needs, the group remains agile and focused on innovation, affordability and speed-to-market to deliver on our current programs and to secure new opportunities.
Revenues for the Combat Systems group were 18 percent of our consolidated revenues in 2014, 19 percent in 2013 and 24 percent in 2012. Revenues by major products and services were as follows:

Year Ended December 31	2014	2013	2012
Wheeled combat vehicles	$2,852	$2,709	$3,930
Weapons systems and munitions	1,635	1,761	1,950
Tanks and tracked vehicles	526	595	792
Engineering and other services	719	767	799
Total Combat Systems	$5,732	$5,832	$7,471

INFORMATION SYSTEMS AND TECHNOLOGY

Our Information Systems and Technology group provides technologies, products and services that address a wide range of military, federal/civilian and commercial information-systems requirements. The group's leadership in this market results from decades of domain expertise, incumbency on high-priority programs and continuous innovation to deliver solutions that meet our customers' needs. We provide full-spectrum support for the design, development, integration, production and sustainment of:

- information technology (IT) solutions and mission support services, and

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- mobile communication systems and intelligence, surveillance and reconnaissance (ISR) solutions.

IT solutions and mission support services: We provide professional and technical services to the U.S. defense and intelligence communities, the Departments of Homeland Security and Health and Human Services, other federal/civilian agencies, and commercial and non-U.S. customers. The group's technical support personnel and domain specialists help customers meet critical planning, staffing, technology and operational needs.

The group designs, builds and operates large-scale, secure IT networks and systems for U.S. government customers, commercial wireless network providers, and federal, state and local public safety agencies. We work closely with our customers to ensure their network infrastructures are secure, efficient, scalable and cost-effective. We are also at the forefront of cloud and virtualization technologies and services. For example, the group is implementing the Department of Defense's (DoD) largest enterprise-wide email infrastructure and a virtual desktop environment for the intelligence community.

As a leading provider in the U.S. healthcare IT market, we support government civilian and military health systems, providing critical services in support of healthcare reform and medical benefits programs. Our offerings include data management, analytics, fraud prevention and detection software, process automation and program management solutions for public and commercial health systems. We are operating customer contact centers for the Centers for Medicare & Medicaid Services, responding to consumer inquiries about key Medicare and Affordable Care Act programs.

Mobile communication systems and ISR solutions: We design, build, deploy and support solutions for customers in the U.S. defense, intelligence and homeland security communities, and U.S. allies. Our offerings include secure communications systems, command and control solutions, signals and information collection, processing and distribution systems; imagery sensors; and cyber security, information assurance, and encryption products, systems and services.

We integrate and manufacture secure communications systems for customers in the DoD, the intelligence community, federal/civilian and public safety agencies, and for non-U.S. customers. These solutions, which include fixed and mobile ground, radio and satellite communications systems and antenna technologies, improve our customers' ability to communicate, collaborate and access vital information.

The group is delivering a modern, secure network to the U.S. Army, known as the Soldier's Network, which provides tactical voice and data communications to soldiers anywhere on the battlefield. We are the prime contractor for Warfighter Information Network-Tactical (WIN-T), the Army's backbone mobile communications network, and we are the prime contractor on many of the Army's core tactical radio programs, including the AN/PRC-154A Rifleman and AN/PRC-155 two-channel Manpack radios. We are developing and deploying the Mobile User Objective System (MUOS) communication waveform and ground system, which will help provide the satellite link to soldiers on the ground so they can access voice, video and data communications in the most remote locations.

The Information Systems and Technology group provides many of these capabilities to non-U.S. public agencies and commercial customers. For the Canadian Department of National Defence, we developed, deployed and continue to modernize and support the Canadian Army's fully integrated, secure combat voice and data network. We leveraged this experience to deliver the U.K. MoD's Bowman tactical communication system, for which we currently provide ongoing support and capability upgrades.

In command-and-control systems, we have a 50-year legacy of providing advanced fire-control systems for U.S. Navy submarine programs and we are developing and integrating commercial off-the-shelf software and hardware upgrades to improve the tactical control capabilities for several submarine classes. Capitalizing on this expertise, we developed the combat and seaframe control systems and we are the lead systems

integrator for the Navy's Independence-variant LCS and the electronic systems for the Navy's Joint High Speed Vessel (JHSV).

Information Systems and Technology provides ISR solutions for classified programs. Our expertise includes multi-intelligence ground systems and large-scale, high-performance data and signal processing. We deliver high-reliability, long-life sensors and payloads designed to perform in the most extreme environments, including space payloads and undersea sensor and power systems.

The group offers comprehensive cyber security-related products and services to help customers protect their networks from internal and external threats and prevent data breaches. For more than 45 years we have developed information assurance technologies that are integral to defending critical information, including a widely deployed Type 1 network encryptor. We also support the DoD's Cyber Crime Center and the Department of Homeland Security's National Cybersecurity Protection System.

The group is well-positioned to continue meeting the needs of our diverse customer base in an increasingly competitive market. We are improving the group's performance and competitive position by optimizing the size of the business, harmonizing capabilities throughout the portfolio and developing innovative solutions to meet evolving customer requirements. Consistent with this focus, in 2014 we announced the consolidation of two businesses in the group to form General Dynamics Mission Systems in an effort to be more efficient and responsive to our customers. The consolidation was effective in January 2015.

Revenues for the Information Systems and Technology group were 30 percent of our consolidated revenues in 2014 and 33 percent in 2013 and 2012. Revenues by major products and services were as follows:

Year Ended December 31	2014	2013	2012
Mobile communication systems	$2,771	$3,657	$3,425
IT solutions and mission support services	4,549	4,734	4,545
ISR solutions	1,839	1,877	2,047
Total Information Systems and Technology	$9,159	$10,268	$10,017

MARINE SYSTEMS

Our Marine Systems group designs, builds and supports submarines and surface ships for the U.S. Navy and Jones Act ships for commercial customers. We are one of two primary shipbuilders for the Navy. The group's diverse portfolio of platforms and capabilities includes:

- nuclear-powered submarines;
- surface combatants;
- auxiliary and combat-logistics ships;
- commercial product carriers and containerships;
- design and engineering support; and
- overhaul, repair and lifecycle support services.

Our work for the Navy includes the construction of new ships and the design and development of next-generation platforms to help meet evolving missions and maintain desired fleet size. Approximately 95 percent of the group's revenues are for major Navy ship-construction programs awarded under large, multi-ship contracts that span several years. These programs include Virginia-class nuclear-powered submarines, Arleigh Burke-class (DDG-51) and Zumwalt-class (DDG-1000) guided-missile destroyers, and Mobile Landing Platform (MLP) auxiliary support ships.

The Virginia-class submarine includes capabilities for open-ocean and littoral missions. These stealthy boats are well-suited for a variety of global assignments, including intelligence gathering, special-operations missions and sea-based missile launch. The Navy is procuring Virginia-class submarines in multi-boat blocks. In 2014, we received a contract for the construction of 10 submarines in the fourth block of the program, bringing the number of boats under contract to 28. The group has delivered 11 of these boats in conjunction with an industry partner that shares in the construction. The remaining 17 boats under contract are scheduled for delivery through 2023.

We are the lead designer and producer of DDG-51s, managing the design, modernization and lifecycle support of these ships. As the only active destroyer in the Navy’s global surface fleet, DDG-51s are multi-mission combatants that offer defense against a wide range of threats, including ballistic missiles. We currently have construction contracts for seven DDG-51s scheduled for delivery through 2022.

The group is one of the Navy's contractors involved in development and construction of the DDG-1000 platform. These ships are equipped with numerous technological enhancements, including a low radar profile, an integrated power system and advanced gun systems that provide a three-fold increase in range over current naval surface gun weapons. Deliveries of the three ships in the program are scheduled through 2019.

MLP ships serve as floating transfer stations, improving the Navy’s ability to deliver equipment and cargo to areas without adequate port access. The group has delivered the first two ships in the program, and construction is underway on two additional ships scheduled for delivery in 2015 and 2018. The third and fourth ships are configured as Afloat Forward Staging Bases (AFSB), designed to facilitate a variety of missions in support of mine countermeasures and special operations, providing significant new capabilities to the customer.

In addition to these ship construction programs, we are advancing new technologies and naval platforms with our customers. These design and engineering efforts include the development of the next-generation ballistic-missile submarine to replace the Ohio class of ballistic-missile submarines. In conjunction with these efforts, the group is leading the design of the Common Missile Compartment under joint development for the U.S. Navy and the U.K. Royal Navy.

Marine Systems provides comprehensive ship and submarine overhaul, repair and lifecycle support services to extend the service life and maximize the value of these ships. We conduct surface-ship repair operations in four locations with full-service maintenance and repair shipyards on both U.S. Coasts. We also provide extensive submarine repair services in a variety of U.S. locations and convert decommissioned submarines to moored training platforms. In support of allied navies, we offer program management, planning, engineering and design support for submarine and surface-ship construction programs.

Beyond its work for the Navy, Marine Systems is advancing commercial shipbuilding technology with the design and production of liquefied natural gas (LNG)-powered and LNG-conversion-ready ships for commercial customers that meet the Jones Act requirement for ships carrying cargo between U.S. ports to be built in U.S. shipyards. Currently, we have construction contracts for 10 ships scheduled for delivery through 2017. Construction is underway on five ships, with all 10 expected to be at various stages of construction by the end of 2015. We anticipate that the age of the Jones Act fleet and environmental regulations that impose more stringent emission control limits will continue to provide additional commercial shipbuilding opportunities.

To further the group’s goals of operating efficiency, innovation, affordability for the customer and continuous improvement, we make strategic investments in our business, often in cooperation with the Navy and local governments. In addition, Marine Systems leverages its design and engineering expertise across

its shipyards to improve program execution and generate cost savings. This knowledge-sharing enables the group to use resources more efficiently and drive process improvements. We are well-positioned to continue to fulfill the ship-construction and support requirements of our customers.
Revenues for the Marine Systems group were 24 percent of our consolidated revenues in 2014, 22 percent in 2013 and 21 percent in 2012. Revenues by major products and services were as follows:

Year Ended December 31	2014	2013	2012
Nuclear-powered submarines	$4,310	$3,697	$3,601
Surface combatants	1,084	1,139	1,152
Auxiliary and commercial ships	640	499	746
Repair and other services	1,278	1,377	1,093
Total Marine Systems	$7,312	$6,712	$6,592

CUSTOMERS
In 2014, 58 percent of our revenues were from the U.S. government, 17 percent were from U.S. commercial customers, 14 percent were from non-U.S. commercial customers and the remaining 11 percent were from non-U.S. defense customers.
U.S. GOVERNMENT
Our primary customer is the U.S. Department of Defense (DoD). We also contract with other U.S. government customers, including the intelligence community, the Departments of Homeland Security and Health and Human Services and first-responder agencies. Our revenues from the U.S. government were as follows:

Year Ended December 31	2014		2013		2012	
DoD	$14,516		$15,441		$17,217	
Non-DoD	2,750		2,790		2,382	
Foreign Military Sales (FMS)*	689		1,032		1,206	
Total U.S. government	$17,955		$19,263		$20,805	
Percent of total revenues	58	%	62	%	67	%

* In addition to our direct non-U.S. sales, we sell to non-U.S. governments through the FMS program. Under the FMS program, we contract with and are paid by the U.S. government, and the U.S. government assumes the risk of collection from the non-U.S. government customer.
We perform our U.S. government business under fixed-price, cost-reimbursement and time-and-materials contracts. Our production contracts are primarily fixed-price. Under these contracts, we agree to perform a specific scope of work for a fixed amount. Contracts for research, engineering, repair and maintenance and other services are typically cost-reimbursement or time-and-materials. Under cost-reimbursement contracts, the customer reimburses contract costs and pays a fixed, incentive or award-based fee. These fees are determined by our ability to achieve targets set in the contract, such as cost, quality, schedule and performance. Under time-and-materials contracts, the customer pays a fixed hourly rate for direct labor and generally reimburses us for the cost of materials.
In our U.S. government business, fixed-price contracts accounted for 53 percent in 2014, 54 percent in 2013 and 56 percent in 2012; cost-reimbursement contracts accounted for 43 percent in 2014, 42 percent in 2013 and 39 percent in 2012; and time-and-materials contracts accounted for 4 percent in 2014 and 2013 and 5 percent in 2012.
Each of these contract types presents advantages and disadvantages. Fixed-price contracts typically have higher fee levels as we assume more risk. These types of contracts offer additional profits when we complete the work for less than the contract amount. Cost-reimbursement contracts generally subject us to lower risk.

Accordingly, the negotiated fees are usually lower than fees earned on fixed-price contracts. Additionally, not all costs are allowable under these types of contracts, and the government reviews the costs we charge. Under time-and-materials contracts, our profit may vary if actual labor-hour costs vary significantly from the negotiated rates. Also, because these contracts can provide little or no fee for managing material costs, the content mix can impact profit margin rates.

U.S. COMMERCIAL

Our U.S. commercial revenues were $5.3 billion in 2014, $5.4 billion in 2013 and $3.8 billion in 2012. This represented approximately 17 percent of our consolidated revenues in 2014, 18 percent in 2013 and 12 percent in 2012. The majority of these revenues are for business-jet aircraft and services where our customer base consists of individuals and public and privately held companies across a wide range of industries.

NON-U.S.

Our direct revenues from non-U.S. government and commercial customers were $7.6 billion in 2014, $6.3 billion in 2013 and $6.4 billion in 2012. This represented approximately 25 percent of our consolidated revenues in 2014, 20 percent in 2013 and 21 percent in 2012.

We conduct business with government customers around the world with operations in Australia, Canada, Germany, Mexico, Spain, Switzerland and the United Kingdom. Our non-U.S. defense subsidiaries are committed to maintaining long-term relationships with their respective governments and have established themselves as principal regional suppliers and employers.

Our non-U.S. commercial business consists primarily of business-jet aircraft exports and worldwide aircraft services. The market for business-jet aircraft and related services outside North America has expanded significantly in recent years. While the installed base of aircraft is concentrated in North America, orders from non-U.S. customers represent a significant segment of our aircraft business with approximately 60 percent of total backlog on December 31, 2014.

For a discussion of the risks associated with conducting business in locations outside the United States, see Risk Factors contained herein. For information regarding revenues and assets by geographic region, see Note Q to the Consolidated Financial Statements in Item 8.

COMPETITION

Several factors determine our ability to compete successfully in the defense and business-aviation markets. While customers’ evaluation criteria vary, the principal competitive elements include:

- the technical excellence, reliability, safety and cost competitiveness of our products and services;
- our ability to innovate and develop new products and technologies that improve mission performance and adapt to dynamic threats;
- successful program execution and on-time delivery of complex, integrated systems;
- our global footprint and accessibility to customers;
- the reputation and customer confidence derived from our past performance; and
- the successful management of customer relationships.

DEFENSE MARKET COMPETITION

The U.S. government contracts with numerous domestic and non-U.S. companies for products and services. We compete against other large-platform and system-integration contractors as well as smaller companies that specialize in a particular technology or capability. Outside the U.S., we compete with global defense contractors' exports and the offerings of private and state-owned defense manufacturers. Our Combat Systems group competes with a large number of domestic and non-U.S. businesses. Our Information Systems and Technology group competes with many companies, from large defense companies to small niche competitors with specialized technologies or expertise. Our Marine Systems group has one primary competitor with which it also partners on the Virginia-class submarine program. The operating cycle of many of our major platform programs can result in sustained periods of program continuity when we perform successfully.

We are involved in teaming and subcontracting relationships with some of our competitors. Competitions for major defense programs often require companies to form teams to bring together a spectrum of capabilities to meet the customer's requirements. Opportunities associated with these programs include roles as the program's integrator, overseeing and coordinating the efforts of all participants on a team, or as a provider of a specific component or subsystem.

BUSINESS-JET AIRCRAFT MARKET COMPETITION

The Aerospace group has several competitors for each of its Gulfstream products. Key competitive factors include aircraft safety, reliability and performance; comfort and in-flight productivity; service quality, global footprint and responsiveness; technological and new-product innovation; and price. We believe that Gulfstream competes effectively in all of these areas.

The Aerospace group competes worldwide in the business-jet aircraft services business primarily on the basis of price, quality and timeliness. In our maintenance, repair and FBO businesses, the group competes with several other large companies as well as a number of smaller companies, particularly in the maintenance business. In our completions business, the group competes with other OEMs, as well as several third-party providers.

BACKLOG

Our total backlog represents the estimated remaining value of work to be performed under firm contracts and includes funded and unfunded portions. For additional discussion of backlog, see Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7.

Summary backlog information for each of our business groups follows:

December 31	2014			2013			2014 Total Backlog Not Expected to Be Completed in 2015
	Funded	Unfunded	Total	Funded	Unfunded	Total	
Aerospace	$13,115	$117	$13,232	$13,785	$158	$13,943	$6,931
Combat Systems	19,292	506	19,798	5,451	1,113	6,564	15,060
Information Systems and Technology	7,070	1,539	8,609	7,253	1,267	8,520	2,229
Marine Systems	13,452	17,319	30,771	11,795	5,063	16,858	24,518
Total backlog	$52,929	$19,481	$72,410	$38,284	$7,601	$45,885	$48,738

RESEARCH AND DEVELOPMENT

To foster innovative product development and evolution, we conduct sustained R&D activities as part of our normal business operations. In the commercial sector, most of our Aerospace group’s R&D activities support Gulfstream’s product enhancement and development programs. In our U.S. defense businesses, we conduct customer-sponsored R&D activities under government contracts and company-sponsored R&D. In accordance with government regulations, we recover a portion of company-sponsored R&D expenditures through overhead charges to U.S. government contracts. For more information on our company-sponsored R&D activities, including our expenditures for the past three years, see Note A to the Consolidated Financial Statements in Item 8.

INTELLECTUAL PROPERTY

We develop technology, manufacturing processes and systems-integration practices. In addition to owning a large portfolio of proprietary intellectual property, we license some intellectual property rights to and from others. The U.S. government holds licenses to many of our patents developed in the performance of U.S. government contracts, and it may use or authorize others to use the inventions covered by these patents. Although these intellectual property rights are important to the operation of our business, no existing patent, license or other intellectual property right is of such importance that its loss or termination would have a material impact on our business.

EMPLOYEES

On December 31, 2014, our subsidiaries had 99,500 employees, approximately one-fifth of whom work under collective agreements with various labor unions and worker representatives. Agreements covering approximately 2 percent of total employees are due to expire in 2015. Historically, we have negotiated successor labor agreements without any significant disruption to operating activities.

RAW MATERIALS, SUPPLIERS AND SEASONALITY

We depend on suppliers and subcontractors for raw materials, components and subsystems. These supply networks can experience price fluctuations and capacity constraints, which can put pressure on our costs. Effective management and oversight of suppliers and subcontractors is an important element of our successful performance. We attempt to mitigate these risks with our suppliers by entering into long-term agreements and leveraging company-wide agreements to achieve economies of scale, and by negotiating flexible pricing terms in our customer contracts. We have not experienced, and do not foresee, significant difficulties in obtaining the materials, components or supplies necessary for our business operations.

Our business is not seasonal in nature. The receipt of contract awards, the availability of funding from the customer, the incurrence of contract costs and unit deliveries are all factors that influence the timing of our revenues. In the U.S., these factors are influenced by the federal government’s budget cycle based on its October-to-September fiscal year. Outside the U.S., work for many of our government customers is weighted toward the end of the calendar year.

REGULATORY MATTERS

U.S. GOVERNMENT CONTRACTS

U.S. government contracts are subject to procurement laws and regulations. The Federal Acquisition Regulation (FAR) and the Cost Accounting Standards (CAS) govern the majority of our contracts. The FAR mandates uniform policies and procedures for U.S. government acquisitions and purchased services. Also, individual agencies can have acquisition regulations that provide implementing language for the FAR or that supplement the FAR. For example, the DoD implements the FAR through the Defense Federal

Acquisition Regulation Supplement (DFARS). For all federal government entities, the FAR regulates the phases of any product or service acquisition, including:

- acquisition planning,
- competition requirements,
- contractor qualifications,
- protection of source selection and vendor information, and
- acquisition procedures.

In addition, the FAR addresses the allowability of our costs, while the CAS address how those costs should be allocated to contracts. The FAR subjects us to audits and other government reviews covering issues such as cost, performance and accounting practices relating to our contracts.

NON-U.S. REGULATORY

Our non-U.S. revenues are subject to the applicable foreign government regulations and procurement policies and practices, as well as U.S. policies and regulations. We are also subject to regulations governing investments, exchange controls, repatriation of earnings and import-export control.

BUSINESS-JET AIRCRAFT

The Aerospace group is subject to Federal Aviation Administration (FAA) regulation in the U.S. and other similar aviation regulatory authorities internationally, including the Civil Aviation Administration of Israel (CAAI), the European Aviation Safety Agency (EASA) and the Civil Aviation Administration of China (CAAC). For an aircraft to be manufactured and sold, the model must receive a type certificate from the appropriate aviation authority and each aircraft must receive a certificate of airworthiness. Aircraft outfitting and completions also require approval by the appropriate aviation authority, which often is accomplished through a supplemental type certificate. Aviation authorities can require changes to a specific aircraft or model type before granting approval. Maintenance facilities and charter operations must be licensed by aviation authorities as well.

ENVIRONMENTAL

We are subject to a variety of federal, state, local and foreign environmental laws and regulations. These laws and regulations cover the discharge, treatment, storage, disposal, investigation and remediation of certain materials, substances and wastes. We are directly or indirectly involved in environmental investigations or remediation at some of our current and former facilities and at third-party sites that we do not own but where we have been designated a Potentially Responsible Party (PRP) by the U.S. Environmental Protection Agency or a state environmental agency. As a PRP, we potentially are liable to the government or third parties for the cost of remediating contamination. In cases where we have been designated a PRP, generally we seek to mitigate these environmental liabilities through available insurance coverage and by pursuing appropriate cost-recovery actions. In the unlikely event we are required to fully fund the remediation of a site, the current statutory framework would allow us to pursue contributions from other PRPs. We regularly assess our compliance status and management of environmental matters.

Operating and maintenance costs associated with environmental compliance and management of contaminated sites are a normal, recurring part of our operations. Historically, these costs have not been material. Environmental costs often are recoverable under our contracts with the U.S. government. Based on information currently available and current U.S. government policies relating to cost recovery, we do not expect continued compliance with environmental regulations to have a material impact on our results of operations, financial condition or cash flows. For additional information relating to the impact of environmental matters, see Note N to the Consolidated Financial Statements in Item 8.

AVAILABLE INFORMATION

We file reports and other information with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended. These reports and information include an annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and proxy statements. Free copies of these items are made available on our website (www.generaldynamics.com) as soon as practicable and through the General Dynamics investor relations office at (703) 876-3583.

These items also can be read and copied at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC 20549. Information on the operation of the Public Reference Room is available by calling the SEC at (800) SEC-0330. The SEC maintains a website (www.sec.gov) that contains reports, proxy and information statements and other information.

ITEM 1A. RISK FACTORS

An investment in our common stock or debt securities is subject to risks and uncertainties. Investors should consider the following factors, in addition to the other information contained in this Annual Report on Form 10-K, before deciding whether to purchase our securities.

Investment risks can be market-wide as well as unique to a specific industry or company. The market risks faced by an investor in our stock are similar to the uncertainties faced by investors in a broad range of industries. There are some risks that apply more specifically to our business.

Our revenues are concentrated with the U.S. government. This customer relationship involves some specific risks. In addition, our sales to non-U.S. customers expose us to different financial and legal risks. Despite the varying nature of our U.S. and non-U.S. defense and business-aviation operations and the markets they serve, each group shares some common risks, such as the ongoing development of high-technology products and the price, availability and quality of commodities and subsystems.

The U.S. government provides a significant portion of our revenues. Approximately 60 percent of our revenues are from the U.S. government. U.S. defense spending is driven by threats to national security. While the country has been under an elevated threat level for more than a decade, competing demands for federal funds are pressuring various areas of spending. Defense investment accounts (budgets for procurement and research and development) remain under pressure. Decreases in U.S. government defense spending, including investment accounts, or changes in spending allocation could result in one or more of our programs being reduced, delayed or terminated, which could impact our financial performance.

For additional information relating to the U.S. defense budget, see the Business Environment section of Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7.

U.S. government contracts are not always fully funded at inception, and any funding is subject to disruption or delay. Our U.S. government revenues are funded by agency budgets that operate on an October-to-September fiscal year. Early each calendar year, the President of the United States presents to the Congress the budget for the upcoming fiscal year. This budget proposes funding levels for every federal agency and is the result of months of policy and program reviews throughout the Executive branch. For the remainder of the year, the appropriations and authorization committees of the Congress review the President's budget proposals and establish the funding levels for the upcoming fiscal year. Once these levels are enacted into law, the Executive Office of the President administers the funds to the agencies.

There are two primary risks associated with the U.S. government budget cycle. First, the annual process may be delayed or disrupted, which has occurred in recent years. For example, changes in congressional schedules due to elections or other legislative priorities, or negotiations for program funding levels can interrupt the process. If the annual budget is not approved by the beginning of the government fiscal year, portions of the U.S. government can shut down or operate under a continuing resolution that maintains spending at prior-year levels, which can impact funding for our programs and timing of new awards. Second, the Congress typically appropriates funds on a fiscal-year basis, even though contract performance may extend over many years. Future revenues under existing multi-year contracts are conditioned on the continuing availability of congressional appropriations. Changes in appropriations in subsequent years may impact the funding available for these programs. Delays or changes in funding can impact the timing of available funds or lead to changes in program content.

Our U.S. government contracts are subject to termination rights by the customer. U.S. government contracts generally permit the government to terminate a contract, in whole or in part, for convenience. If a contract is terminated for convenience, a contractor usually is entitled to receive payments for its allowable costs and the proportionate share of fees or earnings for the work performed. The government may also terminate a contract for default in the event of a breach by the contractor. If a contract is terminated for default, the government in most cases pays only for the work it has accepted. The termination of multiple or large programs could have a material adverse effect on our future revenues and earnings.

Government contractors are subject to audit by the U.S. government. Numerous U.S. government agencies routinely audit and review government contractors. These agencies review a contractor’s performance under its contracts and compliance with applicable laws, regulations and standards. The U.S. government also reviews the adequacy of, and a contractor’s compliance with, its internal control systems and policies, including the contractor’s purchasing, property, estimating, material, earned value management and accounting systems. In some cases, audits may result in delayed payments or contractor costs not being reimbursed or subject to repayment. If an audit or investigation were to result in allegations against a contractor of improper or illegal activities, civil or criminal penalties and administrative sanctions could result, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or prohibition from doing business with the U.S. government. In addition, reputational harm could result if allegations of impropriety were made. In some cases, audits may result in disputes with the respective government agency that can result in negotiated settlements, arbitration or litigation.

Our Aerospace group is subject to changing customer demand for business aircraft. The business-jet market is driven by the demand for business-aviation products and services by business, individual and government customers in the United States and around the world. The Aerospace group’s results also depend on other factors, including general economic conditions, the availability of credit and trends in capital goods markets. In addition, if customers default on existing contracts and the contracts are not replaced, the group’s anticipated revenues and profitability could be reduced materially as a result.

Earnings and margins depend on our ability to perform on our contracts. When agreeing to contractual terms, our management team makes assumptions and projections about future conditions and events. The accounting for our contracts and programs requires assumptions and estimates about these conditions and events. These projections and estimates assess:

- the productivity and availability of labor,
- the complexity of the work to be performed,
- the cost and availability of materials and components, and

- schedule requirements.

If there is a significant change in one or more of these circumstances, estimates or assumptions, or if the risks under our contracts are not managed adequately, the profitability of contracts could be adversely affected. This could affect earnings and margins materially.

Earnings and margins depend in part on subcontractor and vendor performance. We rely on other companies to provide materials, components and subsystems for our products. Subcontractors also perform some of the services that we provide to our customers. We depend on these subcontractors and vendors to meet our contractual obligations in full compliance with customer requirements and applicable law. Misconduct by subcontractors, such as a failure to comply with procurement regulations or engaging in unauthorized activities, may harm our future revenues and earnings. We manage our supplier base carefully to avoid customer issues. However, we sometimes rely on only one or two sources of supply that, if disrupted, could have an adverse effect on our ability to meet our customer commitments. Our ability to perform our obligations may be materially adversely affected if one or more of these suppliers is unable to provide the agreed-upon supplies, perform the agreed-upon services in a timely and cost-effective manner or engages in misconduct or other improper activities.

Sales and operations outside the U.S. are subject to different risks that may be associated with doing business in foreign countries. In some countries there is increased chance for economic, legal or political changes, and procurement procedures may be less robust or mature, which may complicate the contracting process. Our non-U.S. business may be sensitive to changes in a foreign government’s budgets, leadership and national priorities. Non-U.S. transactions can involve increased financial and legal risks arising from foreign exchange-rate variability and differing legal systems. Our non-U.S. business is subject to U.S. and foreign laws and regulations, including laws and regulations relating to import-export controls, technology transfers, the Foreign Corrupt Practices Act and certain other anti-corruption laws, and the International Traffic in Arms Regulations (ITAR). An unfavorable event or trend in any one or more of these factors or a failure to comply with U.S. or foreign laws could result in administrative, civil or criminal liabilities, including suspension or debarment from government contracts or suspension of our export privileges and could materially adversely affect revenues and earnings associated with our non-U.S. business.

In addition, some non-U.S. government customers require contractors to enter into letters of credit, performance or surety bonds, bank guarantees and other similar financial arrangements. We may also be required to agree to specific in-country purchases, manufacturing agreements or financial support arrangements, known as offsets, that require us to satisfy certain requirements or face penalties. Offset requirements may extend over several years and could require us to establish joint ventures with local companies. If we do not satisfy these financial or offset requirements, our future revenues and earnings may be materially adversely affected.

Our future success depends in part on our ability to develop new products and technologies and maintain a qualified workforce to meet the needs of our customers. Many of the products and services we provide involve sophisticated technologies and engineering, with related complex manufacturing and system integration processes. Our customers’ requirements change and evolve regularly. Accordingly, our future performance depends in part on our ability to continue to develop, manufacture and provide innovative products and services and bring those offerings to market quickly at cost-effective prices. Due to the highly specialized nature of our business, we must hire and retain the skilled and qualified personnel necessary to perform the services required by our customers. If we were unable to develop new products that meet

customers' changing needs or successfully attract and retain qualified personnel, our future revenues and earnings may be materially adversely affected.

We have made and expect to continue to make investments, including acquisitions and joint ventures, that involve risks and uncertainties. When evaluating potential mergers and acquisitions, we make judgments regarding the value of business opportunities, technologies and other assets and the risks and costs of potential liabilities based on information available to us at the time of the transaction. Whether we realize the anticipated benefits from these transactions depends on multiple factors, including our integration of the businesses involved, the performance of the underlying products, capabilities or technologies, market conditions following the acquisition and acquired liabilities, including some that may not have been identified prior to the acquisition. These factors could materially adversely affect our financial results.

Changes in business conditions may cause goodwill and other intangible assets to become impaired. Goodwill represents the purchase price paid in excess of the fair value of net tangible and intangible assets acquired. Goodwill is not amortized and remains on our balance sheet indefinitely unless there is an impairment. Goodwill is subject to an impairment test on an annual basis and when circumstances indicate that an impairment is more likely than not. Such circumstances include a significant adverse change in the business climate for one of our business groups or a decision to dispose of a business group or a significant portion of a business group. We face some uncertainty in our business environment due to a variety of challenges, including changes in defense spending. We may experience unforeseen circumstances that adversely affect the value of our goodwill or intangible assets and trigger an evaluation of the amount of the recorded goodwill and intangible assets. Future write-offs of goodwill or other intangible assets as a result of an impairment test or any accelerated amortization of other intangible assets could materially adversely affect our results of operations and financial condition.

Our business could be negatively impacted by cyber security events and other disruptions. We face various cyber security threats, including threats to our information technology infrastructure and attempts to gain access to our proprietary or classified information, denial of service attacks, as well as threats to the physical security of our facilities and employees, and threats from terrorist acts. We also design and manage information technology systems for various customers. We generally face the same security threats for these systems as for our own. In addition, we face cyber threats from entities that may seek to target us through our customers, vendors and subcontractors. Accordingly, we maintain information security policies and procedures for managing all systems. We have experienced cyber security threats to our information technology infrastructure and attempts to gain access to our sensitive information, including viruses and attacks by hackers. Such prior events have not had a material impact on our financial condition, results of operations or liquidity. However, future threats could cause harm to our business and our reputation and challenge our eligibility for future work on sensitive or classified systems for U.S. government customers, as well as impact our results of operations materially. Our insurance coverage may not be adequate to cover all the costs related to cyber security attacks or disruptions resulting from such events.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements that are based on management's expectations, estimates, projections and assumptions. Words such as "expects," "anticipates," "plans," "believes," "scheduled," "outlook," "estimates," "should" and variations of these words and similar expressions are intended to identify forward-looking statements. Examples include projections of revenues, earnings, operating margins, segment performance, cash flows, contract awards, aircraft production, deliveries and backlog. In making these statements we rely on assumptions and analyses based on our experience and perception of historical trends, current conditions and expected future developments as well as other factors we consider appropriate under the circumstances. We believe our estimates and judgments are reasonable based on information available to us at the time. Forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, as amended. These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to predict. Therefore, actual future results and trends may differ materially from what is forecast in forward-looking statements due to a variety of factors, including, without limitation, the risk factors discussed in this section.

All forward-looking statements speak only as of the date of this report or, in the case of any document incorporated by reference, the date of that document. All subsequent written and oral forward-looking statements attributable to General Dynamics or any person acting on our behalf are qualified by the cautionary statements in this section. We do not undertake any obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date of this report. These factors may be revised or supplemented in subsequent reports on SEC Forms 10-Q and 8-K.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We operate in a number of offices, manufacturing plants, laboratories, warehouses and other facilities in the United States and abroad. We believe our facilities are adequate for our present needs and, given planned improvements and construction, expect them to remain adequate for the foreseeable future.

On December 31, 2014, our business groups had primary operations at the following locations:

- Aerospace – Lincoln and Long Beach, California; West Palm Beach, Florida; Brunswick and Savannah, Georgia; Cahokia, Illinois; Bedford and Westfield, Massachusetts; Las Vegas, Nevada; Teterboro, New Jersey; Dallas and Houston, Texas; Appleton, Wisconsin; Sorocaba, Brazil; Beijing and Hong Kong, China; Dusseldorf, Germany; Mexicali, Mexico; Moscow, Russia; Singapore; Basel, Geneva and Zurich, Switzerland; Dubai, United Arab Emirates; Luton, United Kingdom.
- Combat Systems – Anniston, Alabama; East Camden and Hampton, Arkansas; Crawfordsville, St. Petersburg and Tallahassee, Florida; Marion, Illinois; Saco, Maine; Westminster, Maryland; Shelby Township and Sterling Heights, Michigan; Joplin, Missouri; Lincoln, Nebraska; Roxboro, North Carolina; Lima and Springboro, Ohio; Eynon, Red Lion and Scranton, Pennsylvania; Edgefield and Ladson, South Carolina; Garland, Texas; Williston, Vermont; Marion, Virginia; Auburn, Washington;

Vienna, Austria; Edmonton, London, La Gardeur, St. Augustin and Valleyfield, Canada; Kaiserslautern, Germany; Granada, Sevilla and Trubia, Spain; Kreuzlingen, Switzerland; Oakdale, United Kingdom.

- Information Systems and Technology – Cullman, Alabama; Phoenix and Scottsdale, Arizona; San Diego and Santa Clara, California; Colorado Springs, Colorado; Lynn Haven and Orlando, Florida; Coralville, Iowa; Lawrence, Kansas; Annapolis Junction and Towson, Maryland; Needham, Pittsfield and Taunton, Massachusetts; Bloomington, Minnesota; Nashua, New Hampshire; Florham Park, New Jersey; Greensboro and Newton, North Carolina; Kilgore, Texas; Sandy, Utah; Arlington, Chantilly, Chesapeake, Fairfax, Herndon, Richmond and Springfield, Virginia; Calgary and Ottawa, Canada; Tallinn, Estonia; Oakdale, St. Leonards and Throckmorton, United Kingdom.
- Marine Systems – San Diego, California; Groton and New London, Connecticut; Jacksonville, Florida; Bath and Brunswick, Maine; North Kingstown, Rhode Island; Norfolk, Virginia; Bremerton, Washington; Mexicali, Mexico.

A summary of floor space by business group on December 31, 2014, follows:

(Square feet in millions)	Company-owned Facilities	Leased Facilities	Government-owned Facilities	Total
Aerospace	5.9	6.1	—	12.0
Combat Systems	7.2	3.8	5.3	16.3
Information Systems and Technology	2.5	9.2	0.9	12.6
Marine Systems	8.0	2.2	—	10.2
Total	23.6	21.3	6.2	51.1

ITEM 3. LEGAL PROCEEDINGS

For information relating to legal proceedings, see Note N to the Consolidated Financial Statements in Item 8.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

EXECUTIVE OFFICERS OF THE COMPANY

All of our executive officers are appointed annually. None of our executive officers was selected pursuant to any arrangement or understanding between the officer and any other person. The name, age, offices and positions of our executives held for at least the past five years as of February 9, 2015, were as follows:

Name, Position and Office	Age
Jason W. Aiken – Senior Vice President and Chief Financial Officer since January 2014; Vice President of the company and Chief Financial Officer of Gulfstream Aerospace Corporation, September 2011 – December 2013; Vice President and Controller of the company, April 2010 – August 2011; Staff Vice President, Accounting of the company, July 2006 – March 2010	42

John P. Casey – Executive Vice President, Marine Systems, since May 2012; Vice President of the company and President of Electric Boat Corporation, October 2003 – May 2012; Vice President of Electric Boat Corporation, October 1996 – October 2003	60
Larry R. Flynn – Vice President of the company and President of Gulfstream Aerospace Corporation since September 2011; Vice President of the company and Senior Vice President, Marketing and Sales of Gulfstream Aerospace Corporation, July 2008 – September 2011; President, Product Support of Gulfstream Aerospace Corporation, May 2002 – June 2008	62
Gregory S. Gallopoulos – Senior Vice President, General Counsel and Secretary of the company since January 2010; Vice President and Deputy General Counsel of the company, July 2008 – January 2010; Managing Partner of Jenner & Block LLP, January 2005 – June 2008	55
Jeffrey S. Geiger – Vice President of the company and President of Electric Boat Corporation since November 2013; Vice President of the company and President of Bath Iron Works Corporation, April 2009 – November 2013; Senior Vice President, Operations and Engineering of Bath Iron Works, March 2008 – March 2009	53
Robert W. Helm – Senior Vice President, Planning and Development of the company since May 2010; Vice President, Government Relations of Northrop Grumman Corporation, August 1989 – April 2010	63
S. Daniel Johnson – Executive Vice President, Information Systems and Technology, and President of General Dynamics Information Technology since January 2015; Vice President of the company and President of General Dynamics Information Technology, April 2008 – December 2014; Executive Vice President of General Dynamics Information Technology, July 2006 – March 2008	67
Kimberly A. Kuryea – Vice President and Controller of the company since September 2011; Chief Financial Officer of General Dynamics Advanced Information Systems, November 2007 – August 2011; Staff Vice President, Internal Audit of the company, March 2004 – October 2007	47
Joseph T. Lombardo – Executive Vice President, Aerospace, since April 2007; President of Gulfstream Aerospace Corporation, April 2007 – September 2011; Vice President of the company and Chief Operating Officer of Gulfstream Aerospace Corporation, May 2002 – April 2007	67
Christopher Marzilli – Vice President of the company and President of General Dynamics Mission Systems since January 2015; Vice President of the company and President of General Dynamics C4 Systems, January 2006 – December 2014; Senior Vice President and Deputy General Manager of General Dynamics C4 Systems, November 2003 – January 2006	55
Phebe N. Novakovic – Chairman and Chief Executive Officer of the company since January 2013; President and Chief Operating Officer of the company, May 2012 – December 2012; Executive Vice President, Marine Systems, May 2010 – May 2012; Senior Vice President, Planning and Development of the company, July 2005 – May 2010; Vice President, Strategic Planning of the company, October 2002 – July 2005	57
Walter M. Oliver – Senior Vice President, Human Resources and Administration of the company since March 2002; Vice President, Human Resources and Administration of the company, January 2001 – March 2002	69
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Mark C. Roualet – Executive Vice President, Combat Systems, since March 2013; Vice President of the company and President of General Dynamics Land Systems, October 2008 – March 2013; Senior Vice President and Chief Operating Officer of General Dynamics Land Systems, July 2007 – October 2008	
Gary L. Whited – Vice President of the company and President of General Dynamics Land Systems since March 2013; Senior Vice President of General Dynamics Land Systems, September 2011 – March 2013; Vice President and Chief Financial Officer of General Dynamics Land Systems, June 2006 – September 2011	54

PART II

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

Our common stock is listed on the New York Stock Exchange.

The high and low sales prices of our common stock and the cash dividends declared on our common stock for each quarter of 2013 and 2014 are included in the Supplementary Data contained in Item 8.

On February 1, 2015, there were approximately 13,000 holders of record of our common stock.

For information regarding securities authorized for issuance under our equity compensation plans, see Note O to the Consolidated Financial Statements contained in Item 8.

We did not make any unregistered sales of equity securities in 2014.

The following table provides information about our fourth-quarter repurchases of equity securities that are registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program*	Maximum Number of Shares That May Yet Be Purchased Under the Program*
Pursuant to Share Buyback Program				
9/28/14-10/26/14	216,000	$ 127.60	216,000	2,394,152
10/27/14-11/23/14	—	$ —	—	2,394,152
11/24/14-12/31/14	—	$ —	—	2,394,152
Total	216,000	$ 127.60		

* On February 5, 2014, the board of directors authorized management to repurchase 20 million shares of common stock.

For additional information relating to our repurchases of common stock during the past three years, see Financial Condition, Liquidity and Capital Resources – Financing Activities – Share Repurchases contained in Item 7.

The following performance graph compares the cumulative total return to shareholders on our common stock, assuming reinvestment of dividends, with similar returns for the Standard & Poor's® 500 Index and the Standard & Poor's® Aerospace & Defense Index, both of which include General Dynamics.

Cumulative Total Return
Based on Investments of $100 Beginning December 31, 2009
(Assumes Reinvestment of Dividends)

ITEM 6. SELECTED FINANCIAL DATA

The following table presents selected historical financial data derived from the Consolidated Financial Statements and other company information for each of the five years presented. This information should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and the Notes thereto.

(Dollars and shares in millions, except per-share and employee amounts)	2014	2013	2012	2011	2010
Summary of Operations					
Revenues	$30,852	$30,930	$30,992	$32,122	$31,964
Operating earnings	3,889	3,689	765	3,747	3,860
Operating margins	12.6 %	11.9 %	2.5 %	11.7 %	12.1 %
Interest, net	(86)	(86)	(156)	(141)	(157)
Provision for income tax, net	1,129	1,125	854	1,139	1,139
Earnings (loss) from continuing operations	2,673	2,486	(381)	2,500	2,567
Return on sales (a)	8.7 %	8.0 %	(1.2)%	7.8 %	8.0 %
Discontinued operations, net of tax	(140)	(129)	49	26	57
Net earnings (loss)	2,533	2,357	(332)	2,526	2,624
Diluted earnings (loss) per share:					
Continuing operations (b)	7.83	7.03	(1.08)	6.80	6.66
Net earnings (loss) (b)	7.42	6.67	(0.94)	6.87	6.81
Cash Flows					
Net cash provided by operating activities	$3,728	$3,111	$2,606	$3,150	$2,946
Net cash used by investing activities	(1,102)	(363)	(642)	(1,961)	(389)
Net cash used by financing activities	(3,575)	(725)	(1,382)	(1,201)	(2,223)
Net cash provided (used) by discontinued operations	36	(18)	65	48	16
Cash dividends declared per common share	2.48	2.24	2.04	1.88	1.68
Financial Position					
Cash and equivalents	$4,388	$5,301	$3,296	$2,649	$2,613
Total assets	35,355	35,494	34,309	34,963	32,617
Short- and long-term debt	3,911	3,909	3,909	3,930	3,202
Shareholders' equity	11,829	14,501	11,390	13,232	13,316
Debt-to-equity (c)	33.1 %	27.0 %	34.3%	29.7 %	24.0 %
Book value per share (d)	35.61	41.03	32.20	37.12	35.79
Other Information					
Free cash flow from operations (e)	$3,207	$2,675	$2,170	$2,705	$2,595
Return on invested capital (f)	15.1 %	14.1 %	8.4 %	14.7 %	15.8 %
Funded backlog	52,929	38,284	44,376	44,420	43,177
Total backlog	72,410	45,885	51,132	57,131	59,359
Shares outstanding	332.2	353.4	353.7	356.4	372.1
Weighted average shares outstanding:					
Basic	335.2	350.7	353.3	364.1	381.2
Diluted	341.3	353.5	353.3	367.5	385.2
Employees	99,500	96,000	92,200	95,100	90,000

Note: Prior period information has been restated to reflect our axle business in discontinued operations.

(a) Return on sales is calculated as earnings (loss) from continuing operations divided by revenues.

(b) 2012 amounts exclude dilutive effect of stock options and restricted stock as it was antidilutive.

(c) Debt-to-equity ratio is calculated as total debt divided by total equity as of year end.

(d) Book value per share is calculated as total equity divided by total outstanding shares as of year end.

(e) See Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, for a reconciliation of net cash provided by operating activities to free cash flow from operations.

(f) See Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, for the calculation of return on invested capital.

(Dollars in millions, except per-share amounts or unless otherwise noted)

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

For an overview of our business groups, including a discussion of products and services provided, see the Business discussion contained in Item 1. The following discussion should be read in conjunction with our Consolidated Financial Statements included in Item 8. The Consolidated Financial Statements have been restated to reflect the results of operations of our axle business in discontinued operations (for further discussion, see Note A to the Consolidated Financial Statements).

BUSINESS ENVIRONMENT

Approximately 60 percent of our revenues are from the U.S. government. Accordingly, our financial performance is impacted by U.S. government spending levels, particularly defense spending. Over the past several years, U.S. defense spending has been reduced, due in part to the country's fiscal shortfalls. Following required reductions mandated by the Budget Control Act of 2011 (BCA) and its related sequester mechanism, the Bipartisan Budget Act of 2013 (BBA) prescribed defense top-line funding for FY 2014 and 2015 at levels generally consistent with FY 2013. The BBA also included sequester reductions of approximately $30 billion in FY 2014 and $43 billion in FY 2015, less than the amounts imposed by the BCA.

In adherence to the BBA, Congress appropriated $497 billion in FY 2015 for the Department of Defense (DoD), including approximately $158 billion for procurement and research and development (R&D) budgets, also known as investment accounts, relatively consistent with FY 2014. These investment accounts are the source of the majority of our U.S. government revenues.

The long-term outlook for our U.S. defense business is influenced by the relevance of our programs to the U.S. military's funding priorities, the diversity of our programs and customers, our insight into customer requirements stemming from our incumbency on core programs, our ability to evolve our products to address a fast-changing threat environment and our proven track record of successful contract execution.

We continue to pursue opportunities outside the U.S. presented by demand for military equipment and information technologies from our non-U.S. operations and through exports from our North American businesses. While the revenue potential can be significant, these opportunities are subject to changing budget priorities and overall spending pressures unique to each country.

In our Aerospace group, business-jet market conditions were strong in 2014. The group benefited from strong order interest for new aircraft across the group's range of customers and lower customer contract defaults. We expect our continued investment in the development of new aircraft products and technologies to support the Aerospace group's long-term growth. Similarly, we believe the aircraft services business will continue to be a strong source of revenues as the global business-jet fleet grows.

In navigating the current business environment, we continue to focus on improving operating earnings, expanding margins and the efficient conversion of earnings into cash through our emphasis on effective program execution and cost-reduction activities across the business.

RESULTS OF OPERATIONS
INTRODUCTION
An understanding of our accounting practices is important to evaluate our operating results. We recognize the majority of our revenues using the percentage-of-completion method of accounting. The following paragraphs explain how this method is applied in recognizing revenues and operating costs in our Aerospace and defense groups.
In the Aerospace group, contracts for new aircraft have two major phases: the manufacture of the “green” aircraft and the aircraft’s outfitting, which includes exterior painting and installation of customer-selected interiors. We record revenues on these contracts at the completion of these two phases: when green aircraft are delivered to and accepted by the customer, and when the customer accepts final delivery of the outfitted aircraft. We do not recognize revenue at green delivery unless (1) a contract has been executed with the customer and (2) the customer can be expected to satisfy its obligations under the contract, as evidenced by the receipt of significant deposits from the customer and other factors. Revenues associated with the group’s completions of other original equipment manufacturers’ (OEMs) aircraft and the group’s services businesses are recognized as work progresses or upon delivery of services. Fluctuations in revenues from period to period result from the number and mix of new aircraft deliveries (green and outfitted), progress on aircraft completions and the level of aircraft service activity during the period.
The majority of the Aerospace group’s operating costs relates to new aircraft production for firm orders and consists of labor, material, subcontractor and overhead costs. The costs are accumulated in production lots and recognized as operating costs at green aircraft delivery based on the estimated average unit cost in a production lot. While changes in the estimated average unit cost for a production lot impact the level of operating costs, the amount of operating costs reported in a given period is based largely on the number and type of aircraft delivered. Operating costs in the Aerospace group’s completions and services businesses are generally recognized as incurred.
For new aircraft, operating earnings and margins are a function of the prices of our aircraft, our operational efficiency in manufacturing and outfitting the aircraft, and the mix of aircraft deliveries between the higher-margin large-cabin and lower-margin mid-cabin aircraft. Additional factors affecting the group’s earnings and margins include the volume, mix and profitability of completions and services work performed, the market for pre-owned aircraft, and the level of general and administrative (G&A) and net R&D costs incurred by the group.
In the defense groups, revenue on long-term government contracts is recognized as work progresses, either as products are produced or services are rendered. As a result, variations in revenues are discussed generally in terms of volume, typically measured by the level of activity on individual contracts or programs. Year-over-year variances attributed to volume are due to changes in production or service levels and delivery schedules.
Operating costs for the defense groups consist of labor, material, subcontractor, overhead and G&A costs and are recognized generally as incurred. Variances in costs recognized from period to period primarily reflect increases and decreases in production or activity levels on individual contracts and, therefore, result largely from the same factors that drive variances in revenues.
Operating earnings and margins in the defense groups are driven by changes in volume, performance or contract mix. Performance refers to changes in profitability based on revisions to estimates at completion on individual contracts. These revisions result from increases or decreases to the estimated value of the contract, the estimated costs to complete or both. Therefore, changes in costs incurred in the period compared

with prior periods do not necessarily impact profitability. It is only when total estimated costs at completion on a given contract change without a corresponding change in the contract value that the profitability of that contract may be impacted. Contract mix refers to changes in the volume of higher- vs. lower-margin work. Additionally, higher or lower margins can be inherent in the contract type (e.g., fixed-price/cost-reimbursable) or type of work (e.g., development/production).

CONSOLIDATED OVERVIEW

REVIEW OF 2014 VS. 2013

Year Ended December 31	2014	2013	Variance	
Revenues	$30,852	$30,930	$(78)	(0.3)%
Operating costs and expenses	26,963	27,241	278	1.0 %
Operating earnings	3,889	3,689	200	5.4 %
Operating margins	12.6 %	11.9 %		

Our revenues were virtually flat in 2014 compared with 2013. Decreased U.S. Army spending continued to affect somewhat our Information Systems and Technology and Combat Systems groups. This was essentially offset by higher Aerospace and Marine Systems revenues due to increased aircraft deliveries and higher ship construction activity, respectively. Operating costs and expenses decreased more than revenues in 2014, resulting in increased operating earnings and margins. The decrease in operating costs and expenses in 2014 was due to improved performance in aircraft manufacturing and outfitting activities in the Aerospace group and significant cost reductions in the Information Systems and Technology group. The resulting consolidated operating margins of 12.6 percent were up 70 basis points over 2013, reflecting strong operating performance across all of our groups.

REVIEW OF 2013 VS. 2012

Year Ended December 31	2013	2012	Variance	
Revenues	$30,930	$30,992	$(62)	(0.2)%
Operating costs and expenses	27,241	30,227	2,986	9.9 %
Operating earnings	3,689	765	2,924	382.2 %
Operating margins	11.9 %	2.5 %		

While our revenues were essentially flat in 2013 compared with 2012, operating earnings and margins increased significantly in 2013. We experienced lower volume in our Combat Systems business as a result of decreased U.S. Army spending. This was largely offset by higher revenues in our Aerospace group from increased deliveries of G650 and G280 aircraft. Revenues increased slightly in our Marine Systems and Information Systems and Technology groups in 2013. Operating costs were significantly lower in 2013 due to several discrete charges taken in 2012, including a $2 billion goodwill impairment recorded in the Information Systems and Technology group. These charges are discussed in conjunction with our business groups' operating results. Even absent the charges taken in 2012, operating costs were down in 2013, the effect of cost-reduction efforts and cost savings associated with restructuring activities.

REVIEW OF BUSINESS GROUPS

Year Ended December 31	2014		2013		2012	
	Revenues	Operating Earnings	Revenues	Operating Earnings	Revenues	Operating Earnings
Aerospace	$8,649	$1,611	$8,118	$1,416	$6,912	$858
Combat Systems	5,732	862	5,832	908	7,471	595
Information Systems and Technology	9,159	785	10,268	795	10,017	(1,369)
Marine Systems	7,312	703	6,712	666	6,592	750
Corporate	—	(72)	—	(96)	—	(69)
	$30,852	$3,889	$30,930	$3,689	$30,992	$765

Following is a discussion of the operating results and outlook for each of our business groups. For the Aerospace group, results are analyzed by specific lines of products and services, consistent with how the group is managed. For the defense groups, the discussion is based on the types of products and services each group offers with a supplemental discussion of specific contracts and programs when significant to the group's results. Additional information regarding our business groups can be found in Note Q to the Consolidated Financial Statements in Item 8.

AEROSPACE

Review of 2014 vs. 2013

Year Ended December 31	2014	2013	Variance	
Revenues	$8,649	$8,118	$531	6.5%
Operating earnings	1,611	1,416	195	13.8%
Operating margins	18.6%	17.4%		
Gulfstream aircraft deliveries (in units):				
Green	144	139	5	3.6%
Outfitted	150	144	6	4.2%

The increase in the Aerospace group's revenues in 2014 consisted of the following:

Aircraft manufacturing, outfitting and completions	$605
Aircraft services	69
Pre-owned aircraft	(143)
Total increase	$531

Aircraft manufacturing, outfitting and completions revenues increased in 2014 primarily due to additional deliveries of large-cabin aircraft. Aircraft services activity was higher in 2014 due to growth in the number of aircraft in service and the resulting increased demand for maintenance work. We experienced reduced aircraft trade-in activity in 2014 leading to lower pre-owned aircraft sales. We had three pre-owned aircraft sales in 2014 compared to 11 in 2013.

The increase in the group's operating earnings in 2014 consisted of the following:

Aircraft manufacturing, outfitting and completions	$279
Aircraft services	15
Pre-owned aircraft	5
G&A/other expenses	(104)
Total increase	$195

Aircraft manufacturing, outfitting and completions earnings grew in 2014 due to the increase in aircraft deliveries, as well as improved operating performance on our large- and mid-cabin aircraft production. Partially offsetting this increase was higher net R&D expenses associated with ongoing product-development efforts. As a result, the Aerospace group's operating margins increased 120 basis points in 2014.

Review of 2013 vs. 2012

Year Ended December 31	2013	2012	Variance	
Revenues	$8,118	$6,912	$1,206	17.4 %
Operating earnings	1,416	858	558	65.0 %
Operating margins	17.4 %	12.4 %		
Gulfstream aircraft deliveries (in units):				
Green	139	121	18	14.9 %
Outfitted	144	94	50	53.2 %

The Aerospace group's revenues and earnings increased in 2013 primarily due to additional deliveries of G650 and G280 aircraft. Operating earnings also increased in 2013 due to a $191 impairment of Jet Aviation's maintenance business intangible asset in 2012 as the business experienced an increasingly competitive marketplace.

2015 Outlook

We expect an increase of approximately 8 percent in the group's revenues in 2015 compared with 2014 as a result of Gulfstream aircraft deliveries. Operating margins are expected to be around 18 percent, down somewhat from 2014 primarily due to higher net R&D expenses, aircraft manufacturing mix and more pre-owned aircraft sales.

COMBAT SYSTEMS

Review of 2014 vs. 2013

Year Ended December 31	2014	2013	Variance	
Revenues	$5,732	$5,832	$(100)	(1.7)%
Operating earnings	862	908	(46)	(5.1)%
Operating margins	15.0 %	15.6 %		

The change in the Combat Systems group's revenues in 2014 consisted of the following:

U.S. military vehicles	$(663)
Weapons systems and munitions	(61)
International military vehicles	624
Total decrease	$(100)

U.S. military vehicle revenues were down in 2014 consistent with our expectations as a result of a decrease in U.S. Army spending as the Iraqi and Afghan conflicts wound down. This impacted our primary U.S. vehicle programs, including Stryker, Abrams, Buffalo and Mine Resistant, Ambush Protected (MRAP) vehicles. Revenues also decreased on the completed Ground Combat Vehicle (GCV) design and development program. Weapons systems and munitions volume decreased in 2014 primarily due to lower tank ammunition production for non-U.S. customers. Revenues for international military vehicles were up significantly in 2014 as work commenced on a $10 billion international order received in the first quarter. Work on this order was somewhat offset by lower revenues on several other international contracts that are nearing completion.

The Combat Systems group's operating margins decreased 60 basis points in 2014 primarily due to a mix shift from more mature programs nearing completion to the start up of new programs. Somewhat offsetting this shift in contract mix, operating margins were up in our European and weapons systems businesses as a result of reduced overhead costs following restructuring activities completed in 2013 and early 2014.

Review of 2013 vs. 2012

Year Ended December 31	2013	2012	Variance	
Revenues	$5,832	$7,471	$(1,639)	(21.9)%
Operating earnings	908	595	313	52.6%
Operating margins	15.6%	8.0%		

In 2013, revenues were down across the Combat Systems group. Decreased U.S. Army spending, in part due to sequestration and a government shutdown, impacted U.S. military vehicle programs, including Stryker, Abrams and MRAP, and weapons systems and munitions programs.

The Combat Systems group’s operating earnings and margins increased significantly in 2013 despite the reduced revenues due to the negative impact of three discrete charges in 2012 in our European Land Systems business:

- $292 for contract dispute accruals, primarily related to the termination of a contract to provide Pandur vehicles for Portugal ($169 of this amount was recorded as a reduction of revenues);
- $98 of restructuring-related charges, primarily severance, for activities associated with eliminating excess capacity; and
- $67 of out-of-period adjustments recorded in the first quarter of 2012 ($48 of this amount was recorded as a reduction of revenues).

These charges reduced the group’s 2012 operating margins approximately 570 basis points. Operating earnings and margins increased in 2013 due to strong operating performance across our U.S. businesses and the favorable impact of cost savings associated with restructuring activities in our European military vehicles business.

2015 Outlook

We expect the Combat Systems group’s revenues and margins in 2015 to be consistent with 2014 as growth on our international military vehicle contracts offsets some scheduled reductions in spending on a few U.S. military production programs.

INFORMATION SYSTEMS AND TECHNOLOGY

Review of 2014 vs. 2013

Year Ended December 31	2014	2013	Variance	
Revenues	$9,159	$10,268	$(1,109)	(10.8)%
Operating earnings	785	795	(10)	(1.3)%
Operating margins	8.6%	7.7%		

The Information Systems and Technology group’s revenues in 2014 were lower than 2013, though higher than our initial expectations. The decrease from the prior year consisted of the following:

Mobile communication systems	$(886)
Information technology (IT) solutions and mission support services	(185)
Intelligence, surveillance and reconnaissance (ISR) solutions	(38)
Total decrease	$(1,109)

Revenues decreased nearly 25 percent in the mobile communication systems business in 2014 primarily as a result of lower U.S. Army spending on certain programs, including the Handheld, Manpack and Small Form Fit (HMS) radio, Warfighter Information Network-Tactical (WIN-T) and Common Hardware Systems-4 (CHS-4) programs. Revenues decreased in 2014 in our IT services business due to lower volume on several programs, including our commercial wireless work. This decrease was partially offset by increased contact-center services work under our contract with the Centers for Medicare & Medicaid Services. Revenues were essentially flat in our ISR business.

Despite the revenue decline, the group's operating margins increased 90 basis points in 2014, the result of solid operating performance and ongoing cost-reduction efforts across all our lines of business. As part of these efforts, we consolidated two businesses in the group effective in January of 2015 in an effort to be more efficient and responsive to our customers.

Review of 2013 vs. 2012

Year Ended December 31	2013	2012	Variance	
Revenues	$10,268	$10,017	$251	2.5%
Operating earnings (loss)	795	(1,369)	2,164	(158.1)%
Operating margins	7.7%	(13.7)%		

The Information Systems and Technology group’s revenues increased in 2013 compared with 2012 as higher volume in the mobile communication systems and IT services businesses was partially offset by decreased revenues in the ISR business. Revenues increased in 2013 in the mobile communication systems business due to higher volume on programs that received production awards in late 2012 or 2013, including WIN-T, HMS and CHS-4. In the IT services business, revenues were up as we worked to meet commercial wireless customers’ accelerated schedules and commenced work on the contact-center services contract discussed above. Revenues decreased in 2013 across the ISR business driven by lower U.S. defense spending and a slower-than-expected transition to related follow-on work.

The Information Systems and Technology group’s operating earnings and margins increased in 2013 driven by the negative impact of four discrete charges in 2012:

- $2 billion goodwill impairment resulting from slowed defense spending and the threat of sequestration, coupled with margin compression due to a shift in the group’s contract mix impacting projected cash flows;
- $110 of intangible asset impairments on several assets in our optical products business as a result of competitive losses and delays indicative of lower overall demand caused by the economic downturn;
- $58 write-down of substantially all of the remaining ruggedized hardware inventory based on anticipated remaining demand for products that ceased production in 2012; and
- $26 for cost growth associated with the demonstration phase of the U.K. Specialist Vehicle (SV) program.

Excluding these charges, operating margins decreased slightly in 2013 primarily due to growth in the lower-margin IT services business and performance challenges in the group’s U.K. business. Management of the U.K. business was consolidated into our North American mobile communication systems business in 2013.

2015 Outlook

We expect 2015 revenues in the Information Systems and Technology group to decrease approximately 5.5 percent from 2014 as some of 2014’s anticipated revenue reduction flows into 2015. Operating margins are expected to improve again to slightly more than 9 percent.

MARINE SYSTEMS

Review of 2014 vs. 2013

Year Ended December 31	2014	2013	Variance	
Revenues	$7,312	$6,712	$600	8.9 %
Operating earnings	703	666	37	5.6 %
Operating margins	9.6 %	9.9 %		

The increase in the Marine Systems group’s revenues in 2014 consisted of the following:

Navy ship construction	$444
Navy ship engineering, repair and other services	(121)
Commercial ship construction	277
Total increase	$600

The group’s U.S. Navy ship construction programs include Virginia-class submarines, DDG-1000 and DDG-51 destroyers, and Mobile Landing Platform (MLP) auxiliary support ships. The increase in Navy ship construction revenues in 2014 is primarily due to higher volume on the Virginia-class program, including long-lead materials for the Block IV contract, which was awarded in the second quarter of 2014. This increase was partially offset by lower volume on the MLP program, as two of the four ships under contract have been delivered. Revenues for Navy engineering, repair and other services decreased in 2014 primarily due to lower spending by the Navy on submarine-related overhaul and repair services. Commercial ship construction revenues increased in 2014 as work ramped up on the group's construction of Jones Act ships. All 10 commercial ships under contract are expected to be at various stages of construction by the end of 2015.

Operating margins decreased 30 basis points in 2014 primarily due to a shift in contract mix as work on the Block IV Virginia-class and Jones Act commercial ship contracts ramped up, volume decreased on

mature contracts, including MLP and Blocks II and III of the Virginia-class program, and construction progressed on the first of the three DDG-1000 ships and two of the DDG-51 ships in the Navy’s restart of the program.

Review of 2013 vs. 2012

Year Ended December 31	2013	2012	Variance	
Revenues	$6,712	$6,592	$120	1.8 %
Operating earnings	666	750	(84)	(11.2)%
Operating margins	9.9 %	11.4 %		

The Marine Systems group’s revenues increased in 2013 compared with 2012 as lower ship construction revenues were offset by higher revenues from engineering and repair programs for the Navy and commercial ship construction. The decrease in 2013 construction revenues was due to the completion of the T-AKE combat-logistics ship program in late 2012. However, this decrease was partially offset by higher revenues on the Virginia-class program, primarily due to long-lead materials for the Block IV contract. Revenues were higher on Navy engineering and repair programs in 2013 due to increased submarine overhaul and repair work. Commercial ship construction revenues increased as work commenced on contracts for Jones Act ships secured in late 2012 and 2013. Operating earnings and margins decreased in 2013 due to the completion of the mature, higher-margin T-AKE program in 2012.

2015 Outlook

We expect the Marine Systems group’s 2015 revenues to increase 2 to 2.5 percent from 2014, primarily due to higher revenues on the Virginia-class program. Operating margins are expected to remain in the mid-9 percent range.

CORPORATE

Corporate results consist primarily of compensation expense for stock options. Corporate operating costs totaled $72 in 2014, $96 in 2013 and $69 in 2012. We expect Corporate operating costs in 2015 of approximately $65 to $70.

OTHER INFORMATION

PRODUCT AND SERVICE REVENUES AND OPERATING COSTS

Review of 2014 vs. 2013

Year Ended December 31	2014	2013	Variance	
Revenues:				
Products	$19,564	$19,100	$464	2.4 %
Services	11,288	11,830	(542)	(4.6)%
Operating Costs:				
Products	$15,335	$15,065	$270	1.8 %
Services	9,644	10,137	(493)	(4.9)%

The increase in product revenues in 2014 consisted of the following:

Ship construction	$626
Aircraft manufacturing and outfitting	619
Mobile communication products	(536)
Pre-owned aircraft	(143)
Other, net	(102)
Total increase	$464

Aircraft manufacturing and outfitting revenues increased in 2014 due to additional deliveries of large-cabin aircraft. Ship construction revenues increased due to higher volume on the Virginia-class submarine program and commercial Jones Act ships. Offsetting these increases, lower U.S. Army spending negatively impacted revenues from mobile communication products. Pre-owned aircraft sales were down as there were fewer aircraft trade-ins and resulting sales in 2014.

Despite the 2.4 percent increase in product revenues, product operating costs rose only 1.8 percent compared with 2013 due to strong operating performance. The majority of the change in product operating costs was due to volume, although costs in 2014 were affected by other changes, including higher net R&D expenses in the Aerospace group associated with ongoing product-development efforts. No other changes were individually significant.

Primary changes due to volume:	
Ship construction	$514
Aircraft manufacturing and outfitting	357
Mobile communication products	(504)
Pre-owned aircraft	(148)
	219
Other changes, net	51
Total increase	$270

The decrease in service revenues in 2014 consisted of the following:

Military vehicle services	$(194)
Mobile communication support services	(191)
IT services	(155)
Other, net	(2)
Total decrease	$(542)

Military vehicle and mobile communication support services revenues were lower due to decreased U.S. Army spending, while IT services revenues decreased due to reduced commercial wireless work.

Service operating costs were lower in 2014 compared with 2013. As shown below, the decrease in service operating costs was due to lower volume. No other changes were individually significant.

Primary changes due to volume:	
Military vehicle services	$(144)
Mobile communication support services	(200)
IT services	(102)
	(446)
Other changes, net	(47)
Total decrease	$(493)

Review of 2013 vs. 2012

Year Ended December 31	2013	2012	Variance	
Revenues:				
Products	$19,100	$19,264	$(164)	(0.9)%
Services	11,830	11,728	102	0.9%
Operating Costs:				
Products	$15,065	$15,830	$(765)	(4.8)%
Services	10,137	10,182	(45)	(0.4)%

The decrease in product revenues in 2013 consisted of the following:

Military vehicle production	$(1,218)
Aircraft manufacturing and outfitting	1,123
Other, net	(69)
Total decrease	$(164)

In 2013, military vehicle production revenues decreased on several programs, including the Stryker, Abrams and MRAP programs. Offsetting these decreases, aircraft manufacturing and outfitting revenues increased due to additional deliveries of the G650 and G280 aircraft.

Product operating costs were lower in 2013 compared with 2012. Discrete charges totaling $289 in 2012 in the Combat Systems and Information Systems and Technology business groups included $110 of intangible asset impairments on several assets in our optical products business, $89 related to the termination of a contract to provide Pandur vehicles to the Portuguese government, $58 of ruggedized hardware inventory write-downs for products that ceased production in 2012, and $32 for cost growth associated

with the demonstration phase of the SV program for the U.K. Ministry of Defence. Excluding these charges, the decrease in product operating costs was primarily due to lower volume. No other changes were individually significant.

Primary changes due to volume:	
Military vehicle production	$(1,180)
Aircraft manufacturing and outfitting	864
	(316)
2012 discrete charges	(289)
Other changes, net	(160)
Total decrease	$(765)

The increase in service revenues in 2013 consisted of the following:

Ship engineering and repair	$178
Other, net	(76)
Total increase	$102

Ship engineering and repair revenues increased in 2013 due to submarine overhaul and repair work.

Service operating costs were lower in 2013 compared with 2012. While ship engineering and repair cost volume increased, this was offset by the intangible asset impairment in 2012 in Jet Aviation’s maintenance business. No other changes were individually significant.

Ship engineering and repair volume	$163
2012 intangible asset impairment	(191)
Other changes, net	(17)
Total decrease	$(45)

GOODWILL IMPAIRMENT

In 2012, we recorded a $2 billion goodwill impairment in the Information Systems and Technology group discussed in conjunction with the business group’s operating results.

G&A EXPENSES

As a percentage of revenues, G&A expenses were 6.4 percent in 2014, 6.6 percent in 2013 and 7.2 percent in 2012. We expect G&A expenses in 2015 to be generally consistent with 2014.

INTEREST, NET

Net interest expense was $86 in 2014 and 2013 and $156 in 2012. The decrease in interest expense in 2013 results from our debt refinancing completed in December 2012. See Note J to the Consolidated Financial Statements in Item 8 for additional information regarding our debt obligations. We expect full-year 2015 net interest expense to be $82.

OTHER, NET

In 2012, other expenses included a $123 loss on the redemption of debt associated with the refinancing discussed above.

PROVISION FOR INCOME TAX, NET

Our effective tax rate was 29.7 percent in 2014, 31.2 percent in 2013 and 180.5 percent in 2012. The decrease in the effective tax rate in 2014 was primarily due to increased income from international operations and utilization of foreign tax credits. The atypically high tax rate in 2012 was driven by the largely non-deductible goodwill impairment recorded in the Information Systems and Technology group and, to a lesser extent, the establishment of valuation allowances related to deferred tax assets in our non-U.S. operations. For further discussion and a reconciliation of our effective tax rate from the statutory federal rate, see Note E to the Consolidated Financial Statements in Item 8. We anticipate the full-year effective tax rate to be approximately 30.5 percent in 2015.

DISCONTINUED OPERATIONS, NET OF TAX

In 2014, we entered into an agreement to sell our axle business in the Combat Systems group and recognized a $146 loss, net of tax (the sale was completed in January 2015). In 2013, we recognized a $129 loss, net of tax, from the settlement of our litigation with the U.S. Navy related to the terminated A-12 contract in the company's discontinued tactical military aircraft business. See Note A to the Consolidated Financial Statements in Item 8 for further discussion of these transactions.

BACKLOG AND ESTIMATED POTENTIAL CONTRACT VALUE

Our total backlog, including funded and unfunded portions, was $72.4 billion at the end of 2014, nearly 60 percent higher than the prior-year amount of $45.9 billion. On December 31, 2014, our estimated potential contract value was $26.7 billion compared to $27.6 billion at the end of 2013. Our total estimated contract value, which combines total backlog with estimated potential contract value, was $99.1 billion on December 31, 2014, our highest year-end balance ever.

Estimated potential contract value includes work awarded on unfunded indefinite delivery, indefinite quantity (IDIQ) contracts or unexercised options associated with existing firm contracts. IDIQ contracts provide customers with flexibility when they have not defined the exact timing and quantity of deliveries

or services that will be required at the time the contract is executed. Contract options in our defense business represent agreements to perform additional work under existing contracts at the election of the customer. The actual amount of funding received in the future may be higher or lower than our estimate of potential contract value. We recognize options in backlog when the customer exercises the option and establishes a firm order.

AEROSPACE

Aerospace funded backlog represents aircraft orders for which we have definitive purchase contracts and deposits from customers. Unfunded backlog consists of agreements to provide future aircraft maintenance and support services. The Aerospace group ended 2014 with backlog of $13.2 billion, compared with $13.9 billion at year-end 2013. Orders were up more than 15 percent compared to 2013 and included strong demand across our product portfolio. Our backlog included orders for an all-new family of business jets introduced in 2014, the G500 and G600 aircraft, designed to optimize speed, cabin comfort, efficiency and industry-leading safety technologies. The aircraft are expected to enter into service in 2018 and 2019, respectively, following type certification from the U.S. Federal Aviation Administration and European Aviation Safety Agency.

Despite strong orders in 2014, the group’s backlog has declined in recent years as G650 production has ramped up to fulfill the substantial orders we received upon introduction of the aircraft in 2008. We have approximately three years of backlog for the G650. We expect backlog to continue to decrease over the next several years as the time period between customer order and delivery of the G650 aircraft normalizes. At that time, we expect order activity to more closely match deliveries.

Estimated potential contract value in the Aerospace group primarily represents options to purchase new aircraft and long-term agreements with fleet customers. Estimated potential contract value of $2.7 billion on December 31, 2014, increased more than 60 percent from $1.7 billion at year-end 2013. The increase is largely due to new multi-aircraft agreements in 2014 that include options for several Gulfstream aircraft models.

Demand for Gulfstream aircraft remains strong across customer types and geographic regions, generating orders from public and private companies, individuals and governments around the world.

Geographically, non-U.S. customers represented approximately 60 percent of the group's backlog on December 31, 2014.

DEFENSE GROUPS

The total backlog in our defense groups represents the estimated remaining sales value of work to be performed under firm contracts. The funded portion of this backlog includes items that have been authorized and appropriated by the Congress and funded by the customer, as well as commitments by non-U.S. customers that are similarly approved and funded by their governments. We have included in total backlog firm contracts at the amounts we believe are likely to receive funding but there is no guarantee that future budgets and appropriations will provide funding for a given program.

Total backlog in our defense groups was $59.2 billion on December 31, 2014, up more than 85 percent from $31.9 billion at the end of 2013 due to major awards received in 2014 in our Combat Systems and Marine Systems groups detailed below. Estimated potential contract value was $23.9 billion on December 31, 2014, compared to $25.9 billion at year-end 2013.

COMBAT SYSTEMS

Combat Systems' total backlog was $19.8 billion at the end of 2014, tripling the year-end 2013 backlog of $6.6 billion. Growth in the group's backlog was primarily due to two major contract awards received in 2014, a $5.9 billion award from the U.K. Ministry of Defence to deliver Specialist Vehicle (SV) platforms to the British Army between 2017 and 2024, and a $10 billion award to provide wheeled armored vehicles, training and support services to an international customer through 2028. The wheeled vehicle contract also provides for an additional potential $3 billion of vehicles and services.

The Combat Systems group has several other significant non-U.S. military vehicle production contracts in backlog, including:

- $515 for light armored vehicles (LAVs) for various international customers, including $230 for the upgrade and modernization of LAV III combat vehicles for the Canadian Army;
- $130 for Pizarro Advanced Infantry Fighting Vehicles scheduled for delivery to the Spanish Army through 2018; and

- $110 for the production of Eagle vehicles for Germany and Duro vehicles for Switzerland.

The Army's Stryker wheeled combat vehicle program represented $780 of the group's backlog on December 31, 2014, with vehicles scheduled for delivery through 2016. The group received $460 of Stryker orders in 2014, including awards for double-V-hulled vehicles, contractor logistics support and engineering services. The group's backlog on December 31, 2014, included $540 for M1 Abrams main battle tank modernization and upgrade programs for the Army and U.S. allies around the world, including $105 for M1A2 tanks for the Kingdom of Saudi Arabia.

The Combat Systems group's backlog on December 31, 2014, also included $2.2 billion for multiple weapons systems and munitions programs.

Combat Systems' estimated potential contract value was $5.5 billion on December 31, 2014, up more than 50 percent since year-end 2013 primarily due to the international wheeled vehicle contract discussed previously.

INFORMATION SYSTEMS AND TECHNOLOGY

Unlike our other defense businesses, the Information Systems and Technology group's backlog consists of thousands of contracts and is reconstituted each year with new programs and task order awards. The group's total backlog was $8.6 billion at the end of 2014, up slightly from $8.5 billion at year-end 2013. This amount does not include $16.1 billion of estimated potential contract value associated with its anticipated share of IDIQ contracts and unexercised options. In 2014, funding under IDIQ contracts and options contributed nearly $4 billion to the group's orders.

The group received a number of significant contract awards in 2014, including the following:

- $645 to extend the period of performance for support on the Canadian Maritime Helicopter Project (MHP);
- $210 for the U.K.'s Bowman tactical communication system for long-term support and capability upgrades;
- $335 from the Army for ruggedized computing equipment under the CHS-4 program. $655 of estimated potential contract value remains under this IDIQ contract;

- $165 from Austal USA for combat and seaframe control systems for two Littoral Combat Ships for the U.S. Navy, bringing the value in backlog to $350. Options to provide these naval control systems for two additional ships will be reported in backlog when they are exercised; and
- $180 from the U.S. Department of State to provide supply chain management services.

Backlog at year-end 2014 also included the following key programs:

- $495 for contact-center services for the Centers for Medicare & Medicaid Services, including the 1-800-MEDICARE program;
- $390 of support and modernization work for the intelligence community, the DoD and the Department of Homeland Security, including the St. Elizabeths campus, New Campus East and NETCENTS infrastructure programs; and
- $305 for the WIN-T mobile communications network program. The group has an additional $380 of estimated potential contract value associated with this program awarded as an IDIQ contract.

MARINE SYSTEMS

The Marine Systems group’s backlog consists of long-term submarine and ship construction programs, as well as numerous engineering and repair contracts. Backlog increased more than 80 percent from $16.9 billion at the end of 2013 to $30.8 billion on December 31, 2014.

The Virginia-class submarine program was the company’s largest program in 2014 and the largest contract in the company’s backlog. In 2014, we received a contract for the construction of 10 submarines in Block IV of the program. The group’s backlog at year end included $21 billion for 17 Virginia-class submarines scheduled for delivery through 2023.

Navy destroyer programs represented $4.6 billion of the group’s backlog at year-end 2014. We currently have construction contracts for seven DDG-51 destroyers, including one awarded in 2014, scheduled for delivery through 2022. Backlog at year end also included three ships under the DDG-1000 program scheduled for delivery through 2019.

The Marine Systems group’s backlog on December 31, 2014, included $560 for construction of MLP ships. The group has delivered the first two ships in this program, and received a $500 award in 2014 for

procurement of a fourth ship. Construction is underway on the two additional ships, scheduled for delivery in 2015 and 2018. The third and fourth ships are configured as Afloat Forward Staging Bases (AFSB).
The year-end backlog also included $880 for 10 liquefied natural gas (LNG)-powered and LNG-conversion-ready Jones Act ships for commercial customers scheduled for delivery through 2017.
Complementing these ship construction programs, engineering services represented approximately $2 billion of the Marine Systems group's backlog on December 31, 2014, including $1.4 billion for design and development efforts on the Ohio-class submarine replacement program. Additionally, year-end backlog for maintenance, repair and other services totaled $1.7 billion.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

We place a strong emphasis on cash flow generation. This focus gives us the flexibility for capital deployment while preserving a strong balance sheet to position us for future opportunities. The $9.4 billion of cash generated by operating activities over the past three years was deployed to repurchase our common stock, pay dividends and fund capital expenditures. Our net cash position, defined as cash and equivalents and marketable securities less debt, was $1 billion at year-end 2014, down $415 from the end of 2013.
Our cash balances are invested primarily in time deposits from highly rated banks and commercial paper rated A1/P1 or higher. On December 31, 2014, $1.9 billion of our cash was held by non-U.S. operations. Should this cash be repatriated, it generally would be subject to U.S. federal income tax but would generate offsetting foreign tax credits.

Year Ended December 31	2014	2013	2012
Net cash provided by operating activities	$3,728	$3,111	$2,606
Net cash used by investing activities	(1,102)	(363)	(642)
Net cash used by financing activities	(3,575)	(725)	(1,382)
Net cash provided (used) by discontinued operations	36	(18)	65
Net (decrease) increase in cash and equivalents	(913)	2,005	647
Cash and equivalents at beginning of year	5,301	3,296	2,649
Cash and equivalents at end of year	4,388	5,301	3,296
Marketable securities	500	—	—
Short- and long-term debt	(3,911)	(3,909)	(3,909)
Net cash (debt)	$977	$1,392	$(613)
Debt-to-equity (a)	33.1%	27.0%	34.3%
Debt-to-capital (b)	24.8%	21.2%	25.6%

(a) Debt-to-equity ratio is calculated as total debt divided by total equity.
(b) Debt-to-capital ratio is calculated as total debt divided by the sum of total debt plus total equity.

We expect to continue to generate funds in excess of our short- and long-term liquidity needs. We believe we have adequate funds on hand and sufficient borrowing capacity to execute our financial and operating strategy. The following is a discussion of our major operating, investing and financing activities for each of the past three years, as classified on the Consolidated Statements of Cash Flows in Item 8.

OPERATING ACTIVITIES

We generated cash from operating activities of $3.7 billion in 2014, $3.1 billion in 2013 and $2.6 billion in 2012. In all three years, the primary driver of cash flows was net earnings (loss) after removing the impact of non-cash charges. Operating cash flows in 2014 included significant customer deposits related to a large non-U.S. contract awarded in our Combat Systems group. As these deposits are utilized to fund supplier commitments on the program, we expect operating cash flows to be less. Operating cash flows in

2013 benefited from reductions in operating working capital, primarily in our Marine Systems group where deposits were received for commercial ship orders.

INVESTING ACTIVITIES

We used $1.1 billion in 2014, $363 in 2013 and $642 in 2012 for investing activities. The primary uses of cash for investing activities were capital expenditures and purchases of marketable securities.

Capital Expenditures. Capital expenditures were $521 in 2014, $436 in 2013 and 2012. We expect capital expenditures of approximately 2 percent of revenues in 2015.

Marketable Securities. In 2014, we purchased $500 of short-term held-to-maturity securities. Other net purchases, sales and maturities of marketable securities in all three years were not material.

Other, Net. Investing activities also include proceeds from the sale of assets and cash paid for business acquisitions. We completed one acquisition in 2014, no acquisitions in 2013 and seven acquisitions in 2012 for $444. We used cash on hand to fund these acquisitions. See Note B to the Consolidated Financial Statements in Item 8 for further discussion of acquisition activity.

FINANCING ACTIVITIES

We used $3.6 billion in 2014, $725 in 2013 and $1.4 billion in 2012 for financing activities. Our financing activities include repurchases of common stock, payment of dividends and debt issuances and repayments. Net cash from financing activities also included proceeds received from stock option exercises.

Share Repurchases. We repurchased 29 million of our outstanding shares in 2014 (11.4 million of the shares were repurchased under an accelerated share repurchase program), 9.4 million shares in 2013 and 9.1 million shares in 2012. As a result, we have reduced our shares outstanding by approximately 7 percent since the end of 2011. On December 31, 2014, 2.4 million shares remain authorized by our board of directors for repurchase, less than 1 percent of our total shares outstanding.

Dividends. On March 5, 2014, our board of directors declared an increased quarterly dividend of $0.62 per share, the 17th consecutive annual increase. Previously, the board had increased the quarterly dividend to $0.56 per share in March 2013 and $0.51 per share in March 2012. We did not pay any dividends in the first three months of 2013 because we made our first quarter dividend payment in December 2012.

Debt Proceeds, Net. In 2012, we issued $2.4 billion of fixed-rate notes and used the proceeds to redeem, prior to maturity, an equal amount of fixed-rate notes with higher interest rates.

In January 2015, we repaid $500 of fixed-rate notes on their scheduled maturity date with the proceeds from maturing marketable securities purchased in 2014 (see discussion above). We have no additional material repayments of long-term debt scheduled until 2016. See Note J to the Consolidated Financial Statements in Item 8 for additional information regarding our debt obligations, including scheduled debt maturities and interest rates.

We ended 2014 with no commercial paper outstanding. We have $2 billion in bank credit facilities that remain available, including a $1 billion facility expiring in July 2016 and a $1 billion facility expiring in July 2018. These facilities provide backup liquidity to our commercial paper program.

NON-GAAP MANAGEMENT METRICS

We emphasize the efficient conversion of net earnings into cash and the deployment of that cash to maximize shareholder returns. As described below, we use free cash flow and return on invested capital (ROIC) to measure our performance in these areas. While we believe these metrics provide useful information, they are not defined operating measures under U.S. generally accepted accounting principles (GAAP), and there are limitations associated with their use. Our calculation of these metrics may not be completely comparable to similarly titled measures of other companies due to potential differences in the method of calculation. As a result, the use of these metrics should not be considered in isolation from, or as a substitute for, other GAAP measures.

Free Cash Flow. We define free cash flow from operations as net cash provided by operating activities less capital expenditures. We believe free cash flow from operations is a useful measure for shareholders because it portrays our ability to generate cash from our core businesses for purposes such as repaying maturing debt, funding business acquisitions, repurchasing our common stock and paying dividends. We use free cash flow from operations to assess the quality of our earnings and as a performance measure in evaluating management. The following table reconciles the free cash flow from operations with net cash provided by operating activities, as classified on the Consolidated Statements of Cash Flows:

Year Ended December 31	2014	2013	2012	2011	2010
Net cash provided by operating activities	$3,728	$3,111	$2,606	$3,150	$2,946
Capital expenditures	(521)	(436)	(436)	(445)	(351)
Free cash flow from operations	$3,207	$2,675	$2,170	$2,705	$2,595
Cash flow as a percentage of earnings from continuing operations:					
Net cash provided by operating activities	139%	125%	NM*	126%	115%
Free cash flow from operations	120%	108%	NM*	108%	101%

* Not meaningful (NM) due to net loss in 2012.

Return on Invested Capital. We believe ROIC is a useful measure for shareholders because it reflects our ability to generate returns from the capital we have deployed in our operations. We use ROIC to evaluate investment decisions and as a performance measure in evaluating management. We define ROIC as net operating profit after taxes divided by average invested capital. Net operating profit after taxes is defined as earnings from continuing operations plus after-tax interest and amortization expense. Average invested capital is defined as the sum of the average debt and shareholders' equity for the year. ROIC excludes accumulated other comprehensive loss, goodwill impairments and non-economic accounting changes as they are not reflective of our operating performance. Prior-year amounts have been adjusted for comparative purposes to reflect our current definition.

ROIC is calculated as follows:

Year Ended December 31	2014	2013	2012*	2011	2010
Earnings from continuing operations	$2,673	$2,486	$1,414	$2,500	$2,567
After-tax interest expense	67	67	109	101	109
After-tax amortization expense	79	93	139	141	135
Net operating profit after taxes	$2,819	$2,646	$1,662	$2,742	$2,811
Average invested capital	$18,692	$18,764	$19,899	$18,608	$17,844
Return on invested capital	15.1%	14.1%	8.4%	14.7%	15.8%

*2012 loss from continuing operations of ($381) has been adjusted for $1,994 goodwill impairment and associated $199 tax benefit. 2012 shareholders' equity, a component of average invested capital, has been similarly adjusted.

ADDITIONAL FINANCIAL INFORMATION

OFF-BALANCE SHEET ARRANGEMENTS

On December 31, 2014, other than operating leases, we had no material off-balance sheet arrangements.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following tables present information about our contractual obligations and commercial commitments on December 31, 2014:

		Payments Due by Period			
Contractual Obligations	Total Amount Committed	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years
Long-term debt (a)	$ 4,771	$586	$1,549	$122	$ 2,514
Capital lease obligations	31	2	4	4	21
Operating leases	1,078	210	313	172	383
Purchase obligations (b)	31,121	9,482	12,090	5,757	3,792
Other long-term liabilities (c)	19,358	3,554	2,330	1,705	11,769
	$ 56,359	$13,834	$16,286	$7,760	$ 18,479

(a)Includes scheduled interest payments. See Note J to the Consolidated Financial Statements in Item 8 for a discussion of long-term debt.

(b)Includes amounts committed under legally enforceable agreements for goods and services with defined terms as to quantity, price and timing of delivery. This amount includes $24.6 billion of purchase obligations for products and services to be delivered under firm government contracts under which we expect full recourse under normal contract termination clauses.

(c)Represents other long-term liabilities on our Consolidated Balance Sheets, including the current portion of these liabilities. The projected timing of cash flows associated with these obligations is based on management's estimates, which are based largely on historical experience. This amount also includes all liabilities under our defined-benefit retirement plans. See Note P to the Consolidated Financial Statements in Item 8 for information regarding these liabilities and the plan assets available to satisfy them.

		Amount of Commitment Expiration by Period			
Commercial Commitments	Total Amount Committed	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years
Letters of credit and guarantees*	$ 1,032	$454	$225	$131	$ 222
Trade-in options*	63	—	63	—	—
	$ 1,095	$454	$288	$131	$ 222

* See Note N to the Consolidated Financial Statements in Item 8 for a discussion of letters of credit and aircraft trade-in options.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our Consolidated Financial Statements, which have been prepared in accordance with U.S. GAAP. The preparation of financial statements in accordance with GAAP requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the period. On an ongoing basis, we evaluate our estimates, including most pervasively those related to various assumptions and projections for our long-term contracts and programs. Other significant estimates include those related to goodwill and other intangible assets, income taxes, pensions and other post-retirement benefits, workers' compensation, warranty obligations, and litigation and other contingencies. We employ judgment in making our estimates but they are based on historical experience, currently available information and various other assumptions that we believe to be reasonable under the circumstances. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily available from other sources. Actual results could differ from

these estimates. We believe that our judgment is applied consistently and produces financial information that fairly depicts the results of operations for all periods presented.

We believe the following policies are critical and require the use of significant judgment in their application:

Revenue Recognition. We account for revenues and earnings using the percentage-of-completion method. Under this method, contract revenue and profit are recognized as work progresses, either as products are produced or as services are rendered. We determine progress using either input measures (e.g., costs incurred) or output measures (e.g., contract milestones or units delivered), as appropriate to the circumstances. An input measure is used in most cases unless an output measure is identified that is reliably determinable and representative of progress toward completion. We estimate the profit on a contract as the difference between the total estimated revenue and the total estimated costs of a contract and recognize that profit over the life of the contract. If at any time the estimate of contract profitability reveals an anticipated loss on the contract, we recognize the loss in the quarter it is identified.

We generally measure progress toward completion on contracts in our defense businesses based on the proportion of costs incurred to date relative to total estimated costs at completion (input measure). For our contracts for the manufacture of business-jet aircraft, we record revenue at two contractual milestones: when green aircraft are delivered to and accepted by the customer and when the customer accepts final delivery of the fully outfitted aircraft (output measure). We do not recognize revenue at green delivery unless (1) a contract has been executed with the customer and (2) the customer can be expected to satisfy its obligations under the contract, as evidenced by the receipt of significant deposits from the customer and other factors.

Accounting for long-term contracts and programs involves the use of various techniques to estimate total contract revenues and costs. Contract estimates are based on various assumptions to project the outcome of future events that often span several years. These assumptions include labor productivity and availability; the complexity of the work to be performed; the cost and availability of materials; the performance of subcontractors; and the availability and timing of funding from the customer. We include in our contract estimates additional revenues for submitted contract modifications or claims against the customer when the amount can be estimated reliably and its realization is probable. In evaluating these criteria, we consider the contractual/legal basis for the claim, the cause of any additional costs incurred, the reasonableness of those costs and the objective evidence available to support the claim. We include award or incentive fees in the estimated contract value when there is a basis to reasonably estimate the amount of the fee. Estimates of award or incentive fees are based on historical award experience and anticipated performance. These estimates are based on our best judgment at the time. As a significant change in one or more of these estimates could affect the profitability of our contracts, we review our performance monthly and update our contract-related estimates at least annually and often quarterly, as well as when required by specific events and circumstances.

We recognize changes in the estimated profit on contracts under the reallocation method. Under this method, the impact of revisions in estimates is recognized prospectively over the remaining contract term. We use this method because we believe the majority of factors that typically result in changes in estimates on our long-term contracts affect the period in which the change is identified and future periods. These changes generally reflect our current expectations as to future performance and, therefore, the reallocation method is the method that best matches our profits to the periods in which they are earned. Most government contractors recognize the impact of a change in estimated profit immediately under the cumulative catch-up method. The impact on operating earnings in the period the change is identified is generally lower under the reallocation method as compared to the cumulative catch-up method. The net increase in our operating

earnings (and on a per-share basis) from the impact of revisions in contract estimates totaled favorable changes in estimate of $184 ($0.35) in 2014, $351 ($0.65) in 2013 and $180 ($0.33) in 2012. The 2013 impact of changes in estimate was higher as a result of numerous programs that neared completion in the Combat Systems group. No revisions on any one contract were material to our Consolidated Financial Statements in 2014.

In the second quarter of 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. ASU 2014-09 prescribes a single, common revenue standard that replaces most existing revenue recognition guidance in GAAP. The standard outlines a five-step model, whereby revenue is recognized as performance obligations within a contract are satisfied. The standard also requires new, expanded disclosures regarding revenue recognition. ASU 2014-09 is effective in the first quarter of 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. We have not yet selected a transition method nor have we determined the effect of the standard on our Consolidated Financial Statements.

The required adoption of the ASU in 2017 will preclude our use of the reallocation method of recognizing revisions in estimated profit on contracts discussed above. As changes in estimated profit will be recognized in the period they are identified (cumulative catch-up method), rather than prospectively over the remaining contract term, we expect that the impact of revisions of contract estimates may be larger and potentially more variable from period to period. Anticipated losses on contracts will continue to be recognized in the quarter they are identified.

Goodwill and Intangible Assets. Goodwill represents the purchase price paid in excess of the fair value of net tangible and intangible assets acquired. Goodwill is not amortized but is subject to an impairment test on an annual basis and when circumstances indicate that an impairment is more likely than not. Such circumstances include a significant adverse change in the business climate for one of our reporting units or a decision to dispose of a reporting unit or a significant portion of a reporting unit. The test for goodwill impairment is a two-step process that requires a significant level of estimation and use of judgment by management, particularly the estimate of the fair value of our reporting units. We estimate the fair value of our reporting units primarily based on the discounted projected cash flows of the underlying operations. This requires numerous assumptions, including the timing of work embedded in our backlog, our performance and profitability under our contracts, our success in securing future business, the appropriate risk-adjusted interest rate used to discount the projected cash flows, and terminal value growth and earnings rates applied to the final year of projected cash flows. Due to the variables inherent in our estimates of fair value, differences in assumptions may have a material effect on the result of our impairment analysis. To assess the reasonableness of our discounted projected cash flows, we compare the sum of our reporting units' fair value to our market capitalization and calculate an implied control premium (the excess of the sum of the reporting units' fair values over the market capitalization). We evaluate the reasonableness of this control premium by comparing it to control premiums for recent comparable market transactions.

We completed the required annual goodwill impairment test as of December 31, 2014. The first step of the goodwill impairment test compares the fair value of our reporting units to their carrying values. Our reporting units are consistent with our business groups. The estimated fair values for each of our reporting units were well in excess of their respective carrying values as of December 31, 2014. In our Information Systems and Technology reporting unit (for which we recorded a $2 billion goodwill impairment in 2012), this excess increased from 2013 as there was an improvement in the fair value and a decrease in the carrying value of the reporting unit.

We review intangible assets subject to amortization for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Impairment losses, where identified, are determined as the excess of the carrying value over the estimated fair value of the long-lived asset. We assess the recoverability of the carrying value of assets held for use based on a review of projected undiscounted cash flows.
Commitments and Contingencies. We are subject to litigation and other legal proceedings arising either from the ordinary course of our business or under provisions relating to the protection of the environment. Estimating liabilities and costs associated with these matters requires the use of judgment. We record a charge against earnings when a liability associated with claims or pending or threatened litigation is probable and when our exposure is reasonably estimable. The ultimate resolution of our exposure related to these matters may change as further facts and circumstances become known.
Deferred Contract Costs. Certain costs incurred in the performance of our government contracts are recorded under GAAP but are not allocable currently to contracts. Such costs include a portion of our estimated workers' compensation obligations, other insurance-related assessments, pension and other post-retirement benefits, and environmental expenses. These costs will become allocable to contracts generally after they are paid. We have elected to defer (or inventory) these costs in contracts in process until they can be allocated to contracts. We expect to recover these costs through ongoing business, including existing backlog and probable follow-on contracts. We regularly assess the probability of recovery of these costs. This assessment requires that we make assumptions about future contract costs, the extent of cost recovery under our contracts and the amount of future contract activity. These estimates are based on our best judgment. If the backlog in the future does not support the continued deferral of these costs, the profitability of our remaining contracts could be adversely affected.
Retirement Plans. Our defined-benefit pension and other post-retirement benefit costs and obligations depend on several assumptions and estimates. The key assumptions include interest rates used to discount estimated future liabilities and projected long-term rates of return on plan assets. We determine the discount rate used each year based on the rate of return currently available on a portfolio of high-quality fixed-income investments with a maturity that is consistent with the projected benefit payout period. We determine the long-term rate of return on assets based on consideration of historical and forward-looking returns and the current and expected asset allocation strategy.
In 2014, we adopted updated mortality tables published by the Society of Actuaries that predict increasing life expectancies in the United States. Additionally, we updated several other assumptions to align them with historical experience, including rates of retirement and cost of living increases. The impact of these changes was a net increase of $566 and $28 in the benefit obligations of our pension and other post-retirement benefit plans, respectively, on December 31, 2014.
These estimates are based on our best judgment, including consideration of current and future market conditions. In the event any of the assumptions change, pension and post-retirement benefit cost could increase or decrease. For further discussion, including the impact of hypothetical changes in the discount rate and expected long-term rate of return on plan assets, see Note P to the Consolidated Financial Statements in Item 8.
As discussed under Deferred Contract Costs, our contractual arrangements with the U.S. government provide for the recovery of benefit costs for our government retirement plans. We have elected to defer recognition of the benefit costs that cannot currently be allocated to contracts to provide a better matching of revenues and expenses. Accordingly, the impact on the retirement benefit cost for these plans that results from annual changes in assumptions does not impact our earnings.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, primarily from foreign currency exchange rates, interest rates, commodity prices and investments. See Note M to the Consolidated Financial Statements in Item 8 for a discussion of these risks. The following discussion quantifies the market risk exposure arising from hypothetical changes in foreign currency exchange rates and interest rates.

Foreign Currency. We had notional forward foreign exchange contracts outstanding of $9.1 billion on December 31, 2014, and $1.7 billion on December 31, 2013. The increase in 2014 is due to significant international contract awards. A 10 percent unfavorable exchange rate movement in our portfolio of foreign currency forward contracts would have resulted in the following hypothetical, incremental pretax losses:

	2014	2013
Recognized	$(25)	$(51)
Unrecognized	(823)	(40)

This exchange-rate sensitivity relates primarily to changes in the U.S. dollar/Canadian dollar, euro/Canadian dollar and euro/British pound exchange rates. While the hypothetical pretax losses in the table above have increased significantly from 2013, we do not believe this represents a meaningful increase in our risk profile as these losses would continue to be offset by corresponding gains in the remeasurement of the underlying transactions being hedged. We believe these forward contracts and the offsetting underlying commitments, when taken together, do not create material market risk.

Interest Rate Risk. Our financial instruments subject to interest rate risk include fixed-rate long-term debt obligations and variable-rate commercial paper. On December 31, 2014, we had $3.9 billion par value of fixed-rate debt and no commercial paper outstanding. Our fixed-rate debt obligations are not putable, and we do not trade these securities in the market. A 10 percent unfavorable interest rate movement would not have a material impact on the fair value of our debt obligations.

Our investment policy allows for purchases of fixed-income securities with an investment-grade rating and a maximum maturity of up to five years. On December 31, 2014, we held $4.4 billion in cash and equivalents and $500 of marketable securities reported in other current assets.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CONSOLIDATED STATEMENTS OF EARNINGS (LOSS)

	Year Ended December 31		
(Dollars in millions, except per-share amounts)	2014	2013	2012
Revenues:			
Products	$19,564	$19,100	$19,264
Services	11,288	11,830	11,728
	30,852	30,930	30,992
Operating costs and expenses:			
Products	15,335	15,065	15,830
Services	9,644	10,137	10,182
Goodwill impairment	—	—	1,994
General and administrative (G&A)	1,984	2,039	2,221
	26,963	27,241	30,227
Operating earnings	3,889	3,689	765
Interest, net	(86)	(86)	(156)
Other, net	(1)	8	(136)
Earnings from continuing operations before income tax	3,802	3,611	473
Provision for income tax, net	1,129	1,125	854
Earnings (loss) from continuing operations	2,673	2,486	(381)
Discontinued operations, net of tax of ($16) in 2014, ($73) in 2013, and $19 in 2012	(140)	(129)	49
Net earnings (loss)	$2,533	$2,357	$(332)
Earnings (loss) per share			
Basic:			
Continuing operations	$7.97	$7.09	$(1.08)
Discontinued operations	(0.41)	(0.37)	0.14
Net earnings (loss)	$7.56	$6.72	$(0.94)
Diluted:			
Continuing operations	$7.83	$7.03	$(1.08)
Discontinued operations	(0.41)	(0.36)	0.14
Net earnings (loss)	$7.42	$6.67	$(0.94)

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Year Ended December 31		
(Dollars in millions)	2014	2013	2012
Net earnings (loss)	$2,533	$2,357	$(332)
(Losses) gains on cash flow hedges	(279)	3	(23)
Unrealized gains on securities	10	12	6
Foreign currency translation adjustments	(436)	(118)	141
Change in retirement plans' funded status	(1,745)	2,595	(1,149)
Other comprehensive (loss) income, pretax	(2,450)	2,492	(1,025)
(Benefit) provision for income tax, net	(703)	902	(562)
Other comprehensive (loss) income, net of tax	(1,747)	1,590	(463)
Comprehensive income (loss)	$786	$3,947	$(795)

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED BALANCE SHEETS

	December 31	
(Dollars in millions)	2014	2013
ASSETS		
Current assets:		
Cash and equivalents	$4,388	$5,301
Accounts receivable	4,050	4,370
Contracts in process	4,591	4,780
Inventories	3,221	2,890
Other current assets	1,157	821
Total current assets	17,407	18,162
Noncurrent assets:		
Property, plant and equipment, net	3,329	3,359
Intangible assets, net	912	1,044
Goodwill	11,731	11,932
Other assets	1,976	997
Total noncurrent assets	17,948	17,332
Total assets	$35,355	$35,494
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term debt and current portion of long-term debt	$501	$1
Accounts payable	2,057	2,216
Customer advances and deposits	7,335	6,584
Other current liabilities	3,858	3,458
Total current liabilities	13,751	12,259
Noncurrent liabilities:		
Long-term debt	3,410	3,908
Other liabilities	6,365	4,826
Commitments and contingencies (see Note N)		
Total noncurrent liabilities	9,775	8,734
Shareholders' equity:		
Common stock	482	482
Surplus	2,548	2,226
Retained earnings	21,127	19,428
Treasury stock	(9,396)	(6,450)
Accumulated other comprehensive loss	(2,932)	(1,185)
Total shareholders' equity	11,829	14,501
Total liabilities and shareholders' equity	$35,355	$35,494

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31		
(Dollars in millions)	2014	2013	2012
Cash flows from operating activities - continuing operations:			
Net earnings (loss)	$2,533	$2,357	$(332)
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Depreciation of property, plant and equipment	375	382	376
Amortization of intangible assets	121	143	214
Goodwill and intangible asset impairments	—	—	2,295
Stock-based compensation expense	128	120	114
Excess tax benefit from stock-based compensation	(83)	(23)	(29)
Deferred income tax (benefit) provision	136	115	(144)
Discontinued operations, net of tax	140	129	(49)
(Increase) decrease in assets, net of effects of business acquisitions:			
Accounts receivable	330	(223)	225
Contracts in process	281	177	149
Inventories	(303)	(200)	(490)
Increase (decrease) in liabilities, net of effects of business acquisitions:			
Accounts payable	(161)	(204)	(413)
Customer advances and deposits	691	330	730
Other current liabilities	(246)	(118)	23
Other, net	(214)	126	(63)
Net cash provided by operating activities	3,728	3,111	2,606
Cash flows from investing activities - continuing operations:			
Capital expenditures	(521)	(436)	(436)
Purchases of held-to-maturity securities	(500)	—	(260)
Purchases of available-for-sale securities	(136)	(135)	(252)
Sales of available-for-sale securities	135	99	186
Maturities of available-for-sale securities	4	14	110
Other, net	(84)	95	10
Net cash used by investing activities	(1,102)	(363)	(642)
Cash flows from financing activities - continuing operations:			
Purchases of common stock	(3,382)	(740)	(602)
Dividends paid	(822)	(591)	(893)
Proceeds from option exercises	547	583	146
Repayment of fixed-rate notes	—	—	(2,400)
Proceeds from fixed-rate notes	—	—	2,382
Other, net	82	23	(15)
Net cash used by financing activities	(3,575)	(725)	(1,382)
Net cash provided (used) by discontinued operations	36	(18)	65
Net (decrease) increase in cash and equivalents	(913)	2,005	647
Cash and equivalents at beginning of year	5,301	3,296	2,649
Cash and equivalents at end of year	$4,388	$5,301	$3,296

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS’ EQUITY

	Common Stock		Retained	Treasury	Accumulated Other Comprehensive	Total Shareholders’
(Dollars in millions)	Par	Surplus	Earnings	Stock	Loss	Equity
Balance, December 31, 2011	$482	$1,888	$18,917	$(5,743)	$(2,312)	$ 13,232
Net loss	—	—	(332)	—	—	(332)
Cash dividends declared	—	—	(725)	—	—	(725)
Stock-based awards	—	100	—	180	—	280
Shares purchased	—	—	—	(602)	—	(602)
Other comprehensive loss	—	—	—	—	(463)	(463)
Balance, December 31, 2012	482	1,988	17,860	(6,165)	(2,775)	11,390
Net earnings	—	—	2,357	—	—	2,357
Cash dividends declared	—	—	(789)	—	—	(789)
Stock-based awards	—	238	—	455	—	693
Shares purchased	—	—	—	(740)	—	(740)
Other comprehensive income	—	—	—	—	1,590	1,590
Balance, December 31, 2013	482	2,226	19,428	(6,450)	(1,185)	14,501
Net earnings	—	—	2,533	—	—	2,533
Cash dividends declared	—	—	(834)	—	—	25.6271 shares of our stock per $1,000 principle amount of notes which equates to approximately 5.2 million shares of common stock, or a conversion price of $39.02 per share of common stock. The conversion rate at the time of redemption, conversion or repurchase will be dependent on certain factors as stated in the Offering Memorandum of the Notes. We intend to use the proceeds from the Notes for working capital and general corporate purposes, including the funding of future potential acquisitions, although none has been identified as of the filing of this Annual Report on Form

10-K.

We have also utilized equipment lines to fund capital purchases. Most recently, we entered into an equipment loan agreement with Silicon Valley Bank in April 2011 for an aggregate loan principal amount of $6.0 million. Interest on the advances is equal to the prime rate plus 0.50%. As of December 31, 2013, the interest rate on the outstanding advances was 4.50%. We had the ability to draw down on this equipment line through April 19, 2012 and each drawn amount is due 48 months after funding. Borrowings outstanding under the equipment loan at December 31, 2013 were $2.3 million. Equipment financed under this loan arrangement is collateralized by the respective assets underlying the loan. The terms of the loan restrict our ability to pay dividends. The loan includes a covenant that requires us to maintain cash and cash equivalents plus net accounts receivables of at least two times the amount of all outstanding indebtedness. As of December 31, 2013, as a result of

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the issuance of the Notes, we were not in compliance with the covenant which Silicon Valley Bank waived. Subsequently, we amended the loan agreement with Silicon Valley Bank to exclude the impact of the Notes on the covenant.

We plan to grow our customer base by continuing to emphasize investments in sales and marketing to add new customers, expand our customers' use of our platform, and maintain high renewal rates. We also expect to incur additional cost of subscription revenue in accordance with the resulting growth in our customer base. We believe that the combination of our ongoing improvements in gross margins, the benefits of lower sales and marketing costs associated with our renewal activity, and the fact that our contracts are structured to bill our customers in advance should enable us to improve our cash flow from operations as we grow. Based on our current level of operations and anticipated growth, both of which are expected to be consistent with recent quarters, we believe that our existing sources of liquidity will be sufficient to fund our operations for at least the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities, and the timing and extent of spending to support product

development efforts and expansion into new territories, and the timing of introductions of new features and enhancements to our solutions. To the extent that existing cash and cash equivalents and cash from operations are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. We have invested, and plan to continue investing in acquiring complementary business, applications and technologies, and may continue to make such investments in the future, any of which could also require us to seek equity or debt financing in addition to our Notes. Additional funds may not be available on terms favorable to us or at all.

Cash Flows

The following table sets forth a summary of our consolidated cash flows for the periods indicated:

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Net cash provided by (used in) operating activities	$12,624	$6,836	$(168)
Net cash used in investing activities	(9,968)	(50,735)	(7,353)
Net cash provided by financing activities	201,876	73,386	5,201

Net Cash Flows Provided by (Used in) Operating Activities

Our net loss and cash flows from operating activities are significantly influenced by our investments in headcount and data center operations to support anticipated growth. Our cash flows are also influenced by cash payments from customers. We invoice customers for the entire contract amount at the start of the term, and as such our cash flow from operations is also affected by the length of a customer contract.

We generated $12.6 million of cash in operating activities in 2013. The generation of cash was the result of a net loss of $27.5 million, offset by non-cash expenditures of $19.7 million, which included depreciation, amortization, provision for allowance of bad debt, stock-based compensation expense, deferred income taxes and the accretion of the debt discount and amortization of debt issuance costs related to the Notes. These non-cash expenditures increased due to capital expenditure, headcount growth and the issuance of the Notes primarily related to continued investment in our business. Cash used in operations was further offset by an increase in deferred revenue of $22.6 million due to sales growth and the acquisitions. The remaining use of funds was due to the net change in working capital items, most notably an increase in accounts receivable

of $4.5 million due to strong sales growth, an increase of $0.3 million in noncurrent assets, primarily related to the debt issuance costs on the Notes, and an increase in accounts payable and accrued liabilities of $0.9 million and $1.9 million, respectively, related to timing of compensation and employee stock purchase plan contribution.

We generated $6.8 million of cash in operating activities in 2012. The generation of cash was the result of a net loss of $20.4 million, offset by non-cash expenditures of $15.6 million, which primarily included depreciation, amortization, provision for allowance of bad debt and stock-based compensation expense. These non-cash expenditures increased due to capital expenditure and headcount growth, primarily related to continued investment in our business. Cash used in operations was further offset by an increase in deferred revenue of $10.6 million due to sales growth and a decrease in deferred product costs of $1.3 million. The remaining use of funds was due to the net change in working capital items, most notably an increase in accounts receivable of $2.4 million due to strong sales growth, an increase of $0.9 million in prepaid expenses and other

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current assets, and an increase in accrued liabilities of $3.5 million related to timing of compensation, employee stock purchase plan contribution and increase in tax liability.

We used $0.2 million of cash in operating activities in 2011. This use of cash was the result of a net loss of $20.1 million, offset by non-cash expenditures of $12.4 million, which included depreciation, amortization and stock-based compensation expense. These non-cash expenditures increased due to capital expenditure and headcount growth, primarily related to continued investment in our business. Cash used in operations was further offset by an increase in deferred revenue of $7.1 million due to sales growth and a decrease in deferred product costs of $2.8 million. The remaining use of funds was due to the net change in working capital items, most notably an increase in accounts receivable of $2.7 million due to strong sales efforts during the last quarter of the fiscal year, an increase of $0.8 million in prepaid expenses and other current assets, and an increase in accrued liabilities of $0.7 million related to timing of compensation and capital expenditures.

Net Cash Flows Provided by (Used in) Investing Activities

Our primary investing activities consisted of acquisitions of businesses,

capital expenditures in support of expanding our infrastructure and workforce and the purchase and sale of short-term investments. As our business grows, we expect our capital expenditures and our investment activity to continue to increase. We may also target other companies for acquisition, however, there are none currently pending.

We used $10.0 million of cash in investing activities during 2013. This was primarily due to the five acquisitions totaling $41.0 million and purchases of short-term investments of $20.4 million. In addition, we used $7.7 million to purchase equipment for infrastructure expansion and daily operations. These uses of cash were partially offset by net proceeds of $59.0 million from the sales and maturities of short-term investments.

We used $50.7 million of cash in investing activities during 2012. This was primarily due to purchases of short-term investments of $60.1 million with proceeds generated from our initial public offering, offset by net proceeds of $15.3 million from sales and maturities of short-term investments. In addition, we used $5.9 million to purchase equipment for infrastructure expansion. These expenditures were primarily for replacement and upgrade of equipment to lower the cost of deployment as well as to improve the efficiency for our cloud based architecture.

We used $7.4 million of cash in investing activities during 2011. This was primarily from the net purchase of $2.3 million in short-term investments. In addition, we used $4.9 million to purchase equipment for infrastructure expansion. These expenditures were primarily for replacement and upgrade of equipment to lower the cost of deployment as well as to improve the efficiency for our cloud-based architecture.

Net Cash Flows Provided by (Used in) Financing Activities

Cash provided by financing activities in 2013 was $201.9 million. This was primarily related to proceeds of $195.6 million from the issuance of the Notes in December 2013 which were net of payments totaling $5.6 million in discount and issuance costs on the Notes. Additionally, contributions included $16.4 million of proceeds from the exercise of stock options, partially offset by $10.0 million in payments of our equipment financing loans and debt assumed from the acquisitions.

Cash provided by financing activities in 2012 was $73.4 million. This was primarily related to proceeds from our initial public offering, net of offering costs, of $68.3 million. Contributions also included $6.1 million of proceeds from the exercise of stock options, partially offset by $1.0 million in repayments under our equipment financing loans.

Cash provided by financing activities in 2011 was $5.2 million. This consisted of $1.2 million of proceeds from the exercise of stock options and borrowings under our new equipment line of $4.9 million during this period, partially offset by repayments under our equipment financing loans of $0.2 million and $0.7 million in earn-out payments.

Contractual Obligations and Commitments

Our principal commitments consist of obligations under our outstanding leases for our office space and third-party data centers as well as equipment leases and loans for certain computer and office equipment. The following table summarizes our contractual obligations as of December 31, 2013 (in thousands):

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	Payment Due By Period			
	Total (7)	Less Than 1 Year	1-3 Years	3-5 Year
Convertible senior notes(1)	$201,250	$—	$—	$201,25
Interest payments(2)	12,611	2,653	5,031	4,927
Debt obligations(3)	2,326	1,642	684	—
Interest expense payments(4)	80	72	8	—
Capital and operating lease obligations(5)	3,729	1,562	1,668	499
Purchase obligations(6)	3,678	3,061	617	—
Total	$223,674	$8,990	$8,008	$206,67

(1) Represents the 1.25% convertible senior notes issued in December 2013. See Note 8, "Convertible Senior Notes" for further information.

(2) Represents interest payments on the 1.25% senior convertible notes issued in December 2013.

(3) Represents our outstanding debt under our equipment loan.

(4) Represents interest payments on our outstanding debt under our equipment loan, including the loan and equipment agreement commencing April 2011.

(5) Consists of capital leases and contractual obligations under operating leases for office space.

(6) Consists of purchase obligations for servers and similar equipment to support our third-party data centers.

(7) As we are unable to reasonably predict the timing of settlement of liabilities related to unrecognized tax benefits, net, the table does not include $0.7 million of such non-current liabilities included in deferred and other tax liabilities recorded on our Consolidated Balance Sheets as of December 31, 2013.

We have recorded a liability for sales and use taxes. A variety of factors could affect the liability, which factors include recovery of amounts from customers and any changes in relevant statutes in the various states in which we have done business. To the extent that the actual amount of our liabilities for sales and use taxes materially differs from the amount we have recorded on our consolidated balance sheet, our future results of operations and cash flows could be negatively affected.

As of December 31, 2013, the amount of cash and cash equivalents held by our foreign subsidiaries was $21.3 million, including intercompany receivable balances. If these funds were needed for our operations in the United States, we would be required to withhold foreign taxes on the funds repatriated

of approximately $0.8 million. We have only provided $0.2 million for these taxes in accordance with ASC 740-30-25, as it is our intention that the majority of these funds are indefinitely reinvested outside the United States and our current plans do not demonstrate a need to repatriate these funds to our United States operations.

Under the indemnification provisions of our standard customer agreements, we agree to indemnify, defend and hold harmless our customers against, among other things, infringement of any patents, trademarks or copyrights under any country's laws or the misappropriation of any trade secrets arising from the customer's legal use of our solutions. Certain indemnification provisions potentially expose us to losses in excess of the aggregate amount paid to us by the customer under the applicable customer agreement. No material claims have been made against us pursuant to these indemnification provisions to date.

Off-Balance Sheet Arrangements

During the periods presented, we did not have, nor do we currently have, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating

off-balance sheet arrangements or other contractually narrow or limited purposes. We are therefore not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in those types of relationships.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have operations both within the United States and internationally, and we are exposed to market risks in the ordinary course of our business. These risks primarily include interest rate, foreign exchange and inflation risks, as well as risks relating to changes in the general economic conditions in the countries where we conduct business. To reduce certain of these risks, we monitor the financial condition of our large clients and limit credit exposure by collecting in advance and setting credit limits as we deem appropriate. In addition, our investment strategy has been to invest in financial instruments that are highly liquid and readily convertible into cash with maturity dates within three months from the date of purchase. To date, we

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have not used derivative instruments to mitigate the impact of our market risk exposures. We have also not used, nor do we intend to use, derivatives for trading or speculative purposes.

Interest Rate Risk

We are exposed to market risk related to changes in interest rates. Our investments are considered cash equivalents and primarily consist of money market funds, corporate debt securities and a certificate of deposit. As of December 31, 2013, we had cash, cash equivalents, and short-term investments of $251.8 million. The carrying amount of our cash equivalents and short-term investments reasonably approximates fair value, due to the short maturities of these investments. The primary objectives of our investment activities are the preservation of capital, the fulfillment of liquidity needs and the fiduciary control of cash and investments. We do not enter into investments for trading or speculative purposes. Our investments are exposed to market risk due to a fluctuation in interest rates, which may affect our interest income and the fair market value of our investments. Due to the short-term nature of our investment portfolio, we believe only dramatic fluctuations in interest rates would have a material effect on our investments. As such we do not expect our operating

results or cash flows to be materially affected by a sudden change in market interest rates.

As of December 31, 2013, we had an outstanding balance of $201.3 million aggregate principle amount of the Notes, which has a fixed interest rate of 1.25%, and other outstanding borrowings with principal amounts of $2.3 million, which has a fixed interest rate of 4.5%. We carry these instruments at face value, less relative fair value of conversion option allocated to equity and unamortized discounts, on our Consolidated Balance Sheets. Since these instruments bear interest at fixed rates, we have no financial statement risk associated with changes in interest rates. However, the fair value of these instruments fluctuates as interest rate changes and, in the case of the Notes, when the market price of our common stock fluctuates.

Foreign Currency Risk

Our sales to international customers are generally U.S. dollar-denominated. As a result, there are no significant foreign currency gains or losses related to these transactions. The functional currency for our wholly owned foreign subsidiaries is the U.S. dollar. Accordingly, the subsidiaries remeasure monetary assets and liabilities at period-end exchange rates, while nonmonetary items are remeasured at historical rates. Income and expense accounts

are remeasured at the average exchange rates in effect during the year. Remeasurement adjustments are recognized in the Consolidated Statements of Operations as foreign currency transaction gains or losses in the year of occurrence. Aggregate foreign currency transaction gain (losses) included in determining net loss were $(0.2) million for both 2013 and 2012, and less than $0.1 million for 2011. Transaction gains and losses are included in other income (expense), net.

As our international operations grow, our risks associated with fluctuation in currency rates will become greater, and we will continue to reassess our approach to managing this risk. In addition, currency fluctuations or a weakening U.S. dollar can increase the costs of our international expansion. To date, we have not entered into any foreign currency hedging contracts, since exchange rate fluctuations have not had a material impact on our operating results and cash flows. Based on our current international structure, we do not plan on engaging in hedging activities in the near future.

Inflation Risk

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. Nonetheless, if our costs were to become subject to significant inflationary pressures, we may

not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

Critical Accounting Policies

Our management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with GAAP. GAAP requires us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the dates of the consolidated financial statements, the disclosure of contingencies as of the dates of the consolidated financial statements, and the reported amounts of revenue and expenses during the periods presented. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operations for future periods could be materially affected. See "Risk Factors" for certain matters that may affect our future financial condition or results of operations. An accounting policy is deemed to be critical if it requires an accounting

estimate to be made based on
assumptions

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about matters that are uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if the changes in estimate that are reasonably likely to occur could materially impact the financial statements. Our management has discussed the development, selection and disclosure of these estimates with the audit committee of our board of directors.

Our significant accounting policies, including those considered to be critical accounting policies, are summarized in “Note 1 - The Company and Summary of Significant Accounting Policies” to the accompanying Consolidated Financial Statements in this report. The following critical accounting policies reflect significant judgments and estimates used in the preparation of our consolidated financial statements:

- Revenue recognition and deferred revenue;
- Stock-based compensation;
- Allowance for doubtful accounts;
- Business combinations;
- Goodwill and intangible assets - impairment assessments
- Impairment of long lived assets; and
- Income taxes.

Revenue Recognition and Deferred Revenue

We derive our revenue primarily from two sources: (1) subscription revenue for rights related to the use of our security-as-a-service platform and (2) hardware, training, and professional services revenue provided to customers related to their use of our platform. Subscription revenue is derived from a subscription-based enterprise licensing model with contract terms typically ranging from one to three years, and consists of (i) subscription fees from the licensing of our security-as-a-service platform, (ii) subscription fees for access to the on-demand elements of our platform and (iii) subscription fees for the right to access our customer support services.

We apply the provision of Accounting Standard Codification (ASC) 985-605, "Software Revenue Recognition," and related interpretations, to all transactions involving the licensing of software, as well as related support, training, and other professional services. ASC 985-605 requires revenue earned on software arrangements involving multiple elements such as software license, support, training, and other professional services to be allocated to each element based on the relative fair values of these elements. The fair value of an element must be based on vendor-specific

objective evidence (VSOE) of fair value. VSOE of fair value of each element is based on the price charged when the element is sold separately. Revenue is recognized when all of the following criteria are met as set forth in ASC 985-605:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred;
- The fee is fixed or determinable; and
- Collectability is probable.

We have analyzed all of the elements included in our multiple element arrangements and have determined that we do not have sufficient VSOE of fair value to allocate revenue to our subscription and software license agreements, support, training, and professional services. We defer all revenue under the arrangement until the commencement of the subscription services and any associated professional services. Once the subscription services and the associated professional services have commenced, the entire fee from the arrangement is recognized ratably over the remaining period of the arrangement. If the professional services are essential to the functionality of the subscription, then the revenue recognition does not commence until such services are completed.

Our hosted on-demand service agreements do not provide customers with the right to take possession of the software supporting the hosted service. We recognize revenue from our on-demand services in accordance with ASC 605-20, and as such recognize revenue when the following criteria are met:

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- Persuasive evidence of an arrangement exists;
- Delivery of our obligations to our customers has occurred;
- Collection of the fees is probable; and
- The amount of fees to be paid by the customer is fixed or determinable.

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting guidance for multiple element arrangements (ASU 2009-13) to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the arrangement consideration should be allocated among its elements;
- Require an entity to allocate revenue in an arrangement that has separate units of accounting using best estimated selling price (BESP) of deliverables if a vendor does not have VSOE of fair value or third-party evidence of selling price (TPE); and
- Eliminate the use of the residual method and require an entity to allocate revenue using the relating selling price method to the separate unit of accounting.

Concurrently, the FASB amended the accounting

guidance for revenue recognition (ASU 2009-14) to exclude hardware appliances containing software components and hardware components that function together to deliver the hardware appliance's essential functionality from the scope of the software revenue recognition guidance of ASC 985-605.
Prior to the adoption of ASU 2009-14, revenue derived from hardware appliance sales were recognized based on the software revenue recognition guidance. We could not establish VSOE of fair value for the undelivered elements in the arrangement, and therefore the entire fee from the arrangement was recognized ratably over the contractual term of the agreement. In addition, we were unable to establish VSOE of fair value of our hosted on-demand service agreements, and therefore the entire fee for the agreement was recognized ratably over the contractual term of the agreement.

As a result of the adoption of this new accounting guidance, revenue derived from our subscription services and hardware appliance sales are no longer subject to industry-specific software revenue recognition guidance. For all arrangements within the scope of the new guidance, including our hosted on-demand services, we evaluate each element in a multiple element arrangement to determine whether it represents a separate unit of accounting. An element

constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within our control. Revenue derived from the licensing of the security-as-a-service platform continues to be accounted for in accordance with the industry specific revenue recognition guidance.

When we are unable to establish the selling price of our non-software deliverables using VSOE or TPE, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for an individual element within a multiple element revenue arrangement using the same methods utilized to determine the selling price of an element sold on a standalone basis. We estimate the selling price for our subscription solutions by considering internal factors such as historical pricing practices and we estimate the selling price of our hardware and services using a combination of our historical costs paired with external measurements regarding the pricing of similar products and services in similar industries. As there is a significant amount of judgment when determining BESP, we regularly review all of our assumptions and inputs around BESP and maintain internal controls over the establishment and updates of

these estimates.

Hardware appliance revenue is recognized upon shipment. Subscription and support revenue are recognized over the contract period commencing on the start date of the contract. Professional services and training, when sold with hardware appliances or subscription and support services, are accounted for separately when those services have standalone value. In determining whether professional services and training services can be accounted for separately from subscription and support services, we consider the following factors: availability of the services from other vendors, the nature of the services, and the dependence of the subscription services on the customer's decision to buy the professional services. If professional services and training do not qualify for separate accounting, we recognize the professional services and training ratably over the contract term of the subscription services.

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Delivery generally occurs when the hardware appliance is delivered to a common carrier freight on board shipping point by us or the hosted service has been activated and communicated to the customer accordingly. Our fees are typically considered to be fixed or determinable at the inception of an arrangement and are negotiated at the outset of an arrangement, generally based on specific products and quantities to be delivered. In the event payment terms are provided that differ significantly from our standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized as the fees become paid.

We assess collectability based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. Through December 31, 2013, we have not experienced any significant credit losses.

Stock-Based Compensation

Effective January 1, 2006, we adopted ASC 718, which requires non-public companies that used the minimum value method under ASC 718 for either recognition or pro forma disclosures to apply ASC 718 using the prospective-transition method. In accordance with ASC 718, we recognize the compensation cost of

employee stock-based awards granted subsequent to December 31, 2005 in the Consolidated Statements of Operations using the straight-line method over the vesting period of the award.

The following table set for the stock-based compensation expense included in the related consolidated financial statement line items:

	Years Ended December 31,		
	2013	2012	2011
	(in thousands)		
Cost of subscription revenue	$1,007	$657	$366
Cost of hardware and services revenue	196	70	29
Research and development	3,608	1,869	1,247
Sales and marketing	4,270	3,103	1,976
General and administrative	3,002	1,622	930

We estimated the fair value of each option granted using the Black-Scholes option pricing model using the following assumptions for the periods presented in the table below:

	Year Ended December 31,		
	2013	2012	2011
Expected life (in years)	5.31 - 6.08	5.50 - 6.08	5.85 - 6.08
Volatility	57% - 61%	59% - 60%	59% - 61%
Risk-free interest rate	0.9% - 1.8%	0.9% - 1.2%	1.2% - 2.5%
Estimated dividend	0	0	0

yield

As of each stock option grant date, we considered the fair value of the underlying common stock, determined as described below, in order to establish the options exercise price.

As our common stock has been publicly traded less than two years, and therefore a lack of company-specific historical and implied volatility data, we have determined the share price volatility for options granted based on an analysis of reported data for a peer group of companies that granted options with substantially similar terms. We analyzed a population of possible comparable companies and selected those for our peer group that we considered to be the most comparable to us in terms of industry business model, revenue, growth and gross profit margins. The expected volatility of options granted has been determined using an average of the historical volatility measures of this peer group of companies for a period equal to the expected life of the option. We intend to continue to consistently apply this process using the same or similar entities until a sufficient amount of historical information regarding the volatility of our own share price becomes available, or unless circumstances change such that the identified entities are no longer similar to us. In this latter case, more suitable entities whose share prices are publicly available would be

utilized in the calculation.

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The expected life of options granted has been determined utilizing the "simplified" method as permitted by the SEC. The risk-free interest rate is based on a daily treasury yield curve rate whose term is consistent with the expected life of the stock options. We have not, historically, paid and, in the future, do not anticipate paying cash dividends on our shares of common stock and therefore, the expected dividend yield is assumed to be zero.

In addition, ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We apply an estimated forfeiture rate based on our historical forfeiture experience.

Prior to our IPO, we have historically granted stock options at exercise prices no less than the fair market value as determined by our board of directors, who used a number of factors, with input from management and a third-party valuation firm.

For our valuations, we calculated the enterprise value by applying both the market approach and the income approach. In the market approach, the valuations and outcomes of comparable peer companies in the public market were reviewed. The income approach consisted of

a discounted cash flow analysis. The methodology we used derived equity values utilizing a probability-weighted expected return method. Under this approach, the value of our common stock was estimated based upon an analysis of values for our common stock assuming the following various possible future events for the company, including initial public offering, strategic merger or sale, remaining a private company, and dissolution of the business with no resulting value to common stockholders.

Allowance for Doubtful Accounts

We assess collectability based on a number of factors, including credit worthiness of the customer along with past transaction history; in addition, we perform periodic evaluations of our customers' financial condition. Credit losses historically have not been material, which is directly attributable to our subscription-based services model, enabling us to immediately discontinue the availability of the services in question in the event of non-payment. Through December 31, 2013, we have not experienced any significant credit losses.

Business Combinations

We apply the provisions of ASC 805, Business Combinations, in the accounting for our acquisitions. It requires us to

recognize the assets acquired and the liabilities assumed at their acquisition date fair values separately from goodwill. Goodwill as of the acquisition date is measured as the excess of consideration transferred over the net of the acquisition date fair values of the assets acquired and the liabilities assumed. While we use our best estimates and assumptions to accurately value assets acquired and liabilities assumed at the acquisition date as well as contingent consideration, where applicable, our estimates are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, we may record adjustments to the assets acquired and liabilities assumed with the corresponding offset to goodwill. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded to our consolidated statements of operations.

Accounting for business combinations requires our management to make significant estimates and assumptions, especially at the acquisition date including our estimates for intangible assets, contractual obligations assumed, restructuring liabilities, pre-acquisition contingencies and contingent consideration, where applicable. Although we

believe the assumptions and estimates we have made in the past have been reasonable and appropriate, they are based in part on historical experience and information obtained from the management of the acquired companies and are inherently uncertain.

Examples of critical estimates in valuing certain of the intangible assets we have acquired include but are not limited to:

- future expected cash flows from our revenue streams;
- the acquired company's brand and competitive position, as well as assumptions about the period of time the acquired brand will continue to be used in the combined company's product portfolio; and
- discount rates.

Unanticipated events and circumstances may occur that may affect the accuracy or validity of such assumptions, estimates or actual results.

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For a given acquisition, we may identify certain pre-acquisition contingencies as of the acquisition date and may extend our review and evaluation of these pre-acquisition contingencies throughout the measurement period in order to obtain sufficient information to assess whether we include these contingencies as a part of the fair value estimates of assets acquired and liabilities assumed and, if so, to determine their estimated amounts.

If we cannot reasonably determine the fair value of a pre-acquisition contingency (non-income tax related) by the end of the measurement period, which is generally the case given the nature of such matters, we will recognize an asset or a liability for such pre-acquisition contingency if: (i) it is probable that an asset existed or a liability had been incurred at the acquisition date and (ii) the amount of the asset or liability can be reasonably estimated. Subsequent to the measurement period, changes in our estimates of such contingencies will affect earnings and could have a material effect on our results of operations and financial position.

In addition, uncertain tax positions and tax related valuation allowances assumed in connection with a business combination are initially estimated as of the acquisition date. We reevaluate these

items quarterly based upon facts and circumstances that existed as of the acquisition date with any adjustments to our preliminary estimates being recorded to goodwill if identified within the measurement period. Subsequent to the measurement period or our final determination of the tax allowance's or contingency's estimated value, whichever comes first, changes to these uncertain tax positions and tax related valuation allowances will affect our provision for income taxes in our Consolidated Statements of Operations and could have a material impact on our results of operations and financial position.

Goodwill, Intangible Assets and Other Long-Lived Assets - Impairment Assessments

We review goodwill for impairment annually and whenever events or changes in circumstances indicate its carrying value may not be recoverable in accordance with ASC 350, Intangibles—Goodwill and Other. For the purposes of impairment testing, we have determined that we have one reporting unit. We perform the two-step impairment test, whereby we compare the fair value of each reporting unit to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not considered impaired and we are not required to perform further testing. If the carrying

value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then we would record an impairment loss equal to the difference. No impairment has been noted to date.

We periodically review the carrying amounts of intangible assets and other long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. We measure the recoverability of these assets by comparing the carrying amount of such assets (or asset group) to the future undiscounted cashflow we expect the assets (or asset group) to generate. If we consider any of these assets to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its fair value. We make judgments about the recoverability of purchased intangible assets whenever events or changes in circumstances indicate that an impairment may exist.

Each period we evaluate the estimated remaining useful lives of intangible assets and other long-lived assets to assess whether a revision to the remaining periods of amortization is required.

Assumptions and estimates about remaining useful lives of our intangible and other long-lived assets are 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. Although we believe the historical assumptions and estimates we have made are reasonable and appropriate, different assumptions and estimates could materially impact our reported financial results. We did not recognize any intangible asset impairment charges to date.

Income Taxes

We account for income taxes in accordance with authoritative guidance, which requires the use of the asset and liability method. Under this method, deferred income tax assets and liabilities are determined based on the difference between the consolidated financial statement carrying amounts and the tax basis of assets and liabilities and are measured using the enacted tax rates expected to apply to taxable income in the years in which differences are expected to be reversed. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making such determination, we consider all available positive and negative evidence, including future reversals of existing taxable temporary differences,

projected future taxable income, tax planning strategies and recent financial operations.

We have elected to use the "with and without" approach as described in ASC 740-20, Intraperiod Tax Allocation, in determining the order in which tax attributes are utilized. As a result, we will only recognize a tax benefit from stock-based

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awards in additional paid-in capital if an incremental tax benefit is realized after all other tax attributes currently available to us have been utilized. In addition, we have elected to account for the impact of stock-based awards on other tax attributes, such as the research tax credit, through the Consolidated Statements of Operations.

Recent Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-11, "Income Taxes", a new accounting standard update on the financial statement presentation of unrecognized tax benefits. The new guidance provides that a liability related to an unrecognized tax benefit would be presented as a reduction of a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. The new guidance becomes effective for the Company on January 1, 2014 and it should be applied prospectively to unrecognized tax benefits that exist at the effective date with retrospective application permitted. The Company is currently assessing the impact of this new guidance but does not believe it will have a material impact.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information in response to this item is included in our consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP, appearing on Item 15 of this Annual Report on Form 10-K, and in Item 7 under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Regulations under the Securities Exchange Act of 1934, or the Exchange Act, require public companies, including us, to maintain “disclosure controls and procedures,” which are defined in Rule 13a-15(e) and Rule 15d-15(e) to mean a company’s controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure

controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports that we file or submit under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as of December 31, 2013. Based on their evaluation, as of December 31, 2013, our Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f) and Rule 15d-15(f). Our management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework (1992) issued by

the Committee of Sponsoring Organizations of the Treadway Commission. Based on its evaluation under the framework in Internal Control - Integrated Framework (1992), our management concluded that our internal control over financial reporting was effective as of December 31, 2013.

We acquired Armorize Technologies, Inc. and Sendmail, Inc. in September 2013 and October 2013, respectively. We have excluded these entities, which were business combinations, from our evaluation of internal control over financial reporting as of December 31, 2013. These two companies are wholly-owned subsidiaries whose combined total assets and total revenue represented 2% and 3%, respectively, of the related consolidated financial statements as of and for the year ended December 31, 2013.

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The effectiveness of our internal control over financial reporting as of December 31, 2013, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears in Item 15(a) of this Annual Report on Form 10-K.

Changes in Internal Controls

There have been no changes in our internal control over financial reporting during the quarter ended December 31, 2013 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it

is possible to design into the process safeguards to reduce, though not eliminate, this risk. Our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives and are effective at the reasonable assurance level. However, our management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the controls. The design of any system of controls also is based in part upon certain

assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

ITEM 9B. OTHER INFORMATION

Not applicable.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item will be set forth in the definitive Proxy Statement for our 2014 Annual Meeting of Stockholders (the "Proxy Statement") and is incorporated into this report by reference.

ITEM 11. EXECUTIVE COMPENSATION

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

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

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

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

The information required by this item will be set forth in the Proxy Statement and is incorporated into this report by

reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

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

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)

(1) Financial Statements

The list of consolidated financial statements and schedules set forth in the accompanying Index to the Consolidated Financial Statements at page F-1 of this annual report is incorporated herein by reference. Such consolidated financial statements and schedules are filed as part of this annual report.

(2) Financial Statement Schedules

The schedule required by this item is included in Note 4 to the Consolidated Financial Statements. All other financial statement schedules are not required or are inapplicable and therefore have been omitted.

(b)

(3) Exhibits

The exhibits listed on the accompanying Index to Exhibits in Item 15(b) below are filed or incorporated by reference as part of this annual report on Form 10-K. See Exhibit Index immediately following the Signature Pages.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Proofpoint, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of comprehensive loss, of changes in convertible preferred stock and stockholders' equity (deficit) and of cash flows present fairly, in all material respects, the financial position of Proofpoint, Inc. and its subsidiaries at December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal

control over financial reporting, included in Management's Annual Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our audits (which was an integrated audit in 2013). We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we

considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect

misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management's Annual Report on Internal Control over Financial Reporting, management has excluded Armorize Technologies, Inc. and Sendmail, Inc. from its assessment of internal control over financial reporting as of December 31, 2013 because they were acquired by the Company in purchase business combinations during 2013. We have also excluded Armorize Technologies, Inc. and Sendmail, Inc. from our audit of internal control over financial reporting. Armorize Technologies, Inc. and Sendmail, Inc. are wholly-owned subsidiaries whose combined total assets and total revenues represent 2% and 3%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2013.

/s/ PricewaterhouseCoopers LLP

San Jose, California
March 14, 2014

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Proofpoint, Inc.
Consolidated Balance Sheets
(in thousands, except per share amounts)

	At December 31,	
	2013	2012
Assets		
Current assets		
Cash and cash equivalents	$243,786	$39,254
Short-term investments	8,015	47,263
Accounts receivable, net of allowance for doubtful accounts of $276 and $187 at December 31, 2013 and 2012, respectively	26,221	18,115
Inventory	860	567
Deferred product costs, current	1,004	1,184
Prepaid expenses and other current assets	7,963	3,491
Total current assets	287,849	109,874
Property and equipment, net	11,221	8,560
Deferred product costs, noncurrent	357	326
Goodwill	63,764	18,557
Intangible assets, net	22,976	2,913
Other noncurrent assets	4,392	211
Total assets	$390,559	$140,441
Liabilities and Stockholders' Equity		

Current liabilities		
Accounts payable	$7,281	$2,496
Accrued liabilities	19,260	12,078
Notes payable and lease obligations, current	1,655	1,658
Deferred rent, current	297	462
Deferred revenue, current	89,450	62,642
Total current liabilities	117,943	79,336
Convertible senior notes	152,928	—
Notes payable and lease obligations, noncurrent	695	2,354
Other long-term liabilities, noncurrent	7,300	726
Deferred revenue, noncurrent	34,533	24,217
Total liabilities	313,399	106,633
Commitments and contingencies (Note 7)		
Stockholders' equity		
Preferred stock, $0.0001 par value; 5,000 shares authorized; no shares issued and outstanding at December 31, 2013 and 2012	—	—
Common stock, $0.0001 par value—200,000 shares	4	3

authorized at December 31, 2013 and 2012; 36,140 and 33,044 shares outstanding at December 31, 2013 and 2012, respectively		
Additional paid-in capital	287,165	216,280
Accumulated other comprehensive income	—	3
Accumulated deficit	(210,009)	(182,478)
Total stockholders' equity	77,160	33,808
Total liabilities and stockholders' equity	$390,559	$140,441

The accompanying notes are an integral part of these consolidated financial statements.

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Proofpoint, Inc.
Consolidated Statements of Operations
(in thousands, except per share amounts)

	Year Ended December 31,		
	2013	2012	2011
Revenue:			
Subscription	$132,062	$101,470	$73,896
Hardware and services	5,869	4,825	7,942
Total revenue	137,931	106,295	81,838
Cost of revenue:(1)(2)			
Subscription	35,438	28,246	24,193
Hardware and services	6,124	4,867	5,537
Total cost of revenue	41,562	33,113	29,730
Gross profit	96,369	73,182	52,108
Operating expense:(1)(2)			
Research and development	34,449	24,827	19,779
Sales and marketing	71,781	55,239	42,676
General and administrative	19,622	12,693	9,237
Total operating expense	125,852	92,759	71,692
Operating loss	(29,483)	(19,577)	(19,584)
Interest expense, net	(641)	(108)	(300)
Other (expense) income, net	(215)	(154)	113
Loss before benefit from (provision for) income taxes	(30,339)	(19,839)	(19,771)
Benefit from (provision for) income taxes	2,808	(521)	(370)
Net loss	$(27,531)	$(20,360)	$(20,141)
Net loss per share, basic and diluted	$(0.79)	$(0.85)	$(5.03)
	34,874	24,056	4,005

Weighted average shares outstanding, basic and diluted

(1) Includes stock-based compensation expense as follows:			
Cost of subscription revenue	$1,007	$657	$366
Cost of hardware and services revenue	196	70	29
Research and development	3,608	1,869	1,247
Sales and marketing	4,270	3,103	1,976
General and administrative	3,002	1,622	930
(2) Includes intangible amortization expense as follows:			
Cost of subscription revenue	$2,220	$2,785	$3,772
Research and development	47	30	1
Sales and marketing	1,743	461	769
General and administrative	34	—	—

The accompanying notes are an integral part of these consolidated financial statements.

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Proofpoint, Inc.
Consolidated Statements of Comprehensive Loss
(In thousands)

	Year Ended December 31,		
	2013	2012	2011
Net loss	$(27,531)	$(20,360)	$(20,141)
Other comprehensive income (loss), net of tax:			
Unrealized (losses) gains on investments, net	(3)	6	(3)
Comprehensive loss	$(27,534)	$(20,354)	$(20,144)

See accompanying Notes to the Consolidated Financial Statements.

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Proofpoint, Inc.
Consolidated Statements of Changes in Convertible Preferred Stock and Stockholders' Equity (Deficit)
(in thousands)

	Convertible Preferred Stock		Common Stock		A P C
	Shares	Amount	Shares	Am	
Balances at December 31, 2010	38,893	$109,820	3,829	$1	$
Net loss	—	—	—	—	–
Unrealized loss on short-term investments	—	—	—	—	–
Issuance of Series B preferred stock upon net exercise of warrants	49	91	—	—	–
Issuance of common stock as part of the consideration for acquisitions	—	—	677	—	5
Fair value of vested restricted stock units assumed in connection with acquisition	—	—	—	—	5
Stock-based compensation expense	—	—	—	—	4
Stock options exercised	—	—	456	—	1
Repurchase of stock options	—	—	(1)	—	(
	—	—		—	1

Vesting of early exercise options					
Balances at December 31, 2011	38,942	109,911	4,961	1	2
Net loss	—	—	—	—	–
Unrealized gain on short-term investments	—	—	—	—	–
Issuance of common stock in April 2012 initial public offering at $13.00 per share, net of issuance costs of $7,879	—	—	5,860	1	6
Conversion of preferred stock into shares of common stock	(38,942)	(109,911)	19,567	1	1
Stock-based compensation expense	—	—	—	—	7
Stock options exercised	—	—	2,543	—	4
Issuance of common stock in connection with vested restricted stock units assumed with acquisition	—	—	21	—	–
Restricted stock withholding taxes net-settlement	—	—	(7)	—	(
Issuance of common stock under employee stock purchase plan	—	—	99	—	1
Vesting of early exercise	—	—	—	—	2

options					
Balances at December 31, 2012	—	—	33,044	3	2
Net loss	—	—	—	—	-
Unrealized loss on short-term investments	—	—	—	—	-
Equity component of the convertible senior notes, net	—	—	—	—	4
Stock-based compensation expense	—	—	—	—	1
Stock options exercised	—	—	2,879	1	1
Issuance of common stock under employee stock purchase plan	—	—	217	—	2
Vesting of early exercise options	—	—	—	—	1
Balances at December 31, 2013	—	$—	36,140	$4	$

The accompanying notes are an integral part of these consolidated financial statements.

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Proofpoint, Inc.
Consolidated Statements of Cash Flows
(in thousands)

	Year Ended December 31,		
	2013	2012	2011
Cash flows from operating activities			
Net loss	$(27,531)	$(20,360)	$(20,141)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities			
Depreciation and amortization	9,967	7,710	7,684
Loss on disposal of property and equipment	2	—	—
Accretion of discounts on investments	575	520	—
Provision for allowance for doubtful accounts	40	54	8
Stock-based compensation	12,083	7,321	4,548
Deferred income taxes	(3,458)	—	—
Change in fair value of warrant liability	—	—	(66)
Change in fair value of contingent earn-outs	9	—	208
Amortization of debt issuance costs and accretion	489	—	—

of debt discount			
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable	(4,500)	(2,380)	(2,702)
Inventory	(223)	162	(144)
Deferred products costs	149	1,280	2,779
Prepaid expenses and other current assets	388	(934)	(778)
Noncurrent assets	(316)	97	168
Accounts payable	931	(683)	300
Accrued liabilities	1,883	3,485	722
Earn-out payment	(1)	—	(285)
Deferred rent	(438)	(55)	447
Deferred revenue	22,575	10,619	7,084
Net cash provided by (used in) operating activities	12,624	6,836	(168)
Cash flows from investing activities			
Proceeds from sales and maturities of short-term investments	59,046	15,264	2,791
Purchase of short-term investments	(20,376)	(60,095)	(5,080)
Purchase of property and equipment, net	(7,666)	(5,904)	(4,930)
Acquisitions of business, net of cash acquired	(40,972)	—	(134)

Net cash used in investing activities	(9,968)	(50,735)	(7,353)
Cash flows from financing activities			
Proceeds from issuance of common stock, net of repurchases	16,367	6,060	1,199
Proceeds from initial public offering, net of offering costs	—	68,295	—
Proceeds from issuance of convertible senior notes, net of discount and issuance costs	195,641	—	—
Proceeds from equipment financing loans	—	—	4,925
Repayments of notes payable and loans	(10,033)	(969)	(208)
Payment of contingent earn-outs	(99)	—	(715)
Net cash provided by financing activities	201,876	73,386	5,201
Net increase (decrease) in cash and cash equivalents	204,532	29,487	(2,320)
Cash and cash equivalents			
Beginning of period	39,254	9,767	12,087
End of period	$243,786	$39,254	$9,767
Supplemental disclosures of cash flow			

information			
Cash paid for interest	$148	$49	$97
Cash paid for taxes	385	370	210
Supplemental disclosure of noncash investing and financing activities			
Common stock issued in connection with acquisition	$—	$—	$5,406
Fair value of vested restricted stock units assumed in connection with acquisition	—	—	58
Issuance of Series B preferred stock upon net exercise of warrants	—	—	91
Unpaid deferred offering costs	195	—	967
Unpaid purchases of property and equipment	1,039	659	931

The accompanying notes are an integral part of these consolidated financial statements.

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Proofpoint, Inc.
Notes to Consolidated Financial Statements
(dollars and share amounts in thousands, except per share amounts)

1. The Company and Summary of Significant Accounting Policies

The Company

Proofpoint, Inc. (the "Company") was incorporated in Delaware in June 2002 and is headquartered in California.

Proofpoint is a pioneering security-as-a-service vendor that enables large and mid-sized organizations worldwide to defend, protect, archive and govern their most sensitive data. The Company's security-as-a-service platform is comprised of a number of data protection solutions, including threat protection, regulatory compliance, archiving and governance, and secure communication.

Reverse Stock Split

On March 30, 2012, the Company's Board of Directors approved a 1-for-2 reverse stock split of the Company's common stock. The reverse stock split became effective on April 2, 2012. Upon the effectiveness of the reverse stock split, (i) every two shares of outstanding common stock was decreased to one share of common stock, (ii) the number of shares of common stock into which each

outstanding option to purchase common stock is exercisable was proportionally decreased on a 1-for-2 basis, (iii) the exercise price of each outstanding option to purchase common stock was proportionately increased on a 1-for-2 basis, and (iv) the conversion ratio for each share of preferred stock outstanding was proportionately reduced on a 1-for-2 basis. All of the share numbers, share prices, and exercise prices have been retrospectively adjusted to reflect the reverse stock split.

Principles of Consolidation

The Consolidated Financial Statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

In 2013 and 2011, the Company made a number of acquisitions which are more fully described in Note 2, "Acquisitions". The Consolidated Financial Statements include the results of operations from these business combinations from their date of acquisition.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the

reported amounts of expenses during the reporting period. Actual results could differ from those estimates and such difference may be material to the financial statements.

Foreign Currency Remeasurement and Transactions

The Company's sales to international customers are generally U.S. dollar-denominated. As a result, there are no significant foreign currency gains or losses related to these transactions. The functional currency for the Company's wholly-owned foreign subsidiaries is the U.S. dollar. Accordingly, the subsidiaries remeasure monetary assets and liabilities at period-end exchange rates, while nonmonetary items are remeasured at historical rates. Income and expense accounts are remeasured at the average exchange rates in effect during the year. Remeasurement adjustments are recognized in the Consolidated Statements of Operations as transaction gains or losses within other income (expense), net, in the period of occurrence. Aggregate transaction gain (losses) included in determining net loss were $(180), $(157) and $8 for the years ended December 31, 2013, 2012 and 2011, respectively.

Cash, Cash Equivalents and Short-term Investments

The Company considers all highly liquid instruments purchased with an original

maturity date of 90 days or less from the date of purchase to be cash equivalents. Cash equivalents consist of money market funds and certain types of commercial

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paper. Cash and cash equivalents were $243,786 and $39,254 at December 31, 2013 and 2012, respectively. Short-term investments consist of readily marketable securities with maturity dates within three months from the date of purchase and include certain types of commercial paper, corporate bonds, debt securities and certificates of deposit. Short-term investments were $8,015 and $47,263 at December 31, 2013 and 2012, respectively, and all were classified as available-for-sale and were carried at fair value, with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss). Realized gains and losses are included in other (expense) income, net. Fair value is estimated based on available market information. The cost of securities sold is based on the specific identification method.

Inventories

Inventories are stated at lower of cost or market value, with costs computed on a first-in, first-out basis. Cost is determined using standard costs which approximate actual costs. The Company periodically reviews its inventories for excess and

obsolete items and adjusts carrying costs to estimated net realizable values when they are determined to be less than cost.
Inventories held at December 31, 2013 and 2012 consist primarily of finished goods.

Revenue Recognition

The Company derives its revenue primarily from two sources: (1) subscription revenue for rights related to the use of the security-as-a-service platform and (2) hardware, training and professional services revenue provided to customers related to their use of the platform. Subscription revenue is derived from a subscription based enterprise licensing model with contract terms typically ranging from one to three years, and consists of (i) subscription fees from the licensing of the security-as-a-service platform, (ii) subscription fees for access to the on-demand elements of the platform and
(iii) subscription fees for the right to access the Company's customer support services.

The Company applies the provision of ASC 985-605, "Software Revenue Recognition" and related interpretations, to all transactions involving the licensing of software, as well as related support, training, and other professional services. ASC 985-605 requires revenue earned on software arrangements involving multiple elements such as software license,

support, training and other professional services to be allocated to each element based on the relative fair values of these elements. The fair value of an element must be based on vendor specific objective evidence (“VSOE”) of fair value. VSOE of fair value of each element is based on the price charged when the element is sold separately. Revenue is recognized when all of the following criteria are met as set forth in ASC 985-605:

- Persuasive evidence of an arrangement exists,
- Delivery has occurred,
- The fee is fixed or determinable, and
- Collectability is probable.

The Company has analyzed all of the elements included in its multiple element arrangements and has determined that it does not have sufficient VSOE of fair value to allocate revenue to its subscription and software license agreements, support, training, and professional services. The Company defers all revenue under the software arrangement until the commencement of the subscription services and any associated professional services. Once the subscription services and the associated professional services have commenced, the entire fee from the arrangement is recognized ratably over the remaining period of the arrangement. If the professional services are essential to the functionality of the subscription, then the revenue recognition does not

commence until such services are completed.

In the Consolidated Statements of Operations, revenue is categorized as "subscription" and "hardware and services." Although the Company is unable to separate its multiple elements under the applicable revenue recognition guidance since it does not have sufficient VSOE of fair value for revenue recognition purposes, the Company has used a systematic and rational estimate to classify revenue between subscription and hardware and services. For presentation purposes only, the Company allocates revenue to hardware and services based upon management's best estimate of fair value of such deliverables using a cost plus model. The remaining consideration of the arrangement is then allocated to subscription revenue. Management

believes that this methodology provides a reasonable basis to allocate revenue between "subscription" and "hardware and services" for presentation purposes.

The hosted on-demand service agreements do not provide customers with the right to take possession of the software supporting the hosted service. The Company recognizes revenue from its hosted on-demand services in accordance with ASC 605-20, and as such recognizes revenue when the following criteria are met:

- Persuasive evidence of an arrangement exists,
- Delivery of the Company's obligations to its customers has occurred,
- Collection of the fees is probable, and
- The amount of fees to be paid by the customer is fixed or determinable.

In October 2009, the FASB amended the accounting guidance for multiple element arrangements ("ASU 2009-13") to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the arrangement consideration should be allocated among its elements;
-

- Require an entity to allocate revenue in an arrangement that has separate units of accounting using best estimated selling price ("BESP") of deliverables if a vendor does not have VSOE of fair value or third-party evidence of selling price ("TPE"), and
- Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method to the separate unit of accounting.

Concurrently, the FASB amended the accounting guidance for revenue recognition ("ASU 2009-14") to exclude hardware appliances containing software components and hardware components that function together to deliver the hardware appliance's essential functionality from the scope of the software revenue recognition guidance of ASC 985-605.

The Company elected to adopt this new guidance in the first quarter of fiscal 2011 for new and materially modified revenue arrangements originating after January 1, 2011.

For all arrangements within the scope of these new accounting pronouncements, including the Company's hosted on-demand services, the Company evaluates each element in a multiple element arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is

probable and within the Company’s control. Revenue derived from the licensing of the security-as-a-service platform continues to be accounted for in accordance with the industry specific revenue recognition guidance. Hardware appliance revenue is recognized upon shipment. Subscription and support revenue are recognized over the contract period commencing on the start date of the contract. Professional services and training, when sold with hardware appliances or subscription and support services, are accounted for separately when those services have standalone value. In determining whether professional services and training services can be accounted for separately from subscription and support services, the Company considers the following factors: availability of the services from other vendors, the nature of the services, and the dependence of the subscription services on the customer’s decision to buy the professional services. If professional services and training do not qualify for separate accounting, the Company recognizes the professional services and training ratably over the contract term of the subscription services. Delivery generally occurs when the hardware appliance is delivered to a common carrier freight on board shipping point by the Company or the hosted service has been activated and communicated to the customer

accordingly. The Company's

fees are typically considered to be fixed or determinable at the inception of an arrangement and are negotiated at the outset of an arrangement, generally based on specific products and quantities to be delivered. In the event payment terms are provided that differ significantly from the Company's standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized as the fees become paid.
The Company assesses collectability based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. Through December 31, 2013, the Company has not experienced significant credit losses.

Deferred Revenue

Deferred revenue primarily consists of billings or payments received in advance of revenue recognition from the sale of the Company’s subscription fees, training and professional services. Once the revenue recognition criteria are met, this revenue is recognized ratably over the term of the associated contract.

Deferred Product Costs

Deferred product costs are the incremental costs that are directly associated with each noncancellable customer contract or hosting agreement and primarily consist of cost of appliances and royalty payments made to third parties, from whom the Company has obtained licenses to integrate certain software into its products. The costs are deferred and amortized over the noncancellable term of the related customer contract or hosting agreement, which typically range from 12 to 36 months.

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful life of the related asset. Amortization of leasehold improvements is computed using the straight-line method over the shorter of the lease term or the estimated useful life of the asset or improvement. Cost of maintenance and repairs that do not improve or extend the lives of the respective assets are expensed as incurred. When property and equipment are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the balance sheet and the resulting gain or loss is included in other (expense) income, net.

Impairment of Intangible Assets and Other Long-Lived Assets

In accordance with ASC 360, "Property, Plant, and Equipment," the Company evaluates long-lived assets, such as property and equipment, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of these assets is measured by comparison of the carrying amount of such assets (or asset group) to the future undiscounted cash flows the assets (or asset group) is expected to generate. If the assets are 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 assets. The Company also evaluates the estimated remaining useful lives of intangible assets and other long-lived assets to assess whether a revision to the remaining periods of amortization is required. No assets were determined to be impaired to date.

Advertising and Promotion Costs

Expenses related to advertising and promotion of solutions is charged to sales and marketing expense as incurred. The Company did not incur any significant advertising and promotion expenses during the years ended December 31, 2013, 2012 and 2011.

Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price of the acquired enterprise over the fair value of identifiable assets acquired and liabilities assumed. The Company applies ASC 350, "Intangibles—Goodwill and Other" and performs an annual goodwill impairment test during the fourth quarter of the Company's fiscal year and more frequently if an event or circumstances indicates that an impairment may have occurred. For the purposes of impairment testing, the Company has determined that it has one reporting unit. The Company performs a two-step impairment test of goodwill whereby the fair value

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of the reporting unit is compared to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not considered impaired and further testing is not required. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then the Company must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then an impairment loss equal to the difference is recorded. The identification and measurement of goodwill impairment involves the estimation of the fair value of the Company. The estimate of fair value of the Company, based on the best information available as of the date of the assessment, is subjective and requires judgment, including management assumptions about expected future revenue forecasts and discount rates, changes in the overall economy, trends in the stock price and other factors. No impairment was identified by the Company as of December 31, 2013.

Intangible assets consist of developed technology, vendor relationships and customer relationships. The values assigned to intangibles are based on estimates and judgments regarding expectations for success and life cycle of solutions and technologies acquired.

Intangible assets are amortized on a straight-line basis over their estimated lives, which approximate the pattern in which the economic benefits of the intangible assets are consumed, as follows (in years):

	Low	High
Patents	4	5
Developed technology	3	7
Customer relationships	2	4
Non-compete agreements	2	4
Tradenames and trademarks	1	5

Warranty

The Company provides limited warranties on all sales and provides for the estimated cost of the warranties at the date of sale, to the extent not already provided by its own vendors. The estimated cost of warranties has not been material to date.

Income Taxes

The Company accounts for income taxes in accordance with authoritative guidance, which requires use of the asset and liability method. Under this method, deferred income

tax assets and liabilities are determined based on the difference between the Consolidated Financial Statements carrying amounts and the tax basis of assets and liabilities and are measured using the enacted tax rates expected to apply to taxable income in the years in which the differences are expected to be reversed.

The Company records net deferred tax assets to the extent the Company believes these assets will more likely than not be realized. In making such determination, the Company considers all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax planning strategies and recent financial operations.

The Company has elected to use the "with and without" approach as described in ASC 740-20, "Intraperiod Tax Allocation" in determining the order in which tax attributes are utilized. As a result, the Company will only recognize a tax benefit from stock-based awards in additional paid-in capital if an incremental tax benefit is realized after all other tax attributes currently available to the Company have been utilized. In addition, the Company has elected to account for the impact of stock-based awards on other tax attributes, such as the research tax credit, through the Consolidated Statements of Operations.

The Company recognizes interest and penalties related to uncertain tax positions within the income tax expense line in the Consolidated Statements of Operations. Accrued interest and penalties are included within the related tax liability line in the Consolidated Balance Sheets.

Employee Benefit Plans

The Company sponsors a 401(k) defined contribution plan covering all employees. The Company may make discretionary contributions to the 401(k). To date, no contributions have been made by the Company.

Stock-Based Compensation

The Company accounts for stock-based compensation under ASC 718, "Compensation—Stock Compensation" using the prospective transition method prescribed for private companies. Using the prospective transition method, compensation expense recognized includes the compensation cost for all share-based payment awards granted to employees subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of ASC 718. The Company uses the Black-Scholes option pricing model to determine the fair value of stock options. Stock compensation expense is recognized on a straight-line basis over the requisite service period of the award, which generally equals the vesting period. Under ASC 718, the Company is required to estimate potential forfeitures

of stock grants and adjust compensation cost recorded accordingly. The estimate of forfeitures is computed based on historical data of employee turnover and is adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from the prior estimates. Changes in estimated forfeitures are recognized in the period of change and will impact the amount of stock compensation expenses to be recognized in future periods.

Stock-based compensation expense recognized is shown in the operating activities section of the Consolidated Statements of Cash Flows. In addition, ASC 718 requires the cash flows resulting from the tax benefits due to tax deductions on stock option exercises in excess of the stock-based compensation expense recognized (excess tax benefits) to be classified in the financing activities section of the Consolidated Statements of Cash Flows. During the years ended December 31, 2013, 2012 and 2011, the Company did not recognize any excess tax benefits.

The Company accounts for stock options issued to non-employees in accordance with the provisions of ASC 505-50 using a fair-value approach. The measurement of stock-based compensation for non-employees is subject to periodic adjustments as the options vest, and the expense is recognized over the period

over which services are received. Stock-based compensation expense for non-employees has not been material for all periods presented.

Comprehensive Income (Loss)
Comprehensive income (loss) includes all changes in equity that are not the result of transactions with stockholders. The Company's comprehensive income (loss) consists of its net loss and changes in unrealized gains (losses) from its available-for-sale investments. Total comprehensive loss has been presented in the Consolidated Statements of Comprehensive Loss. During the year ended December 31, 2013, the Company adopted ASU 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," which requires filers to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net loss. The Company had no significant reclassifications out of accumulated other comprehensive income into net loss for the years ended December 31, 2013, 2012 and 2011.

Recent Accounting Policies
In July 2013, the FASB issued ASU 2013-11, "Income Taxes", a new accounting standard update on the financial statement presentation of unrecognized tax benefits. The new guidance provides that a

liability related to an unrecognized tax benefit would be presented as a reduction of a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. The new guidance becomes effective for the Company on January 1, 2014 and it should be applied prospectively to unrecognized tax benefits that exist at the effective date with retrospective application permitted. The Company is currently assessing the impact of this new guidance but does not believe it will have a material impact.

2. Acquisitions

In 2013, the Company entered into agreements to acquire five companies (collectively, the "Acquisitions"). Additionally, there were two other acquisitions in 2011 by the Company. Each acquisition was accounted for under the purchase method of accounting in which the tangible and identifiable intangible assets and liabilities of each acquired company were

recorded at their respective fair values as of each acquisition date, including an amount for goodwill representing the difference between the respective acquisition consideration and fair values of identifiable net assets. The Company believes the combined entities will achieve savings in corporate overhead costs and opportunities for growth through expanded geographic and customer segment diversity with the ability to leverage additional products and capabilities. These factors, among others, contributed to a purchase price in excess of the estimated fair value of each acquired company's net identifiable assets acquired and, as a result, goodwill was recorded in connection with each acquisition. Goodwill is not deductible for tax purposes.

Sendmail, Inc.

On October 1, 2013 (the "Sendmail Acquisition Date"), pursuant to the terms of an Agreement and Plan of Merger, a wholly-owned subsidiary of the Company merged with and into Sendmail, Inc. ("Sendmail"), with Sendmail surviving as a wholly-owned subsidiary of the Company. Formerly based

in Emeryville, California, Sendmail is a leading provider of messaging infrastructure solutions to enterprises whose solutions ensure global email connectivity, routing and message delivery between people, systems and applications located on-premise, in-cloud or on mobile devices. The acquisition of Sendmail allows the Company access to its Sentrion Email Platform business, customers, core engineering and professional teams which have demonstrated a sustained level of expertise in messaging infrastructure.

During the quarter ended December 31, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the Sendmail Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the Consolidated Financial Statements since the Sendmail Acquisition Date. The Company recorded $2,975 in revenue from Sendmail for the year ended December 31, 2013.

At the Sendmail Acquisition Date, the Company paid $12,463 in cash consideration, net of cash acquired of $1,117. Of the cash consideration paid, $3,422 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Annual Report on

Form 10-K. As part of the acquisition, the Company assumed and paid off $7,933 in long-term debt on the Sendmail Acquisition Date. The Company incurred $1,877 in acquisition-related costs which were recorded in operating expenses for the year ended December 31, 2013.

Fair value of acquired assets and liabilities assumed

The following table summarizes the fair values of tangible assets acquired, liabilities assumed, intangible assets and goodwill:

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	$5,202	N/A
Liabilities assumed	(5,398)	N/A
Deferred revenue assumed	(14,549)	N/A
Long-term debt assumed	(7,933)	N/A
Trade name	400	5
Customer relationships	8,000	3
Patents	300	5
Core/developed technology	3,000	3
Goodwill	24,558	Indefinite
	$13,580	

Armorize Technologies, Inc.

On September 5, 2013 (the "Armorize Acquisition Date"), pursuant to the terms of an Agreement and Plan of Merger, a wholly-owned

subsidiary of the Company merged with and into Armorize Technologies, Inc. ("Armorize"), with Armorize surviving as a wholly-owned subsidiary of the Company. Based in Taiwan, Armorize develops and markets leading cloud-based

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SaaS anti-malware products and will add real-time dynamic detection of next generation threats and malware to the Company's existing capabilities.

During the quarter ended September 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the Armorize Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the Consolidated Financial Statements since the Armorize Acquisition Date. The Company recorded $781 in revenue from Armorize for the year ended December 31, 2013.

At the Armorize Acquisition Date, the Company paid $24,215 in cash consideration, net of cash acquired of $1,746. Of the cash consideration paid, $3,750 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Annual Report on Form 10-K. The Company incurred $747 in acquisition-related costs which were recorded in operating expenses for the year ended

December 31, 2013.

Fair value of acquired assets and liabilities assumed

The following table summarizes the fair values of tangible assets acquired, liabilities assumed, intangible assets and goodwill:

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	$2,754	N/A
Liabilities assumed	(1,256)	N/A
Customer relationships	1,300	2
Non-compete agreements	500	3
Core/developed technology	3,850	5
Goodwill	18,813	Indefinite
	$25,961	

Abaca Technology Corporation

On July 19, 2013 (the "Abaca Technology Acquisition Date"), pursuant to the terms of an Agreement and Plan of Merger, a wholly-owned subsidiary of the Company merged with and into Abaca Technology Corporation ("Abaca Technology"), with Abaca Technology surviving as a wholly-owned subsidiary of the Company. Abaca Technology specializes in email filtering and protection algorithms and their cloud-based, in-memory threat scoring technologies are expected to complement the Company's continued

investment in anti-spam and threat detection capabilities.

During the quarter ended September 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities at the Abaca Technology Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the Consolidated Financial Statements since the Abaca Technology Acquisition Date. The Company recorded $311 in revenue from Abaca Technology for the year ended December 31, 2013.

At the Abaca Technology Acquisition Date, the Company paid $23 in cash consideration, net of cash acquired of $3. The purchase consideration included an additional amount of $1,520 which was held back to secure contingent liabilities related to indemnification obligations. The initial fair values of the contingent liabilities of $1,397 were recorded in other long-term liabilities in the Consolidated Balance Sheets. The indemnification obligations have not been released as of the filing date of this Annual Report on Form 10-K. The Company incurred $218 in acquisition-related costs which were recorded in operating expenses for the year ended December 31, 2013.

Fair value of acquired assets and liabilities assumed

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

The following table summarizes the fair values of tangible assets acquired, liabilities assumed, intangible assets and goodwill:

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	$311	N/A
Liabilities assumed	(975)	N/A
Customer relationships	40	3
Core/developed technology	1,770	5
Goodwill	277	Indefinite
	$1,423	

eDynamics, LLC

On July 10, 2013 (the "eDynamics Acquisition Date"), pursuant to the terms of an Asset Purchase Agreement. the Company purchased substantially all of the business intellectual property and assumed certain liabilities of eDynamics, LLC ("eDynamics"). eDynamics is a social media archiving company and is expected to be an integral part of the Company's broader effort in rolling out a comprehensive social media archiving platform for customers.

During the quarter ended September 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the eDynamics Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the Consolidated Financial Statements since the eDynamics Acquisition Date. Revenue from eDynamics was immaterial for the year ended December 31, 2013.

At the eDynamics Acquisition Date, the Company paid $500 in cash consideration. The Company also agreed to pay earn-out consideration ("Acquisition-related contingent earn-out liability") of up to $600 through April 2014, such liability being contingent upon the achievement of specified product development milestones. The initial fair value of the contingent earn-out liability of $586 was recorded as part of the purchase consideration. The purchase consideration also included an additional amount of $100, which was held back to secure any claims that may arise in the 12-month period after the eDynamics Acquisition Date. The initial fair value of such amount withheld of $72 as well as the Acquisition-related contingent earn-out liability were recorded in accrued liabilities on the Consolidated Balance Sheets. The Company paid $100 of the contingent

earn-out liability during the year ended December 31, 2013. The Company incurred $6 in acquisition-related costs which were recorded in operating expenses for the year ended December 31, 2013.

Fair value of acquired assets and liabilities assumed

The following table summarizes the fair values of tangible assets acquired, liabilities assumed, intangible assets and goodwill:

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Customer relationships	$243	3.5
Non-compete agreements	75	2
Core/developed technology	733	3.5
Goodwill	107	Indefinite
	$1,158	

Mail Distiller Limited

On April 5, 2013 (the "Mail Distiller Acquisition Date"), pursuant to the terms of a share transfer agreement, the Company purchased all of the outstanding share capital of Mail Distiller Limited, a Northern Ireland Company ("Mail

Distiller"). Mail Distiller is a European-based provider of the SaaS email security solutions. Mail Distiller allowed the Company to create the Proofpoint Essentials product line, a suite of SaaS security and compliance solutions specifically designed for distribution across managed service providers and dedicated security resellers.

During the quarter ended June 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the Mail Distiller Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the Consolidated Financial Statements since the Mail Distiller Acquisition Date. The Company recognized $216 in revenue from Mail Distiller for the year ended December 31, 2013.

At the Mail Distiller Acquisition Date, the Company paid $3,771 in cash consideration, net of cash acquired of $60. The purchase consideration included an additional amount of $669 held back to secure

indemnification obligations, which was recorded in accrued liabilities on the Consolidated Balance Sheets. The indemnification obligations have not been released as of the filing date of this Annual Report on Form 10-K. The Company incurred $258 in acquisition-related costs which were recorded in operating expenses for the year ended December 31, 2013.

Fair value of acquired assets and liabilities assumed

The following table summarizes the fair values of tangible assets acquired, liabilities assumed, intangible assets and goodwill:

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	$204	N/A
Liabilities assumed	(1,052)	N/A
Trade name	7	1
Customer relationships	1,291	2
Non-compete agreements	123	2
Core/developed technology	2,475	7
Goodwill	1,452	Indefinite
	$4,500	

NextPage, Inc.

On December 23, 2011, the Company acquired NextPage, Inc. ("NextPage"), a Delaware corporation, for a combination of common stock, restricted stock units and cash for a value totaling $5,465. NextPage

contributed to the Company's file archiving and governance capabilities and was incorporated into its Enterprise Governance solution.

Spam and Open Relay Blocking System ("SORBS")
On June 30, 2011, the Company completed an asset purchase from GFI Software Ltd., a British Virgin Islands corporation (the "SORBS Agreement"). Under the terms of the SORBS agreement, the Company paid cash considerations of $200 for intellectual property and fixed assets
Pro Forma Financial Information

The following unaudited pro forma financial information presents the combined results of operations for the years ended December 31, 2013 and 2012 as if all the Acquisitions completed during 2013 had been completed on January 1, 2012, with adjustments to give effect to pro forma events that are directly attributable to the Acquisitions such as amortization expense from revenue, acquired intangible assets and acquisition-related transaction costs. The unaudited pro forma results do not reflect any operating efficiencies or potential cost savings which may result from the consolidation of the operations of the Company and Acquisitions. Accordingly, these unaudited pro formas results are presented for informational purposes only and

are not necessarily indicative of what the actual results of operations of the combined company would have been if the Acquisitions had occurred at the beginning of the period presented, nor are they indicative of future results of operations:

	Twelve Months Ended December 31,	
	2013	2012
Total revenue	$165,787	$150,934
Net loss	(37,000)	(28,229)
Basic and diluted net loss per share	$(1.06)	$(1.17)

The unaudited pro forma financial information includes non-recurring acquisition-related transaction costs of $3,107 for the year ended December 31, 2012.

3. Concentration of Risks

Financial instruments that potentially subject the Company to credit risk consist principally of cash, cash equivalents, short-term investments and accounts receivable.

The Company limits its concentration of risk in cash

equivalents and short-term investments by diversifying its investments among a variety of industries and issuers and by limiting the average maturity to one year or less. The Company's professional portfolio managers adhere to this investment policy as approved by the Company's Board of Directors.

The Company's investment policy is to invest only in fixed income investments denominated and payable in U.S. dollars. Investment in obligations of the U.S. government and its agencies, money market instruments, commercial paper, certificates of deposit, bankers' acceptances, corporate bonds of U.S. companies, municipal securities and asset backed securities are allowed. The Company does not invest in auction rate securities, futures contracts, or hedging instruments.

The Company's accounts receivables are derived from revenue earned from customers primarily located in the United States of America. The Company performs periodic evaluations of its customers' financial condition and generally does not require its customers to provide collateral or other security to support accounts receivable, and maintains an allowance for doubtful accounts. Credit losses historically have not been significant.

During the years ended December 31, 2013 and 2012, one customer accounted for

14% of total revenue. No single customer accounted for more than 10% of total revenue in the year ended December 31, 2011.

At December 31, 2013, there were no customers that accounted for more than 10% of total accounts receivable. At December 31, 2012, one customer accounted for 10% of total accounts receivable.

At December 31, 2013 and 2012, one vendor accounted for 16% and 22%, respectively, of total accounts payable. No other vendors accounted for more than 10% of total accounts payable.

4. Balance Sheet Components

Allowance for doubtful accounts activity and balances are presented below:

	Balance at Beginning Period	Additions to Costs and Expenses	Write Offs	Balance at End of Period
Year ended December 31, 2011	$257	$8	$(32)	$233
Year ended December 31, 2012	233	54	(100)	187
Year ended December 31, 2013	$187	$91	$(2)	$276

Additions during the year ended December 31, 2013 includes allowance for doubtful accounts activity from the Acquisitions.

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

Property and equipment at December 31, 2013 and 2012, consist of the following:

	Useful Life (in years)	December 31, 2013	2012
Computer equipment	2 to 3	$31,305	$22,204
Software	2	1,782	1,712
Furniture	5	76	76
Office equipment	2 to 5	397	347
Leasehold improvements	5 years or shorter of the lease term	1,298	1,217
Other	2	59	54
Construction in progress		339	1,158
		35,256	26,768
Less: Accumulated depreciation and amortization		(24,035)	(18,208)
		$11,221	$8,560

Property and equipment acquired under capital leases:

	December 31, 2013	2012
Computer equipment	$346	$341
Less: Accumulated depreciation	(317)	(269)
	$29	$72

Depreciation expense for the years ended December 31, 2013, 2012 and 2011, was approximately $5,923, $4,434, and $3,142, respectively. This included depreciation expense for assets under capital leases of $48, $42 and $151 for the years ended December 31, 2013, 2012 and 2011, respectively.

The Company capitalized software development costs of $400 for the year ended December 31, 2011. Amortization of capitalized software development costs was approximately $159, $200 and $41 for the years ended December 31, 2013, 2012 and 2011, respectively. Capitalized software development costs were fully amortized as of December 31, 2013.

Accrued liabilities at December 31, 2013 and 2012 consisted of the following:

	December 31,	
	2013	2012
Accrued compensation	$8,886	$7,125
Customer deposits	2,098	102
Accrued royalties	766	262
Other	7,510	4,589
	$19,260	$12,078

5. Goodwill and Intangible Assets

The goodwill activity and balances are presented below:

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

	December 31,	
	2013	2012
Opening balance	$18,557	$18,557
Add:		
Goodwill from acquisitions	45,207	—
Closing balance	$63,764	$18,557

The goodwill balance as of December 31, 2013 was the result of the acquisitions of Fortiva, Sigaba, EDN, SORBS, NextPage and the Acquisitions completed during the year ended December 31, 2013 (see Note 2, "Acquisitions").

Intangible Assets

Intangible assets excluding goodwill, consisted of the following:

	December 31, 2013			Decem
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carryi Amou
Developed technology	$29,468	$(17,383)	$12,085	$17,64
Customer relationships	13,282	(3,726)	9,556	2,408
Non-compete	804	(170)	634	106
Trademark and patents	806	(105)	701	98
	$44,360	$(21,384)	$22,976	$20,2

Amortization expense of intangibles totaled $4,044, $3,276 and $4,542 during the

years ended December 31, 2013, 2012 and 2011, respectively.

Future estimated amortization costs of intangible assets as of December 31, 2013 are presented below:

Year Ended December 31,	
2014	$7,858
2015	7,100
2016	4,767
2017	1,622
2018	1,175
Thereafter	454
	$22,976

6. Fair Value Measurements and Investments

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date. A hierarchy for inputs used in measuring fair value has been defined to minimize the use of unobservable inputs by requiring the use of observable market data when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on active market data. Unobservable inputs are inputs that reflect the Company’s assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. The fair value hierarchy prioritizes the inputs into three broad levels:

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Level 1: Quoted (unadjusted) prices in active markets for identical assets or liabilities. The Company's Level 1 assets generally consist of money market funds.

- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

The Company's Level 2 assets and liabilities generally consist of corporate bonds and agency debt securities, commercial paper, certificates of deposit and convertible senior notes.

- Level 3: Unobservable inputs to the valuation methodology that are supported by little or no market activity and that are significant to the measurement of the fair value of the assets or liabilities. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies or similar valuation techniques, as well as significant management judgment or estimation.

In connection with the acquisition of eDynamics, a liability was recognized on the eDynamics Acquisition Date for the estimate of the fair value of the Company's

contingent earn-out payments related to eDynamics. The Company determined the fair value of the Acquisition-related contingent earn-out liability based on the probability-based attainment of product development milestones. Any changes to the variables and assumptions could significantly impact the estimated fair values recorded for the liability, resulting in significant charges to the Consolidated Statements of Operations. The fair value measurements are based on significant inputs not observable in the market and thus represent Level 3 measurements, which reflect the Company's own assumptions concerning achievement of the product development milestones of eDynamics, in measuring the fair value of the Acquisition-related contingent earn-out liability.

The following tables summarize, for each category of assets or liabilities carried at fair value, the respective fair value as of December 31, 2013 and 2012 and the classification by level of input within the fair value hierarchy:

	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significan Other Observab Inputs (Level 2)	U I (I
Assets				
Cash equivalents:				
Money market funds	$215,094	$215,094	$—	$

Short-term investments:				
Corporate debt securities	6,015	—	6,015	—
Certificates of deposit	2,000	—	2,000	—
Total financial assets	$223,109	$215,094	$8,015	$[illegible]
Liabilities				
Acquisition-related contingent earn-out liability	$495	$—	$—	$[illegible]

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobser Inputs (Level 3
Assets				
Cash equivalents:				
Money market funds	$26,485	$26,485	$—	$—
Commercial paper	1,020	1,020	—	—
Short-term investments:				
Corporate debt securities	29,267	—	29,267	—
Commercial paper	15,988	—	15,988	—
Certificates of deposit	2,008	—	2,008	—
Total financial assets	$74,768	$27,505	$47,263	$—

Based on quoted market prices as of December 31, 2013, the fair value of the Notes was approximately $216,306, determined using Level 2 inputs as they are not actively traded in markets.

The following table represents a reconciliation of the Acquisition-related contingent earn-out liability measured at fair value on a recurring basis,

using significant unobservable inputs (Level 3) for the year ended December 31, 2013:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
Balance at December 31, 2012	$—
Additions during the period	586
Payments during the period	(100)
Adjustments to fair value during the period recorded in General and Administrative expenses	9
Balance at December 31, 2013	$495

The carrying amounts of the Company's cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair values due to their short maturities. Based on borrowing rates that are available to the Company for loans with similar terms and consideration of the Company's credit risk, the carrying value of the notes payable approximates their fair values using Level 2 inputs.

Investments

The cost and fair value of the Company’s cash and available-for-sale investments as of December 31, 2013 and 2012 were as follows:

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	December 31, 2013			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and cash equivalents:				
Cash	$28,692	$—	$—	$28,692
Money market funds	215,094	—	—	215,094
Total	$243,786	$—	$—	$243,786
Short-term investments:				
Corporate debt securities	$6,015	$—	$—	$6,015
Certificates of deposit	2,000	—	—	2,000
Total	$8,015	$—	$—	$8,015

	December 31, 2012			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and cash equivalents:				
Cash	$11,749	$—	$—	$11,749
Money market funds	26,485	—	—	26,485
Commercial paper	1,020	—	—	1,020
Total	$39,254	$—	$—	$39,254
Short-term investments:				
Corporate debt securities	$29,266	$4	$(3)	$29,267
Commercial paper	15,987	1	—	15,988
Certificate of deposit	2,007	1	—	2,008
Total	$47,260	$6	$(3)	$47,263

As of December 31, 2013 and 2012, all investments mature in less than one year. Estimated fair values for marketable securities are based on quoted market prices for the same or similar instruments.

7. Commitments and Contingencies

Operating Leases

The Company leases certain of its facilities under noncancellable operating leases with various expiration dates through January 2019.

Rent expense was $1,774, $1,520 and $1,471 for the years ended December 31, 2013, 2012 and 2011, respectively.

Capital Leases

In July 2012, the Company entered into two lease agreements to lease certain office equipment with expiration dates in July and October 2015. The leases bear an annual interest rate of 4.50% and are secured by fixed assets used in the Company's office locations. At December 31, 2013, future annual minimum lease payments under noncancellable operating and capital leases were as follows:

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
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	Capital Leases	Operating Leases
2014	$ 18	$ 4,605
2015	11	1,382
2016	—	893
2017	—	310
2018	—	181
Thereafter	—	8
Total minimum lease payments	29	$ 7,379
Less: Amount representing interest	(1)	
Present value of capital lease obligations	28	
Less: Current portion	(18)	
Long-term portion of capital lease obligations	$ 10	

Contingencies

Under the indemnification provisions of the Company's customer agreements, the Company agrees to indemnify and defend and hold harmless its customers against, among other things, infringement of any patent, trademark or copyright under any country's laws or the misappropriation of any trade secret arising from the customers' legal use of the Company's solutions. The exposure to the Company under these indemnification provisions is generally limited to the total amount paid by the

customers under the applicable customer agreement. However, certain indemnification provisions potentially expose the Company to losses in excess of the aggregate amount paid to the Company by the customer under the applicable customer agreement. To date, there have been no claims against the Company or its customers pursuant to these indemnification provisions.

Legal Contingencies

From time to time, the Company may be involved in legal proceedings and subject to claims incident to the ordinary course of business. On December 16, 2013, Finjan, Inc. sued the Company and Armorize in the United States District Court, Northern District of California for alleged patent infringement of a variety of its patents, demanding preliminary and permanent injunctive relief, and unspecified damages. The Company filed an answer to the complaint on February 10, 2014. An initial case management conference is scheduled for April 2014. The Company intends to vigorously defend the lawsuit. Based on the early stage of the claims and evaluation of the facts available at this time, the amount or range of reasonable possible losses to which the Company is exposed cannot be estimated and the ultimate resolution of this matter and the associated financial impact, if any, remains uncertain at this time. However, intellectual property

litigation is subject to inherent uncertainties, and there can be no assurance that the expenses associated with defending any litigation or the resolution of this dispute would not have a material adverse impact on the Company's results of operations or cash flows. Regardless of the outcome, such proceedings and claims can have an adverse impact on the Company because of defense and settlement costs, diversion of resources and other factors, and there can be no assurances that favorable outcomes will be obtained.

8. Convertible Senior Notes

On December 11, 2013, the Company issued $175,000 principal amount of 1.25% Convertible Senior Notes (the "Notes") due 2018 in a private offering to qualified institutional buyers ("Holders") pursuant to Rule 144A under the Securities Act of 1944 (the "Exchange Act"), as amended. The initial Holders of the Notes also had an option to purchase an additional$26,250 in principal amount which was exercised in full. The net proceeds after underwriter discount and issuance costs of $5,803 from the Notes offering were approximately $195,446. The Company intends to use the net proceeds for working capital and general corporate purposes, which may include funding the Company's operations, capital expenditures, potential acquisitions of businesses, products or technologies believed to be of strategic

importance. The Notes bear interest at 1.25% per year, payable semi-annually in arrears every June 15 and December 15, beginning on June 15, 2014.

The Notes are unsecured and rank senior in right of payment to any indebtedness expressly subordinated in right of payment to the Notes. They rank equally with the Company's other existing and future unsecured indebtedness that is not

subordinated and are structurally subordinated to any current or future secured indebtedness to the extent of the value of the assets securing the indebtedness and other liabilities of the Company's subsidiaries.

The initial conversion rate is 25.6271 shares of the Company’s common stock per $1 principal amount of notes which equates to 5,158 shares of common stock, or a conversion price equivalent of $39.02 per share of common stock. Throughout the term of the Notes, the conversion rate may be adjusted upon the occurrence of certain events. The Notes mature on December 15, 2018, unless repurchased, redeemed or converted in accordance with their terms prior to such date.

At the Company's option, on or after December 20, 2016, the Company will be able redeem all or a portion of the Notes at 100% of the principal amount, plus any accrued and unpaid interest, under certain conditions. The Company may redeem the Notes in shares of the Company’s common stock, cash, or some combination of each.

Prior to June 15, 2018, the Notes will be convertible at

the option of the Holders only upon the satisfaction of certain conditions and during certain periods if any of the the following events occur:

- during the calendar quarter commencing after March 31, 2014, if the last reported sale price of the Company's common stock is greater than or equal to 130% of the applicable conversion price on each such trading day for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter;
- during the 5 business day period after any 5 consecutive trading day period in which the trading price, as defined, per $1 principal amount of Notes for each trading day of such measurement period was less than 98% of the product of the last reported sale price of the Company's common stock and the applicable conversion rate on each such trading day;
- upon a notice of redemption by the Company; or
- upon the occurrence of specified corporate transactions.

Subsequent to June 15, 2018, Holders may convert their Notes at the applicable conversion rate at any time prior to the close of business on the second scheduled trading day immediately preceding the maturity date.

Holders of the Notes also have the right to require the Company to repurchase all or

a portion of the Notes at 100% of the principal amount, plus accrued and unpaid special interest, if any, upon the occurrence of certain fundamental changes to the Company.

In accordance with the authoritative accounting guidance, the Company allocated the total amount of the Notes into liability and equity components. The carrying value of the liability component at issuance was calculated as the present value of its cash flows using a discount rate of 6.5% based on the a blended rate between the yield rate for a Moody's B1-rating and the average debt rate for comparable convertible transactions from similar companies. The difference between the Notes principal and the carrying value of the liability component, representing the value of conversion premium assigned to the equity component, was recorded as an increase to additional paid in capital and as a debt discount on the issuance date. The equity component is being accreted using the effective interest rate method over the period from the issuance date through December 15, 2018 as a non-cash charge to interest expense. The amount recorded to additional paid in capital is not remeasured as long as it continues to meet the conditions for equity classification. Upon issuance of the Notes, the Company recorded $156,672 as debt and $44,578 as additional paid in capital within stockholders'

equity.

Additionally, the underwriters' discount and issuance costs were bifurcated into debt issuance costs (attributable to the liability component) and equity issuance costs (attributable to the equity component) based on their relative fair values. The debt issuance costs were capitalized and recorded as deferred offering costs in other noncurrent assets and are being amortized to interest expense using the effective interest rate method from the issuance date through December 15, 2018. The equity issuance costs were recorded as a decrease to additional paid-in capital at the issuance date.

At December 31, 2013, the net carrying amount of the liability component of the Notes consists of:

Liability component:	
Principal	$201,250
Less: debt discount, net of amortization	(48,322)
Net carrying amount	$152,928
Equity component (1)	$43,293

(1) Recorded in the Consolidated Balance Sheets as additional paid-in capital, net of the $1,285 issuance costs in equity

For the year ended December 31, 2013, the Company incurred the interest expense related to the Notes:

1.25% coupon	$138
Amortization of debt discount	486
Amortization of debt issuance costs	3
	$627

9. Debt

Equipment Financing Loans

The Company entered into a new equipment loan agreement with Silicon Valley Bank in April 2011 for an aggregate loan principal amount of $6,000. Interest on the advances is equal to prime rate plus 0.50%. As of December 31, 2013, the interest on the outstanding

advances was 4.50%. The Company had the ability to draw down on this equipment line through April 19, 2012. Each drawn amount is due 48 months after funding. Borrowings outstanding under the equipment loan at December 31, 2013 were $2,326. Equipment financed under this loan arrangement is collateralized by the respective assets underlying the loan. The terms of the loan restrict the Company's ability to pay dividends. The loan includes a covenant that requires the Company to maintain cash and cash equivalents plus net accounts receivable of at least two times the amount of all outstanding indebtedness. As of December 31, 2013, as a result of the issuance of the Notes, the Company was not in compliance with the covenant which Silicon Valley Bank waived. Subsequently, the Company has amended the loan agreement with Silicon Valley Bank to exclude the impact of the Notes on the covenant.

Interest expense for equipment financing loans for the years ended December 31, 2013, 2012 and 2011 was $140, $211 and $54, respectively. At December 31, 2013, the remaining repayment commitments related to the equipment loans are as follows:

2014	$1,642
2015	684
	$2,326

10. Common Stock

Initial Public Offering

In April 2012, the Company completed its initial public offering of its common stock to the public (“IPO”) whereby 5,859 shares of common stock sold by the Company (inclusive of 729 shares of common stock from the partial exercise of the overallotment option granted to the underwriters) and 1,370 shares of common stock sold by the selling shareholders (inclusive of 171 shares of common stock from the partial exercise of the overallotment option granted to the underwriters). The public offering price of the shares sold in the offering was $13.00 per share. The Company did not receive any proceeds from the sales of shares by the selling stockholders. The total gross proceeds from the offering to the Company were $76,200. After deducting underwriters’ discounts and commissions and offering expenses, the aggregate net proceeds received by the Company totaled

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approximately $68,300. Immediately prior to the closing of the IPO, all shares of the Company’s outstanding redeemable convertible preferred stock automatically converted into 19,567 shares of common stock. As a result, following the IPO, the Company has two classes of authorized stock: common stock and preferred stock.

As of December 31, 2013, the Company is authorized to issue two classes of stock totaling 205,000 shares, of which 5,000 are designated as preferred stock and 200,000 are designated common stock, each with a par value of $0.0001 per share.

On March 30, 2012, the Company's Board of Directors approved a 1-for-2 reverse stock split of the Company's common stock. The reverse stock split became effective on April 2, 2012. All of the share numbers, share prices, and exercise prices have been retrospectively adjusted to reflect the reverse stock split.

The following table presents the shares authorized and issued and outstanding as of the dates presented:

	As of December 31, 2013		As of December 31, 2012	
	Shares Authorized	Outstanding	Shares Authorized	Outstanding
Common stock	200,000	36,140	200,000	33,044
Undesignated preferred stock	5,000	—	5,000	—
	205,000	36,140	205,000	33,044

Number of shares of common stock reserved for future

issuance was as follows:

	Year Ended December 31,	
	2013	2012
Options available for future grant under the stock plans	4,584	4,611
Options outstanding under stock plans	7,223	9,636
Shares available for future issuance under ESPP	759	646
Common stock issuable upon exercise of warrant and settlement of outstanding restricted stock units	1,216	3
Common stock issuable upon conversion of the convertible senior notes	5,158	—
Total shares reserved	18,940	14,896

11. Stock Option Plans

Stock-Based Compensation Plans

On March 30, 2012, the Board of Directors and the Company’s stockholders approved the 2012 Equity Incentive Plan (the "2012 Plan"), which became effective in April 2012. The Company has two equity incentive plans: the Company’s 2002 stock option plan (the “2002 Plan”) and the 2012 Plan. Upon the IPO, all shares that were reserved under the 2002 Plan but not issued, and shares

issued but subsequently returned to the plan through forfeitures, cancellations and repurchases became part of the 2012 Plan and no further shares will be granted pursuant to the 2002 Plan. All outstanding stock awards under the 2002 and 2012 Plans will continue to be governed by their existing terms. Under the 2012 Plan, the Company has the ability to issue incentive stock options (“ISOs”), nonstatutory stock options (“NSOs”), restricted stock awards, stock bonus awards, stock appreciation rights ("SARs"), restricted stock units (“RSUs”), and performance shares. The 2012 Plan also allows direct issuance of common stock to employees, outside directors and consultants at prices equal to the fair market value at the date of grant of options or issuance of common stock. Additionally, the 2012 Plan provides for the grant of performance cash awards to employees, directors and consultants. The Company has the right to repurchase any unvested shares (at the option exercise price) of common stock issued directly or under option exercises. The right of repurchase generally expires over the vesting period.

Under the 2002 and 2012 Plans, the term of an option grant shall not exceed ten years from the date of its grant and options generally vest over a three to four-year period, with vesting on a monthly or annual interval. Under the 2012 Plan, 20,316 shares of common stock are reserved for issuance to eligible participants. As of December 31, 2013, 4,584 shares were available for future grant. Restricted stock awards generally vest over a four-year period with 25% vesting at the end of one year and the remaining vest quarterly thereafter. The number of shares available for grant and issuance under the 2012 Plan will be increased automatically on each January 1 of 2013 through 2016 by an amount equal to 5% of the Company's shares outstanding on the immediately preceding December 31, but not to exceed 3,724 shares, unless the Board of Directors, in its discretion, determines to make a smaller increase.

Stock Options

The fair value of options granted is estimated on the grant date using the Black-Scholes option valuation model. This valuation model for stock-based compensation

expense requires the Company to make assumptions and judgments about the variables used in the calculation, including the expected term (weighted-average period of time that the options granted are expected to be outstanding), the volatility of the common stock price, an assumed risk-free interest rate and the estimated forfeitures of unvested stock options. To the extent actual forfeitures differ from the estimates, the difference will be recorded as a cumulative adjustment in the period estimates are revised. No compensation cost is recorded for options that do not vest and the compensation cost from vested options, whether forfeited or not, is not reversed.

Prior to the Company's IPO, the Board of Directors, in good faith, determined the fair market values of the Company's common stock, based on the best information available to the Board and the Company's management at the time of grant. The Company performed its analysis in accordance with applicable elements of the practice aid issued by the American Institute of Certified Public Accountants entitled Valuation of Privately Held Company Equity Securities Issued as Compensation. The procedures performed to determine the fair value of the Company's common stock were based on a probability weighted expected return method to estimate the aggregate equity value of the Company.

The weighted average fair value of stock options granted to employees during the years ended December 31, 2013, 2012 and 2011, was $9.50, $5.65 and $6.33, respectively. The fair values were estimated on the grant dates using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Year Ended December 31,		
	2013	2012	2011
Expected life (in years)	5.31 - 6.08	5.50 - 6.08	5.85 - 6.08
Volatility	57% - 61%	59% - 60%	59% - 61%
Risk-free interest rate	0.9% - 1.8%	0.9% - 1.2%	1.2% - 2.5%
Dividend yield	—%	—%	—%

The estimate for expected life of options granted reflects the midpoint of the vesting term and the contractual life computed utilizing the simplified method as allowed by the SEC staff. The Company does not have significant historical share option exercise experience and hence considers the expected term assumption calculated using the simplified method to be reasonable. Since the Company's stock has been publicly traded for a limited time, the stock volatility assumptions represent an estimate of the historical volatilities of the common stock of a group of publicly-traded peer companies that operate in a similar industry. The estimate

was determined based on the average historical volatilities of these peer companies. The risk-free interest rate used was the Federal Reserve Bank's constant maturities interest rate commensurate with the expected life of the options in effect at the time of the grant. The expected dividend yield was zero, as the Company does not anticipate paying a dividend within the relevant time frame. Expected forfeitures are estimated based on the Company's historical experience.

The Company realized no income tax benefit from stock option exercises in each of the periods presented due to recurring losses and valuation allowances.

Stock option activity under the Plan is as follows:

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

	Shares subject to Options Outstanding			
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Balance at December 31, 2010	9,711	$3.15	6.18	$21,619
Options granted	2,533	6.33		
Options exercised	(456)	2.63		
Options forfeited and canceled	(1,083)	4.16		
Balance at December 31, 2011	10,705	3.83	6.77	44,466
Options granted	2,243	10.29		
Options exercised	(2,543)	1.95		
Options forfeited and canceled	(769)	6.26		
Balance at December 31, 2012	9,636	5.63	7.33	64,719
Options granted	1,618	17.46		
Options exercised	(2,879)	4.69		
Options forfeited and canceled	(1,152)	8.65		
Balance at December 31, 2013	7,223	$8.17	6.82	$180,543

Exercisable, December 31, 2013	4,000	$4.76	5.61	$113,648
Vested and expected to vest, December 31, 2013	6,750	$7.77	6.70	$171,429

The total intrinsic value of options exercised was $45,454, $18,950 and $1,505, for the years ended December 31, 2013, 2012 and 2011, respectively. Total cash proceeds from such option exercises were $13,509, $4,966 and $1,198 for the years ended December 31, 2013, 2012 and 2011, respectively.

The fair value of option grants that vested was $8,206, $5,736 and $4,015 during the years ended December 31, 2013, 2012 and 2011, respectively.

As of December 31, 2013, the Company had unamortized stock-based compensation expense of $15,680 related to stock options, that will be recognized net of forfeitures over the average remaining vesting term of the options of 2.35 years.

Restricted Stock Units

A summary of the status of RSUs awarded and unvested under the stock option plans as of December 31, 2013 is presented below:

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

	RSUs Outstanding	
	Number of Shares	Granted Fair Value Per Unit
Awarded and unvested at December 31, 2010	—	$—
Awards assumed	23	7.98
Awards vested	(15)	7.98
Awards forfeited	—	—
Awarded and unvested at December 31, 2011	8	7.98
Awards granted	—	—
Awards vested	(6)	7.98
Awards forfeited	(1)	7.98
Awarded and unvested at December 31, 2012	1	7.98
Awards granted	1,236	28.94
Awards vested	(1)	24.15
Awards forfeited	(22)	24.61
Awarded and unvested at December 31, 2013	1,214	$29.57

As of December 31, 2013, there was $25,627 of unamortized stock-based compensation expense related to unvested RSUs, which are

expected to be recognized over a weighted average period of 3.71 years.

Employee Stock Purchase Plan

On March 30, 2012, the Board of Directors and the Company’s stockholders approved the 2012 Employee Stock Purchase Plan (the "ESPP"), which became effective in April 2012. A total of 745 shares of the Company's common stock was initially reserved for future issuance under the ESPP. The number of shares reserved for issuance under the ESPP will increase automatically on January 1 of each of the first eight years commencing with 2013 by the number of shares equal to 1% of the Company's shares outstanding on the immediately preceding December 31, but not to exceed 1,490 shares, unless the Board of Directors, in its discretion, determines to make a smaller increase. As of December 31, 2013, there were 759 shares of the Company's common stock available for future issuance under the ESPP.

The fair value of the option component of the ESPP shares was estimated at the grant date using the Black-Scholes option pricing model with the following weighted average assumptions:

	Year ended December 31,	
	2013	2012*
Expected life (in years)	0.50 - 0.54	0.50 - 0.53
Volatility	38% - 40%	46% - 51%

Risk-free interest rate	0.08%	0.13% - 0.15%
Dividend yield	—%	—%

* Employee participation in the ESPP did not begin until the second quarter of 2012.

As of December 31, 2013, the Company expects to recognize $497 of the total unamortized compensation cost related to employee purchases under the ESPP over a weighted average period of 0.37 years.

12. Net Loss per Share

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Basic net loss per share of common stock is calculated by dividing the net loss by the weighted average number of shares of common stock outstanding for the period. The weighted average number of shares of common stock used to calculate our basic net loss per share of common stock excludes those shares subject to repurchase related to stock options that were exercised prior to vesting as these shares are not deemed to be issued for accounting purposes until they vest. Diluted net loss per share of common stock is computed by dividing the net loss using the weighted average number of shares of common stock, excluding common stock subject to repurchase, and, if dilutive, potential shares of common stock outstanding during the period. Basic and diluted net loss per common share was the same for all periods presented as the impact of all potentially dilutive securities outstanding was anti-dilutive.

The following table presents the calculation of basic and diluted net loss per share:

	Years Ended December 31,		
	2013	2012	2011
Numerator:			
Net loss	$(27,531)	$(20,360)	$(20,141)
Denominator:			
Weighted average number of common shares used in	34,874	24,056	4,005

computing basic and diluted net loss per share			
Net loss per common share			
Basic and diluted net loss per share	$(0.79)	$(0.85)	$(5.03)

The following table presents the potentially dilutive common shares outstanding that were excluded from the computation of diluted net loss per share of common stock for the periods presented because including them would have been anti-dilutive:

	Years Ended December 31,		
	2013	2012	2011
Convertible preferred stock	—	—	39,134
Stock options to purchase common stock	7,223	9,636	10,705
Employee stock purchase plan	89	133	—
Common stock subject to repurchase	1	4	6
Common stock warrants	2	2	2
Restricted stock units	1,214	1	—
Convertible senior notes	5,158	—	—
Total	13,687	9,776	49,847

13. Segment Reporting

Operating segments are reported in a manner consistent with the internal reporting supported and defined by the components of an enterprise about which separate financial information is available, provided and is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is its Chief Executive Officer. The Company's Chief Executive Officer reviews financial information presented on a consolidated basis and as a result, the Company concluded that there is only one operating and reportable segment.

The following set forth total revenue by solutions offered by the Company and geographic area. Revenue by geographic area is based upon the billing address of the customer:

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	Year Ended December 31,		
	2013	2012	2011
Total revenue by solution:			
Privacy, Protection and Security	$101,083	$78,979	$65,882
Archiving and Governance	36,848	27,316	15,956
Total revenue	137,931	106,295	81,838

	Year Ended December 31,		
	2013	2012	2011
Total revenue by geographic area:			
United States	$113,819	$86,661	$65,044
Rest of world	24,112	19,634	16,794
Total revenue	$137,931	$106,295	$81,838

The following sets forth long-lived assets by geographic area:

	Year Ended December 31,	
	2013	2012
Long-lived assets:		
United States	$9,425	$6,857
Rest of world	1,796	1,703
Total long-lived assets	$11,221	$8,560

14. Income Taxes

The Company accounts for income taxes in accordance with authoritative guidance, which requires the use of the asset and liability method. Under this method, deferred

income tax assets and liabilities are determined based on the difference between the Consolidated Financial Statements carrying amounts and the tax basis of assets and liabilities and are measured using the enacted tax rates expected to apply to taxable income in the years in which the differences are expected to be reversed.

The domestic and foreign components of loss before benefit from (provision for) income taxes were as follows for the years ended December 31, 2013, 2012 and 2011:

	Year Ended December 31,		
	2013	2012	2011
Domestic	$(34,284)	$(23,506)	$(17,566)
Foreign	3,945	3,667	(2,205)
Loss before benefit from (provision for) income taxes	$(30,339)	$(19,839)	$(19,771)

The benefit from (provision for) income taxes is comprised of:

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	Year Ended December 31,		
	2013	2012	2011
Current tax expense:			
Federal	$—	$—	$—
State	70	30	52
Foreign	641	491	318
Total current	711	521	370
Deferred tax expense:			
Federal	—	—	—
State	—	—	—
Foreign	(3,519)	—	—
Total deferred	(3,519)	—	—
(Benefit from) provision for income taxes	$(2,808)	$521	$370

The reconciliation of income tax expense at the statutory federal income tax rate of 34% to the income tax provision included in the accompanying Statements of Operations for the years ended December 31, 2013, 2012 and 2011 is as follows:

	Year Ended December 31,		
	2013	2012	2011
Tax at federal statutory rate	$(10,315)	$(6,745)	$(6,722)
Foreign income tax	(232)	(262)	219

rate differential			
State, net of federal benefit	(1,130)	(822)	(821)
Stock compensation charges	636	1,256	1,091
SubPart F and other permanent items	1,583	1,204	849
Provision to return & other	937	1,074	850
Research and development credits	(2,112)	(1,061)	(1,427)
Uncertain tax positions	617	301	1,004
Valuation allowance	7,208	5,576	5,327
(Benefit from) provision for income taxes	$(2,808)	$521	$370

Deferred tax assets and liabilities reflect the net tax effects of net operating loss and tax credit carryovers and the temporary differences between the carrying amount of assets and liabilities for financial reporting and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets were as follows for the years ended December 31, 2013 and 2012:

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Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

	Year Ended December 31,	
	2013	2012
Deferred tax assets:		
Net operating loss carryforwards	$60,280	$44,045
Tax credit carryforwards	8,228	6,639
Research expenditures	3,314	4,567
Deferred revenue	13,292	7,726
Stock compensation	3,696	2,294
Fixed assets	1,262	926
Accruals and other	7,250	3,487
Total deferred tax assets	97,322	69,684
Deferred tax liabilities:		
Intangible assets and other	(7,769)	(990)
Interest expense on the Notes	(16,090)	—
Valuation allowance	(71,052)	(68,694)
Net deferred tax assets	$2,411	$—
Current deferred income tax assets (included in other current assets)	$4,166	$137
Non-current deferred	$1,755	$137

income tax liabilities (included in long-term liabilities)

The Company records net deferred tax assets to the extent that Company believes these assets will more likely than not be realized. In making such determination, the Company considers all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax planning strategies and recent financial operations.

Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. The valuation allowance increased by approximately $2,400, $3,700 and $6,400 during the years ended December 31, 2013, 2012 and 2011, respectively. The total valuation allowance increase of $2,400 for the year ended December 31, 2013 included a reduction of $4,300 resulting from a change in management's assertion about the realization of the Company's Canada deferred tax assets, a reduction of $16,200 related to the Notes and an increase of $12,300 related to the Company's acquisitions of Sendmail, Abaca and Mail Distiller.

As of December 31, 2013 and 2012, the Company had net operating loss carry-forwards for federal income tax

purposes of $187,700 and $120,100, respectively. The amount of federal net-operating loss carry-forwards at December 31, 2013 and 2012 for which a benefit will be recorded in APIC when realized is approximately $34,500 and $7,500, respectively. The federal net operating losses will begin to expire in 2018. As of December 31, 2013 and 2012, the Company had federal research credit carry-forwards of $4,200 and $3,200 respectively. The federal research and development credits will begin to expire in 2022.

As of December 31, 2013 and 2012, the Company had net operating loss carry-forwards for state income tax purposes of approximately $146,400 and $92,400, respectively. The amount of state net-operating loss carry-forwards at December 31, 2013 and 2012 for which a benefit will be recorded in APIC when realized is approximately $11,700 and $4,100, respectively. The state net operating losses will expire between 2014 and 2032. As of December 31, 2013 and 2012, the Company had research and development credit carry-forwards for state income tax purpose of $5,900 and $4,700, respectively. The state research and development credits have no expiration period.

As of December 31, 2013 and 2012, the Company had net operating losses carry-forwards in its non-U.S.

locations of approximately $3,900 and $4,700, respectively. In addition, as of December 31, 2013 and 2012, the Company had research and development credit carry-forwards in its non-U.S. locations of approximately $2,700 and $2,400, respectively. The non-U.S. research and development credits will begin to expire in 2025.

Proofpoint, Inc.
Notes to Consolidated Financial Statements (Continued)
(dollars and share amounts in thousands, except per share amounts)

Utilization of the federal and state net operating losses may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Analyses have been conducted to determine whether an ownership change had occurred since inception. The analyses have indicated that although an ownership change occurred in a prior year, the net operating losses and research and development credits would not expire before utilization as a result of the ownership change. In the event the Company has subsequent changes in ownership, net operating losses and research and development credit carryovers could be limited and may expire unutilized as a result of the subsequent ownership change.

The Company recognizes interest and penalties related to uncertain tax positions within the income tax expense line in the Consolidated Statements of Operations. Accrued interest and penalties are included within the related tax liability line in the Consolidated Balance Sheets. During the year ended December 31, 2013, the

Company accrued interest and penalties of $8 as a component of income tax expense related to tax contingencies and has $233 of interest and penalties recorded as a long-term income tax liability as of December 31, 2013. During the year ended December 31, 2012, the Company accrued interest and penalties of $178 as a component of income tax expense related to tax contingencies and had $183 of interest and penalties recorded as a long-term income tax liability.

As of December 31, 2013, the Company had recorded unrecognized tax benefits of $1,541 that if recognized, would benefit the Company's effective tax rate. As of December 31, 2012, the Company had recorded unrecognized tax benefits of $255 that if recognized, would benefit the Company's effective tax rate.

The Company does not anticipate that the amount of unrecognized tax benefits relating to tax positions existing at December 31, 2013 will significantly increase or decrease within the next twelve months.

Because of net operating loss and credit carry-forwards, all of the Company's tax years dating to inception in 2002 remain open to tax examination in all major tax jurisdictions. The Company is not currently under audit in any material jurisdictions.

The aggregate changes in the balance of gross unrecognized tax benefits were as follows:

Ending balance as of December 31, 2010	$1,464
Increase in balances related to tax positions taken during the current period	651
Increase in balances related to tax positions taken during the prior period	411
Ending balance as of December 31, 2011	2,526
Increase in balances related to tax positions taken during the current period	357
Decrease in balances related to tax positions taken during the prior period	(135)
Decrease in balances related to statute expirations during the current period	(8)
Ending balance as of December 31, 2012	2,740
Increase in balances related to tax positions taken during the current period	618
Increase in balances related to tax positions taken during the prior period	517
Decrease in balances related to tax positions taken during the prior period	(40)
Decrease in balances related to statute expirations during the current period	(12)
Ending balance as of December 31, 2013	$3,823

As of December 31, 2013, $240 of foreign withholding taxes associated with the

repatriation of earning of foreign subsidiaries had been provided on $4,800 of undistributed earnings for certain foreign subsidiaries. The Company intends to reinvest the remainder of its undistributed earnings indefinitely outside the United States. As of December 31, 2013, the Company estimated that no material additional U.S. income taxes would have to be provided if all of the undistributed earnings of the foreign subsidiaries were repatriated back to the United States as substantially all earnings from its foreign subsidiaries are previously taxed income. As of December 31, 2013, the Company estimated that approximately $570 of additional foreign withholding tax would have to be provided if all of the undistributed earnings of the Company's foreign subsidiaries were repatriated back to the United States.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 14, 2014.

PROOFPOINT INC.

By: /s/ GARY STEELE
Gary Steele
Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Gary Steele and Paul Auvil, and each of them, as his or her true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him or her and in his or her name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as

he or she might or could do in person, hereby ratifying and confirming that all said attorneys-in-fact and agents, or any of them or their or his or her substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

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

Name	Title	Date
/s/ GARY STEELE Gary Steele	Chief Executive Officer (principal executive officer)	March 14, 2014
/s/ PAUL AUVIL Paul Auvil	Chief Financial Officer (principal financial and accounting officer)	March 14, 2014
/s/ ANTHONY BETTENCOURT Anthony Bettencourt	Director	March 14, 2014
/s/ SYDNEY CAREY Sydney Carey	Director	March 14, 2014
/s/ DANA EVAN Dana Evan	Director	March 14, 2014
/s/ JONATHAN FEIBER Jonathan Feiber	Director	March 14, 2014
/s/ DOUGLAS GARN	Director	March 14, 2014

Douglas Garn		
/s/ ERIC HAHN	Director	March 14, 2014
Eric Hahn		
/s/ KEVIN HARVEY	Director	March 14, 2014
Kevin Harvey		
/s/ PHILIP KOEN	Director	March 14, 2014
Philip Koen		

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EXHIBIT INDEX

Exhibit Number		Exhibit Title	Incorpo
			Form
2.01		Agreement and Plan of Merger for Armorize Technologies, Inc.	10-Q
2.02		Agreement and Plan of Merger for Sendmail, Inc.	
3.01		Amended and Restated Certificate of Incorporation of the Registrant.	S-1A
3.02		Amended and Restated Bylaws of the Registrant.	S-1A
4.01		Form of Registrant's common stock certificate.	S-1A
4.02		Fourth Amended and Restated Investors' Rights Agreement by and among the Registrant and the investors named therein of the Registrant dated February 19, 2008.	S-1
4.03		Indenture between Proofpoint, Inc. and Wells Fargo Bank, National Association, dated as of December 11, 2013 including the form of 1.25% Convertible Senior Notes due 2018 therein.	8-K
10.01		Form of Indemnity Agreement.	S-1A
10.02	†	2002 Stock Option/Stock Issuance Plan and form of option grant.	S-1A
10.03	†	2012 Equity Incentive Plan and form of grant agreements.	S-1A
10.04	†	2012 Employee Stock Purchase Plan.	S-1A
10.05		Lease Agreement between Registrant and Hines VAF No Cal Properties, L.P., dated as of March 28, 2011, as amended July 28, 2011.	S-1
10.06		Loan and Security Agreement, dated as of April 19, 2011, as amended May 19, 2011, between the Registrant and Silicon Valley Bank.	S-1
10.07			

		Third Amendment to Loan and Security Agreement, dated February 27, 2014, between the Registrant and Silicon Valley Bank		
10.08	†	Offer Letter to Gary Steele from the Registrant, dated November 17, 2002.	S-1	3
10.09	†	Offer letter to Paul Auvil from the Registrant, dated March 9, 2007.	S-1A	3
10.10	†	Offer Letter to David Knight from the Registrant, dated March 14, 2011.	S-1A	3
10.11	†	Offer Letter to Tracey Newell from the Registrant, dated August 16, 2013.		
21.01		Subsidiaries of Registrant.		
23.01		Consent of PricewaterhouseCoopers LLP, independent registered public accounting firm.		
31.01		Certification of Chief Executive Officer Pursuant to Rule 13-a-14 of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.		
31.02		Certification of Chief Financial Officer Pursuant to Rule 13-a-14 of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.		
32.01	*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		
32.02	*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		
101.INS	*	XBRL Instance Document		
101.SCH	*	XBRL Taxonomy 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

† Indicates a management contract or compensatory plan.
*These exhibits are furnished with this Annual Report on Form 10-K and are not deemed filed with the Securities and Exchange Commission and are not incorporated by reference in any filing of Proofpoint, Inc. under the Securities Act of 1933 or the Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in such filings.