

CISCO SYSTEMS, INC.  
Form 10-Q  
February 19, 2019  
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

(Mark One)

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

For the quarterly period ended January 26, 2019

OR

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

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

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CISCO SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

California 77-0059951

(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification Number)

170 West Tasman Drive

San Jose, California 95134

(Address of principal executive office and zip code)

(408) 526-4000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes  No

Number of shares of the registrant's common stock outstanding as of February 14, 2019: 4,402,027,716

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Cisco Systems, Inc.

Form 10-Q for the Quarter Ended January 26, 2019

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

## CISCO SYSTEMS, INC.

## CONSOLIDATED BALANCE SHEETS

(in millions, except par value)

(Unaudited)

|   | January 26,<br>2019 | July 28,<br>2018  |
|---|---------------------|-------------------|
| <b>ASSETS</b>   |                     |                   |
| Current assets:   |                     |                   |
| Cash and cash equivalents   | \$9,835             | \$8,934           |
| Investments   | 30,548              | 37,614            |
| Accounts receivable, net of allowance for doubtful accounts of \$135 at January 26, 2019 and \$129 at July 28, 2018   | 3,745               | 5,554             |
| Inventories   | 1,701               | 1,846             |
| Financing receivables, net  | 5,057               | 4,949             |
| Other current assets  | 2,231               | 2,940             |
| Total current assets  | 53,117              | 61,837            |
| Property and equipment, net   | 2,931               | 3,006             |
| Financing receivables, net  | 4,565               | 4,882             |
| Goodwill  | 33,293              | 31,706            |
| Purchased intangible assets, net  | 2,270               | 2,552             |
| Deferred tax assets   | 4,081               | 3,219             |
| Other assets  | 2,205               | 1,582             |
| <b>TOTAL ASSETS</b>   | <b>\$ 102,462</b>   | <b>\$ 108,784</b> |
| <b>LIABILITIES AND EQUITY</b>   |                     |                   |
| Current liabilities:  |                     |                   |
| Short-term debt   | \$9,737             | \$5,238           |
| Accounts payable  | 1,655               | 1,904             |
| Income taxes payable  | 1,110               | 1,004             |
| Accrued compensation  | 2,599               | 2,986             |
| Deferred revenue  | 9,976               | 11,490            |
| Other current liabilities   | 4,402               | 4,413             |
| Total current liabilities   | 29,479              | 27,035            |
| Long-term debt  | 15,893              | 20,331            |
| Income taxes payable  | 7,760               | 8,585             |
| Deferred revenue  | 7,285               | 8,195             |
| Other long-term liabilities   | 1,256               | 1,434             |
| Total liabilities   | 61,673              | 65,580            |
| Commitments and contingencies (Note 13)   |                     |                   |
| Equity:   |                     |                   |
| Cisco shareholders' equity:   |                     |                   |
| Preferred stock, no par value: 5 shares authorized; none issued and outstanding   | —                   | —                 |
| Common stock and additional paid-in capital, \$0.001 par value: 20,000 shares authorized; 4,424 and 4,614 shares issued and outstanding at January 26, 2019 and July 28, 2018, respectively | 41,361              | 42,820            |
| Retained earnings   | 538                 | 1,233             |
| Accumulated other comprehensive income (loss)   | (1,110)             | (849)             |
| Total equity  | 40,789              | 43,204            |

TOTAL LIABILITIES AND EQUITY

\$ 102,462 \$ 108,784

See Notes to Consolidated Financial Statements.

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

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | January 26, 2019   | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| REVENUE:                                    |                    |                  |                  |                  |
| Product                                     | \$9,273            | \$ 8,709         | \$19,163         | \$ 17,763        |
| Service                                     | 3,173              | 3,178            | 6,355            | 6,260            |
| Total revenue                               | 12,446             | 11,887           | 25,518           | 24,023           |
| COST OF SALES:                              |                    |                  |                  |                  |
| Product                                     | 3,614              | 3,354            | 7,413            | 6,969            |
| Service                                     | 1,059              | 1,035            | 2,186            | 2,129            |
| Total cost of sales                         | 4,673              | 4,389            | 9,599            | 9,098            |
| GROSS MARGIN                                | 7,773              | 7,498            | 15,919           | 14,925           |
| OPERATING EXPENSES:                         |                    |                  |                  |                  |
| Research and development                    | 1,557              | 1,549            | 3,165            | 3,116            |
| Sales and marketing                         | 2,271              | 2,235            | 4,681            | 4,569            |
| General and administrative                  | 509                | 483              | 720              | 1,040            |
| Amortization of purchased intangible assets | 39                 | 60               | 73               | 121              |
| Restructuring and other charges             | 186                | 98               | 264              | 250              |
| Total operating expenses                    | 4,562              | 4,425            | 8,903            | 9,096            |
| OPERATING INCOME                            | 3,211              | 3,073            | 7,016            | 5,829            |
| Interest income                             | 328                | 396              | 672              | 775              |
| Interest expense                            | (223 )             | (247 )           | (444 )           | (482 )           |
| Other income (loss), net                    | 27                 | 10               | 8                | 72               |
| Interest and other income (loss), net       | 132                | 159              | 236              | 365              |
| INCOME BEFORE PROVISION FOR INCOME TAXES    | 3,343              | 3,232            | 7,252            | 6,194            |
| Provision for income taxes                  | 521                | 12,010           | 881              | 12,578           |
| NET INCOME (LOSS)                           | \$2,822            | \$ (8,778 )      | \$6,371          | \$ (6,384 )      |
| Net income (loss) per share:                |                    |                  |                  |                  |
| Basic                                       | \$0.63             | \$ (1.78 )       | \$1.41           | \$ (1.29 )       |
| Diluted                                     | \$0.63             | \$ (1.78 )       | \$1.40           | \$ (1.29 )       |
| Shares used in per-share calculation:       |                    |                  |                  |                  |
| Basic                                       | 4,470              | 4,924            | 4,517            | 4,942            |
| Diluted                                     | 4,505              | 4,924            | 4,557            | 4,942            |

See Notes to Consolidated Financial Statements.

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## CISCO SYSTEMS, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in millions)

(Unaudited)

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | January 26, 2019   | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Net income (loss)   | \$2,822            | \$ (8,778 )      | \$6,371          | \$ (6,384 )      |
| Available-for-sale investments:   |                    |                  |                  |                  |
| Change in net unrealized gains and losses, net of tax benefit (expense) of \$(12) and \$1 for the second quarter and first six months of fiscal 2019, respectively, and \$1 and \$(22) for the corresponding periods of fiscal 2018, respectively                                     | 82                 | (191 )           | 87               | (196 )           |
| Net (gains) losses reclassified into earnings, net of tax (benefit) expense of \$(1) for each of the second quarter and first six months of fiscal 2019, respectively, and \$15 and \$25 for the corresponding periods of fiscal 2018, respectively                                   | 4                  | (43 )            | 10               | (66 )            |
|   | 86                 | (234 )           | 97               | (262 )           |
| Cash flow hedging instruments:  |                    |                  |                  |                  |
| Change in unrealized gains and losses, net of tax benefit (expense) of \$1 and \$2 for the second quarter and first six months of fiscal 2019, respectively, and \$(2) and \$(3) for the corresponding periods of fiscal 2018, respectively   | (4 )               | 28               | (7 )             | 35               |
| Net (gains) losses reclassified into earnings, net of tax (benefit) expense of \$0 for each of the second quarter and first six months of fiscal 2019, respectively, and \$2 and \$4 for the corresponding periods of fiscal 2018, respectively                                       | (1 )               | (16 )            | (1 )             | (27 )            |
|   | (5 )               | 12               | (8 )             | 8                |
| Net change in cumulative translation adjustment and actuarial gains and losses net of tax benefit (expense) of \$0 and \$(1) for the second quarter and first six months of fiscal 2019, respectively, and \$(4) and \$(6) for the corresponding periods of fiscal 2018, respectively | 27                 | 274              | (182 )           | 291              |
| Other comprehensive income (loss)   | 108                | 52               | (93 )            | 37               |
| Comprehensive income (loss)   | 2,930              | (8,726 )         | 6,278            | (6,347 )         |
| Comprehensive (income) loss attributable to noncontrolling interests  | —                  | —                | —                | —                |
| Comprehensive income (loss) attributable to Cisco Systems, Inc.   | \$2,930            | \$ (8,726 )      | \$6,278          | \$ (6,347 )      |

See Notes to Consolidated Financial Statements.

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

|  | Six Months Ended |             |
|--|------------------|-------------|
|  | January 26,      | January 27, |
|  | 2019             | 2018        |
| Cash flows from operating activities:  |                  |             |
| Net income (loss)  | \$6,371          | \$(6,384 )  |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:     |                  |             |
| Depreciation, amortization, and other  | 952              | 1,112       |
| Share-based compensation expense   | 792              | 785         |
| Provision (benefit) for receivables  | 30               | (43 )       |
| Deferred income taxes  | (257 )           | 1,021       |
| (Gains) losses on divestitures, investments and other, net                                   | (77 )            | (174 )      |
| Change in operating assets and liabilities, net of effects of acquisitions and divestitures: |                  |             |
| Accounts receivable  | 1,613            | 1,236       |
| Inventories  | (203 )           | (276 )      |
| Financing receivables  | 161              | (156 )      |
| Other assets   | (652 )           | (15 )       |
| Accounts payable   | (296 )           | (338 )      |
| Income taxes, net  | (830 )           | 10,246      |
| Accrued compensation   | (339 )           | (189 )      |
| Deferred revenue   | 207              | 237         |
| Other liabilities  | 88               | 88          |
| Net cash provided by operating activities  | 7,560            | 7,150       |
| Cash flows from investing activities:  |                  |             |
| Purchases of investments   | (677 )           | (13,954 )   |
| Proceeds from sales of investments   | 3,055            | 9,111       |
| Proceeds from maturities of investments  | 6,263            | 7,365       |
| Acquisitions and divestitures  | (1,599 )         | (727 )      |
| Purchases of investments in privately held companies   | (68 )            | (89 )       |
| Return of investments in privately held companies  | 43               | 124         |
| Acquisition of property and equipment  | (473 )           | (379 )      |
| Proceeds from sales of property and equipment  | 10               | 51          |
| Other  | (12 )            | (17 )       |
| Net cash provided by investing activities  | 6,542            | 1,485       |
| Cash flows from financing activities:  |                  |             |
| Issuances of common stock  | 312              | 302         |
| Repurchases of common stock—repurchase program   | (10,062)         | (5,457 )    |
| Shares repurchased for tax withholdings on vesting of restricted stock units                 | (514 )           | (433 )      |
| Short-term borrowings, original maturities of 90 days or less, net                           | —                | 5,095       |
| Issuances of debt  | —                | 6,877       |
| Repayments of debt   | —                | (6,230 )    |
| Dividends paid   | (2,970 )         | (2,861 )    |
| Other  | 18               | (22 )       |
| Net cash used in financing activities  | (13,216)         | (2,729 )    |
| Net increase in cash, cash equivalents, and restricted cash                                  | 886              | 5,906       |
| Cash, cash equivalents, and restricted cash, beginning of period                             | 8,993            | 11,773      |

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|  |         |           |
|--|---------|-----------|
| Cash, cash equivalents, and restricted cash, end of period | \$9,879 | \$ 17,679 |
| Supplemental cash flow information:                        |         |           |
| Cash paid for interest                                     | \$421   | \$ 454    |
| Cash paid for income taxes, net                            | \$1,968 | \$ 1,311  |

See Notes to Consolidated Financial Statements.

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

| Three Months Ended January 26, 2019  | Shares of<br>Common<br>Stock | Common Stock<br>and<br>Additional<br>Paid-In Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total Cisco<br>Shareholders'<br>Equity | Non-control-<br>ling<br>Interests | Total<br>Equity |
|--|------------------------------|--|----------------------|---|--|-----------------------------------|-----------------|
| BALANCE AT OCTOBER 27, 2018  | 4,517                        | \$ 41,897  | \$3,169              | \$ (1,218 )   | \$ 43,848                              | \$                                | —\$43,848       |
| Net income   |                              |  | 2,822                |   | 2,822                                  |                                   | 2,822           |
| Other comprehensive income (loss)  |                              |  |                      | 108   | 108                                    |                                   | 108             |
| Issuance of common stock   | 22                           | 304  |                      |   | 304                                    |                                   | 304             |
| Repurchase of common stock   | (111 )                       | (1,033 )   | (3,983 )             |   | (5,016 )                               |                                   | (5,016 )        |
| Shares repurchased for tax<br>withholdings on vesting of restricted<br>stock units | (4 )                         | (196 )   |                      |   | (196 )                                 |                                   | (196 )          |
| Cash dividends declared (\$0.33 per<br>common share)                               |                              |  | (1,470 )             |   | (1,470 )                               |                                   | (1,470 )        |
| Share-based compensation   |                              | 389  |                      |   | 389                                    |                                   | 389             |
| BALANCE AT JANUARY 26, 2019  | 4,424                        | \$ 41,361  | \$538                | \$ (1,110 )   | \$ 40,789                              | \$                                | —\$40,789       |

| Six Months Ended January 26, 2019  | Shares of<br>Common<br>Stock | Common Stock<br>and<br>Additional<br>Paid-In Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total Cisco<br>Shareholders'<br>Equity | Non-control-<br>ling<br>Interests | Total<br>Equity |
|--|------------------------------|--|----------------------|---|--|-----------------------------------|-----------------|
| BALANCE AT JULY 28, 2018   | 4,614                        | \$ 42,820  | \$1,233              | \$ (849 )   | \$ 43,204                              | \$                                | —\$43,204       |
| Net income   |                              |  | 6,371                |   | 6,371                                  |                                   | 6,371           |
| Other comprehensive income (loss)  |                              |  |                      | (93 )   | (93 )                                  |                                   | (93 )           |
| Issuance of common stock   | 41                           | 312  |                      |   | 312                                    |                                   | 312             |
| Repurchase of common stock   | (220 )                       | (2,049 )   | (7,993 )             |   | (10,042 )                              |                                   | (10,042 )       |
| Shares repurchased for tax<br>withholdings on vesting of restricted<br>stock units | (11 )                        | (514 )   |                      |   | (514 )                                 |                                   | (514 )          |
| Cash dividends declared (\$0.66 per<br>common share)                               |                              |  | (2,970 )             |   | (2,970 )                               |                                   | (2,970 )        |
| Effect of adoption of accounting<br>standards                                      |                              |  | 3,897                | (168 )  | 3,729                                  |                                   | 3,729           |
| Share-based compensation   |                              | 792  |                      |   | 792                                    |                                   | 792             |
| BALANCE AT JANUARY 26, 2019  | 4,424                        | \$ 41,361  | \$538                | \$ (1,110 )   | \$ 40,789                              | \$                                | —\$40,789       |

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| Three Months Ended January 27, 2018   | Shares of<br>Common<br>Stock | Common Stock<br>and<br>Additional<br>Paid-In Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total Cisco<br>Shareholders'<br>Equity | Non-control-<br>ling<br>Interests | Total<br>Equity |
|---|------------------------------|--|----------------------|---|--|-----------------------------------|-----------------|
| BALANCE AT OCTOBER 28, 2017   | 4,951                        | \$ 44,872  | \$20,647             | \$ 31   | \$ 65,550                              | \$                                | —\$65,550       |
| Net loss  |                              |  | (8,778 )             |   | (8,778 )                               |                                   | (8,778 )        |
| Other comprehensive income (loss)   |                              |  |                      | 52  | 52                                     | —                                 | 52              |
| Issuance of common stock  | 22                           | 293  |                      |   | 293                                    |                                   | 293             |
| Repurchase of common stock  | (103 )                       | (931 )   | (3,080 )             |   | (4,011 )                               |                                   | (4,011 )        |
| Shares repurchased for tax withholdings<br>on vesting of restricted stock units | (2 )                         | (91 )  |                      |   | (91 )                                  |                                   | (91 )           |
| Cash dividends declared (\$0.29 per<br>common share)                            |                              |  | (1,425 )             |   | (1,425 )                               |                                   | (1,425 )        |
| Share-based compensation  |                              | 393  |                      |   | 393                                    |                                   | 393             |
| Purchase acquisitions and other   |                              | (1 )   |                      |   | (1 )                                   |                                   | (1 )            |
| BALANCE AT JANUARY 27, 2018   | 4,868                        | \$ 44,535  | \$7,364              | \$ 83   | \$ 51,982                              | \$                                | —\$51,982       |
| Six Months Ended January 27, 2018   | Shares of<br>Common<br>Stock | Common Stock<br>and<br>Additional<br>Paid-In Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total Cisco<br>Shareholders'<br>Equity | Non-control-<br>ling<br>Interests | Total<br>Equity |
| BALANCE AT JULY 29, 2017  | 4,983                        | \$ 45,253  | \$20,838             | \$ 46   | \$ 66,137                              | \$                                | —\$66,137       |
| Net loss  |                              |  | (6,384 )             |   | (6,384 )                               |                                   | (6,384 )        |
| Other comprehensive income (loss)   |                              |  |                      | 37  | 37                                     |                                   | 37              |
| Issuance of common stock  | 52                           | 302  |                      |   | 302                                    |                                   | 302             |
| Repurchase of common stock  | (154 )                       | (1,393 )   | (4,238 )             |   | (5,631 )                               |                                   | (5,631 )        |
| Shares repurchased for tax withholdings<br>on vesting of restricted stock units | (13 )                        | (433 )   |                      |   | (433 )                                 |                                   | (433 )          |
| Cash dividends declared (\$0.58 per<br>common share)                            |                              |  | (2,861 )             |   | (2,861 )                               |                                   | (2,861 )        |
| Effect of adoption of accounting<br>standards                                   |                              |  | 9                    |   | 9                                      |                                   | 9               |
| Share-based compensation  |                              | 785  |                      |   | 785                                    |                                   | 785             |
| Purchase acquisitions and other   |                              | 21   |                      |   | 21                                     |                                   | 21              |
| BALANCE AT JANUARY 27, 2018   | 4,868                        | \$ 44,535  | \$7,364              | \$ 83   | \$ 51,982                              | \$                                | —\$51,982       |

See Notes to Consolidated Financial Statements.

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

1. Basis of Presentation

The fiscal year for Cisco Systems, Inc. (the “Company,” “Cisco,” “we,” “us,” or “our”) is the 52 or 53 weeks ending on the last Saturday in July. Fiscal 2019 and fiscal 2018 are each 52-week fiscal years. The Consolidated Financial Statements include our accounts and those of our subsidiaries. All intercompany accounts and transactions have been eliminated. We conduct business globally and are primarily managed on a geographic basis in the following three geographic segments: the Americas; Europe, Middle East, and Africa (EMEA); and Asia Pacific, Japan, and China (APJC). We have prepared the accompanying financial data as of January 26, 2019 and for the second quarter and first six months of fiscal 2019 and fiscal 2018, without audit, pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. The July 28, 2018 Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. However, we believe that the disclosures are adequate to make the information presented not misleading. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended July 28, 2018.

We consolidate our investments in certain variable interest entities (VIEs) where we are the primary beneficiary. The noncontrolling interests attributed to these investments, if any, are presented as a separate component from our equity in the equity section of the Consolidated Balance Sheets. The share of earnings attributable to the noncontrolling interests are not presented separately in the Consolidated Statements of Operations as these amounts are not material for any of the fiscal periods presented.

In the opinion of management, all normal recurring adjustments necessary to present fairly the consolidated balance sheet as of January 26, 2019; the results of operations and the statements of comprehensive income (loss) for the second quarter and first six months of fiscal 2019 and fiscal 2018; the statements of cash flows for the first six months of fiscal 2019 and fiscal 2018; and the statements of equity for the second quarter and first six months of fiscal 2019 and fiscal 2018, as applicable, have been made. The results of operations for the second quarter and first six months of fiscal 2019 and fiscal 2018 are not necessarily indicative of the operating results for the full fiscal year or any future periods.

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

2. Recent Accounting Pronouncements

(a) New Accounting Updates Recently Adopted

**Revenue Recognition** In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Codification (“ASC”) 606, Revenue from Contracts with Customers, a new accounting standard related to revenue recognition. ASC 606 supersedes nearly all U.S. GAAP on revenue recognition and eliminated industry-specific guidance. The underlying principle of ASC 606 is to recognize revenue when a customer obtains control of promised goods or services at an amount that reflects the consideration that is expected to be received in exchange for those goods or services. It also requires increased disclosures including the nature, amount, timing, and uncertainty of revenues and cash flows related to contracts with customers.

ASC 606 allows two methods of adoption: i) retrospectively to each prior period presented (“full retrospective method”), or ii) retrospectively with the cumulative effect recognized in retained earnings as of the date of adoption (“modified retrospective method”). At the beginning of the first quarter of fiscal 2019, we adopted ASC 606 using the modified retrospective method to those contracts that were not completed as of July 28, 2018. Refer to Opening Balance Adjustments below for the impact of adoption on our Consolidated Financial Statements.

We have implemented new accounting policies, systems, processes, and internal controls necessary to support the requirements of ASC 606.

ASC 606 primarily impacts our revenue recognition for software arrangements and sales to two-tier distributors. In both areas, the new standard accelerates the recognition of revenue.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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The table below details the timing of when revenue was typically recognized under the prior revenue standard compared to the timing of when revenue is typically recognized under ASC 606 for these major areas:

|   | Prior Revenue Standard | ASC<br>606 |
|---|------------------------|------------|
| Software arrangements:                            |                        |            |
| Perpetual software licenses                       | Upfront                | Upfront    |
| Term software licenses                            | Ratable                | Upfront    |
| Security software licenses                        | Ratable                | Ratable    |
| Enterprise license agreements (software licenses) | Ratable                | Upfront    |
| Software support (maintenance)                    | Ratable                | Ratable    |
| Software-as-a-service                             | Ratable                | Ratable    |
| Two-tier distribution                             | Sell-Through           | Sell-In    |

In addition to the above revenue recognition timing impacts, ASC 606 requires incremental contract acquisition costs (such as sales commissions) for customer contracts to be capitalized and amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the assets relates.

We enter into contracts with customers that can include various combinations of products and services which are generally distinct and accounted for as separate performance obligations. As a result, our contracts may contain multiple performance obligations. We determine whether arrangements are distinct based on whether the customer can benefit from the product or service on its own or together with other resources that are readily available and whether our commitment to transfer the product or service to the customer is separately identifiable from other obligations in the contract. We classify our hardware, perpetual software licenses, and software-as-a-service (SaaS) as distinct performance obligations. Term software licenses represent multiple obligations, which include software licenses and software maintenance. In transactions where we deliver hardware or software, we are typically the principal and we record revenue and costs of goods sold on a gross basis. We refer to our term software licenses, security software licenses, SaaS, and associated service arrangements as subscription offers.

We recognize revenue upon transfer of control of promised goods or services in a contract with a customer in an amount that reflects the consideration we expect to receive in exchange for those products or services. Transfer of control occurs once the customer has the contractual right to use the product, generally upon shipment or once delivery and risk of loss has transferred to the customer. Transfer of control can also occur over time for software maintenance and services as the customer receives the benefit over the contract term. Our hardware and perpetual software licenses are distinct performance obligations where revenue is recognized upfront upon transfer of control. Term software licenses include multiple performance obligations where the term licenses are recognized upfront upon transfer of control, with the associated software maintenance revenue recognized ratably over the contract term as services and software updates are provided. SaaS arrangements have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term as the customer consumes the services. On our product sales, we record consideration from shipping and handling on a gross basis within net product sales. We record our revenue net of any associated sales taxes.

**Significant Judgments**

Revenue is allocated among these performance obligations in a manner that reflects the consideration that we expect to be entitled to for the promised goods or services based on standalone selling prices (SSP). SSP is estimated for each distinct performance obligation and judgment may be required in their determination. The best evidence of SSP is the observable price of a product or service when we sell the goods separately in similar circumstances and to similar customers. In instances where SSP is not directly observable, we determine SSP using information that may include market conditions and other observable inputs.

We apply judgment in determining the transaction price as we may be required to estimate variable consideration when determining the amount of revenue to recognize. Variable consideration includes various rebate, cooperative marketing, and other incentive programs that we offer to our distributors, partners and customers. When determining the amount of revenue to recognize, we estimate the expected usage of these programs, applying the expected value or most likely estimate and update the estimate at each reporting period as actual utilization becomes available. We also consider the customers' right of return in determining the transaction price, where applicable.

We assess certain software licenses, such as for security software, that contain critical updates or upgrades which customers can download throughout the contract term. Without these updates or upgrades, the functionality of the software would diminish over a relatively short time period. These updates or upgrades provide the customer the full functionality of the purchased security software licenses and are required to maintain the security license's utility as the risks and threats in the environment are rapidly

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changing. In these circumstances, the revenue from these software arrangements is recognized as a distinct performance obligation satisfied over the contract term.

For the additional disclosures required as part of ASC 606 see Note 3.

**Financial Instruments** In January 2016, the FASB issued an accounting standard update that changes the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The most significant impact of this accounting standard update is that it requires the remeasurement of investments not accounted for under the equity method to be recorded at fair value through the Consolidated Statement of Operations at the end of each reporting period. The application of this accounting standard update increases the variability of other income (loss), net.

Our equity investments are accounted for as follows:

- **Marketable equity securities** have readily determinable fair value (RDFV) that are measured and recorded at fair value.

- **Non-marketable equity securities** do not have RDFV and are measured using a measurement alternative recorded at cost less any impairment, plus or minus changes resulting from qualifying observable price changes. For certain of these securities, we have elected to apply the net asset value (NAV) practical expedient. The NAV is the estimated fair value of these investments.

- **Equity method investments** are securities we do not control, but are able to exert significant influence over the investee. These investments are measured at cost less any impairment, plus or minus our share of equity method investee income or loss.

We adopted this accounting standard update beginning the first quarter of fiscal 2019. The standard was adopted using the modified retrospective method for our marketable equity securities and non-marketable equity securities measured using the NAV practical expedient. For our non-marketable equity securities measured using the measurement alternative, we applied the prospective method. Refer to Opening Balance Adjustments below for the impact of adoption on our Consolidated Balance Sheet.

**Income Taxes on Intra-Entity Transfers of Assets** In October 2016, the FASB issued an accounting standard update that requires recognition of the income tax consequences of intra-entity transfers of assets (other than inventory) at the transaction date. We adopted this accounting standard update beginning in the first quarter of fiscal 2019 on a modified retrospective basis. The ongoing impact of this standard will be facts and circumstances dependent on any transactions within its scope. Refer to Opening Balance Adjustments below for the impact of adoption on our Consolidated Balance Sheet.

**Classification of Cash Flow Elements** In August 2016, the FASB issued an accounting standard update related to the classification of certain cash receipts and cash payments on the statement of cash flows. We adopted this accounting standard update beginning in the first quarter of fiscal 2019 on a retrospective basis. The application of this accounting standard update did not have an impact on our Consolidated Statements of Cash Flows.

**Restricted Cash in Statement of Cash Flows** In November 2016, the FASB issued an accounting standard update that provides guidance on the classification and presentation of changes in restricted cash and cash equivalents in the statement of cash flows. We adopted this accounting standard update beginning in the first quarter of fiscal 2019 using a retrospective transition method to each period presented. The application of this accounting standard update did not have a material impact on our Consolidated Statements of Cash Flows. Prior period information has been retrospectively adjusted due to the adoption of ASU 2016-18, Statement of Cash Flows, Restricted Cash at the beginning of the first quarter of fiscal 2019.

**Simplifying the Test for Goodwill Impairment** In January 2017, the FASB issued an accounting standard update that removes Step

2 of the goodwill impairment test, which requires the assessment of fair value of individual assets and liabilities of a reporting unit to measure goodwill impairments. Goodwill impairment will now be the amount by which a reporting

unit's carrying value exceeds its fair value. We early adopted this accounting standard update beginning in the first quarter of fiscal 2019 on a prospective basis. The application of this accounting standard update did not have any impact on our Consolidated Financial Statements.

**Definition of a Business** In January 2017, the FASB issued an accounting standard update that clarifies the definition of a business to help companies evaluate whether acquisition or disposal transactions should be accounted for as asset groups or as businesses. We adopted this accounting standard update beginning in the first quarter of fiscal 2019 on a prospective basis. The impact of this accounting standard update will be fact dependent, but we expect that some transactions that were previously accounted for as business combinations or disposal transactions will be accounted for as asset purchases or asset sales under the accounting standard update.

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## Opening Balance Adjustments

The following table summarizes the cumulative effect of the changes made to the Consolidated Balance Sheet for the adoption of ASC 606, ASU 2016-01, Financial Instruments, and ASU 2016-16, Intra-Entity Transfers of Assets Other than Inventory (in millions):

| Line Item in Consolidated Balance Sheet:                               | Balance at<br>July 28,<br>2018 | New<br>Revenue<br>Recognition<br>Standard | New<br>Financial<br>Instruments<br>Standard | New<br>Intra-Entity<br>Transfers<br>Standard | Adjusted<br>Balance at<br>July 29,<br>2018 |
|--|--------------------------------|---|---|--|--|
| <b>ASSETS</b>  |                                |   |   |  |  |
| Accounts receivable, net   | \$5,554                        | \$ (104 ) <sup>(1)</sup>                  | \$ —  | \$ —   | \$5,450                                    |
| Inventories  | \$1,846                        | \$ (302 ) <sup>(2)</sup>                  | \$ —  | \$ —   | \$1,544                                    |
| Other current assets (includes capitalized contract acquisition costs) | \$2,940                        | \$ 371 <sup>(3), (4)</sup>                | \$ —  | \$ (25 ) <sup>(3)</sup>                      | \$3,286                                    |
| Deferred tax assets  | \$3,219                        | \$ (624 ) <sup>(3)</sup>                  | \$ (15 ) <sup>(3)</sup>                     | \$ 1,415 <sup>(8)</sup>                      | \$3,995                                    |
| Other assets (includes capitalized contract acquisition costs)         | \$1,582                        | \$ 327 <sup>(4)</sup>                     | \$ 136 <sup>(7)</sup>                       | \$ (91 ) <sup>(3)</sup>                      | \$1,954                                    |
| <b>TOTAL ASSETS</b>  | <b>\$108,784</b>               | <b>\$ (332 )</b>                          | <b>\$ 121</b>                               | <b>\$ 1,299</b>                              | <b>\$109,872</b>                           |
| <b>LIABILITIES AND EQUITY</b>  |                                |   |   |  |  |
| Income taxes payable   | \$1,004                        | \$ —                                      | \$ —  | \$ 11 <sup>(3)</sup>                         | \$1,015                                    |
| Deferred revenue — current   | \$11,490                       | \$ (1,702 ) <sup>(5)</sup>                | \$ —  | \$ —   | \$9,788                                    |
| Other current liabilities  | \$4,413                        | \$ 33 <sup>(6)</sup>                      | \$ —  | \$ —   | \$4,446                                    |
| Deferred revenue — non-current   | \$8,195                        | \$ (1,081 ) <sup>(5)</sup>                | \$ —  | \$ —   | \$7,114                                    |
| Other long-term liabilities  | \$1,434                        | \$ 85 <sup>(3)</sup>                      | \$ 13 <sup>(3)</sup>                        | \$ —   | \$1,532                                    |
| Retained earnings  | \$1,233                        | \$ 2,333 <sup>(10)</sup>                  | \$ 283 <sup>(10)</sup>                      | \$ 1,281 <sup>(10)</sup>                     | \$5,130                                    |
| Accumulated other comprehensive income (loss)                          | \$(849 )                       | \$ —                                      | \$ (175 ) <sup>(9)</sup>                    | \$ 7 <sup>(3)</sup>                          | \$(1,017 )                                 |
| <b>TOTAL LIABILITIES AND EQUITY</b>                                    | <b>\$108,784</b>               | <b>\$ (332 )</b>                          | <b>\$ 121</b>                               | <b>\$ 1,299</b>                              | <b>\$109,872</b>                           |

(1) Primarily represents the decrease to accounts receivable related to the change in recognizing revenue on sales to two-tier distributors from a sell-through to a sell-in basis

(2) Primarily represents the reduction of inventory for the change from recognizing revenue on sales to two-tier distributors from a sell-through to a sell-in basis

(3) Includes the impacts to deferred tax assets, liabilities and other income tax balances

(4) Primarily represents capitalized contract acquisition costs (e.g. commissions)

(5) Primarily represents deferred revenue adjusted to retained earnings primarily due to the change in revenue recognition for certain software arrangements from ratable to upfront, recognizing revenue on sales to two-tier distributors from a sell-through to a sell-in basis. Of this total \$2.8 billion adjustment, \$2.6 billion related to product deferred revenue, of which \$1.3 billion relates to our recurring software and subscription offers, \$0.6 billion relates to two-tier distribution, and the remainder relates to non-recurring software and other adjustments.

(6) Primarily represents the reclassification of accounts receivable contra balances to other current liabilities, adjustments to rebate liabilities for the change from recognizing revenue on sales to two-tier distributors from a sell-through to a sell-in basis, and reclassifications from other current liabilities for amounts that are not contract liabilities under ASC 606

- (7) Represents the adjustment due to the remeasurement of non-marketable equity investments at fair value
- (8) Primarily represents the change in net deferred tax assets related to unrecognized income tax effects of intra-entity asset transfers
- (9) Represents the reclassification of net unrealized gains from accumulated other comprehensive income (loss) to retained earnings
- (10) Retained earnings impact from the adjustments noted above

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**Impact of ASC 606 Adoption**

The application of ASC 606 increased our total revenue by \$267 million and \$516 million in the second quarter and first six months of fiscal 2019, respectively. The application of ASC 606 did not have a material impact to either our cost of sales or our operating expenses in the second quarter and first six months of fiscal 2019. We recognized a \$152 million benefit to our provision for income taxes relating to indirect effects from the adoption of ASC 606 in the first quarter of fiscal 2019. For additional information regarding ASC 606, see Note 3 to the Consolidated Financial Statements.

In connection with the adoption of ASC 606, we recorded a transition adjustment to increase retained earnings by \$2.3 billion. See above for the transition impact of ASC 606 by balance sheet line item. As of January 26, 2019, the balance sheet changes attributable to ASC 606 related to accounts receivable, inventories, and deferred revenue were not materially different than the impacts upon adoption. In connection with the adoption of ASC 606, we established contract assets for unbilled receivables. As of January 26, 2019, we had total contract assets of \$557 million, of which \$241 million was recorded in other current assets and \$316 million was recorded in other assets. As of January 26, 2019, we had total capitalized contract acquisition costs of \$686 million, of which \$380 million was recorded in other current assets and \$306 million was recorded in other assets. The adoption of ASC 606 did not have any impact on net cash provided by operating activities.

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

**Leases** In February 2016, the FASB issued an accounting standard update and subsequent amendments related to leases requiring lessees to recognize operating and financing lease liabilities on the balance sheet, as well as corresponding right-of-use assets. The new lease standard also makes some changes to lessor accounting and aligns key aspects of the lessor accounting model with the revenue recognition standard. In addition, disclosures will be required to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The accounting standard update will be effective for us beginning in the first quarter of fiscal 2020 and early adoption is permitted. We expect to adopt this accounting standard update on a modified retrospective basis in the first quarter of fiscal 2020, and we are currently evaluating the impact of this accounting standard update on our Consolidated Financial Statements.

**Credit Losses of Financial Instruments** In June 2016, the FASB issued an accounting standard update that requires measurement and recognition of expected credit losses for financial assets held based on historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the reported amount. The accounting standard update will be effective for us beginning in the first quarter of fiscal 2021 and early adoption in fiscal 2020 is permitted. We expect to adopt this accounting standard update on a modified retrospective basis in the first quarter of fiscal 2021, and we are currently evaluating the impact of this accounting standard update on our Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 3. Revenue

## (a) Disaggregation of Revenue

We disaggregate our revenue into groups of similar products and services that depict the nature, amount, and timing of revenue and cash flows for our various offerings. The sales cycle, contractual obligations, customer requirements, and go-to-market strategies differ for each of our product categories, resulting in different economic risk profiles for each category. The following table presents this disaggregation of revenue (in millions):

|                          | Three Months Ended |             | Six Months Ended |             |
|--------------------------|--------------------|-------------|------------------|-------------|
|                          | January 26,        | January 27, | January 26,      | January 27, |
|                          | 2019               | 2018        | 2019             | 2018        |
| Revenue:                 |                    |             |                  |             |
| Infrastructure Platforms | \$7,128            | \$ 6,710    | \$14,770         | \$ 13,690   |
| Applications             | 1,465              | 1,184       | 2,884            | 2,387       |
| Security                 | 658                | 557         | 1,308            | 1,142       |
| Other Products           | 22                 | 258         | 200              | 544         |
| Total Product            | 9,273              | 8,709       | 19,163           | 17,763      |
| Services                 | 3,173              | 3,178       | 6,355            | 6,260       |
| Total <sup>(1)</sup>     | \$12,446           | \$ 11,887   | \$25,518         | \$ 24,023   |

Amounts may not sum due to rounding.

<sup>(1)</sup> During the second quarter of fiscal 2019, we completed the divestiture of the Service Provider Video Software Solutions ("SPVSS") business. Total revenue includes SPVSS business revenue of \$0 and \$230 million for the second quarter of fiscal 2019 and 2018, respectively, and \$168 million and \$478 million for the first six months of fiscal 2019 and 2018, respectively.

Infrastructure Platforms consist of our core networking technologies of switching, routing, data center products, and wireless that are designed to work together to deliver networking capabilities and transport and/or store data. These technologies consist of both hardware and software offerings, including software licenses and software-as-a-service (SaaS), that help our customers build networks, automate, orchestrate, integrate, and digitize data. We are shifting and expanding more of our business to software and subscriptions across our core networking portfolio. Our hardware and perpetual software in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control. Term software licenses are multiple performance obligations where the term license is recognized upfront upon transfer of control with the associated software maintenance revenue recognized ratably over the contract term. SaaS arrangements in this category have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term.

Applications consists of offerings that utilize the core networking and data center platforms to provide their functions. The products consist primarily of software offerings, including software licenses and SaaS, as well as hardware. Our perpetual software and hardware in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control. Term software licenses are multiple performance obligations where the term license is recognized upfront upon transfer of control with the associated software maintenance revenue recognized ratably over the contract term. SaaS arrangements in this category have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term.

Security primarily includes our unified threat management, advanced threat security, and web security products. These products consist of both hardware and software offerings, including software licenses and SaaS. Updates and upgrades for the term software licenses are critical for our software to perform its intended commercial purpose because of the continuous need for our software to secure our customers' network environments against frequent threats. Therefore, security software licenses are generally represented by a single distinct performance obligation with revenue recognized ratably over the contract term. Our hardware and perpetual software in this category are distinct

performance obligations where revenue is recognized upfront upon transfer of control. SaaS arrangements in this category have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term.

Other Products primarily include our Service Provider Video Software Solutions and cloud and system management products. On May 1, 2018, we announced a definitive agreement to sell the SPVSS business. The sale closed on October 28, 2018. These products include both hardware and software licenses. Our offerings in this category are distinct performance obligations where revenue is recognized upfront upon transfer of control.

In addition to our product offerings, we provide a broad range of service and support options for our customers, including technical support services and advanced services. Technical support services represent the majority of these offerings which are distinct

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

performance obligations that are satisfied over time with revenue recognized ratably over the contract term. Advanced services are distinct performance obligations that are satisfied over time with revenue recognized as services are delivered.

The sales arrangements as discussed above are typically made pursuant to customer purchase orders based on master purchase or partner agreements. Cash is received based on our standard payment terms which is typically 30 days. We provide financing arrangements to customers for all of our hardware, software and service offerings. Refer to Note 8 for additional information. For these arrangements, cash is typically received over time.

**(b) Contract Balances**

Accounts receivable, net was \$3.7 billion as of January 26, 2019 compared to \$5.6 billion as of July 28, 2018, as reported on the Consolidated Balance Sheet.

Contract assets consist of unbilled receivables and are recorded when revenue is recognized in advance of scheduled billings to our customers. These amounts are primarily related to software and service arrangements where transfer of control has occurred but we have not yet invoiced. As of January 26, 2019 and July 29, 2018, our contract assets for these unbilled receivables were \$557 million and \$122 million, respectively, and were included in other current assets and other assets.

Contract liabilities consist of deferred revenue. Deferred revenue was \$17.3 billion as of January 26, 2019 compared to \$19.7 billion as of July 28, 2018. In connection with the adoption of ASC 606, we recorded an adjustment to retained earnings to reduce deferred revenue by \$2.8 billion. We recognized approximately \$2.6 billion and \$6.0 billion of revenue during the second quarter and first six months of fiscal 2019, respectively, that was included in the deferred revenue balance at July 29, 2018.

**(c) Remaining Performance Obligations**

Remaining Performance Obligations (RPO) are comprised of deferred revenue plus unbilled contract revenue. As of January 26, 2019, the aggregate amount of RPO was \$22.5 billion, comprised of \$17.3 billion of deferred revenue and \$5.2 billion of unbilled contract revenue. We expect approximately 56% of this amount to be recognized as revenue over the next year. Unbilled contract revenue represents non-cancelable contracts for which we have not invoiced, have an obligation to perform, and revenue has not yet been recognized in the financial statements.

**(d) Capitalized Contract Acquisition Costs**

In connection with the adoption of ASC 606, we began to capitalize direct and incremental costs incurred to acquire contracts, primarily sales commissions, for which the associated revenue is expected to be recognized in future periods. We incur these costs in connection with both initial contracts and renewals. These costs are initially deferred and typically amortized over the term of the customer contract which corresponds to the period of benefit. Deferred sales commissions were \$686 million and \$644 million as of January 26, 2019 and July 29, 2018, respectively, and were included in other current assets and other assets. The amortization expense associated with these costs was \$100 million and \$212 million for the second quarter and first six months of fiscal 2019, respectively, and was included in sales and marketing expenses.

**4. Acquisitions and Divestitures**

We completed three acquisitions during the first six months of fiscal 2019. A summary of the allocation of the total purchase consideration is presented as follows (in millions):

| Purchase<br>Consideration | Net<br>Tangible<br>Assets<br>Acquired<br>(Liabilities) | Purchased<br>Intangible<br>Assets | Goodwill |
|---------------------------|--|-----------------------------------|----------|
|---------------------------|--|-----------------------------------|----------|

|                       |          |          |        |          |
|-----------------------|----------|----------|--------|----------|
|                       |          | Assumed) |        |          |
| Duo                   | \$ 2,025 | \$ (57 ) | \$ 342 | \$ 1,740 |
| Others (two in total) | 60       | 3        | 8      | 49       |
| Total                 | \$ 2,085 | \$ (54 ) | \$ 350 | \$ 1,789 |

On September 28, 2018, we completed our acquisition of privately held Duo Security, Inc. ("Duo"), a leading provider of unified access security and multi-factor authentication delivered through the cloud. Revenue from the Duo acquisition has been included in our Security product category.

The total purchase consideration related to acquisitions completed during the first six months of fiscal 2019 consisted of cash consideration. The total cash and cash equivalents acquired from these acquisitions was approximately \$85 million. Total transaction costs related to acquisition and divestiture activities were \$11 million and \$14 million for the first six months of fiscal 2019 and

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fiscal 2018, respectively. These transaction costs were expensed as incurred in general and administrative expenses ("G&A") in the Consolidated Statements of Operations.

The goodwill generated from acquisitions completed during the first six months of fiscal 2019 is primarily related to expected synergies. The goodwill is generally not deductible for income tax purposes.

The Consolidated Financial Statements include the operating results of each acquisition from the date of acquisition. Pro forma results of operations and the revenue and net income subsequent to the acquisition date for the acquisitions completed during the first six months of fiscal 2019 have not been presented because the effects of the acquisitions, individually and in the aggregate, were not material to our financial results.

**Divestiture of Service Provider Video Software Solutions** On October 28, 2018, we completed the sale of the Service Provider Video Software Solutions business. This business had tangible assets of approximately \$160 million (primarily comprised of accounts receivables, inventories and various other current and long-term assets) and net intangible assets and goodwill (based on relative fair value) of \$340 million. In addition, the business had total liabilities of approximately \$200 million (primarily comprised of deferred revenue and various other current and long-term liabilities). We recognized an immaterial gain from this transaction in the second quarter of fiscal 2019. We completed two divestitures during the second quarter of fiscal 2018. The financial statement impact of these divestitures was not material for the second quarter and first six months of fiscal 2018.

**Acquisition of Luxtera** On February 6, 2019, we completed our acquisition of Luxtera, Inc. ("Luxtera"), a semiconductor company, for total consideration of approximately \$660 million in cash and assumed equity awards. Revenue from the Luxtera acquisition will be included in our Infrastructure Platforms product category. We expect that most of the purchase price will be allocated to goodwill and purchased intangible assets.

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(Unaudited)

## 5. Goodwill and Purchased Intangible Assets

## (a) Goodwill

The following table presents the goodwill allocated to our reportable segments as of January 26, 2019 and during the first six months of fiscal 2019 (in millions):

|          | Balance<br>at<br>July 28,<br>2018 | Acquisitions<br>&<br>Divestitures | Other   | Balance at<br>January 26,<br>2019 |
|----------|-----------------------------------|-----------------------------------|---------|-----------------------------------|
| Americas | \$ 19,998                         | \$ 1,082                          | \$(79 ) | \$ 21,001                         |
| EMEA     | 7,529                             | 429                               | (22 )   | 7,936                             |
| APJC     | 4,179                             | 190                               | (13 )   | 4,356                             |
| Total    | \$ 31,706                         | \$ 1,701                          | \$(114) | \$ 33,293                         |

“Other” in the table above primarily consists of foreign currency translation as well as immaterial purchase accounting adjustments.

## (b) Purchased Intangible Assets

The following table presents details of our intangible assets acquired through acquisitions completed during the first six months of fiscal 2019 (in millions, except years):

|                       | FINITE LIVES                                   |        |   |        | INDEFINITE LIVES                                  |        | TOTAL  |        |
|-----------------------|--|--------|---|--------|---|--------|--------|--------|
|                       | TECHNOLOGY                                     |        | CUSTOMER RELATIONSHIPS                            |        | IPR&D   |        |        |        |
|                       | Weighted-<br>Average Useful<br>Life (in Years) | Amount | Weighted-<br>Average Useful<br>Life<br>(in Years) | Amount | Weighted-<br>Average Useful<br>Life<br>(in Years) | Amount | Amount |        |
| Duo                   | 5.0  | \$ 153 | 5.0   | \$ 94  | 2.5   | \$ 18  | \$ 77  | \$ 342 |
| Others (two in total) | 5.0  | 8      | —   | —      | —   | —      | —      | 8      |
| Total                 |  | \$ 161 |   | \$ 94  |   | \$ 18  | \$ 77  | \$ 350 |

The following tables present details of our purchased intangible assets (in millions):

| January 26, 2019   | Gross    | Accumulated<br>Amortization | Net      |
|--|----------|-----------------------------|----------|
| Purchased intangible assets with finite lives:             |          |                             |          |
| Technology   | \$ 3,165 | \$ (1,620 )                 | \$ 1,545 |
| Customer relationships                                     | 812      | (292 )                      | 520      |
| Other  | 55       | (30 )                       | 25       |
| Total purchased intangible assets with finite lives        | 4,032    | (1,942 )                    | 2,090    |
| In-process research and development, with indefinite lives | 180      | —                           | 180      |
| Total  | \$ 4,212 | \$ (1,942 )                 | \$ 2,270 |

July 28, 2018

|  | Gross    | Accumulated<br>Amortization | Net      |
|--|----------|-----------------------------|----------|
| Purchased intangible assets with finite lives: |          |                             |          |
| Technology                                     | \$ 3,711 | \$ (1,888 )                 | \$ 1,823 |
| Customer relationships                         | 1,538    | (937 )                      | 601      |

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|  |         |           |   |         |
|--|---------|-----------|---|---------|
| Other  | 63      | (38       | ) | 25      |
| Total purchased intangible assets with finite lives        | 5,312   | (2,863    | ) | 2,449   |
| In-process research and development, with indefinite lives | 103     | —         |   | 103     |
| Total  | \$5,415 | \$ (2,863 | ) | \$2,552 |

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

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

There were no impairment charges related to purchased intangible assets for the second quarter and first six months of fiscal 2019 and for the corresponding periods of fiscal 2018. Impairment charges are primarily a result of declines in estimated fair values of certain purchased intangible assets resulting from the reduction or elimination of expected future cash flows associated with certain of our technology and in-process research and development (IPR&D) intangible assets.

The following table presents the amortization of purchased intangible assets, including impairment charges (in millions):

|  | Three Months<br>Ended<br>January 26,<br>2019 |        | Six Months<br>Ended<br>January 26,<br>2019 |        |
|--|--|--------|--|--------|
| Amortization of purchased intangible assets: |  |        |  |        |
| Cost of sales                                | \$156  | \$ 160 | \$307                                      | \$ 314 |
| Operating expenses                           | 39   | 60     | 73   | 121    |
| Total  | \$195  | \$ 220 | \$380                                      | \$ 435 |

The estimated future amortization expense of purchased intangible assets with finite lives as of January 26, 2019 is as follows (in millions):

| Fiscal Year                 | Amount |
|-----------------------------|--------|
| 2019 (remaining six months) | \$ 382 |
| 2020                        | \$ 726 |
| 2021                        | \$ 530 |
| 2022                        | \$ 274 |
| 2023                        | \$ 133 |
| Thereafter                  | \$ 45  |

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 6. Restructuring and Other Charges

We initiated a restructuring plan during fiscal 2018 (the "Fiscal 2018 Plan") in order to realign the organization and enable further investment in key priority areas with estimated pretax charges of approximately \$600 million. These aggregate pretax charges are primarily cash-based and consist of employee severance and other one-time termination benefits, and other associated costs. In connection with the Fiscal 2018 Plan, we have incurred charges of \$186 million and \$264 million for the second quarter and first six months of fiscal 2019, respectively, and have incurred cumulative charges of \$372 million. We expect the Fiscal 2018 Plan to be substantially completed in fiscal 2019.

We announced a restructuring plan in August 2016 (the "Fiscal 2017 Plan"), in order to reinvest in our key priority areas. In connection with the Fiscal 2017 Plan, we incurred cumulative charges of approximately \$1.0 billion, which were primarily cash-based and consisted of employee severance and other one-time termination benefits, and other associated costs. We completed the Fiscal 2017 Plan in fiscal 2018.

The following tables summarize the activities related to the restructuring and other charges (in millions):

|                                  | FISCAL<br>2017 AND<br>PRIOR<br>PLANS |       | FISCAL<br>2018 PLAN   |       |       |
|----------------------------------|--------------------------------------|-------|-----------------------|-------|-------|
|                                  | Employee<br>Severance                | Other | Employee<br>Severance | Other | Total |
| Liability as of July 28, 2018    | \$41                                 | \$13  | \$19                  | \$—   | \$73  |
| Charges                          | —                                    | (1)   | 222                   | 43    | 264   |
| Cash payments                    | (31)                                 | (3)   | (202)                 | (1)   | (237) |
| Non-cash items                   | —                                    | —     | —                     | (42)  | (42)  |
| Liability as of January 26, 2019 | \$10                                 | \$9   | \$39                  | \$—   | \$58  |

|                                  | FISCAL<br>2017 AND<br>PRIOR<br>PLANS |       |       |
|----------------------------------|--------------------------------------|-------|-------|
|                                  | Employee<br>Severance                | Other | Total |
| Liability as of July 29, 2017    | \$74                                 | \$43  | \$117 |
| Charges                          | 223                                  | 27    | 250   |
| Cash payments                    | (213)                                | (27)  | (240) |
| Non-cash items                   | 3                                    | (18)  | (15)  |
| Liability as of January 27, 2018 | \$87                                 | \$25  | \$112 |

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 7. Balance Sheet Details

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

|  | January 26, July 28, |          |
|--|----------------------|----------|
|  | 2019                 | 2018     |
| Cash and cash equivalents                                | \$ 9,835             | \$ 8,934 |
| Restricted cash included in other current assets         | 23                   | 32       |
| Restricted cash included in other assets                 | 21                   | 27       |
| Total cash, cash equivalents, and restricted cash        | \$ 9,879             | \$ 8,993 |
| Inventories:   |                      |          |
| Raw materials  | \$468                | \$423    |
| Finished goods:  |                      |          |
| Deferred cost of sales and distributor inventory         | 74                   | 443      |
| Manufactured finished goods                              | 908                  | 689      |
| Total finished goods                                     | 982                  | 1,132    |
| Service-related spares                                   | 228                  | 258      |
| Demonstration systems                                    | 23                   | 33       |
| Total  | \$1,701              | \$1,846  |
| Property and equipment, net:                             |                      |          |
| Gross property and equipment:                            |                      |          |
| Land, buildings, and building and leasehold improvements | \$4,731              | \$4,710  |
| Computer equipment and related software                  | 965                  | 1,085    |
| Production, engineering, and other equipment             | 5,616                | 5,734    |
| Operating lease assets                                   | 529                  | 356      |
| Furniture and fixtures                                   | 369                  | 358      |
| Total gross property and equipment                       | 12,210               | 12,243   |
| Less: accumulated depreciation and amortization          | (9,279 )             | (9,237 ) |
| Total  | \$2,931              | \$3,006  |
| Deferred revenue:  |                      |          |
| Service  | \$11,246             | \$11,431 |
| Product  | 6,015                | 8,254    |
| Total  | \$17,261             | \$19,685 |
| Reported as:   |                      |          |
| Current  | \$9,976              | \$11,490 |
| Noncurrent   | 7,285                | 8,195    |
| Total  | \$17,261             | \$19,685 |

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 8. Financing Receivables and Operating Leases

## (a) Financing Receivables

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

A summary of our financing receivables is presented as follows (in millions):

|                           | Lease<br>Receivables | Loan<br>Receivables | Financed<br>Service<br>Contracts | Total    |
|---------------------------|----------------------|---------------------|----------------------------------|----------|
| January 26, 2019          |                      |                     |                                  |          |
| Gross                     | \$ 2,483             | \$ 4,926            | \$ 2,398                         | \$9,807  |
| Residual value            | 153                  | —                   | —                                | 153      |
| Unearned income           | (138 )               | —                   | —                                | (138 )   |
| Allowance for credit loss | (127 )               | (64 )               | (9 )                             | (200 )   |
| Total, net                | \$ 2,371             | \$ 4,862            | \$ 2,389                         | \$9,622  |
| Reported as:              |                      |                     |                                  |          |
| Current                   | \$ 1,121             | \$ 2,502            | \$ 1,434                         | \$5,057  |
| Noncurrent                | 1,250                | 2,360               | 955                              | 4,565    |
| Total, net                | \$ 2,371             | \$ 4,862            | \$ 2,389                         | \$9,622  |
| July 28, 2018             |                      |                     |                                  |          |
| Gross                     | \$ 2,688             | \$ 4,999            | \$ 2,326                         | \$10,013 |
| Residual value            | 164                  | —                   | —                                | 164      |
| Unearned income           | (141 )               | —                   | —                                | (141 )   |
| Allowance for credit loss | (135 )               | (60 )               | (10 )                            | (205 )   |
| Total, net                | \$ 2,576             | \$ 4,939            | \$ 2,316                         | \$9,831  |
| Reported as:              |                      |                     |                                  |          |
| Current                   | \$ 1,249             | \$ 2,376            | \$ 1,324                         | \$4,949  |
| Noncurrent                | 1,327                | 2,563               | 992                              | 4,882    |
| Total, net                | \$ 2,576             | \$ 4,939            | \$ 2,316                         | \$9,831  |

Future minimum lease payments to Cisco on lease receivables as of January 26, 2019 are summarized as follows (in millions):

| Fiscal Year                 | Amount |
|-----------------------------|--------|
| 2019 (remaining six months) | \$ 637 |
| 2020                        | 855    |
| 2021                        | 532    |
| 2022                        | 309    |
| 2023                        | 126    |

|            |          |
|------------|----------|
| Thereafter | 24       |
| Total      | \$ 2,483 |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (b) Credit Quality of Financing Receivables

Gross receivables, excluding residual value, less unearned income categorized by our internal credit risk rating as of January 26, 2019 and July 28, 2018 are summarized as follows (in millions):

|                            | INTERNAL CREDIT RISK RATING |         |              |         |
|----------------------------|-----------------------------|---------|--------------|---------|
|                            | 1 to 4                      | 5 to 6  | 7 and Higher | Total   |
| January 26, 2019           |                             |         |              |         |
| Lease receivables          | \$1,233                     | \$1,066 | \$ 46        | \$2,345 |
| Loan receivables           | 3,000                       | 1,875   | 51           | 4,926   |
| Financed service contracts | 1,390                       | 995     | 13           | 2,398   |
| Total                      | \$5,623                     | \$3,936 | \$ 110       | \$9,669 |

|                            | INTERNAL CREDIT RISK RATING |         |              |         |
|----------------------------|-----------------------------|---------|--------------|---------|
|                            | 1 to 4                      | 5 to 6  | 7 and Higher | Total   |
| July 28, 2018              |                             |         |              |         |
| Lease receivables          | \$1,294                     | \$1,199 | \$ 54        | \$2,547 |
| Loan receivables           | 3,184                       | 1,752   | 63           | 4,999   |
| Financed service contracts | 1,468                       | 835     | 23           | 2,326   |
| Total                      | \$5,946                     | \$3,786 | \$ 140       | \$9,872 |

We determine the adequacy of our allowance for credit loss by assessing the risks and losses inherent in our financing receivables by portfolio segment. The portfolio segment is based on the types of financing offered by us to our customers, which consist of the following: lease receivables, loan receivables, and financed service contracts. Our internal credit risk ratings of 1 through 4 correspond to investment-grade ratings, while credit risk ratings of 5 and 6 correspond to non-investment grade ratings. Credit risk ratings of 7 and higher correspond to substandard ratings. The following tables present the aging analysis of gross receivables, excluding residual value and less unearned income as of January 26, 2019 and July 28, 2018 (in millions):

|                            | DAYS PAST DUE<br>(INCLUDES BILLED AND UNBILLED) |        |       |                   | Current | Total   | Nonaccrual<br>Financing<br>Receivables | Impaired<br>Financing<br>Receivables |
|----------------------------|---|--------|-------|-------------------|---------|---------|--|--------------------------------------|
|                            | 31-60   | 61-90  | 91+   | Total<br>Past Due |         |         |  |                                      |
| January 26, 2019           |   |        |       |                   |         |         |  |                                      |
| Lease receivables          | \$79  | \$ 34  | \$152 | \$ 265            | \$2,080 | \$2,345 | \$ 3                                   | \$ 3                                 |
| Loan receivables           | 73  | 39     | 235   | 347               | 4,579   | 4,926   | 28                                     | 28                                   |
| Financed service contracts | 74  | 38     | 280   | 392               | 2,006   | 2,398   | 2                                      | 2                                    |
| Total                      | \$226   | \$ 111 | \$667 | \$ 1,004          | \$8,665 | \$9,669 | \$ 33                                  | \$ 33                                |

|                            | DAYS PAST DUE<br>(INCLUDES BILLED AND UNBILLED) |        |       |                   | Current | Total   | Nonaccrual<br>Financing<br>Receivables | Impaired<br>Financing<br>Receivables |
|----------------------------|---|--------|-------|-------------------|---------|---------|--|--------------------------------------|
|                            | 31-60   | 61-90  | 91+   | Total<br>Past Due |         |         |  |                                      |
| July 28, 2018              |   |        |       |                   |         |         |  |                                      |
| Lease receivables          | \$72  | \$ 27  | \$155 | \$ 254            | \$2,293 | \$2,547 | \$ 9                                   | \$ 9                                 |
| Loan receivables           | 104   | 55     | 252   | 411               | 4,588   | 4,999   | 30                                     | 30                                   |
| Financed service contracts | 138   | 78     | 304   | 520               | 1,806   | 2,326   | 3                                      | 3                                    |
| Total                      | \$314   | \$ 160 | \$711 | \$ 1,185          | \$8,687 | \$9,872 | \$ 42                                  | \$ 42                                |

Past due financing receivables are those that are 31 days or more past due according to their contractual payment terms. The data in the preceding tables is presented by contract, and the aging classification of each contract is based on the oldest outstanding receivable, and therefore past due amounts also include unbilled and current receivables within the same contract. The balances of either unbilled or current financing receivables included in the category of 91 days plus past due for financing receivables were \$396 million and \$503 million as of January 26, 2019 and July 28, 2018, respectively.

As of January 26, 2019, we had financing receivables of \$247 million, net of unbilled or current receivables, that were in the category of 91 days plus past due but remained on accrual status as they are well secured and in the process of collection. Such balance was \$182 million as of July 28, 2018.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (c) Allowance for Credit Loss Rollforward

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

| Three months ended January 26, 2019              | CREDIT LOSS ALLOWANCES |                  |                            |       |
|--|------------------------|------------------|----------------------------|-------|
|  | Lease Receivables      | Loan Receivables | Financed Service Contracts | Total |
| Allowance for credit loss as of October 27, 2018 | \$131                  | \$ 60            | \$ 8                       | \$199 |
| Provisions (benefits)                            | (4 )                   | 4                | 1                          | 1     |
| Allowance for credit loss as of January 26, 2019 | \$127                  | \$ 64            | \$ 9                       | \$200 |
| Six months ended January 26, 2019                | CREDIT LOSS ALLOWANCES |                  |                            |       |
|  | Lease Receivables      | Loan Receivables | Financed Service Contracts | Total |
| Allowance for credit loss as of July 28, 2018    | \$135                  | \$ 60            | \$ 10                      | \$205 |
| Provisions (benefits)                            | (7 )                   | 4                | (1 )                       | (4 )  |
| Foreign exchange and other                       | (1 )                   | —                | —                          | (1 )  |
| Allowance for credit loss as of January 26, 2019 | \$127                  | \$ 64            | \$ 9                       | \$200 |
| Three months ended January 27, 2018              | CREDIT LOSS ALLOWANCES |                  |                            |       |
|  | Lease Receivables      | Loan Receivables | Financed Service Contracts | Total |
| Allowance for credit loss as of October 28, 2017 | \$160                  | \$ 106           | \$ 23                      | \$289 |
| Provisions (benefits)                            | 3                      | (13 )            | (10 )                      | (20 ) |
| Foreign exchange and other                       | 2                      | 1                | —                          | 3     |
| Allowance for credit loss as of January 27, 2018 | \$165                  | \$ 94            | \$ 13                      | \$272 |
| Six months ended January 27, 2018                | CREDIT LOSS ALLOWANCES |                  |                            |       |
|  | Lease Receivables      | Loan Receivables | Financed Service Contracts | Total |
| Allowance for credit loss as of July 29, 2017    | \$162                  | \$ 103           | \$ 30                      | \$295 |
| Provisions (benefits)                            | 1                      | (11 )            | (16 )                      | (26 ) |
| Foreign exchange and other                       | 2                      | 2                | (1 )                       | 3     |
| Allowance for credit loss as of January 27, 2018 | \$165                  | \$ 94            | \$ 13                      | \$272 |

We assess the allowance for credit loss related to financing receivables on either an individual or a collective basis.

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

Typically, we also consider receivables with a risk rating of 8 or higher to be impaired and will include them in the individual assessment for allowance. These balances, as of January 26, 2019 and July 28, 2018, are presented under "(b) Credit Quality of Financing Receivables" above.

We evaluate the remainder of our financing receivables portfolio for impairment on a collective basis and record an allowance for credit loss at the portfolio segment level. When evaluating the financing receivables on a collective basis, we use expected default frequency rates published by a major third-party credit-rating agency as well as our own historical loss rate in the event of default, while also systematically giving effect to economic conditions,

concentration of risk, and correlation.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (d) Operating Leases

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

|                                 | January 26, July 28, |        |
|---------------------------------|----------------------|--------|
|                                 | 2019                 | 2018   |
| Operating lease assets          | \$ 529               | \$ 356 |
| Accumulated depreciation (370 ) | (238 )               |        |
| Operating lease assets, net     | \$ 159               | \$ 118 |

Minimum future rentals on noncancelable operating leases as of January 26, 2019 are summarized as follows (in millions):

| Fiscal Year                 | Amount |
|-----------------------------|--------|
| 2019 (remaining six months) | \$ 81  |
| 2020                        | 111    |
| 2021                        | 48     |
| 2022                        | 5      |
| Total                       | \$ 245 |

## 9. Available-for-Sale Debt Investments and Equity Investments

The following table summarizes our available-for-sale debt investments and equity investments (in millions):

|  | January 26, July 28, |           |
|--|----------------------|-----------|
|  | 2019                 | 2018      |
| Available-for-sale debt investments                                      | \$ 30,486            | \$ 37,009 |
| Marketable equity securities   | 62                   | 605       |
| Total investments  | 30,548               | 37,614    |
| Non-marketable equity securities included in other assets <sup>(1)</sup> | 1,133                | 978       |
| Equity method investments included in other assets                       | 115                  | 118       |
| Total  | \$ 31,796            | \$ 38,710 |

<sup>(1)</sup> We held equity interests in certain private equity funds of \$0.6 billion as of January 26, 2019 which are accounted for under the NAV practical expedient following the adoption of ASU 2016-01, Financial Instruments, in the first quarter of fiscal 2019.

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

The following tables summarize our available-for-sale debt investments (in millions):

| January 26, 2019                          | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|----------------|------------------------|-------------------------|------------|
| U.S. government securities                | \$ 3,486       | \$ —                   | \$ (14 )                | \$ 3,472   |
| U.S. government agency securities         | 356            | —                      | (2 )                    | 354        |
| Non-U.S. government and agency securities | 115            | —                      | —                       | 115        |
| Corporate debt securities                 | 25,103         | 16                     | (366 )                  | 24,753     |
| U.S. agency mortgage-backed securities    | 1,475          | 1                      | (42 )                   | 1,434      |
| Commercial paper                          | 243            | —                      | —                       | 243        |
| Certificates of deposit                   | 115            | —                      | —                       | 115        |

Total <sup>(1)</sup> \$ 30,893 \$ 17 \$ (424 ) \$30,486

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

| July 28, 2018                             | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| U.S. government securities                | \$ 7,318          | \$ —                         | \$ (43 )                      | \$7,275       |
| U.S. government agency securities         | 732               | —                            | (5 )                          | 727           |
| Non-U.S. government and agency securities | 209               | —                            | (1 )                          | 208           |
| Corporate debt securities                 | 27,765            | 44                           | (445 )                        | 27,364        |
| U.S. agency mortgage-backed securities    | 1,488             | —                            | (53 )                         | 1,435         |
| Total <sup>(1)</sup>                      | \$ 37,512         | \$ 44                        | \$ (547 )                     | \$37,009      |

<sup>(1)</sup> Net unsettled investment purchases were \$4 million and net unsettled investment sales were \$1.5 billion as of January 26, 2019 and July 28, 2018, respectively and were included in other current assets and other current liabilities. Non-U.S. government and agency securities include agency and corporate debt securities that are guaranteed by non-U.S. governments.

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

|                       | Three Months<br>Ended<br>January 26,<br>2019 |         | Six Months<br>Ended<br>January 26,<br>2018 |         |
|-----------------------|--|---------|--|---------|
| Gross realized gains  | \$1  | \$ 6    | \$3  | \$ 14   |
| Gross realized losses | (6 )   | (102 )  | (14 )                                      | (106 )  |
| Total                 | \$(5)  | \$(96 ) | \$(11)                                     | \$(92 ) |

The following tables present the breakdown of the available-for-sale debt investments with gross unrealized losses and the duration that those losses had been unrealized at January 26, 2019 and July 28, 2018 (in millions):

|   | UNREALIZED LOSSES<br>LESS THAN 12 MONTHS |                               | UNREALIZED LOSSES<br>2 MONTHS OR GREATER |                               | TOTAL         |                               |
|---|--|-------------------------------|--|-------------------------------|---------------|-------------------------------|
|   | Fair Value                               | Gross<br>Unrealized<br>Losses | Fair Value                               | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses |
| January 26, 2019                          |  |                               |  |                               |               |                               |
| U.S. government securities                | \$ 6                                     | \$ —                          | \$ 3,437                                 | \$ (14 )                      | \$3,443       | \$ (14 )                      |
| U.S. government agency securities         | —  | —                             | 344                                      | (2 )                          | 344           | (2 )                          |
| Non-U.S. government and agency securities | —  | —                             | 115                                      | —                             | 115           | —                             |
| Corporate debt securities                 | 5,849                                    | (61 )                         | 15,108                                   | (305 )                        | 20,957        | (366 )                        |
| U.S. agency mortgage-backed securities    | 47                                       | —                             | 1,216                                    | (42 )                         | 1,263         | (42 )                         |
| Total                                     | \$ 5,902                                 | \$ (61 )                      | \$ 20,220                                | \$ (363 )                     | \$26,122      | \$ (424 )                     |

|   | UNREALIZED LOSSES<br>LESS THAN 12 MONTHS |                               | UNREALIZED LOSSES<br>2 MONTHS OR GREATER |                               | TOTAL      |                               |
|---|--|-------------------------------|--|-------------------------------|------------|-------------------------------|
|   | Fair Value                               | Gross<br>Unrealized<br>Losses | Fair Value                               | Gross<br>Unrealized<br>Losses | Fair Value | Gross<br>Unrealized<br>Losses |
| July 28, 2018                             |  |                               |  |                               |            |                               |
| U.S. government securities                | \$ 2,966                                 | \$ (20 )                      | \$ 4,303                                 | \$ (23 )                      | \$7,269    | \$ (43 )                      |
| U.S. government agency securities         | 206                                      | (2 )                          | 521                                      | (3 )                          | 727        | (5 )                          |
| Non-U.S. government and agency securities | 105                                      | (1 )                          | 103                                      | —                             | 208        | (1 )                          |

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|  |           |           |          |           |           |           |
|--|-----------|-----------|----------|-----------|-----------|-----------|
| Corporate debt securities              | 16,990    | (344 )    | 3,511    | (101 )    | 20,501    | (445 )    |
| U.S. agency mortgage-backed securities | 826       | (24 )     | 581      | (29 )     | 1,407     | (53 )     |
| Total                                  | \$ 21,093 | \$ (391 ) | \$ 9,019 | \$ (156 ) | \$ 30,112 | \$ (547 ) |

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

There were no impairment charges related to our available-for-sale debt investments for the second quarter and first six months of fiscal 2019, and for the corresponding periods of fiscal 2018, respectively. For available-for-sale debt investments that were in an unrealized loss position as of January 26, 2019, we have determined that no other-than-temporary impairments were required to be recognized.

The following table summarizes the maturities of our available-for-sale debt investments as of January 26, 2019 (in millions):

|  | Amortized<br>Cost | Fair Value |
|--|-------------------|------------|
| Within 1 year                                      | \$ 10,131         | \$ 10,104  |
| After 1 year through 5 years                       | 17,704            | 17,426     |
| After 5 years through 10 years                     | 1,568             | 1,507      |
| After 10 years                                     | 15                | 15         |
| Mortgage-backed securities with no single maturity | 1,475             | 1,434      |
| Total  | \$ 30,893         | \$ 30,486  |

Actual maturities may differ from the contractual maturities because borrowers may have the right to call or prepay certain obligations.

## (b) Summary of Equity Investments

We recorded adjustments to the carrying value of our non-marketable equity securities measured using the measurement alternative during the second quarter and first six months of fiscal 2019 as follows (in millions):

|   | Three<br>Months<br>Ended<br>January 26,<br>2019 | Six<br>Months<br>Ended<br>January 26,<br>2019 |
|---|---|---|
| Adjustments to non-marketable equity securities measured using the measurement alternative: |   |   |
| Upward adjustments  | \$ 14   | \$ 24   |
| Downward adjustments, including impairments   | (2 )  | (18 )   |
| Net upward adjustments  | \$ 12   | \$ 6  |

Gains and losses recognized on our marketable and non-marketable equity securities for the second quarter and first six months of fiscal 2019 are summarized below (in millions):

|  | Three<br>Months<br>Ended<br>January 26,<br>2019 | Six<br>Months<br>Ended<br>January 26,<br>2019 |
|--|---|---|
| Net gains and losses recognized during the period on equity investments  | \$ 67   | \$ 75   |
| Less: Net gains and losses recognized on equity investments sold   | 5   | (7 )  |
| Unrealized gains and losses recognized during reporting period on equity securities still held at the reporting date | \$ 72   | \$ 68   |

## (c) Securities Lending

We periodically engage in securities lending activities with certain of our available-for-sale debt investments. These transactions are accounted for as a secured lending of the securities, and the securities are typically loaned only on an overnight basis. The average daily balance of securities lending was \$1.2 billion and \$0.4 billion for the first six months of fiscal 2019 and fiscal 2018, respectively. We require collateral equal to at least 102% of the fair market value of the loaned security and that the collateral be in the form of cash or liquid, high-quality assets. We engage in

these secured lending transactions only with highly creditworthy counterparties, and the associated portfolio custodian has agreed to indemnify us against collateral losses. We did not experience any losses in connection with the secured lending of securities during the periods presented. As of January 26, 2019 and July 28, 2018, we had no outstanding securities lending transactions.

(d) Variable Interest Entities

In the ordinary course of business, we have investments in privately held companies and provide financing to certain customers. These privately held companies and customers may be considered to be variable interest entities. We evaluate on an ongoing basis our investments in these privately held companies and our customer financings, and have determined that as of January 26, 2019,

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

except as disclosed in Note 1, there were no significant variable interest entities required to be consolidated in our Consolidated Financial Statements.

As of January 26, 2019, the carrying value of investments in privately held companies was \$1.25 billion, of which \$670 million of such investments are considered to be in variable interest entities which are unconsolidated. In addition, we have additional funding commitments of \$192 million related to these investments, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The carrying value of these investments and the additional funding commitments collectively represent our maximum exposure related to these variable interest entities.

#### 10. Fair Value

Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be either recorded or disclosed at fair value, we consider the principal or most advantageous market in which we would transact, and we also consider assumptions that market participants would use when pricing the asset or liability.

##### (a) Fair Value Hierarchy

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

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

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

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

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

Assets and liabilities measured at fair value on a recurring basis were as follows (in millions):

|   | JANUARY 26, 2019 |          |                  | JULY 28, 2018 |          |                  |
|---|------------------|----------|------------------|---------------|----------|------------------|
|   | FAIR VALUE       |          |                  | FAIR VALUE    |          |                  |
|   | MEASUREMENTS     |          |                  | MEASUREMENTS  |          |                  |
|   | Level 1          | Level 2  | Total<br>Balance | Level 1       | Level 2  | Total<br>Balance |
| Assets:                                   |                  |          |                  |               |          |                  |
| Cash equivalents:                         |                  |          |                  |               |          |                  |
| Money market funds                        | \$7,888          | \$—      | \$7,888          | \$6,890       | \$—      | \$6,890          |
| Commercial paper                          | —                | 99       | 99               | —             | —        | —                |
| Certificates of deposit                   | —                | 25       | 25               | —             | —        | —                |
| Available-for-sale debt investments:      |                  |          |                  |               |          |                  |
| U.S. government securities                | —                | 3,472    | 3,472            | —             | 7,275    | 7,275            |
| U.S. government agency securities         | —                | 354      | 354              | —             | 727      | 727              |
| Non-U.S. government and agency securities | —                | 115      | 115              | —             | 208      | 208              |
| Corporate debt securities                 | —                | 24,753   | 24,753           | —             | 27,364   | 27,364           |
| U.S. agency mortgage-backed securities    | —                | 1,434    | 1,434            | —             | 1,435    | 1,435            |
| Commercial paper                          | —                | 243      | 243              | —             | —        | —                |
| Certificates of deposit                   | —                | 115      | 115              | —             | —        | —                |
| Equity investments:                       |                  |          |                  |               |          |                  |
| Marketable equity securities              | 62               | —        | 62               | 605           | —        | 605              |
| Derivative assets                         | —                | 23       | 23               | —             | 2        | 2                |
| Total                                     | \$7,950          | \$30,633 | \$38,583         | \$7,495       | \$37,011 | \$44,506         |
| Liabilities:                              |                  |          |                  |               |          |                  |
| Derivative liabilities                    | \$—              | \$40     | \$40             | \$—           | \$74     | \$74             |
| Total                                     | \$—              | \$40     | \$40             | \$—           | \$74     | \$74             |

Level 1 marketable equity securities are determined by using quoted prices in active markets for identical assets.

Level 2 available-for-sale debt investments are priced using quoted market prices for similar instruments or nonbinding market prices that are corroborated by observable market data. We use inputs such as actual trade data, benchmark yields, broker/dealer quotes, and other similar data, which are obtained from quoted market prices, independent pricing vendors, or other sources, to determine the ultimate fair value of these assets and liabilities. We use such pricing data as the primary input to make our assessments and determinations as to the ultimate valuation of our investment portfolio and have not made, during the periods presented, any material adjustments to such inputs. We are ultimately responsible for the financial statements and underlying estimates. Our derivative instruments are primarily classified as Level 2, as they are not actively traded and are valued using pricing models that use observable market inputs. We did not have any transfers between Level 1 and Level 2 fair value measurements during the periods presented.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

The following table presents gains and losses on assets that were measured at fair value on a nonrecurring basis (in millions):

|  | TOTAL<br>GAINS<br>(LOSSES)<br>FOR THE<br>THREE<br>MONTHS<br>ENDED<br>January<br>26, 27,<br>2019 | TOTAL<br>GAINS<br>(LOSSES)<br>FOR THE<br>SIX<br>MONTHS<br>ENDED<br>January<br>26, 27,<br>2018 |
|--|---|---|
| Non-marketable equity securities                   | \$ 12   | \$ (18 )  |
| Property held for sale—land and buildings          | —   | 20  |
| Total gains (losses) for nonrecurring measurements | \$ 12   | \$ 2  |

These assets were measured at fair value due to events or circumstances we identified as having significant impact on their fair value during the respective periods. The carrying value of our non-marketable equity securities recorded to fair value on a non-recurring basis is adjusted for observable transactions for identical or similar investments of the same issuer or impairment. These securities are classified as Level 3 in the fair value hierarchy because we estimate the value based on valuation methods using the observable transaction price at the transaction date and other unobservable inputs such as volatility, rights, and obligations of the securities we hold.

The fair value of property held for sale was measured with the assistance of third-party valuation models, which used discounted cash flow techniques as part of their analysis. The fair value measurement was categorized as Level 3, as significant unobservable inputs were used in the valuation report. The impairment charge as a result of the valuations, which represented the difference between the fair value less cost to sell and the carrying amount of the assets held for sale, was included in restructuring and other charges. The remaining carrying value of property held for sale that was impaired was zero as of January 27, 2018.

## (d) Other Fair Value Disclosures

The fair value of short-term loan receivables and financed service contracts approximates their carrying value due to their short duration. The aggregate carrying value of long-term loan receivables and financed service contracts as of January 26, 2019 and July 28, 2018 was \$3.3 billion and \$3.6 billion, respectively. The estimated fair value of long-term loan receivables and financed service contracts approximates their carrying value. We use significant unobservable inputs in determining discounted cash flows to estimate the fair value of our long-term loan receivables and financed service contracts, and therefore they are categorized as Level 3.

As of January 26, 2019, the estimated fair value of our short-term debt approximates its carrying value due to the short maturities. As of January 26, 2019, the fair value of our senior notes and other long-term debt was \$26.5 billion with a carrying amount of \$25.6 billion. This compares to a fair value of \$26.4 billion and a carrying amount of \$25.6 billion as of July 28, 2018. The fair value of the senior notes and other long-term debt was determined based on observable market prices in a less active market and was categorized as Level 2 in the fair value hierarchy.

## 11. Borrowings

## (a) Short-Term Debt

The following table summarizes our short-term debt (in millions, except percentages):

January 26, 2019 July 28, 2018

|                                   | Amount  | Effective<br>Rate |  | Amount  | Effective<br>Rate |
|-----------------------------------|---------|-------------------|--|---------|-------------------|
| Current portion of long-term debt | \$9,737 | 3.62 %            |  | \$5,238 | 3.46 %            |

We repaid our senior notes due on February 15, 2019 for an aggregate principal amount of \$2.0 billion upon maturity.

We have a short-term debt financing program of up to \$10.0 billion through the issuance of commercial paper notes.

We use the proceeds from the issuance of commercial paper notes for general corporate purposes. We had no commercial paper notes outstanding as of January 26, 2019 and July 28, 2018. As of February 18, 2019, we had approximately \$2 billion of commercial paper notes outstanding.

The effective rates for the short- and long-term debt include the interest on the notes, the accretion of the discount, the issuance costs, and, if applicable, adjustments related to hedging.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (b) Long-Term Debt

The following table summarizes our long-term debt (in millions, except percentages):

|   | Maturity Date      | January 26, 2019 |                | July 28, 2018 |                |
|---|--------------------|------------------|----------------|---------------|----------------|
|   |                    | Amount           | Effective Rate | Amount        | Effective Rate |
| Senior notes:                           |                    |                  |                |               |                |
| Floating-rate notes:                    |                    |                  |                |               |                |
| Three-month LIBOR plus 0.50%            | March 1, 2019      | \$ 500           | 3.30%          | \$ 500        | 2.86%          |
| Three-month LIBOR plus 0.34%            | September 20, 2019 | 500              | 3.17%          | 500           | 2.71%          |
| Fixed-rate notes:                       |                    |                  |                |               |                |
| 4.95%                                   | February 15, 2019  | 2,000            | 5.28%          | 2,000         | 5.17%          |
| 1.60%                                   | February 28, 2019  | 1,000            | 1.67%          | 1,000         | 1.67%          |
| 2.125%                                  | March 1, 2019      | 1,750            | 3.13%          | 1,750         | 2.71%          |
| 1.40%                                   | September 20, 2019 | 1,500            | 1.48%          | 1,500         | 1.48%          |
| 4.45%                                   | January 15, 2020   | 2,500            | 4.87%          | 2,500         | 4.52%          |
| 2.45%                                   | June 15, 2020      | 1,500            | 2.54%          | 1,500         | 2.54%          |
| 2.20%                                   | February 28, 2021  | 2,500            | 2.30%          | 2,500         | 2.30%          |
| 2.90%                                   | March 4, 2021      | 500              | 3.28%          | 500           | 2.86%          |
| 1.85%                                   | September 20, 2021 | 2,000            | 1.90%          | 2,000         | 1.90%          |
| 3.00%                                   | June 15, 2022      | 500              | 3.55%          | 500           | 3.11%          |
| 2.60%                                   | February 28, 2023  | 500              | 2.68%          | 500           | 2.68%          |
| 2.20%                                   | September 20, 2023 | 750              | 2.27%          | 750           | 2.27%          |
| 3.625%                                  | March 4, 2024      | 1,000            | 3.40%          | 1,000         | 2.98%          |
| 3.50%                                   | June 15, 2025      | 500              | 3.71%          | 500           | 3.27%          |
| 2.95%                                   | February 28, 2026  | 750              | 3.01%          | 750           | 3.01%          |
| 2.50%                                   | September 20, 2026 | 1,500            | 2.55%          | 1,500         | 2.55%          |
| 5.90%                                   | February 15, 2039  | 2,000            | 6.11%          | 2,000         | 6.11%          |
| 5.50%                                   | January 15, 2040   | 2,000            | 5.67%          | 2,000         | 5.67%          |
| Total                                   |                    | 25,750           |                | 25,750        |                |
| Unaccreted discount/issuance costs      |                    | (107 )           |                | (116 )        |                |
| Hedge accounting fair value adjustments |                    | (13 )            |                | (65 )         |                |
| Total                                   |                    | \$25,630         |                | \$25,569      |                |

## Reported as:

|                                   |          |          |
|-----------------------------------|----------|----------|
| Current portion of long-term debt | \$9,737  | \$5,238  |
| Long-term debt                    | 15,893   | 20,331   |
| Total                             | \$25,630 | \$25,569 |

We entered into interest rate swaps in prior periods with an aggregate notional amount of \$6.75 billion designated as fair value hedges of certain of our fixed-rate senior notes. These swaps convert the fixed interest rates of the fixed-rate notes to floating interest rates based on the London InterBank Offered Rate ("LIBOR"). The gains and losses related to changes in the fair value of the interest rate swaps substantially offset changes in the fair value of the hedged portion of the underlying debt that are attributable to the changes in market interest rates. For additional information, see Note 12.

Interest is payable semiannually on each class of the senior fixed-rate notes and payable quarterly on the floating-rate notes. Each of the senior fixed-rate notes is redeemable by us at any time, subject to a make-whole premium. The senior notes rank at par with the commercial paper notes that may be issued in the future pursuant to our short-term

debt financing program, as discussed above under “(a) Short-Term Debt.” As of January 26, 2019, we were in compliance with all debt covenants.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of January 26, 2019, future principal payments for long-term debt, including the current portion, are summarized as follows (in millions):

| Fiscal Year                 | Amount   |
|-----------------------------|----------|
| 2019 (remaining six months) | \$5,250  |
| 2020                        | 6,000    |
| 2021                        | 3,000    |
| 2022                        | 2,500    |
| 2023                        | 500      |
| Thereafter                  | 8,500    |
| Total                       | \$25,750 |

(c) Credit Facility

On May 15, 2015, we entered into a credit agreement with certain institutional lenders that provides for a \$3.0 billion unsecured revolving credit facility that is scheduled to expire on May 15, 2020. Any advances under the credit agreement will accrue interest at rates that are equal to, based on certain conditions, either (i) the highest of (a) the Federal Funds rate plus 0.50%, (b) Bank of America's "prime rate" as announced from time to time, or (c) LIBOR, or a comparable or successor rate that is approved by the Administrative Agent ("Eurocurrency Rate"), for an interest period of one-month plus 1.00%, or (ii) the Eurocurrency Rate, plus a margin that is based on our senior debt credit ratings as published by Standard & Poor's Financial Services, LLC and Moody's Investors Service, Inc., provided that in no event will the Eurocurrency Rate be less than zero. We may also, upon the agreement of either the then-existing lenders or additional lenders not currently parties to the agreement, increase the commitments under the credit facility by up to an additional \$2.0 billion and/or extend the expiration date of the credit facility up to May 15, 2022.

This credit agreement requires that we comply with certain covenants, including that we maintain an interest coverage ratio as defined in the agreement. As of January 26, 2019, we were in compliance with the required interest coverage ratio and the other covenants, and we had not borrowed any funds under this credit facility.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 12. Derivative Instruments

## (a) Summary of Derivative Instruments

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

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

|  | DERIVATIVE ASSETS       |                  |                  | DERIVATIVE LIABILITIES      |                  |                  |
|--|-------------------------|------------------|------------------|-----------------------------|------------------|------------------|
|  | Balance Sheet Line Item | January 26, 2019 | January 27, 2018 | Balance Sheet Line Item     | January 26, 2019 | January 27, 2018 |
| Derivatives designated as hedging instruments:     |                         |                  |                  |                             |                  |                  |
| Foreign currency derivatives                       | Other current assets    | \$ 1             | \$ 1             | Other current liabilities   | \$ 8             | \$ —             |
| Interest rate derivatives                          | Other current assets    | —                | —                | Other current liabilities   | 13               | 10               |
| Interest rate derivatives                          | Other assets            | 12               | —                | Other long-term liabilities | 15               | 62               |
| Total  |                         | 13               | 1                |                             | 36               | 72               |
| Derivatives not designated as hedging instruments: |                         |                  |                  |                             |                  |                  |
| Foreign currency derivatives                       | Other current assets    | 10               | 1                | Other current liabilities   | 4                | 2                |
| Total  |                         | 10               | 1                |                             | 4                | 2                |
| Total  |                         | \$ 23            | \$ 2             |                             | \$ 40            | \$ 74            |

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

| GAINS (LOSSES) RECOGNIZED<br>IN OCI ON DERIVATIVES FOR THE<br>THREE MONTHS ENDED (EFFECTIVE PORTION) | January 26, 2019 | January 27, 2018 | Line Item in<br>Statements of<br>Operations | GAINS (LOSSES) RECLASSIFIED<br>FROM<br>AOCI INTO INCOME FOR THE<br>THREE MONTHS ENDED (EFFECTIVE<br>PORTION) |                  |
|--|------------------|------------------|---|--|------------------|
|  |                  |                  |   | January 26, 2019   | January 27, 2018 |
| Derivatives designated as cash flow hedging instruments:   |                  |                  |   |  |                  |
| Foreign currency derivatives   | \$ (6 )          | \$ 30            | Revenue — product                           | \$ 1   | \$ —             |
|  |                  |                  | Revenue — service                           | 1  | —                |
|  |                  |                  | Cost of sales — service                     | (1 )   | 4                |
|  |                  |                  | Operating expenses                          | —  | 14               |
| Total  | \$ (6 )          | \$ 30            |   | \$ 1   | \$ 18            |

Derivatives designated as net investment hedging  
instruments:

|                              |         |          |                             |      |      |
|------------------------------|---------|----------|-----------------------------|------|------|
| Foreign currency derivatives | \$ (1 ) | \$ (12 ) | Other income (loss),<br>net | \$ — | \$ — |
|------------------------------|---------|----------|-----------------------------|------|------|

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

| GAINS (LOSSES) RECOGNIZED<br>IN OCI ON DERIVATIVES FOR THE<br>SIX MONTHS ENDED (EFFECTIVE PORTION) | January 26,<br>2019 | January 27,<br>2018 | Line Item in<br>Statements of<br>Operations | GAINS (LOSSES) RECLASSIFIED<br>FROM<br>AOCI INTO INCOME FOR THE<br>SIX MONTHS ENDED (EFFECTIVE<br>PORTION) |                     |
|--|---------------------|---------------------|---|--|---------------------|
|  |                     |                     |   | January 26,<br>2019  | January 27,<br>2018 |
| Derivatives designated as cash flow hedging<br>instruments:  |                     |                     |   |  |                     |
| Foreign currency derivatives   | \$ (10 )            | \$ 38               | Revenue — product                           | \$ 1   | \$ —                |
|  |                     |                     | Revenue — service                           | 2  | —                   |
|  |                     |                     | Cost of sales — service                     | (1 )   | 7                   |
|  |                     |                     | Operating expenses                          | (1 )   | 24                  |
| Total  | \$ (10 )            | \$ 38               |   | \$ 1   | \$ 31               |

Derivatives designated as net investment hedging  
instruments:

|                              |      |          |                             |      |      |
|------------------------------|------|----------|-----------------------------|------|------|
| Foreign currency derivatives | \$ 3 | \$ (17 ) | Other income (loss),<br>net | \$ — | \$ — |
|------------------------------|------|----------|-----------------------------|------|------|

As of January 26, 2019, we estimate that approximately \$9 million of net derivative losses related to our cash flow hedges included in accumulated other comprehensive income (AOCI) will be reclassified into earnings within the next 12 months when the underlying hedged item impacts earnings.

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

| Derivatives Designated as Fair Value Hedging<br>Instruments | Line Item in Statements of<br>Operations | GAINS<br>(LOSSES) ON<br>DERIVATIVE<br>INSTRUMENTS<br>FOR THE<br>THREE<br>MONTHS<br>ENDED |                     | GAINS<br>(LOSSES)<br>RELATED TO<br>HEDGED<br>ITEMS FOR<br>THE<br>THREE<br>MONTHS<br>ENDED |                     |
|---|--|--|---------------------|---|---------------------|
|   |  | January 26,<br>2019  | January 27,<br>2018 | January 26,<br>2019   | January 27,<br>2018 |
| Interest rate derivatives                                   | Interest expense                         | \$ 64  | \$ (63 )            | \$ (61)   | \$ 63               |
| Equity derivatives  | Other income (loss), net                 | —  | (35 )               | —   | 35                  |
| Total   |  | \$ 64  | \$ (98 )            | \$ (61)   | \$ 98               |

| Derivatives Designated as Fair Value Hedging Instruments | Line Item in Statements of Operations | SIX MONTHS ENDED |                  | SIX MONTHS ENDED |                  |
|--|---------------------------------------|------------------|------------------|------------------|------------------|
|  |                                       | January 26, 2019 | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Interest rate derivatives                                | Interest expense                      | \$ 55            | \$ (109 )        | \$ (52)          | \$ 109           |
| Equity derivatives                                       | Other income (loss), net              | —                | (49 )            | —                | 49               |
| Total  |                                       | \$ 55            | \$ (158 )        | \$ (52)          | \$ 158           |

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

| Derivatives Not Designated as Hedging Instruments | Line Item in Statements of Operations | GAINS (LOSSES) FOR THE THREE MONTHS ENDED |                  | GAINS (LOSSES) FOR THE SIX MONTHS ENDED |                  |
|---|---------------------------------------|---|------------------|---|------------------|
|   |                                       | January 26, 2019                          | January 27, 2018 | January 26, 2019                        | January 27, 2018 |
| Foreign currency derivatives                      | Other income (loss), net              | \$ (1 )                                   | \$ 66            | \$ (28 )                                | \$ 73            |
| Total return swaps—deferred compensation          | Operating expenses                    | (9 )                                      | 39               | (33 )                                   | 54               |
|   | Cost of sales — product               | —   | 1                | (1 )                                    | 1                |
|   | Cost of sales — service               | (1 )                                      | 1                | (2 )                                    | 2                |
|   | Other income (loss), net              | (4 )                                      | (3 )             | (8 )                                    | (5 )             |
| Equity derivatives                                | Other income (loss), net              | —   | 2                | 1                                       | 3                |
| Total   |                                       | \$ (15 )                                  | \$ 106           | \$ (71 )                                | \$ 128           |

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CISCO SYSTEMS, INC.

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(Unaudited)

The notional amounts of our outstanding derivatives are summarized as follows (in millions):

|  | January 26, July 28,<br>2019 2018 |          |
|--|-----------------------------------|----------|
| Derivatives designated as hedging instruments:     |                                   |          |
| Foreign currency derivatives—cash flow hedges      | \$ 890                            | \$147    |
| Interest rate derivatives                          | 6,750                             | 6,750    |
| Net investment hedging instruments                 | 299                               | 250      |
| Derivatives not designated as hedging instruments: |                                   |          |
| Foreign currency derivatives                       | 2,643                             | 2,298    |
| Total return swaps—deferred compensation           | 536                               | 566      |
| Total  | \$ 11,118                         | \$10,011 |

**(b) Offsetting of Derivative Instruments**

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

January 26, 2019

|                         | GROSS AMOUNTS<br>OFFSET IN THE<br>CONSOLIDATED<br>BALANCE SHEETS |                             |                  | GROSS AMOUNTS NOT<br>OFFSET IN THE<br>CONSOLIDATED<br>BALANCE SHEETS<br>BUT WITH LEGAL<br>RIGHTS TO OFFSET |               |  |
|-------------------------|--|-----------------------------|------------------|--|---------------|--|
|                         | Gross<br>Amounts<br>Recognized                                   | Net<br>Amounts<br>Presented | Gross<br>Amounts | Cash<br>Collateral   | Net<br>Amount |  |
| Derivatives assets      | \$23   | \$ —                        | \$ (12)          | \$ (11)  | \$ —          |  |
| Derivatives liabilities | \$40   | \$ —                        | \$ (12)          | \$ (19)  | \$ 9          |  |

July 28, 2018

|                         | GROSS AMOUNTS<br>OFFSET IN THE<br>CONSOLIDATED<br>BALANCE SHEETS |                             |                  | GROSS AMOUNTS NOT<br>OFFSET IN THE<br>CONSOLIDATED<br>BALANCE SHEETS<br>BUT WITH LEGAL<br>RIGHTS TO OFFSET |               |  |
|-------------------------|--|-----------------------------|------------------|--|---------------|--|
|                         | Gross<br>Amounts<br>Recognized                                   | Net<br>Amounts<br>Presented | Gross<br>Amounts | Cash<br>Collateral   | Net<br>Amount |  |
| Derivatives assets      | \$2  | \$ —                        | \$ (2)           | \$ —   | \$ —          |  |
| Derivatives liabilities | \$74   | \$ —                        | \$ (2)           | \$ (53)  | \$ 19         |  |

**(c) Foreign Currency Exchange Risk**

We conduct business globally in numerous currencies. Therefore, we are exposed to adverse movements in foreign currency exchange rates. To limit the exposure related to foreign currency changes, we enter into foreign currency

contracts. We do not enter into such contracts for speculative purposes.

We hedge forecasted foreign currency transactions related to certain revenues, operating expenses and service cost of sales with currency options and forward contracts. These currency options and forward contracts, designated as cash flow hedges, generally have maturities of less than 24 months. We assess effectiveness based on changes in total fair value of the derivatives. The effective portion of the derivative instrument's gain or loss is initially reported as a component of AOCI and subsequently reclassified into earnings when the hedged exposure affects earnings. The ineffective portion, if any, of the gain or loss is reported in earnings immediately. During the periods presented, we did not discontinue any cash flow hedges for which it was probable that a forecasted transaction would not occur.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

We hedge certain net investments in our foreign operations with forward contracts to reduce the effects of foreign currency fluctuations on our net investment in those foreign subsidiaries. These derivative instruments generally have maturities of up to six months.

(d) Interest Rate Risk

**Interest Rate Derivatives, Investments** Our primary objective for holding available-for-sale debt investments is to achieve an appropriate investment return consistent with preserving principal and managing risk. To realize these objectives, we may utilize interest rate swaps or other derivatives designated as fair value or cash flow hedges. As of January 26, 2019 and July 28, 2018, we did not have any outstanding interest rate derivatives related to our available-for-sale debt investments.

**Interest Rate Derivatives Designated as Fair Value Hedges, Long-Term Debt** In the first six months of fiscal 2019, we did not enter into any interest rate swaps. In prior fiscal years, we entered into interest rate swaps designated as fair value hedges related to fixed-rate senior notes that are due in fiscal 2019 through 2025. Under these interest rate swaps, we receive fixed-rate interest payments and make interest payments based on LIBOR plus a fixed number of basis points. The effect of such swaps is to convert the fixed interest rates of the senior fixed-rate notes to floating interest rates based on LIBOR. The gains and losses related to changes in the fair value of the interest rate swaps are included in interest expense and substantially offset changes in the fair value of the hedged portion of the underlying debt that are attributable to the changes in market interest rates. The fair value of the interest rate swaps was reflected in other assets and other current and long-term liabilities.

(e) Equity Price Risk

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

We are also exposed to variability in compensation charges related to certain deferred compensation obligations to employees. Although not designated as accounting hedges, we utilize derivatives such as total return swaps to economically hedge this exposure.

(f) Hedge Effectiveness

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

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 13. Commitments and Contingencies

## (a) Operating Leases

We lease office space in many U.S. locations. Outside the United States, larger leased sites include sites in Australia, Belgium, Canada, China, Germany, India, Japan, Mexico, Poland and the United Kingdom. We also lease equipment and vehicles. Future minimum lease payments under all noncancelable operating leases with an initial term in excess of one year as of January 26, 2019 are as follows (in millions):

| Fiscal Year                 | Amount   |
|-----------------------------|----------|
| 2019 (remaining six months) | \$ 214   |
| 2020                        | 331      |
| 2021                        | 233      |
| 2022                        | 163      |
| 2023                        | 106      |
| Thereafter                  | 117      |
| Total                       | \$ 1,164 |

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

We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or establish the parameters defining our requirements. A significant portion of our reported purchase commitments arising from these agreements consists of firm, noncancelable, and unconditional commitments. Certain of these purchase commitments with contract manufacturers and suppliers relate to arrangements to secure long-term pricing for certain product components for multi-year periods. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed.

The following table summarizes our purchase commitments with contract manufacturers and suppliers (in millions):

| Commitments by Period | January 26, July 28, |          |
|-----------------------|----------------------|----------|
|                       | 2019                 | 2018     |
| Less than 1 year      | \$ 5,366             | \$ 5,407 |
| 1 to 3 years          | 731                  | 710      |
| 3 to 5 years          | 180                  | 360      |
| Total                 | \$ 6,277             | \$ 6,477 |

We record a liability for firm, noncancelable, and unconditional purchase commitments for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory. As of January 26, 2019 and July 28, 2018, the liability for these purchase commitments was \$148 million and \$159 million, respectively, and was included in other current liabilities.

## (c) Other Commitments

In connection with our acquisitions, we have agreed to pay certain additional amounts contingent upon the achievement of certain agreed-upon technology, development, product, or other milestones or upon the continued employment with Cisco of certain employees of the acquired entities.

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

|  | Three Months     |                  | Six Months       |                  |
|--|------------------|------------------|------------------|------------------|
|  | Ended            | Ended            | Ended            | Ended            |
|  | January 26, 2019 | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Compensation expense related to acquisitions | \$ 66            | \$ 46            | \$ 175           | \$ 88            |

As of January 26, 2019, we estimated that future cash compensation expense of up to \$528 million may be required to be recognized pursuant to the applicable business combination agreements.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

We also have certain funding commitments, primarily related to our non-marketable equity and other investments, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The funding commitments were \$357 million and \$223 million as of January 26, 2019 and July 28, 2018, respectively.

## (d) Product Warranties

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

|   | Six Months Ended |               |
|---|------------------|---------------|
|   | January 26, 2019 | July 28, 2018 |
| Balance at beginning of period          | \$359            | \$407         |
| Provisions for warranties issued        | 297              | 287           |
| Adjustments for pre-existing warranties | (5 )             | (21 )         |
| Settlements                             | (300 )           | (292 )        |
| Acquisitions and divestitures           | (2 )             | —             |
| Balance at end of period                | \$349            | \$381         |

We accrue for warranty costs as part of our cost of sales based on associated material product costs, labor costs for technical support staff, and associated overhead. Our products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products we provide a limited lifetime warranty.

## (e) Financing and Other Guarantees

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

**Channel Partner Financing Guarantees** We facilitate arrangements for third-party financing extended to channel partners, consisting of revolving short-term financing, generally with payment terms ranging from 60 to 90 days. These financing arrangements facilitate the working capital requirements of the channel partners, and, in some cases, we guarantee a portion of these arrangements. The volume of channel partner financing was \$7.3 billion and \$6.9 billion for the second quarter of fiscal 2019 and fiscal 2018, respectively, and was \$14.5 billion and \$13.6 billion for the first six months of fiscal 2019 and fiscal 2018, respectively. The balance of the channel partner financing subject to guarantees was \$1.3 billion and \$1.0 billion as of January 26, 2019 and July 28, 2018, respectively.

**End-User Financing Guarantees** We also provide financing guarantees for third-party financing arrangements extended to end-user customers related to leases and loans, which typically have terms of up to three years. The volume of financing provided by third parties for leases and loans as to which we had provided guarantees was \$6 million and \$12 million for the second quarter of fiscal 2019 and fiscal 2018, respectively, and was \$9 million and \$26 million for the first six months of fiscal 2019 and fiscal 2018, respectively.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**Financing Guarantee Summary** The aggregate amounts of financing guarantees outstanding at January 26, 2019 and July 28, 2018, representing the total maximum potential future payments under financing arrangements with third parties along with the related deferred revenue, are summarized in the following table (in millions):

|  | January 26,<br>2019 | July 28,<br>2018 |
|--|---------------------|------------------|
| Maximum potential future payments relating to financing guarantees:                                    |                     |                  |
| Channel partner  | \$ 338              | \$ 277           |
| End user   | 25                  | 31               |
| Total  | \$ 363              | \$ 308           |
| Deferred revenue associated with financing guarantees:   |                     |                  |
| Channel partner  | \$ (67 )            | \$ (94 )         |
| End user   | (19 )               | (28 )            |
| Total  | \$ (86 )            | \$ (122 )        |
| Maximum potential future payments relating to financing guarantees, net of associated deferred revenue | \$ 277              | \$ 186           |

**Other Guarantees** Our other guarantee arrangements as of January 26, 2019 and July 28, 2018 that were subject to recognition and disclosure requirements were not material.

**(f) Indemnifications**

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

We have been asked to indemnify Time Warner Cable (“TWC”) for patent infringement claims asserted against it by Sprint Communications Company, L.P. (“Sprint”) in federal court in Kansas. Sprint alleges that TWC infringed certain Sprint patents by offering VoIP telephone services utilizing products provided by us generally in combination with those of other manufacturers. Sprint seeks monetary damages. Following a trial on March 3, 2017, a jury in Kansas found that TWC willfully infringed five Sprint patents and awarded Sprint \$139.8 million in damages. On March 14, 2017, the Kansas court declined Sprint's request for enhanced damages and entered judgment in favor of Sprint for \$139.8 million plus 1.06% in post-judgment interest. On May 30, 2017, the Court awarded Sprint \$20.3 million in pre-judgment interest and denied TWC's post-trial motions. TWC appealed to the U.S. Court of Appeals for the Federal Circuit, and, on November 30, 2018, a panel of the court affirmed the judgment. TWC filed a petition for rehearing en banc on January 29, 2019. Due to the uncertainty surrounding the litigation process, we are unable to reasonably estimate the ultimate outcome of the TWC litigation at this time. Should Sprint prevail in litigation, or TWC agree to a settlement, we, in accordance with our agreements, may have an obligation to indemnify TWC. At this time, we do not anticipate that our obligations regarding the final outcome would be material.

During the first six months of fiscal 2018, we recorded legal and indemnification settlement charges of \$127 million to product cost of sales related to prior indemnification matters resolved in fiscal 2018.

In addition, we have entered into indemnification agreements with our officers and directors, and our Amended and Restated Bylaws contain similar indemnification obligations to our agents.

It is not possible to determine the maximum potential amount under these indemnification agreements due to our limited history with prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by us under these agreements have not had a material effect on our operating results, financial position, or cash flows.



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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(g) Legal Proceedings

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

The asserted claims by Brazilian federal tax authorities that remain are for calendar years 2003 through 2007, and the asserted claims by the tax authorities from the state of Sao Paulo are for calendar years 2005 through 2007. The total asserted claims by Brazilian state and federal tax authorities aggregate to \$215 million for the alleged evasion of import and other taxes, \$1.4 billion for interest, and \$1.0 billion for various penalties, all determined using an exchange rate as of January 26, 2019. We have completed a thorough review of the matters and believe the asserted claims against our Brazilian subsidiary are without merit, and we are defending the claims vigorously. While we believe there is no legal basis for the alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil and the nature of the claims asserting joint liability with the importer, we are unable to determine the likelihood of an unfavorable outcome against our Brazilian subsidiary and are unable to reasonably estimate a range of loss, if any. We do not expect a final judicial determination for several years.

**SRI International** On September 4, 2013, SRI International, Inc. (“SRI”) asserted patent infringement claims against us in the U.S. District Court for the District of Delaware, accusing our products and services in the area of network intrusion detection of infringing two U.S. patents. SRI sought monetary damages of at least a reasonable royalty and enhanced damages. The trial on these claims began on May 2, 2016 and, on May 12, 2016, the jury returned a verdict finding willful infringement of the asserted patents. The jury awarded SRI damages of \$23.7 million. On May 25, 2017, the Court awarded SRI enhanced damages and attorneys’ fees, entered judgment in the new amount of \$57.0 million, and ordered an ongoing royalty of 3.5% through the expiration of the patents in 2018. We have appealed to the United States Court of Appeals for the Federal Circuit on various grounds. We believe we have strong arguments to overturn the jury verdict and/or reduce the damages award. While the ultimate outcome of the case may still result in a loss, we do not expect it to be material.

**Straight Path** On September 24, 2014, Straight Path IP Group, Inc. (“Straight Path”) asserted patent infringement claims against us in the U.S. District Court for the Northern District of California, accusing our 9971 IP Phone, Unified Communications Manager working in conjunction with 9971 IP Phones, and Video Communication Server products of infringement. All of the asserted patents have expired and Straight Path was therefore limited to seeking monetary damages for the alleged past infringement. On November 13, 2017, the Court granted our motion for summary judgment of non-infringement, thereby dismissing Straight Path’s claims against us and cancelling a trial which had been set for March 12, 2018. Straight Path appealed to the U.S. Court of Appeal for the Federal Circuit, and, on January 23, 2019, the court summarily affirmed the finding of non-infringement.

**Arista Networks, Inc.** As reported in our Form 10-K for the fiscal year ended July 28, 2018 we received a payment of \$400 million from Arista Networks, Inc. (“Arista”) in connection with the settlement of litigation. The payment was recognized in general and administrative expenses in our first quarter of fiscal 2019.

**Oyster Optics** On November 24, 2016, Oyster Optics, LLC (“Oyster”) asserted patent infringement claims against us in the U.S. District Court for the Eastern District of Texas. Oyster alleges that certain Cisco ONS 15454 and NCS 2000 line cards infringe U.S. Patent No. 7,620,327 (“the ‘327 Patent”). Oyster seeks monetary damages. Oyster filed infringement claims based on the ‘327 Patent against other defendants, including ZTE, Nokia, NEC, Infinera, Huawei, Ciena, Alcatel-Lucent, and Fujitsu, and the court consolidated the cases alleging infringement of the ‘327 Patent. Oyster’s cases against some of the defendants were resolved. The court vacated the November 4, 2018 trial date set for

Oyster's claims against Cisco and one other remaining defendant, pending resolution of Oyster's appeal of the court's summary judgment ruling dismissing certain of Oyster's claims. While we believe that we have strong non-infringement arguments and that the patent is invalid, if we do not prevail in the District Court, we believe damages ultimately assessed would not be material. Due to uncertainty surrounding patent litigation processes, we are unable to reasonably estimate the ultimate outcome of this litigation at this time. However, we do not anticipate that any final outcome of the dispute would be material.

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

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 14. Shareholders' Equity

## (a) Cash Dividends on Shares of Common Stock

We declared and paid cash dividends of \$0.33 and \$0.29 per common share, or \$1.5 billion and \$1.4 billion, on our outstanding common stock for the second quarter of fiscal 2019 and fiscal 2018, respectively. We declared and paid cash dividends of \$0.66 and \$0.58 per common share, or \$3.0 billion and \$2.9 billion, on our outstanding common stock for the first six months of fiscal 2019 and fiscal 2018, respectively.

On February 13, 2019, our Board of Directors declared a quarterly dividend of \$0.35 per common share to be paid on April 24, 2019 to all shareholders of record as of the close of business on April 5, 2019. Any future dividends will be subject to the approval of our Board of Directors.

## (b) Stock Repurchase Program

In September 2001, our Board of Directors authorized a stock repurchase program. On February 13, 2019, our Board of Directors authorized a \$15 billion increase to the stock repurchase program. The remaining authorized amount for stock repurchases under this program, including the additional authorization, is approximately \$24 billion with no termination date. A summary of the stock repurchase activity for fiscal 2019 and 2018 under the stock repurchase program, reported based on the trade date, is summarized as follows (in millions, except per-share amounts):

| Quarter Ended    | Shares | Weighted-Average<br>Price per Share | Amount   |
|------------------|--------|-------------------------------------|----------|
| Fiscal 2019      |        |                                     |          |
| January 26, 2019 | 111    | \$ 45.09                            | \$ 5,016 |
| October 27, 2018 | 109    | \$ 46.01                            | \$ 5,026 |
| Fiscal 2018      |        |                                     |          |
| July 28, 2018    | 138    | \$ 43.58                            | \$ 6,015 |
| April 28, 2018   | 140    | \$ 42.83                            | \$ 6,015 |
| January 27, 2018 | 103    | \$ 39.07                            | \$ 4,011 |
| October 28, 2017 | 51     | \$ 31.80                            | \$ 1,620 |

There were \$160 million and \$180 million of stock repurchases that were pending settlement as of January 26, 2019 and July 28, 2018, respectively.

The purchase price for the shares of our stock repurchased is reflected as a reduction to shareholders' equity. We are required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings and (ii) a reduction of common stock and additional paid-in capital.

## (c) Preferred Stock

Under the terms of our Articles of Incorporation, the Board of Directors may determine the rights, preferences, and terms of our authorized but unissued shares of preferred stock.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 15. Employee Benefit Plans

## (a) Employee Stock Incentive Plans

**Stock Incentive Plan Program Description** As of January 26, 2019, we had one stock incentive plan: the 2005 Stock Incentive Plan (the "2005 Plan"). In addition, we have, in connection with our acquisitions of various companies, assumed the share-based awards granted under stock incentive plans of the acquired companies or issued share-based awards in replacement thereof. Share-based awards are designed to reward employees for their long-term contributions to us and provide incentives for them to remain with Cisco. The number and frequency of share-based awards are based on competitive practices, operating results of Cisco, government regulations, and other factors. Our primary stock incentive plan is summarized as follows:

**2005 Plan** As of January 26, 2019, the maximum number of shares issuable under the 2005 Plan over its term was 694 million shares, plus shares from certain previous plans that are forfeited or are terminated for any other reason before being exercised or settled. If any awards granted under the 2005 Plan are forfeited or are terminated for any other reason before being exercised or settled, the unexercised or unsettled shares underlying the awards will again be available under the 2005 Plan. In addition, starting November 19, 2013, shares withheld by Cisco from an award other than a stock option or stock appreciation right to satisfy withholding tax liabilities resulting from such award will again be available for issuance, based on the fungible share ratio in effect on the date of grant.

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

The stock options will generally become exercisable for 20% or 25% of the option shares one year from the date of grant and then ratably over the following 48 months or 36 months, respectively. Time-based stock grants and time-based RSUs will generally vest over a four year term. The majority of the performance-based and market-based RSUs vests at the end of the three-year requisite service period or earlier if the award recipient meets certain retirement eligibility conditions. Certain performance-based RSUs, that are based on the achievement of financial and/or non-financial operating goals, typically vest upon the achievement of milestones (and may require subsequent service periods), with overall vesting of the shares underlying the award ranging from six months to three years. The Compensation and Management Development Committee of our Board of Directors has the discretion to use different vesting schedules. Stock appreciation rights may be awarded in combination with stock options or stock grants, and such awards shall provide that the stock appreciation rights will not be exercisable unless the related stock options or stock grants are forfeited. Stock grants may be awarded in combination with non-statutory stock options, and such awards may provide that the stock grants will be forfeited in the event that the related non-statutory stock options are exercised.

## (b) Employee Stock Purchase Plan

We have an Employee Stock Purchase Plan, which includes its subplan named the International Employee Stock Purchase Plan (together, the "Purchase Plan"), under which 721 million shares of our common stock have been reserved for issuance as of January 26, 2019. Eligible employees are offered shares through a 24-month offering period, which consists of four consecutive 6-month purchase periods. Employees may purchase a limited number of shares of our stock at a discount of up to 15% of the lesser of the market value at the beginning of the offering period or the end of

each 6-month purchase period. The Purchase Plan is scheduled to terminate on the earlier of (i) January 3, 2030 and (ii) the date on which all shares available for issuance under the Purchase Plan are sold pursuant to exercised purchase rights. Under the Purchase Plan, we issued 9 million shares during the second quarter and first six months of fiscal 2019 and 12 million shares during the second quarter and first six months of fiscal 2018. As of January 26, 2019, 169 million shares were available for issuance under the Purchase Plan.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

|  | Three Months<br>Ended |                     | Six Months<br>Ended |                        |
|--|-----------------------|---------------------|---------------------|------------------------|
|  | January<br>2019       | January 27,<br>2018 | January<br>26, 2019 | January<br>27,<br>2018 |
| Cost of sales—product                                  | \$22                  | \$ 23               | \$45                | \$ 46                  |
| Cost of sales—service                                  | 31                    | 31                  | 64                  | 65                     |
| Share-based compensation expense in cost of sales      | 53                    | 54                  | 109                 | 111                    |
| Research and development                               | 133                   | 134                 | 263                 | 270                    |
| Sales and marketing                                    | 125                   | 135                 | 262                 | 270                    |
| General and administrative                             | 65                    | 64                  | 127                 | 128                    |
| Restructuring and other charges                        | 19                    | 12                  | 42                  | 18                     |
| Share-based compensation expense in operating expenses | 342                   | 345                 | 694                 | 686                    |
| Total share-based compensation expense                 | \$395                 | \$ 399              | \$803               | \$ 797                 |
| Income tax benefit for share-based compensation        | \$126                 | \$ 96               | \$291               | \$ 271                 |

As of January 26, 2019, the total compensation cost related to unvested share-based awards not yet recognized was \$3.2 billion which is expected to be recognized over approximately 2.7 years on a weighted-average basis.

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

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

|   | Share-Based<br>Awards<br>Available<br>for Grant |
|---|---|
| BALANCE AT JULY 29, 2017  | 272   |
| Restricted stock, stock units, and other share-based awards granted | (70 )   |
| Share-based awards canceled/forfeited/expired                       | 18  |
| Shares withheld for taxes and not issued                            | 25  |
| BALANCE AT JULY 28, 2018  | 245   |
| Restricted stock, stock units, and other share-based awards granted | (37 )   |
| Share-based awards canceled/forfeited/expired                       | 12  |
| Shares withheld for taxes and not issued                            | 15  |
| Other   | 1   |
| BALANCE AT JANUARY 26, 2019   | 236   |

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

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## (e) Restricted Stock and Stock Unit Awards

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

|                                      | Restricted Stock/<br>Stock Units | Weighted-Average<br>Grant Date Fair<br>Value per Share | Aggregate Fair<br>Value |
|--------------------------------------|----------------------------------|--|-------------------------|
| UNVESTED BALANCE AT JULY 29, 2017    | 141                              | \$ 26.94   |                         |
| Granted                              | 46                               | 35.62  |                         |
| Assumed from acquisitions            | 1                                | 28.26  |                         |
| Vested                               | (53 )                            | 26.02  | \$ 1,909                |
| Canceled/forfeited/other             | (16 )                            | 28.37  |                         |
| UNVESTED BALANCE AT JULY 28, 2018    | 119                              | 30.56  |                         |
| Granted                              | 25                               | 44.69  |                         |
| Vested                               | (31 )                            | 27.99  | \$ 1,453                |
| Canceled/forfeited/other             | (10 )                            | 31.20  |                         |
| UNVESTED BALANCE AT JANUARY 26, 2019 | 103                              | \$ 34.66   |                         |

## (f) Stock Option Awards

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

|                             | STOCK OPTIONS OUTSTANDING |  |
|-----------------------------|---------------------------|--|
|                             | Number<br>Outstanding     | Weighted-Average<br>Exercise Price per Share |
| BALANCE AT JULY 29, 2017    | 12                        | \$ 6.15                                      |
| Assumed from acquisitions   | 3                         | 8.20   |
| Exercised                   | (8 )                      | 5.77   |
| Canceled/forfeited/expired  | (1 )                      | 8.75   |
| BALANCE AT JULY 28, 2018    | 6                         | 7.18   |
| Exercised                   | (2 )                      | 6.79   |
| BALANCE AT JANUARY 26, 2019 | 4                         | \$ 7.27                                      |

The following table summarizes significant ranges of outstanding and exercisable stock options as of January 26, 2019 (in millions, except years and share prices):

| Range of Exercise Prices | STOCK OPTIONS<br>OUTSTANDING |  |                                 | STOCK OPTIONS<br>EXERCISABLE |                                 |
|--------------------------|------------------------------|--|---------------------------------|------------------------------|---------------------------------|
|                          | Number<br>Outstanding        | Weighted-<br>Average<br>Exercise<br>Price per<br>Share | Aggregate<br>Intrinsic<br>Value | Number<br>Exercisable        | Aggregate<br>Intrinsic<br>Value |
| \$ 0.01 – 35.00          | 4                            | 5.3  | \$ 7.27                         | 3                            | \$ 7.11                         |
|                          |                              |  |                                 |                              | \$ 130                          |

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on our closing stock price of \$46.13 as of January 25, 2019. The total number of in-the-money stock options exercisable as of January 26, 2019 was 3 million. As of July 28, 2018, 4 million outstanding stock options were exercisable and the weighted-average exercise price was \$6.84.



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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

|  | RESTRICTED STOCK UNITS |                  | PERFORMANCE BASED RESTRICTED STOCK UNITS |                  |
|--|------------------------|------------------|--|------------------|
|  | January 26, 2019       | January 27, 2018 | January 26, 2019                         | January 27, 2018 |
| Three Months Ended                       |                        |                  |  |                  |
| Number of shares granted (in millions)   | 17                     | 21               | —  | —                |
| Grant date fair value per share          | \$44.53                | \$ 34.89         | N/A                                      | \$ 32.47         |
| Weighted-average assumptions/inputs:     |                        |                  |  |                  |
| Expected dividend yield                  | 2.8 %                  | 3.1 %            | N/A                                      | 3.2 %            |
| Range of risk-free interest rates        | 0.0% – 2.8%            | 0.0% – 2.1%      | N/A                                      | 1.0%-1.8%        |
| Range of expected volatilities for index | N/A                    | N/A              | N/A                                      | 13.2%-81.0%      |
|  |                        |                  | PERFORMANCE BASED RESTRICTED STOCK UNITS |                  |
|  | RESTRICTED STOCK UNITS |                  | PERFORMANCE BASED RESTRICTED STOCK UNITS |                  |
|  | January 26, 2019       | January 27, 2018 | January 26, 2019                         | January 27, 2018 |
| Six Months Ended                         |                        |                  |  |                  |
| Number of shares granted (in millions)   | 23                     | 28               | 2  | 3                |
| Grant date fair value per share          | \$44.48                | \$ 33.50         | \$47.00                                  | \$ 31.31         |
| Weighted-average assumptions/inputs:     |                        |                  |  |                  |
| Expected dividend yield                  | 2.8 %                  | 3.2 %            | 2.8 %                                    | 3.6 %            |
| Range of risk-free interest rates        | 0.0% – 2.9%            | 0.0% – 2.1%      | 2.1% – 3.0%                              | 1.0%-1.8%        |
| Range of expected volatilities for index | N/A                    | N/A              | 13.0% – 65.2%                            | 13.2%-81.0%      |

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



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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 16. Comprehensive Income (Loss)

The components of AOCI, net of tax, and the other comprehensive income (loss), excluding noncontrolling interest, for the first six months of fiscal 2019 and fiscal 2018 are summarized as follows (in millions):

|  | Net Unrealized Gains (Losses) on Available-for-Sale Investments | Net Unrealized Gains (Losses) on Cash Flow Hedging Instruments | Cumulative Translation Adjustment and Actuarial Gains (Losses) | Accumulated Other Comprehensive Income (Loss) |
|--|---|--|--|---|
| BALANCE AT JULY 28, 2018   | \$ (310 )   | \$ (11 )   | \$ (528 )  | \$ (849 )                                     |
| Other comprehensive income (loss) before reclassifications attributable to Cisco Systems, Inc. | 86  | (9 )   | (184 )   | (107 )  |
| (Gains) losses reclassified out of AOCI  | 11  | (1 )   | 3  | 13  |
| Tax benefit (expense)  | —   | 2  | (1 )   | 1   |
| Total change for the period  | 97  | (8 )   | (182 )   | (93 )   |
| Effect of adoption of accounting standards   | (168 )  | —  | —  | (168 )  |
| BALANCE AT JANUARY 26, 2019  | \$ (381 )   | \$ (19 )   | \$ (710 )  | \$ (1,110 )                                   |
|  |   |  |  |   |
|  | Net Unrealized Gains (Losses) on Available-for-Sale Investments | Net Unrealized Gains (Losses) on Cash Flow Hedging Instruments | Cumulative Translation Adjustment and Actuarial Gains (Losses) | Accumulated Other Comprehensive Income (Loss) |
| BALANCE AT JULY 29, 2017   | \$ 373  | \$ 32  | \$ (359 )  | \$ 46   |
| Other comprehensive income (loss) before reclassifications attributable to Cisco Systems, Inc. | (174 )  | 38   | 292  | 156   |
| (Gains) losses reclassified out of AOCI  | (91 )   | (31 )  | 5  | (117 )  |
| Tax benefit (expense)  | 3   | 1  | (6 )   | (2 )  |
| Total change for the period  | (262 )  | 8  | 291  | 37  |
| BALANCE AT JANUARY 27, 2018  | \$ 111  | \$ 40  | \$ (68 )   | \$ 83   |

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

|   | Three Months        |               | Six Months          |               | Line Item in Statements of Operations |
|---|---------------------|---------------|---------------------|---------------|---------------------------------------|
|   | Ended               |               | Ended               |               |                                       |
|   | January 2019        | February 2018 | January 2019        | February 2018 |                                       |
| Comprehensive Income Components                                   | Income Before Taxes |               | Income Before Taxes |               |                                       |
| Net unrealized gains and losses on available-for-sale investments | \$ (5)              | \$ 58         | \$ (11)             | \$ 91         | Other income (loss), net              |
| Net unrealized gains and losses on cash flow hedging instruments  |                     |               |                     |               |                                       |
| Foreign currency derivatives                                      | 1                   | —             | 1                   | —             | Revenue—product                       |
| Foreign currency derivatives                                      | 1                   | —             | 2                   | —             | Revenue—service                       |
| Foreign currency derivatives                                      | (1 )                | 4             | (1 )                | 7             | Cost of sales—service                 |
| Foreign currency derivatives                                      | —                   | 14            | (1 )                | 24            | Operating expenses                    |
|   | 1                   | 18            | 1                   | 31            |                                       |
| Cumulative translation adjustment and actuarial gains and losses  | —                   | (4 )          | —                   | (5 )          | Operating expenses                    |
| Cumulative translation adjustment and actuarial gains and losses  | (4 )                | —             | (3 )                | —             | Other income (loss), net              |
| Total amounts reclassified out of AOCI                            | \$ (8)              | \$ 72         | \$ (13)             | \$ 117        |                                       |

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 17. Income Taxes

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

|  | Three Months Ended |             | Six Months Ended |             |
|--|--------------------|-------------|------------------|-------------|
|  | January 26,        | January 27, | January 26,      | January 27, |
|  | 2019               | 2018        | 2019             | 2018        |
| Income before provision for income taxes | \$3,343            | \$3,232     | \$7,252          | \$6,194     |
| Provision for income taxes               | \$521              | \$12,010    | \$881            | \$12,578    |
| Effective tax rate                       | 15.6 %             | 371.6 %     | 12.1 %           | 203.1 %     |

The effective tax rate for the first six months of fiscal 2019 includes a \$152 million tax benefit relating to indirect effects from adoption of ASC 606 at the beginning of fiscal 2019.

On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act") was enacted. The Tax Act significantly revises the U.S. corporate income tax by, among other things, lowering the statutory corporate income tax rate ("federal tax rate") from 35% to 21% effective January 1, 2018, implementing a modified territorial tax system, and imposing a mandatory one-time transition tax on accumulated earnings of foreign subsidiaries. The enactment of the Tax Act resulted in us recording a provisional tax expense of \$10.4 billion in fiscal 2018. In the second quarter of fiscal 2019, we completed our accounting relating to the Tax Act and recorded an additional \$58 million of tax expense. The total tax charge as a result of the Tax Act was \$10.5 billion, consisting of \$8.2 billion of tax expense for the U.S. transition tax on accumulated earnings of foreign subsidiaries, \$1.2 billion of foreign withholding tax and \$1.1 billion of tax expense for DTA re-measurement. The tax expense related to the U.S. transition tax on accumulated earnings in foreign subsidiaries is net of a \$0.9 billion benefit related to U.S. taxation of deemed foreign dividends in the transition fiscal year. This benefit may be reduced or eliminated in future legislation. If such legislation is enacted, we will record the impact of the legislation in the quarter of enactment.

The Tax Act includes a Global Intangible Low-Taxed Income ("GILTI") provision that imposes U.S. tax on certain foreign subsidiary income in the year it is earned. Our accounting policy is to treat tax on GILTI as a current period cost included in tax expense in the year incurred.

As of January 26, 2019, we had \$1.8 billion of unrecognized tax benefit, of which \$1.6 billion, if recognized, would favorably impact the effective tax rate. We regularly engage in discussions and negotiations with tax authorities regarding tax matters in various jurisdictions. We believe it is reasonably possible that certain federal, foreign and state tax matters may be concluded in the next 12 months. Specific positions that may be resolved include issues involving transfer pricing and various other matters. We estimate that the unrecognized tax benefits at January 26, 2019 could be reduced by approximately \$50 million in the next 12 months.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 18. Segment Information and Major Customers

## (a) Revenue and Gross Margin by Segment

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

Summarized financial information by segment for the second quarter and the first six months of fiscal 2019 and fiscal 2018, based on our internal management system and as utilized by our Chief Operating Decision Maker ("CODM"), is as follows (in millions):

|                                    | Three Months Ended |             | Six Months Ended |             |
|------------------------------------|--------------------|-------------|------------------|-------------|
|                                    | January 26,        | January 27, | January 26,      | January 27, |
|                                    | 2019               | 2018        | 2019             | 2018        |
| Revenue:                           |                    |             |                  |             |
| Americas                           | \$7,352            | \$7,004     | \$15,103         | \$14,354    |
| EMEA                               | 3,223              | 3,062       | 6,447            | 5,971       |
| APJC                               | 1,872              | 1,820       | 3,968            | 3,698       |
| Total                              | \$12,446           | \$11,887    | \$25,518         | \$24,023    |
| Gross margin:                      |                    |             |                  |             |
| Americas                           | \$4,796            | \$4,614     | \$9,866          | \$9,336     |
| EMEA                               | 2,070              | 1,977       | 4,141            | 3,816       |
| APJC                               | 1,109              | 1,094       | 2,309            | 2,259       |
| Segment total                      | 7,975              | 7,685       | 16,316           | 15,411      |
| Unallocated corporate items (202 ) | (187 )             | (397 )      | (486 )           |             |
| Total                              | \$7,773            | \$7,498     | \$15,919         | \$14,925    |

Amounts may not sum and percentages may not recalculate due to rounding.

Revenue in the United States was \$6.4 billion and \$6.1 billion for the second quarter of fiscal 2019 and fiscal 2018, respectively, and \$13.3 billion and \$12.6 billion for the first six months of fiscal 2019 and fiscal 2018, respectively.

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

We design, manufacture, and sell Internet Protocol (IP)-based networking and other products related to the communications and information technology (IT) industry and provide services associated with these products and their use.

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CISCO SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

|                          | Three Months Ended |                  | Six Months Ended |                  |
|--------------------------|--------------------|------------------|------------------|------------------|
|                          | January 26, 2019   | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Revenue:                 |                    |                  |                  |                  |
| Infrastructure Platforms | \$7,128            | \$ 6,710         | \$14,770         | \$ 13,690        |
| Applications             | 1,465              | 1,184            | 2,884            | 2,387            |
| Security                 | 658                | 557              | 1,308            | 1,142            |
| Other Products           | 22                 | 258              | 200              | 544              |
| Total Product            | 9,273              | 8,709            | 19,163           | 17,763           |
| Services                 | 3,173              | 3,178            | 6,355            | 6,260            |
| Total <sup>(1)</sup>     | \$12,446           | \$ 11,887        | \$25,518         | \$ 24,023        |

<sup>(1)</sup> Includes SPVSS business revenue of \$0 and \$230 million for the second quarter of fiscal 2019 and 2018, respectively, and \$168 million and \$478 million for the first six months of fiscal 2019 and fiscal 2018, respectively.

## (c) Additional Segment Information

The majority of our assets was attributable to our U.S. operations as of each of January 26, 2019 and July 28, 2018. Property and equipment information is based on the physical location of the assets. The following table presents property and equipment information for geographic areas (in millions):

|                              | January 26, 2019 | July 28, 2018 |
|------------------------------|------------------|---------------|
| Property and equipment, net: |                  |               |
| United States                | \$ 2,394         | \$ 2,487      |
| International                | 537              | 519           |
| Total                        | \$ 2,931         | \$ 3,006      |

## 19. Net Income (Loss) per Share

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

|  | Three Months Ended |                  | Six Months Ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | January 26, 2019   | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Net income (loss)                          | \$2,822            | \$ (8,778 )      | \$6,371          | \$ (6,384 )      |
| Weighted-average shares—basic              | 4,470              | 4,924            | 4,517            | 4,942            |
| Effect of dilutive potential common shares | 35                 | —                | 40               | —                |
| Weighted-average shares—diluted            | 4,505              | 4,924            | 4,557            | 4,942            |
| Net income (loss) per share—basic          | \$0.63             | \$ (1.78 )       | \$1.41           | \$ (1.29 )       |
| Net income (loss) per share—diluted        | \$0.63             | \$ (1.78 )       | \$1.40           | \$ (1.29 )       |

Employee equity share options, unvested shares, and similar equity instruments granted and assumed by Cisco are treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options, unvested restricted stock, and restricted stock units. The dilutive effect of such equity awards is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options and the amount of compensation cost for future service that has not yet recognized are collectively assumed to be used to repurchase shares.

We excluded antidilutive employee-share based awards of 27 million and 28 million for the second quarter and first six months of fiscal 2019, respectively. For the second quarter and first six months of fiscal 2018, we excluded the impact of potentially dilutive common shares from the calculation of net income (loss) per share as the inclusion would have an antidilutive effect.

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## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

## Forward-Looking Statements

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

## OVERVIEW

Cisco designs and sells a broad range of technologies that have been powering the Internet since 1984. Across networking, security, collaboration, applications and the cloud, our evolving intent-based technologies are constantly learning and adapting to provide customers with a highly secure, intelligent platform for their digital business. A summary of our results is as follows (in millions, except percentages and per-share amounts):

|   | Three Months Ended |                  |            | Six Months Ended |                  |            |
|---|--------------------|------------------|------------|------------------|------------------|------------|
|   | January 26, 2019   | January 27, 2018 | Variance   | January 26, 2019 | January 27, 2018 | Variance   |
| Revenue <sup>(1)</sup>  | \$12,446           | \$11,887         | 5 %        | \$25,518         | \$24,023         | 6 %        |
| Gross margin percentage   | 62.5 %             | 63.1 %           | (0.6 ) pts | 62.4 %           | 62.1 %           | 0.3 pts    |
| Research and development  | \$1,557            | \$1,549          | 1 %        | \$3,165          | \$3,116          | 2 %        |
| Sales and marketing   | \$2,271            | \$2,235          | 2 %        | \$4,681          | \$4,569          | 2 %        |
| General and administrative  | \$509              | \$483            | 5 %        | \$720            | \$1,040          | (31 )%     |
| Total research and development, sales and marketing, general and administrative | \$4,337            | \$4,267          | 2 %        | \$8,566          | \$8,725          | (2 )%      |
| Total as a percentage of revenue  | 34.8 %             | 35.9 %           | (1.1 ) pts | 33.6 %           | 36.3 %           | (2.7 ) pts |
| Amortization of purchased intangible assets included in operating expenses      | \$39               | \$60             | (35 )%     | \$73             | \$121            | (40 )%     |
| Restructuring and other charges included in operating expenses                  | \$186              | \$98             | 90 %       | \$264            | \$250            | 6 %        |
| Interest and other income (loss), net   | \$132              | \$159            | (17 )%     | \$236            | \$365            | (35 )%     |
| Operating income as a percentage of revenue                                     | 25.8 %             | 25.9 %           | (0.1 ) pts | 27.5 %           | 24.3 %           | 3.2 pts    |
| Income tax percentage   | 15.6 %             | 371.6 %          | NM         | 12.1 %           | 203.1 %          | NM         |
| Net income (loss) <sup>(2)</sup>  | \$2,822            | \$(8,778 )       | NM         | \$6,371          | \$(6,384 )       | NM         |
| Net income (loss) as a percentage of revenue <sup>(2)</sup>                     | 22.7 %             | (73.8 )%         | NM         | 25.0 %           | (26.6 )%         | NM         |
| Earnings (loss) per share—diluted <sup>(2)</sup>                                | \$0.63             | \$(1.78 )        | NM         | \$1.40           | \$(1.29 )        | NM         |

NM - Not meaningful; we recognized a net loss for the second quarter and first six months of fiscal 2018 related to the enactment of the Tax Cuts and Jobs Act.

We adopted ASC 606 in the first quarter of fiscal 2019 using the modified retrospective method. See Note 2 to the Consolidated Financial Statements for impact of this adoption on our operating results for the second quarter and first six months of fiscal 2019.

<sup>(1)</sup> During the second quarter of fiscal 2019, we completed the sale of our Service Provider Video Software Solutions (“SPVSS”) business. As a result, revenue from this business will not recur in future periods. Includes SPVSS business revenue of \$0 and \$230 million for the second quarter of fiscal 2019 and 2018, respectively, and \$168 million and \$478 million for the first six months of fiscal 2019 and 2018, respectively.

<sup>(2)</sup> Second quarter and first six months of fiscal 2018 results include an \$11.1 billion charge related to the enactment of the Tax Cuts and Jobs Act.

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CISCO SYSTEMS, INC.

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

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

In the second quarter of fiscal 2019, we delivered revenue growth across all geographies and product areas, solid margins and operating cash flow. We remain focused on accelerating innovation across our portfolio, and we believe that we have made continued progress on our strategic priorities. Our product revenue reflected growth in Infrastructure Platforms, Applications and Security, and we continued to make progress in the transition of our business model to increased software and subscriptions. Notwithstanding the second quarter fiscal 2019 results, we continue to operate in a challenging and highly competitive environment. While the overall environment remains uncertain, we continue to aggressively invest in priority areas with the objective of driving profitable growth over the long term.

Total revenue increased by 5% compared with the second quarter of fiscal 2018. Within total revenue, product revenue increased by 6% and service revenue was flat. In the second quarter of fiscal 2019, on October 28, 2018, we completed the sale of our SPVSS business. Total revenue for the second quarter of fiscal 2019 increased 7% not including revenue from SPVSS business in the prior year period. Total gross margin decreased by 0.6 percentage points, driven by unfavorable impacts from pricing and productivity. As a percentage of revenue, research and development, sales and marketing, and general and administrative expenses, collectively, decreased by 1.1 percentage points. Operating income as a percentage of revenue decreased by 0.1 percentage points. The net loss and net loss per share in the prior year period were driven by the one-time transition tax on accumulated earnings of foreign subsidiaries, foreign withholding taxes, and re-measurement of net deferred tax assets and liabilities recorded during the second quarter of fiscal 2018.

In terms of our geographic segments, revenue from the Americas increased \$348 million, EMEA revenue increased by \$161 million, and revenue in our APJC segment increased by \$52 million. These increases reflect broad strength across several countries within these segments. The "BRICM" countries experienced product revenue growth of 5% in the aggregate, driven by increased product revenue in the emerging countries of Mexico, India, Brazil and Russia of 35%, 18%, 14% and 4%, respectively, partially offset by a product revenue decrease of 16% in China.

From a customer market standpoint, we experienced product revenue growth in the public sector, enterprise and commercial markets, partially offset by a product revenue decline in the service provider market.

From a product category perspective, total product revenue, not including SPVSS products in the prior year period, increased 9% year over year. The increase was driven by a 6% product revenue increase in Infrastructure Platforms and solid product revenue growth in Applications and Security, which grew by 24% and 18% respectively.

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CISCO SYSTEMS, INC.

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

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Total revenue increased 6%, with product revenue increasing 8% and service revenue increasing 2%. Total gross margin increased by 0.3 percentage points due to productivity benefits and a \$127 million legal and indemnification settlement charge recorded in the first six months of fiscal 2018, partially offset by unfavorable impacts from pricing. As a percentage of revenue, research and development, sales and marketing, and general and administrative expenses collectively decreased by 2.7 percentage points due to lower general and administrative expenses. General and administrative expenses decreased due to a benefit from the \$400 million litigation settlement with Arista in the first quarter of fiscal 2019. Operating income as a percentage of revenue increased by 3.2 percentage points. The net loss and net loss per share in the prior year period were driven by similar factors as discussed in the three-month period immediately above.

## Strategy and Priorities

As our customers add billions of new connections to their enterprises, and as more applications move to a multi-cloud environment, we believe the network continues to be extremely critical. We believe that our customers are looking for intent-based networks that provide meaningful business value through automation, security, and analytics across private, hybrid, and multi-cloud environments. Our vision is to deliver highly secure, software-defined, automated and intelligent platforms for our customers. Our strategic priorities include the following: accelerating our pace of innovation, increasing the value of the network, and transforming our business model.

For additional discussion of our strategy and priorities, see Item 1. Business in our Annual Report on Form 10-K for the year ended July 28, 2018.

## Other Key Financial Measures

The following is a summary of our other key financial measures for the second quarter and first six months of fiscal 2019 (in millions):

|  | January 26,<br>2019 | July 28,<br>2018 | Six Months Ended    |                     |
|--|---------------------|------------------|---------------------|---------------------|
|  |                     |                  | January 26,<br>2019 | January 27,<br>2018 |
| Cash and cash equivalents and investments            | \$ 40,383           | \$ 46,548        | \$ 7,560            | \$ 7,150            |
| Deferred revenue                                     | \$ 17,261           | \$ 19,685        | \$ 10,042           | \$ 5,631            |
| Inventories  | \$ 1,701            | \$ 1,846         | \$ 2,970            | \$ 2,861            |
| Cash provided by operating activities                |                     |                  |                     |                     |
| Repurchases of common stock—stock repurchase program |                     |                  |                     |                     |
| Dividends  |                     |                  |                     |                     |

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CISCO SYSTEMS, INC.

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

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended July 28, 2018, as updated as applicable in Note 2 to the Consolidated Financial Statements herein, describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The accounting policies described below are significantly affected by critical accounting estimates. Such accounting policies require significant judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements, and actual results could differ materially from the amounts reported based on these policies.

Revenue Recognition

In May 2014, the FASB issued ASC 606, Revenue from Contracts with Customers, a new accounting standard related to revenue recognition. ASC 606 supersedes nearly all U.S. GAAP on revenue recognition and eliminated industry-specific guidance. The underlying principle of ASC 606 is to recognize revenue when a customer obtains control of promised goods or services at an amount that reflects the consideration that is expected to be received in exchange for those goods or services.

ASC 606 allowed two methods of adoption: i) retrospectively to each prior period presented ("full retrospective method"), or ii) retrospectively with the cumulative effect recognized in retained earnings as of the date of adoption ("modified retrospective method"). At the beginning of our first quarter of fiscal 2019, we adopted ASC 606 using the modified retrospective method to those contracts that were not completed as of July 28, 2018.

ASC 606 primarily impacted our revenue recognition for software arrangements and sales to two-tier distributors. In both areas, the new standard accelerates the recognition of revenue.

We enter into contracts with customers that can include various combinations of products and services which are generally distinct and accounted for as separate performance obligations. As a result, our contracts may contain multiple performance obligations. We determine whether arrangements are distinct based on whether the customer can benefit from the product or service on its own or together with other resources that are readily available and whether our commitment to transfer the product or service to the customer is separately identifiable from other obligations in the contract. We classify our hardware, perpetual software licenses, and SaaS as distinct performance obligations. Term software licenses represent multiple obligations, which include software licenses and software maintenance. In transactions where we deliver hardware or software, we are typically the principal and we record revenue and costs of goods sold on a gross basis.

We recognize revenue upon transfer of control of promised goods or services in a contract with a customer in an amount that reflects the consideration we expect to receive in exchange for those products or services. Transfer of control occurs once the customer has the contractual right to use the product, generally upon shipment or once delivery and risk of loss has transferred to the customer. Transfer of control can also occur over time for software maintenance and services as the customer receives the benefit over the contract term. Our hardware and perpetual software licenses are distinct performance obligations where revenue is recognized upfront upon transfer of control. Term software licenses include multiple performance obligations where the term licenses are recognized upfront upon transfer of control, with the associated software maintenance revenue recognized ratably over the contract term as services and software updates are provided. SaaS arrangements have one distinct performance obligation which is satisfied over time with revenue recognized ratably over the contract term as the customer consumes the services. On our product sales, we record consideration from shipping and handling on a gross basis within net product sales. We record our revenue net of any associated sales taxes.

Revenue is allocated among these performance obligations in a manner that reflects the consideration that we expect to be entitled to for the promised goods or services based on standalone selling prices (SSP). SSP is estimated for each distinct performance obligation and judgment may be required in their determination. The best evidence of SSP is the

observable price of a product or service when we sell the goods separately in similar circumstances and to similar customers. In instances where SSP is not directly observable, we determine SSP using information that may include market conditions and other observable inputs.

We apply judgment in determining the transaction price as we may be required to estimate variable consideration when determining the amount of revenue to recognize. Variable consideration includes various rebate, cooperative marketing, and other incentive programs that we offer to our distributors, partners and customers. When determining the amount of revenue to recognize, we estimate the expected usage of these programs, applying the expected value or most likely estimate and update the estimate at each reporting period as actual utilization becomes available. We also consider the customers' right of return in determining the transaction price, where applicable. If actual credits received by distributors under these programs were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

See Notes 2 and 3 to the Consolidated Financial Statements for more details.

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CISCO SYSTEMS, INC.

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

## Allowances for Receivables and Sales Returns

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

|  | January 26, 2019 |     | July 28, 2018 |     |
|--|------------------|-----|---------------|-----|
| Allowance for doubtful accounts                      | \$               | 135 | \$            | 129 |
| Percentage of gross accounts receivable              | 3.5              | %   | 2.3           | %   |
| Allowance for credit loss—lease receivables          | \$               | 127 | \$            | 135 |
| Percentage of gross lease receivables <sup>(1)</sup> | 4.8              | %   | 4.7           | %   |
| Allowance for credit loss—loan receivables           | \$               | 64  | \$            | 60  |
| Percentage of gross loan receivables                 | 1.3              | %   | 1.2           | %   |

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

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

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

A reserve for future sales returns is established based on historical trends in product return rates. The reserve for future sales returns as of January 26, 2019 and July 28, 2018 was \$92 million and \$123 million, respectively, and was recorded as a reduction of our accounts receivable and revenue. If the actual future returns were to deviate from the historical data on which the reserve had been established, our revenue could be adversely affected.

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

Inventory is written down based on excess and obsolete inventories, determined primarily by future demand forecasts. Inventory write-downs are measured as the difference between the cost of the inventory and market, based upon assumptions about future demand, and are charged to the provision for inventory, which is a component of our cost of sales. At the point of the loss recognition, a new, lower cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

We record a liability for firm, noncancelable, and unconditional purchase commitments with contract manufacturers and suppliers for quantities in excess of our future demand forecasts consistent with the valuation of our excess and obsolete inventory.

Our provision for inventory was \$23 million and \$31 million for the first six months of fiscal 2019 and 2018, respectively. The provision for the liability related to purchase commitments with contract manufacturers and suppliers was \$48 million and \$44 million for the first six months of fiscal 2019 and 2018, respectively. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory write-downs, and our liability for purchase commitments with contract manufacturers and suppliers, and accordingly our profitability, could be adversely affected. We regularly evaluate our exposure for inventory write-downs and the adequacy of our liability for purchase commitments.

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CISCO SYSTEMS, INC.

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

Loss Contingencies and Product Warranties

We are subject to the possibility of various losses arising in the ordinary course of business. We consider the likelihood of impairment of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss, in determining loss contingencies. An estimated loss contingency is accrued when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. We regularly evaluate information available to us to determine whether such accruals should be made or adjusted and whether new accruals are required.

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

Our products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products we provide a limited lifetime warranty. We accrue for warranty costs as part of our cost of sales based on associated material costs, technical support labor costs, and associated overhead. Material cost is estimated based primarily upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is estimated based primarily upon historical trends in the rate of customer cases and the cost to support the customer cases within the warranty period. Overhead cost is applied based on estimated time to support warranty activities.

If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our profitability could be adversely affected.

Impairment of Investments

We recognize an impairment charge when the declines in the fair values of our available-for-sale debt investments below their cost basis are judged to be other than temporary. The ultimate value realized on these securities, to the extent unhedged, is subject to market price volatility until they are sold.

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

We hold non-marketable equity and other investments, some of which are in the startup or development stages. As of January 26, 2019, our non-marketable equity and other investments were \$1.3 billion, compared with \$1.1 billion as of July 28, 2018, and were included in other assets. We monitor these investments for events or circumstances indicative of potential impairment, and we make appropriate reductions in carrying values if we determine that an impairment charge is required, based primarily on the financial condition and near-term prospects of these companies. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize.

#### Goodwill and Purchased Intangible Asset Impairments

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

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CISCO SYSTEMS, INC.

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

The goodwill recorded in the Consolidated Balance Sheets as of January 26, 2019 and July 28, 2018 was \$33.3 billion and \$31.7 billion, respectively. In response to changes in industry and market conditions, we could be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses, which could result in an impairment of goodwill. There was no impairment of goodwill in each of the first six months of fiscal 2019 and 2018.

The fair value of acquired technology and patents, as well as acquired technology under development, is determined at acquisition date primarily using the income approach, which discounts expected future cash flows to present value. The discount rates used in the present value calculations are typically derived from a weighted-average cost of capital analysis and then adjusted to reflect risks inherent in the development lifecycle as appropriate. We consider the pricing model for products related to these acquisitions to be standard within the high-technology communications industry, and the applicable discount rates represent the rates that market participants would use for valuation of such intangible assets.

We make judgments about the recoverability of purchased intangible assets with finite lives whenever events or changes in circumstances indicate that an impairment may exist. Recoverability of purchased intangible assets with finite lives is measured by comparing the carrying amount of the asset to the future undiscounted cash flows the asset is expected to generate. We review indefinite-lived intangible assets for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. If the asset is considered to be impaired, the amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset. Assumptions and estimates about future values and remaining useful lives of our purchased intangible assets are complex and subjective. They can be affected by a variety of factors, including external factors such as industry and economic trends, and internal factors such as changes in our business strategy and our internal forecasts.

There were no impairment charges related to purchased intangible assets for the first six months of fiscal 2019 and 2018. Our ongoing consideration of all the factors described previously could result in additional impairment charges in the future, which could adversely affect our net income.

Income Taxes

We are subject to income taxes in the United States and numerous foreign jurisdictions. Our effective tax rates differ from the statutory rate, primarily due to the tax impact of state taxes, foreign operations, R&D tax credits, domestic manufacturing deductions, foreign-derived intangible income deductions, global intangible low-taxed income, tax audit settlements, nondeductible compensation, international realignments, and transfer pricing adjustments. Our effective tax rate was 15.6% and 371.6% in the second quarter of fiscal 2019 and 2018, respectively. Our effective tax rate was 12.1% and 203.1% in the first six months of fiscal 2019 and 2018, respectively.

On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act") was enacted. The Tax Act significantly revises the U.S. corporate income tax by, among other things, lowering the statutory corporate income tax rate ("federal tax rate") from 35% to 21% effective January 1, 2018, implementing a modified territorial tax system, and imposing a mandatory one-time transition tax on accumulated earnings of foreign subsidiaries. As a result of the Tax Act enactment, we recorded a provisional tax expense of \$10.4 billion in fiscal 2018. In the second quarter of fiscal 2019, we completed our accounting relating to the Tax Act and recorded an additional \$58 million tax expense. The total tax charge as the result of the Tax Act is \$10.5 billion, consisting of \$8.2 billion of tax expense for the U.S. transition tax on accumulated earnings of foreign subsidiaries, \$1.2 billion of foreign withholding tax, and \$1.1 billion of tax expense for DTA re-measurement. The tax expense related to the U.S. transition tax on accumulated earnings in foreign subsidiaries is net of a \$0.9 billion benefit related to U.S. taxation of deemed foreign dividends in the transition fiscal year. This benefit may be reduced or eliminated in future legislation. If such legislation is enacted, we will record the impact of the legislation in the quarter of enactment.

Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Although we believe our reserves are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. We

adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest and penalties.

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

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CISCO SYSTEMS, INC.

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

Our provision for income taxes is subject to volatility and could be adversely impacted by earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates; by changes in the valuation of our deferred tax assets and liabilities; by changes to domestic manufacturing deduction, foreign-derived intangible income, global intangible low-tax income and base erosion and anti-abuse tax laws, regulations, or interpretations thereof; by expiration of or lapses in tax incentives; by transfer pricing adjustments, including the effect of acquisitions on our legal structure; by tax effects of nondeductible compensation; by tax costs related to intercompany realignments; by changes in accounting principles; or by changes in tax laws and regulations, treaties, or interpretations thereof, including changes to the taxation of earnings of our foreign subsidiaries, the deductibility of expenses attributable to foreign income, and the foreign tax credit rules. Significant judgment is required to determine the recognition and measurement attributes prescribed in the accounting guidance for uncertainty in income taxes. The Organisation for Economic Co-operation and Development (OECD), an international association comprised of 36 countries, including the United States, has made changes to numerous long-standing tax principles. There can be no assurance that these changes, once adopted by countries, will not have an adverse impact on our provision for income taxes. As a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service (IRS) and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse impact on our operating results and financial condition.

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CISCO SYSTEMS, INC.

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

## RESULTS OF OPERATIONS

## Revenue

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

|                       | Three Months Ended <sup>(1)</sup> |                  |                     |                     | Six Months Ended |                  |                     |                     |
|-----------------------|-----------------------------------|------------------|---------------------|---------------------|------------------|------------------|---------------------|---------------------|
|                       | January 26, 2019                  | January 27, 2018 | Variance in Dollars | Variance in Percent | January 26, 2019 | January 27, 2018 | Variance in Dollars | Variance in Percent |
| Revenue:              |                                   |                  |                     |                     |                  |                  |                     |                     |
| Product               | \$9,273                           | \$8,709          | \$ 564              | 6 %                 | \$19,163         | \$17,763         | \$ 1,400            | 8 %                 |
| Percentage of revenue | 74.5 %                            | 73.3 %           |                     |                     | 75.1 %           | 73.9 %           |                     |                     |
| Service               | 3,173                             | 3,178            | (5 )                | — %                 | 6,355            | 6,260            | 95                  | 2 %                 |
| Percentage of revenue | 25.5 %                            | 26.7 %           |                     |                     | 24.9 %           | 26.1 %           |                     |                     |
| Total                 | \$12,446                          | \$11,887         | \$ 559              | 5 %                 | \$25,518         | \$24,023         | \$ 1,495            | 6 %                 |

<sup>(1)</sup> Total revenue, product revenue and service revenue not including the SPVSS business in the prior year period increased 7%, 9% and 1%, respectively.

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

|                       | Three Months Ended |                  |                     |                     | Six Months Ended |                  |                     |                     |
|-----------------------|--------------------|------------------|---------------------|---------------------|------------------|------------------|---------------------|---------------------|
|                       | January 26, 2019   | January 27, 2018 | Variance in Dollars | Variance in Percent | January 26, 2019 | January 27, 2018 | Variance in Dollars | Variance in Percent |
| Revenue:              |                    |                  |                     |                     |                  |                  |                     |                     |
| Americas              | \$7,352            | \$7,004          | \$ 348              | 5 %                 | \$15,103         | \$14,354         | \$ 749              | 5 %                 |
| Percentage of revenue | 59.1 %             | 58.9 %           |                     |                     | 59.2 %           | 59.7 %           |                     |                     |
| EMEA                  | 3,223              | 3,062            | 161                 | 5 %                 | 6,447            | 5,971            | 476                 | 8 %                 |
| Percentage of revenue | 25.9 %             | 25.8 %           |                     |                     | 25.3 %           | 24.9 %           |                     |                     |
| APJC                  | 1,872              | 1,820            | 52                  | 3 %                 | 3,968            | 3,698            | 270                 | 7 %                 |
| Percentage of revenue | 15.0 %             | 15.3 %           |                     |                     | 15.5 %           | 15.4 %           |                     |                     |
| Total                 | \$12,446           | \$11,887         | \$ 559              | 5 %                 | \$25,518         | \$24,023         | \$ 1,495            | 6 %                 |

Amounts may not sum and percentages may not recalculate due to rounding.

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Total revenue increased by 5%. Product revenue increased by 6% while service revenue was flat. Our total revenue reflected growth across each of our geographic segments. Product revenue for the emerging countries of BRICM, in the aggregate, experienced 5% product revenue growth, with increases in Mexico, India, Brazil and Russia partially offset by a decrease in China.

In addition to the impact of macroeconomic factors, including a reduced IT spending environment and reductions in spending by government entities, revenue by segment in a particular period may be significantly impacted by several factors related to revenue recognition, including the complexity of transactions such as multiple performance obligations; the mix of financing arrangements provided to channel partners and customers; and final acceptance of the product, system, or solution, among other factors. In addition, certain customers tend to make large and sporadic purchases, and the revenue related to these transactions may also be affected by the timing of revenue recognition, which in turn would impact the revenue of the relevant segment. As has been the case in certain emerging countries from time to time, certain customers require greater levels of financing arrangements, service, and support, and these activities may occur in future periods, which may also impact the timing of the recognition of revenue.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Total revenue increased by 6%. Product revenue increased by 8% and service revenue increased by 2%. Our total revenue reflected growth across each of our geographic segments. Product revenue for the emerging countries of BRICM, in the aggregate, experienced 14% product revenue growth, with increases in Mexico, India, Russia and Brazil, partially offset by decrease in China.

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CISCO SYSTEMS, INC.

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

## Product Revenue by Segment

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

|                               | Three Months Ended |                  |                     |                     | Six Months Ended |                  |                     |                     |
|-------------------------------|--------------------|------------------|---------------------|---------------------|------------------|------------------|---------------------|---------------------|
|                               | January 26, 2019   | January 27, 2018 | Variance in Dollars | Variance in Percent | January 26, 2019 | January 27, 2018 | Variance in Dollars | Variance in Percent |
| Product revenue:              |                    |                  |                     |                     |                  |                  |                     |                     |
| Americas                      | \$5,349            | \$4,988          | \$361               | 7 %                 | \$11,060         | \$10,380         | \$680               | 7 %                 |
| Percentage of product revenue | 57.7 %             | 57.3 %           |                     |                     | 57.7 %           | 58.4 %           |                     |                     |
| EMEA                          | 2,512              | 2,375            | 137                 | 6 %                 | 5,039            | 4,614            | 425                 | 9 %                 |
| Percentage of product revenue | 27.1 %             | 27.3 %           |                     |                     | 26.3 %           | 26.0 %           |                     |                     |
| APJC                          | 1,413              | 1,346            | 67                  | 5 %                 | 3,064            | 2,769            | 295                 | 11 %                |
| Percentage of product revenue | 15.2 %             | 15.4 %           |                     |                     | 16.0 %           | 15.6 %           |                     |                     |
| Total                         | \$9,273            | \$8,709          | \$564               | 6 %                 | \$19,163         | \$17,763         | \$1,400             | 8 %                 |

Amounts may not sum and percentages may not recalculate due to rounding.

## Americas

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Product revenue in the Americas segment increased by 7%, led by solid growth in the public sector, enterprise and commercial markets, partially offset by a decline in the service provider market. From a country perspective, product revenue increased by 7% in the United States, 35% in Mexico, 11% in Canada and 14% in Brazil.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

The increase in product revenue in the Americas segment was led by growth in the enterprise, public sector and commercial markets. These increases were partially offset by a product revenue decline in the service provider market. From a country perspective, product revenue increased by 7% in the United States, 48% in Mexico, 16% in Canada and 7% in Brazil.

## EMEA

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Product revenue in the EMEA segment increased by 6%, with growth in the public sector, enterprise and commercial markets partially offset by a decline in the service provider market. Product revenue from emerging countries within EMEA was flat and product revenue for the remainder of the EMEA segment, which primarily consists of countries in Western Europe, increased by 8%.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Product revenue in the EMEA segment increased by 9%, with growth across each of the customer markets in this geographic segment. Product revenue from emerging countries within EMEA increased by 5% and product revenue for the remainder of the EMEA segment increased by 11%.

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CISCO SYSTEMS, INC.

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

## APJC

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Product revenue in the APJC segment increased by 5%, led by solid growth in the public sector and enterprise markets and, to a lesser extent, growth in the commercial market. These increases were partially offset by a product revenue decline in the service provider market. From a country perspective, product revenue in India and in Japan each increased by 18% while product revenue in China decreased by 16%.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Product revenue in the APJC segment increased 11%, with growth across each of the customer markets in this geographic segment. From a country perspective, product revenue increased by 36% in India and 13% in Japan while product revenue in China decreased by 8%.

## Product Revenue by Groups of Similar Products

In addition to the primary view on a geographic basis, we also prepare financial information related to groups of similar products and customer markets for various purposes. We report our product revenue in the following categories: Infrastructure Platforms, Applications, Security, and Other Products. This aligns our product categories with our evolving business model. Prior period amounts have been reclassified to conform to the current period's presentation.

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

|                          | Three Months Ended  |                     |                           | Six Months Ended    |                     |                           | Variance<br>in<br>Dollars | Variance<br>in<br>Percent | Variance<br>in<br>Dollars | Variance<br>in<br>Percent |
|--------------------------|---------------------|---------------------|---------------------------|---------------------|---------------------|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
|                          | January 26,<br>2019 | January 27,<br>2018 | Variance<br>in<br>Dollars | January 26,<br>2019 | January 27,<br>2018 | Variance<br>in<br>Dollars |                           |                           |                           |                           |
| Product revenue:         |                     |                     |                           |                     |                     |                           |                           |                           |                           |                           |
| Infrastructure Platforms | \$7,128             | \$ 6,710            | \$ 418                    | 6                   | %                   | \$14,770                  | \$ 13,690                 | \$ 1,080                  | 8                         | %                         |
| Applications             | 1,465               | 1,184               | 281                       | 24                  | %                   | 2,884                     | 2,387                     | 497                       | 21                        | %                         |
| Security                 | 658                 | 557                 | 101                       | 18                  | %                   | 1,308                     | 1,142                     | 166                       | 15                        | %                         |
| Other Products           | 22                  | 258                 | (236 )                    | (91 )               | %                   | 200                       | 544                       | (344 )                    | (63 )                     | %                         |
| Total                    | \$9,273             | \$ 8,709            | \$ 564                    | 6                   | %                   | \$19,163                  | \$ 17,763                 | \$ 1,400                  | 8                         | %                         |

Amounts may not sum and percentages may not recalculate due to rounding.

## Infrastructure Platforms

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

The Infrastructure Platforms product category represents our core networking offerings related to switching, routing, wireless, and the data center. Infrastructure Platforms revenue increased by 6%, or \$418 million. Switching had solid growth, with double digit revenue growth in campus switching driven by an increase in sales of our intent-based networking Catalyst 9000 Series. We also had double digit revenue growth from wireless products driven by our Wave 2 offerings as well as Meraki. Revenue from our routing products decreased due to weakness in the service provider market. Revenue from data center also decreased driven by lower sales of server products partially offset by revenue growth in our hyperconverged data center offering, HyperFlex.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Revenue from the Infrastructure Platforms product category increased 8% or \$1,080 million, with strength across the portfolio. Switching had solid growth, with solid revenue growth in campus switching driven by an increase in sales of our intent-based networking Catalyst 9000 Series, and with revenue growth in data center switching driven by increased revenue from our Nexus 9000 Series. Routing experienced revenue growth driven by growth in the service provider market. We experienced double digit revenue growth from wireless products driven by our Wave 2 offerings and Meraki. Revenue from data center increased driven by higher sales of our hyperconverged data center offering, HyperFlex, and our server products.



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CISCO SYSTEMS, INC.

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

## Applications

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

The Applications product category includes our collaboration offerings (unified communications, Cisco TelePresence and conferencing) as well as the Internet of Things (IoT) and analytics software offerings from Jasper and AppDynamics, respectively. Revenue in our Applications product category increased by 24%, or \$281 million, with growth across all of the business. We had strong revenue growth in unified communications, Telepresence and analytics from AppDynamics.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Revenue in our Applications product category increased by 21%, or \$497 million, with solid revenue growth in unified communications, TelePresence and analytics from AppDynamics.

## Security

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Revenue in our Security product category increased 18%, or \$101 million, driven by higher sales of identity and access, advance threat security and unified threat management products. The acquisition of Duo Security in the first quarter of fiscal 2019 also contributed to the revenue increase in this product category.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Revenue in our Security product category increased 15%, or \$166 million, driven by higher sales of identity and access, advance threat security, unified threat management and web security products. The acquisition of Duo Security in the first quarter of fiscal 2019 also contributed to the revenue increase in this product category.

## Other Products

The decrease in revenue from our Other Products category for the second quarter and first six months of fiscal 2019, compared to corresponding periods of fiscal 2018, was primarily driven by a decrease in revenue from the SPVSS business which we divested on October 28, 2018.

## Service Revenue by Segment

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

|                               | Three Months Ended |                  |                     |                     | Six Months Ended |                  |                     |                     |
|-------------------------------|--------------------|------------------|---------------------|---------------------|------------------|------------------|---------------------|---------------------|
|                               | January 26, 2019   | January 27, 2018 | Variance in Dollars | Variance in Percent | January 26, 2019 | January 27, 2018 | Variance in Dollars | Variance in Percent |
| Service revenue:              |                    |                  |                     |                     |                  |                  |                     |                     |
| Americas                      | \$2,003            | \$ 2,016         | \$ (13 )            | (1 )%               | \$4,043          | \$ 3,974         | \$ 69               | 2 %                 |
| Percentage of service revenue | 63.1 %             | 63.4 %           |                     |                     | 63.6 %           | 63.5 %           |                     |                     |
| EMEA                          | 711                | 687              | 24                  | 3 %                 | 1,408            | 1,357            | 51                  | 4 %                 |
| Percentage of service revenue | 22.4 %             | 21.6 %           |                     |                     | 22.2 %           | 21.7 %           |                     |                     |
| APJC                          | 459                | 475              | (16 )               | (3 )%               | 904              | 929              | (25 )               | (3 )%               |
| Percentage of service revenue | 14.5 %             | 15.0 %           |                     |                     | 14.2 %           | 14.8 %           |                     |                     |
| Total                         | \$3,173            | \$ 3,178         | \$ (5 )             | — %                 | \$6,355          | \$ 6,260         | \$ 95               | 2 %                 |

Amounts may not sum and percentages may not recalculate due to rounding.

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Service revenue was flat. Service revenue not including the SPVSS business in the prior year period increased by 1%. The service revenue increase in the EMEA segment offset the decreases in service revenue in our APJC and Americas segments.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Service revenue increased 2%, driven by an increase in software and solution support offerings. Service revenue increased in the Americas and EMEA segments, partially offset by decreased revenue in our APJC segment.



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CISCO SYSTEMS, INC.

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

## Gross Margin

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

|               | Three Months Ended |                  |                  |                  | Six Months Ended |                  |                  |                  |
|---------------|--------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
|               | AMOUNT             |                  | PERCENTAGE       |                  | AMOUNT           |                  | PERCENTAGE       |                  |
|               | January 26, 2019   | January 27, 2018 | January 26, 2019 | January 27, 2018 | January 26, 2019 | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Gross margin: |                    |                  |                  |                  |                  |                  |                  |                  |
| Product       | \$5,659            | \$ 5,355         | 61.0 %           | 61.5 %           | \$11,750         | \$ 10,794        | 61.3 %           | 60.8 %           |
| Service       | 2,114              | 2,143            | 66.6 %           | 67.4 %           | 4,169            | 4,131            | 65.6 %           | 66.0 %           |
| Total         | \$7,773            | \$ 7,498         | 62.5 %           | 63.1 %           | \$15,919         | \$ 14,925        | 62.4 %           | 62.1 %           |

## Product Gross Margin

The following table summarizes the key factors that contributed to the change in product gross margin percentage for the second quarter and first six months of fiscal 2019, as compared with the corresponding prior year periods:

|   | Product<br>Gross Margin<br>Percentage |                        |
|---|---------------------------------------|------------------------|
|   | Three<br>Months<br>Ended              | Six<br>Months<br>Ended |
| Fiscal 2018                               | 61.5 %                                | 60.8 %                 |
| Product pricing                           | (1.0 )%                               | (1.5 )%                |
| Mix of products sold                      | 0.3 %                                 | (0.2 )%                |
| Productivity <sup>(1)</sup>               | (0.2 )%                               | 1.1 %                  |
| Legal and indemnification settlements     | (0.1 )%                               | 0.7 %                  |
| Impact from divestiture of SPVSS business | 0.5 %                                 | 0.5 %                  |
| Other                                     | — %                                   | (0.1 )%                |
| Fiscal 2019                               | 61.0 %                                | 61.3 %                 |

<sup>(1)</sup> Productivity includes overall manufacturing-related costs, such as component costs, warranty expense, provision for inventory, freight, logistics, shipment volume, and other items not categorized elsewhere.

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Product gross margin decreased by 0.5 percentage points driven by unfavorable impacts from product pricing and productivity, partially offset by favorable product mix. Our product gross margin also benefited from the sale of our lower margin SPVSS business during the second quarter of fiscal 2019.

The negative pricing impact, which was lower than the year-over-year impact we experienced in the second quarter of fiscal 2018, was driven by typical market factors and impacted each of our geographic segments and customer markets. Our productivity was negatively impacted by higher costs of memory and other components, partially offset by cost reductions including value engineering efforts (e.g. component redesign, board configuration, test processes and transformation processes) and continued operational efficiency in manufacturing operations.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Product gross margin increased by 0.5 percentage points driven by productivity improvements, partially offset by unfavorable impacts from product pricing and product mix. A charge of \$127 million to product cost of sales recorded in the first six months of fiscal 2018 related to legal and indemnification settlements also contributed to the increase. Our product gross margin also benefited from the sale of our lower margin SPVSS business during the second quarter of fiscal 2019.

Productivity improvements were driven by cost reductions including value engineering efforts (e.g. component redesign, board configuration, test processes, and transformation processes) and continued operational efficiency in

manufacturing operations.

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CISCO SYSTEMS, INC.

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

## Service Gross Margin

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Our service gross margin percentage decreased by 0.8 percentage points due to increased headcount-related costs and increased delivery costs, partially offset by favorable mix.

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

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Service gross margin percentage decreased by 0.4 percentage points due to increased headcount-related costs and increased delivery costs. These cost impacts were partially offset by the resulting benefit to gross margin of higher sales volume.

## Gross Margin by Segment

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

|  | Three Months Ended |                  |                  |                  | Six Months Ended |                  |                  |                  |
|--|--------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
|  | AMOUNT             |                  | PERCENTAGE       |                  | AMOUNT           |                  | PERCENTAGE       |                  |
|  | January 26, 2019   | January 27, 2018 | January 26, 2019 | January 27, 2018 | January 26, 2019 | January 27, 2018 | January 26, 2019 | January 27, 2018 |
| Gross margin:                              |                    |                  |                  |                  |                  |                  |                  |                  |
| Americas                                   | \$4,796            | \$ 4,614         | 65.2 %           | 65.9 %           | \$9,866          | \$ 9,336         | 65.3 %           | 65.0 %           |
| EMEA                                       | 2,070              | 1,977            | 64.2 %           | 64.6 %           | 4,141            | 3,816            | 64.2 %           | 63.9 %           |
| APJC                                       | 1,109              | 1,094            | 59.2 %           | 60.1 %           | 2,309            | 2,259            | 58.2 %           | 61.1 %           |
| Segment total                              | 7,975              | 7,685            | 64.1 %           | 64.7 %           | 16,316           | 15,411           | 63.9 %           | 64.2 %           |
| Unallocated corporate items <sup>(1)</sup> | (202 )             | (187 )           |                  |                  | (397 )           | (486 )           |                  |                  |
| Total                                      | \$7,773            | \$ 7,498         | 62.5 %           | 63.1 %           | \$15,919         | \$ 14,925        | 62.4 %           | 62.1 %           |

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

Amounts may not sum and percentages may not recalculate due to rounding.

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

We experienced a gross margin percentage decrease in our Americas segment due to unfavorable impacts from pricing and mix, partially offset by productivity improvements.

The gross margin percentage decrease in our EMEA segment was due primarily to lower service gross margin.

Product gross margin in this segment increased due to favorable product mix partially offset by negative impacts from productivity and pricing.

The APJC segment gross margin percentage decrease was due primarily to lower service gross margin. Product gross margin in this segment increased slightly due to favorable product mix and productivity improvements, partially offset by negative impacts from pricing.

The gross margin percentage for a particular segment may fluctuate, and period-to-period changes in such percentages may or may not be indicative of a trend for that segment.

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

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

The Americas segment had a gross margin percentage increase driven by productivity improvements, partially offset by unfavorable impacts from pricing and mix.

The gross margin percentage increase in our EMEA segment was due to productivity improvements and favorable mix, partially offset by negative impacts from pricing.

The APJC segment gross margin percentage decrease was due to negative impacts from pricing partially offset by favorable mix and productivity improvements.

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

|                            | Three Months Ended  |                     |                           |                           | Six Months Ended    |                     |                           |                           |
|----------------------------|---------------------|---------------------|---------------------------|---------------------------|---------------------|---------------------|---------------------------|---------------------------|
|                            | January 26,<br>2019 | January 27,<br>2018 | Variance<br>in<br>Dollars | Variance<br>in<br>Percent | January 26,<br>2019 | January 27,<br>2018 | Variance<br>in<br>Dollars | Variance<br>in<br>Percent |
| Research and development   | \$ 1,557            | \$ 1,549            | \$ 8                      | 1 %                       | \$ 3,165            | \$ 3,116            | \$ 49                     | 2 %                       |
| Percentage of revenue      | 12.5 %              | 13.0 %              |                           |                           | 12.4 %              | 13.0 %              |                           |                           |
| Sales and marketing        | 2,271               | 2,235               | 36                        | 2 %                       | 4,681               | 4,569               | 112                       | 2 %                       |
| Percentage of revenue      | 18.2 %              | 18.8 %              |                           |                           | 18.3 %              | 19.0 %              |                           |                           |
| General and administrative | 509                 | 483                 | 26                        | 5 %                       | 720                 | 1,040               | (320 )                    | (31 )%                    |
| Percentage of revenue      | 4.1 %               | 4.1 %               |                           |                           | 2.8 %               | 4.3 %               |                           |                           |
| Total                      | \$ 4,337            | \$ 4,267            | \$ 70                     | 2 %                       | \$ 8,566            | \$ 8,725            | \$ (159 )                 | (2 )%                     |
| Percentage of revenue      | 34.8 %              | 35.9 %              |                           |                           | 33.6 %              | 36.3 %              |                           |                           |

## R&amp;D Expenses

## Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

R&D expenses increased slightly as increases in headcount-related expenses and acquisition-related/divestiture costs significantly offset the decrease in discretionary spending.

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

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

R&D expenses increased primarily due to higher headcount-related expenses and, to a lesser extent, higher contracted services and higher acquisition-related/divestiture costs. These increases were partially offset by lower discretionary spending and share-based compensation expense.

## Sales and Marketing Expenses

## Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Sales and marketing expenses increased due to higher discretionary spending, headcount-related expenses, contracted services and acquisition-related/divestiture costs, partially offset by lower share-based compensation expense.

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Sales and marketing expenses increased due to higher discretionary spending, higher headcount-related expenses and, to a lesser extent, higher contracted services and higher acquisition-related/divestiture costs, partially offset by lower share-based compensation expense.



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CISCO SYSTEMS, INC.

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

## G&amp;A Expenses

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

G&amp;A expenses increased due to higher discretionary spending and headcount-related expenses, partially offset by lower contracted services.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

G&amp;A expenses decreased due to a benefit from the \$400 million litigation settlement with Arista, partially offset by higher discretionary spending, higher acquisition-related/divestiture costs and higher headcount-related expenses.

## Effect of Foreign Currency

In the second quarter of fiscal 2019, foreign currency fluctuations, net of hedging, decreased the combined R&amp;D, sales and marketing, and G&amp;A expenses by approximately \$52 million, or 1.2%, compared with the second quarter of fiscal 2018.

In the first six months of fiscal 2019, foreign currency fluctuations, net of hedging, decreased the combined R&amp;D, sales and marketing, and G&amp;A expenses by approximately \$102 million, or 1.2%, compared with the first six months of fiscal 2018.

## Share-Based Compensation Expense

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

|  | Three Months<br>Ended<br>January 26,<br>2019 |        | Six Months<br>Ended<br>January 27,<br>2018 |        |
|--|--|--------|--|--------|
| Cost of sales—product                                  | \$22   | \$ 23  | \$45                                       | \$ 46  |
| Cost of sales—service                                  | 31   | 31     | 64   | 65     |
| Share-based compensation expense in cost of sales      | 53   | 54     | 109  | 111    |
| Research and development                               | 133  | 134    | 263  | 270    |
| Sales and marketing                                    | 125  | 135    | 262  | 270    |
| General and administrative                             | 65   | 64     | 127  | 128    |
| Restructuring and other charges                        | 19   | 12     | 42   | 18     |
| Share-based compensation expense in operating expenses | 342  | 345    | 694  | 686    |
| Total share-based compensation expense                 | \$395  | \$ 399 | \$803                                      | \$ 797 |

Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

The decrease in share-based compensation expense was due primarily to higher forfeitures partially offset by higher restructuring charges.

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

The increase in share-based compensation expense was due primarily to higher restructuring charges.

## Amortization of Purchased Intangible Assets

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

|  | Three Months<br>Ended<br>January 26,<br>2019 |        | Six Months<br>Ended<br>January 27,<br>2018 |        |
|--|--|--------|--|--------|
| Amortization of purchased intangible assets: |  |        |  |        |
| Cost of sales                                | \$156  | \$ 160 | \$307                                      | \$ 314 |
| Operating expenses                           | 39   | 60     | 73   | 121    |
| Total  | \$195  | \$ 220 | \$380                                      | \$ 435 |



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

## Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Amortization of purchased intangible assets decreased due largely to the purchased intangible assets related to the divestiture of SPVSS business on October 28, 2018, partially offset by amortization from our recent acquisitions.

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Amortization of purchased intangible assets decreased due largely to the purchased intangible assets related to the divestiture of SPVSS business on October 28, 2018, partially offset by amortization from our recent acquisitions.

## Restructuring and Other Charges

We initiated a restructuring plan during fiscal 2018 in order to realign our organization and enable further investment in key priority areas, with estimated pretax charges of approximately \$600 million. In connection with this restructuring plan, we incurred charges of \$186 million and \$264 million for the second quarter and first six months of fiscal 2019, respectively, and have incurred cumulative charges of \$372 million since inception. We expect this restructuring plan to be substantially completed in fiscal 2019.

We incurred restructuring and other charges of \$98 million and \$250 million for the second quarter and first six months of fiscal 2018 in connection with the restructuring plan announced in August 2016.

These charges were primarily cash-based and consisted of employee severance and other one-time termination benefits, and other associated costs. We expect to reinvest substantially all of the cost savings from these restructuring actions in our key priority areas. As a result, the overall cost savings from these restructuring actions are not expected to be material for future periods.

## Operating Income

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

|   | Three Months Ended |             | Six Months Ended |             |
|---|--------------------|-------------|------------------|-------------|
|   | January 26,        | January 27, | January 26,      | January 27, |
|   | 2019               | 2018        | 2019             | 2018        |
| Operating income                            | \$3,211            | \$ 3,073    | \$7,016          | \$ 5,829    |
| Operating income as a percentage of revenue | 25.8 %             | 25.9 %      | 27.5 %           | 24.3 %      |

## Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

Operating income increased by 4% and as a percentage of revenue operating income decreased by 0.1 percentage points. These changes resulted primarily from: a revenue increase, a gross margin percentage decrease (driven primarily by unfavorable impacts from pricing and productivity), and higher restructuring and other charges.

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

Operating income increased by 20% and as a percentage of revenue operating income increased by 3.2 percentage points. These increases resulted primarily from: a revenue increase, a gross margin percentage increase (driven primarily by productivity improvements and a charge of \$127 million to product cost of sales recorded in the first six months of fiscal 2018 related to legal and indemnification settlements) and a benefit from the \$400 million litigation settlement with Arista in the first quarter of fiscal 2019.

## Interest and Other Income (Loss), Net

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

|                                | Three Months Ended |             |          | Six Months Ended |             |           |
|--------------------------------|--------------------|-------------|----------|------------------|-------------|-----------|
|                                | January 26,        | January 27, | Variance | January 26,      | January 27, | Variance  |
|                                | 2019               | 2018        | in       | 2019             | 2018        | in        |
|                                |                    |             | Dollars  |                  |             | Dollars   |
| Interest income                | \$328              | \$ 396      | \$ (68 ) | \$672            | \$ 775      | \$ (103 ) |
| Interest expense               | (223 )             | (247 )      | ) 24     | (444 )           | (482 )      | ) 38      |
| Interest income (expense), net | \$105              | \$ 149      | \$ (44 ) | \$228            | \$ 293      | \$ (65 )  |

Interest income decreased, driven by a decrease in the average balance of cash and available-for-sale debt investments. The decrease in interest expense was driven by a lower average debt balance, partially offset by the impact of higher effective interest rates.

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CISCO SYSTEMS, INC.

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

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

|   | Three Months Ended  |                     |                           | Six Months Ended    |                     |                           |
|---|---------------------|---------------------|---------------------------|---------------------|---------------------|---------------------------|
|   | January 26,<br>2019 | January 27,<br>2018 | Variance<br>in<br>Dollars | January 26,<br>2019 | January 27,<br>2018 | Variance<br>in<br>Dollars |
| Gains (losses) on investments, net:         |                     |                     |                           |                     |                     |                           |
| Available-for-sale debt investments         | \$(5 )              | \$( 96 )            | \$ 91                     | \$(11)              | \$( 92 )            | \$ 81                     |
| Marketable equity investments               | 61                  | 154                 | (93 )                     | 57                  | 183                 | (126 )                    |
| Non-marketable equity and other investments | (3 )                | 2                   | (5 )                      | 1                   | 37                  | (36 )                     |
| Net gains (losses) on investments           | 53                  | 60                  | (7 )                      | 47                  | 128                 | (81 )                     |
| Other gains (losses), net                   | (26 )               | (50 )               | 24                        | (39 )               | (56 )               | 17                        |
| Other income (loss), net                    | \$27                | \$ 10               | \$ 17                     | \$8                 | \$ 72               | \$ (64 )                  |

## Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

The total change in net gains (losses) on available-for-sale debt investments was primarily attributable to lower realized losses as a result of market conditions, and the timing of sales of these investments.

The total change in net gains (losses) on marketable equity investments was attributable to market value fluctuations and the timing of recognition of gains and losses.

The change in net gains (losses) on non-marketable equity and other investments was primarily due to higher realized net losses, partially offset by higher unrealized gains and lower impairment charges.

The change in other gains (losses), net was primarily driven by net favorable foreign exchange impacts.

## Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

The total change in net gains (losses) on available-for-sale debt investments was primarily attributable to lower realized losses as a result of market conditions, and the timing of sales of these investments.

The total change in net gains (losses) on marketable equity investments was attributable to market value fluctuations and the timing of recognition of gains and losses.

The change in net gains (losses) on non-marketable equity and other investments was primarily due to higher realized net losses, partially offset by higher unrealized gains and lower impairment charges.

The change in other gains (losses), net was driven by net favorable foreign exchange impacts partially offset by lower gains from customer lease terminations.

## Provision for Income Taxes

## Three Months Ended January 26, 2019 Compared with Three Months Ended January 27, 2018

The provision for income taxes resulted in an effective tax rate of 15.6% for the second quarter of fiscal 2019 compared with 371.6% for the second quarter of fiscal 2018. The decrease in the effective tax rate was primarily due to the one-time transition tax on accumulated earnings of foreign subsidiaries, foreign withholding tax, and DTA re-measurement recorded during the second quarter of fiscal 2018.

Our effective tax rate will increase or decrease based upon the tax effect of the difference between the share-based compensation expenses and the benefits taken on the company's tax returns. We recognize excess tax benefits on a discrete basis and therefore anticipate the effective tax rate to vary from quarter to quarter depending on our share price in each period.

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CISCO SYSTEMS, INC.

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

Six Months Ended January 26, 2019 Compared with Six Months Ended January 27, 2018

The provision for income taxes resulted in an effective tax rate of 12.1% for the first six months of fiscal 2019 compared with 203.1% for the first six months of fiscal 2018. The decrease in the effective tax rate was primarily due to the one-time transition tax on accumulated earnings of foreign subsidiaries, foreign withholding tax, and DTA re-measurement recorded during the first six months of fiscal 2018.

## LIQUIDITY AND CAPITAL RESOURCES

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

## Balance Sheet and Cash Flows

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

|                                     | January 26, July 28, |          | Increase    |
|-------------------------------------|----------------------|----------|-------------|
|                                     | 2019                 | 2018     | (Decrease)  |
| Cash and cash equivalents           | \$ 9,835             | \$8,934  | \$ 901      |
| Available-for-sale debt investments | 30,486               | 37,009   | (6,523 )    |
| Marketable equity securities        | 62                   | 605      | (543 )      |
| Total                               | \$ 40,383            | \$46,548 | \$ (6,165 ) |

The decrease in cash and cash equivalents and investments in the first six months of fiscal 2019 was primarily driven by cash returned to shareholders in the form of repurchases of common stock of \$10.1 billion under the stock repurchase program and cash dividends of \$3.0 billion; net cash paid for acquisitions and divestitures of \$1.6 billion; and capital expenditures of \$0.5 billion. These uses of cash were partially offset by cash provided by operating activities of \$7.6 billion and timing of settlements of investments and other of \$1.6 billion.

In addition to cash requirements in the normal course of business, in the third quarter of fiscal 2019 on February 6, 2019, we closed the acquisition of Luxtera for a purchase price of approximately \$0.7 billion in cash and assumed equity awards. Also approximately \$0.7 billion of the U.S. transition tax on accumulated earnings for foreign subsidiaries is payable in less than one year. Additionally, \$9.7 billion of long term debt which was outstanding at January 26, 2019 (of which \$2.0 billion was repaid on February 15, 2019) and approximately \$2 billion of commercial paper notes (issued in February 2019) will mature within the next 12 months from the balance sheet date. See further discussion of liquidity under "Liquidity and Capital Resource Requirements" below.

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

**Free Cash Flow and Capital Allocation** As part of our capital allocation strategy, we intend to return a minimum of 50% of our free cash flow annually to our shareholders through cash dividends and repurchases of common stock. We define free cash flow as net cash provided by operating activities less cash used to acquire property and equipment. The following table reconciles our net cash provided by operating activities to free cash flow (in millions):

|   | Six Months Ended |             |
|---|------------------|-------------|
|   | January 26,      | January 27, |
|   | 2019             | 2018        |
| Net cash provided by operating activities | \$7,560          | \$ 7,150    |

|                                       |         |          |
|---------------------------------------|---------|----------|
| Acquisition of property and equipment | (473 )  | (379 )   |
| Free cash flow                        | \$7,087 | \$ 6,771 |

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CISCO SYSTEMS, INC.

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

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

We consider free cash flow to be a liquidity measure that provides useful information to management and investors because of our intent to return a stated percentage of free cash flow to shareholders in the form of dividends and stock repurchases. We further regard free cash flow as a useful measure because it reflects cash that can be used to, among other things, invest in our business, make strategic acquisitions, repurchase common stock, and pay dividends on our common stock, after deducting capital investments. A limitation of the utility of free cash flow as a measure of financial performance and liquidity is that the free cash flow does not represent the total increase or decrease in our cash balance for the period. In addition, we have other required uses of cash, including repaying the principal of our outstanding indebtedness. Free cash flow is not a measure calculated in accordance with U.S. generally accepted accounting principles and should not be regarded in isolation or as an alternative for net income provided by operating activities or any other measure calculated in accordance with such principles, and other companies may calculate free cash flow in a different manner than we do.

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

| Quarter Ended    | DIVIDENDS |          | STOCK REPURCHASE PROGRAM |                                  |          |          |
|------------------|-----------|----------|--------------------------|----------------------------------|----------|----------|
|                  | Per Share | Amount   | Shares                   | Weighted-Average Price per Share | Amount   | TOTAL    |
| Fiscal 2019      |           |          |                          |                                  |          |          |
| January 26, 2019 | \$0.33    | \$ 1,470 | 111                      | \$ 45.09                         | \$ 5,016 | \$ 6,486 |
| October 27, 2018 | \$0.33    | \$ 1,500 | 109                      | \$ 46.01                         | \$ 5,026 | \$ 6,526 |
| Fiscal 2018      |           |          |                          |                                  |          |          |
| July 28, 2018    | \$0.33    | \$ 1,535 | 138                      | \$ 43.58                         | \$ 6,015 | \$ 7,550 |
| April 28, 2018   | \$0.33    | \$ 1,572 | 140                      | \$ 42.83                         | \$ 6,015 | \$ 7,587 |
| January 27, 2018 | \$0.29    | \$ 1,425 | 103                      | \$ 39.07                         | \$ 4,011 | \$ 5,436 |
| October 28, 2017 | \$0.29    | \$ 1,436 | 51                       | \$ 31.80                         | \$ 1,620 | \$ 3,056 |

On February 13, 2019, our Board of Directors declared a quarterly dividend of \$0.35 per common share to be paid on April 24, 2019 to all shareholders of record as of the close of business on April 5, 2019. Any future dividends are subject to the approval of our Board of Directors.

On February 13, 2019, our Board of Directors authorized a \$15 billion increase to the stock repurchase program. The remaining authorized amount for stock repurchases under this program, including the additional authorization, is approximately \$24 billion, with no termination date.

The purchase price for the shares of our stock repurchased is reflected as a reduction to shareholders' equity. We are required to allocate the purchase price of the repurchased shares as (i) a reduction to retained earnings and (ii) a reduction of common stock and additional paid-in capital. As a result of future stock repurchases, we may report an accumulated deficit in future periods in shareholders' equity.

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

|                          | January 26, 2019 | July 28, 2018 | Increase (Decrease) |
|--------------------------|------------------|---------------|---------------------|
| Accounts receivable, net | \$ 3,745         | \$ 5,554      | \$ (1,809 )         |

Our accounts receivable net, as of January 26, 2019 decreased by approximately 33%, as compared with the end of fiscal 2018, primarily due to product and service billings being more linear in the second quarter of fiscal 2019 compared with the fourth quarter of fiscal 2018.

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CISCO SYSTEMS, INC.

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

**Inventory Supply Chain** The following table summarizes our inventories and purchase commitments with contract manufacturers and suppliers (in millions):

|             | January 26, 2019 | July 28, 2018 | Increase (Decrease) |
|-------------|------------------|---------------|---------------------|
| Inventories | \$ 1,701         | \$ 1,846      | \$ (145 )           |

Inventory as of January 26, 2019 decreased by 8% from our inventory balance at the end of fiscal 2018. The decrease in inventory was due primarily to lower deferred cost of sales related to the adoption of ASC 606 in the beginning of our first quarter of fiscal 2019.

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

Our purchase commitments are for short-term product manufacturing requirements as well as for commitments to suppliers to secure manufacturing capacity. Certain of our purchase commitments with contract manufacturers and suppliers relate to arrangements to secure long-term pricing for certain product components for multi-year periods. A significant portion of our reported purchase commitments arising from these agreements are firm, noncancelable, and unconditional commitments. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. We believe our inventory and purchase commitments levels are in line with our current demand forecasts. The following table summarizes our purchase commitments with contract manufacturers and suppliers as of the respective period ends (in millions):

| Commitments by Period | January 26, 2019 | July 28, 2018 |
|-----------------------|------------------|---------------|
| Less than 1 year      | \$ 5,366         | \$ 5,407      |
| 1 to 3 years          | 731              | 710           |
| 3 to 5 years          | 180              | 360           |
| Total                 | \$ 6,277         | \$ 6,477      |

Purchase commitments with contract manufacturers and suppliers decreased 3% compared to the end of fiscal 2018. On a combined basis, inventories and purchase commitments with contract manufacturers and suppliers decreased by 4% compared with the end of fiscal 2018.

Inventory and supply chain management remain areas of focus as we balance the need to maintain supply chain flexibility to help ensure competitive lead times with the risk of inventory obsolescence because of rapidly changing technology and customer requirements. We believe the amount of our inventory and purchase commitments is appropriate for our revenue levels.

**Financing Receivables and Guarantees** The following table summarizes our financing receivables (in millions):

|                                 | January 26, 2019 | July 28, 2018 | Increase (Decrease) |
|---------------------------------|------------------|---------------|---------------------|
| Lease receivables, net          | \$ 2,371         | \$ 2,576      | \$ (205 )           |
| Loan receivables, net           | 4,862            | 4,939         | (77 )               |
| Financed service contracts, net | 2,389            | 2,316         | 73                  |
| Total, net                      | \$ 9,622         | \$ 9,831      | \$ (209 )           |

**Financing Receivables** Our financing arrangements include leases, loans, and financed service contracts. Lease receivables include sales-type and direct-financing leases. Arrangements related to leases are generally collateralized by a security interest in the underlying assets. Our loan receivables include customer financing for purchases of our hardware, software and services and also may include additional funds for other costs associated with network installation and integration of our products and services. We also provide financing to certain qualified customers for

long-term service contracts, which primarily relate to technical support services. The majority of the revenue from these financed service contracts is deferred and is recognized ratably over the period during which the services are performed. Financing receivables decreased by 2%. We expect to continue to expand the use of our financing programs in the near term.

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CISCO SYSTEMS, INC.

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

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

The volume of channel partner financing was \$14.5 billion and \$13.6 billion for the first six months of fiscal 2019 and 2018, respectively. These financing arrangements facilitate the working capital requirements of the channel partners, and in some cases, we guarantee a portion of these arrangements. The balance of the channel partner financing subject to guarantees was \$1.3 billion and \$1.0 billion as of January 26, 2019 and July 28, 2018, respectively. We could be called upon to make payments under these guarantees in the event of nonpayment by the channel partners or end-user customers. Historically, our payments under these arrangements have been immaterial. Where we provide a guarantee, we defer the revenue associated with the channel partner and end-user financing arrangement in accordance with revenue recognition policies, or we record a liability for the fair value of the guarantees. In either case, the deferred revenue is recognized as revenue when the guarantee is removed. As of January 26, 2019, the total maximum potential future payments related to these guarantees was approximately \$363 million, of which approximately \$86 million was recorded as deferred revenue.

**Borrowings**

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

|                              | Maturity Date         | January 26,<br>2019 | July 28,<br>2018 |
|------------------------------|-----------------------|---------------------|------------------|
| Senior notes:                |                       |                     |                  |
| Floating-rate notes:         |                       |                     |                  |
| Three-month LIBOR plus 0.50% | March 1, 2019         | \$ 500              | \$ 500           |
| Three-month LIBOR plus 0.34% | September 20,<br>2019 | 500                 | 500              |
| Fixed-rate notes:            |                       |                     |                  |
| 4.95%                        | February 15,<br>2019  | 2,000               | 2,000            |
| 1.60%                        | February 28,<br>2019  | 1,000               | 1,000            |
| 2.125%                       | March 1, 2019         | 1,750               | 1,750            |
| 1.40%                        | September 20,<br>2019 | 1,500               | 1,500            |
| 4.45%                        | January 15,<br>2020   | 2,500               | 2,500            |
| 2.45%                        | June 15, 2020         | 1,500               | 1,500            |
| 2.20%                        | February 28,<br>2021  | 2,500               | 2,500            |
| 2.90%                        | March 4, 2021         | 500                 | 500              |
| 1.85%                        | September 20,<br>2021 | 2,000               | 2,000            |
| 3.00%                        | June 15, 2022         | 500                 | 500              |
| 2.60%                        |                       | 500                 | 500              |

|        |                       |           |           |
|--------|-----------------------|-----------|-----------|
|        | February 28,<br>2023  |           |           |
| 2.20%  | September 20,<br>2023 | 750       | 750       |
| 3.625% | March 4, 2024         | 1,000     | 1,000     |
| 3.50%  | June 15, 2025         | 500       | 500       |
| 2.95%  | February 28,<br>2026  | 750       | 750       |
| 2.50%  | September 20,<br>2026 | 1,500     | 1,500     |
| 5.90%  | February 15,<br>2039  | 2,000     | 2,000     |
| 5.50%  | January 15,<br>2040   | 2,000     | 2,000     |
| Total  |                       | \$ 25,750 | \$ 25,750 |

We repaid our senior notes due on February 15, 2019 for an aggregate principal amount of \$2.0 billion upon maturity. Interest is payable semiannually on each class of the senior fixed-rate notes, each of which is redeemable by us at any time, subject to a make-whole premium. Interest is payable quarterly on the floating-rate notes. We were in compliance with all debt covenants as of January 26, 2019.

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CISCO SYSTEMS, INC.

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

**Commercial Paper** We have a short-term debt financing program in which up to \$10.0 billion is available through the issuance of commercial paper notes. We use the proceeds from the issuance of commercial paper notes for general corporate purposes. We had no commercial paper notes outstanding as of January 26, 2019 and July 28, 2018. As of February 18, 2019, we had approximately \$2 billion of commercial paper notes outstanding.

**Credit Facility** On May 15, 2015, we entered into a credit agreement with certain institutional lenders that provides for a \$3.0 billion unsecured revolving credit facility that is scheduled to expire on May 15, 2020. Any advances under the credit agreement will accrue interest at rates that are equal to, based on certain conditions, either (i) the highest of (a) the Federal Funds rate plus 0.50%, (b) Bank of America's "prime rate" as announced from time to time, or (c) LIBOR, or a comparable or successor rate that is approved by the Administrative Agent ("Eurocurrency Rate"), for an interest period of one month plus 1.00%, or (ii) the Eurocurrency Rate, plus a margin that is based on our senior debt credit ratings as published by Standard & Poor's Financial Services, LLC and Moody's Investors Service, Inc., provided that in no event will the Eurocurrency Rate be less than zero. We may also, upon the agreement of either the then-existing lenders or additional lenders not currently parties to the agreement, increase the commitments under the credit facility by up to an additional \$2.0 billion and/or extend the expiration date of the credit facility up to May 15, 2022. This credit agreement requires that we comply with certain covenants, including that we maintain an interest coverage ratio as defined in the agreement. As of January 26, 2019, we were in compliance with the required interest coverage ratio and the other covenants, and we had not borrowed any funds under the credit facility.

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

|              | January 26,<br>2019 | July 28,<br>2018 | Increase<br>(Decrease) |
|--------------|---------------------|------------------|------------------------|
| Service      | \$ 11,246           | \$ 11,431        | \$ (185 )              |
| Product      | 6,015               | 8,254            | (2,239 )               |
| Total        | \$ 17,261           | \$ 19,685        | \$ (2,424 )            |
| Reported as: |                     |                  |                        |
| Current      | \$ 9,976            | \$ 11,490        | \$ (1,514 )            |
| Noncurrent   | 7,285               | 8,195            | (910 )                 |
| Total        | \$ 17,261           | \$ 19,685        | \$ (2,424 )            |

Deferred revenue decreased primarily due to the adoption of ASC 606 in the beginning of our first quarter of fiscal 2019. Of the total deferred revenue decrease related to ASC 606 of \$2.8 billion, \$2.6 billion relates to deferred product revenue and \$0.2 billion relates to deferred service revenue. Of the adjustment to deferred product revenue, \$1.3 billion relates to our recurring software and subscription offers, \$0.6 billion relates to two-tier distribution, and the remainder relates to non-recurring software and other adjustments.

**Contractual Obligations****Operating Leases**

We lease office space in many U.S. locations. Outside the United States, larger leased sites include sites in Australia, Belgium, Canada, China, Germany, India, Japan, Mexico, Poland and the United Kingdom. We also lease equipment and vehicles. The future minimum lease payments under all of our noncancelable operating leases with an initial term in excess of one year as of January 26, 2019 were \$1.2 billion.

**Transition Tax Payable**

The income tax payable outstanding as of January 26, 2019 for the U.S. transition tax on accumulated earnings for foreign subsidiaries is \$7.4 billion. Approximately \$0.7 billion is payable in less than one year; \$1.3 billion is payable between 1 to 3 years; \$1.9 billion is payable between 3 to 5 years; and the remaining \$3.5 billion is payable in more than 5 years. See Note 17 to the Consolidated Financial Statements.

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CISCO SYSTEMS, INC.

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

Other Commitments

In connection with our acquisitions, we have agreed to pay certain additional amounts contingent upon the achievement of certain agreed-upon technology, development, product, or other milestones or the continued employment with us of certain employees of the acquired entities. See Note 13 to the Consolidated Financial Statements.

**Other Funding Commitments** We also have certain funding commitments primarily related to our non-marketable equity and other investments, some of which are based on the achievement of certain agreed-upon milestones, and some of which are required to be funded on demand. The funding commitments were \$357 million as of January 26, 2019, compared with \$223 million as of July 28, 2018.

Off-Balance Sheet Arrangements

We consider our investments in unconsolidated variable interest entities to be off-balance sheet arrangements. In the ordinary course of business, we have non-marketable equity and other investments and provide financing to certain customers. Certain of these investments are considered to be variable interest entities. We evaluate on an ongoing basis our non-marketable equity and other investments and customer financings, and we have determined that as of January 26, 2019 there were no material unconsolidated variable interest entities.

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

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

Liquidity and Capital Resource Requirements

Based on past performance and current expectations, we believe our cash and cash equivalents, investments, cash generated from operations, and ability to access capital markets and committed credit lines will satisfy, through at least the next 12 months, our liquidity requirements, both in total and domestically, including the following: working capital needs, capital expenditures, investment requirements, stock repurchases, cash dividends, contractual obligations, commitments, principal and interest payments on debt, pending acquisitions, future customer financings, and other liquidity requirements associated with our operations. There are no other transactions, arrangements, or relationships with unconsolidated entities or other persons that are reasonably likely to materially affect the liquidity and the availability of, as well as our requirements for, capital resources.

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

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

**Interest Rate Risk**

**Available-for-Sale Debt Investments** We maintain an investment portfolio of various holdings, types, and maturities. Our primary objective for holding available-for-sale debt investments is to achieve an appropriate investment return consistent with preserving principal and managing risk. At any time, a sharp rise in market interest rates could have a material adverse impact on the fair value of our available-for-sale debt investment portfolio. Conversely, declines in interest rates, including the impact from lower credit spreads, could have a material adverse impact on interest income for our investment portfolio. We may utilize derivative instruments designated as hedging instruments to achieve our investment objectives. We had no outstanding hedging instruments for our available-for-sale debt investments as of January 26, 2019. Our available-for-sale debt investments are held for purposes other than trading. Our available-for-sale debt investments are not leveraged as of January 26, 2019. We monitor our interest rate and credit risks, including our credit exposures to specific rating categories and to individual issuers. We believe the overall credit quality of our portfolio is strong.

**Financing Receivables** As of January 26, 2019, our financing receivables had a carrying value of \$9.6 billion, compared with \$9.8 billion as of July 28, 2018. As of January 26, 2019, a hypothetical 50 basis points (“BPS”) increase or decrease in market interest rates would change the fair value of our financing receivables by a decrease or increase of approximately \$0.1 billion, respectively.

**Debt** As of January 26, 2019, we had \$25.8 billion in principal amount of senior notes outstanding, which consisted of \$1.0 billion floating-rate notes and \$24.8 billion fixed-rate notes. The carrying amount of the senior notes was \$25.6 billion, and the related fair value based on market prices was \$26.5 billion. As of January 26, 2019, a hypothetical 50 BPS increase or decrease in market interest rates would change the fair value of the fixed-rate debt, excluding the \$6.8 billion of hedged debt, by a decrease or increase of approximately \$0.5 billion, respectively. However, this hypothetical change in interest rates would not impact the interest expense on the fixed-rate debt that is not hedged.

**Equity Price Risk**

**Marketable Equity Investments.** The fair value of our marketable equity investments is subject to market price volatility. We may hold equity securities for strategic purposes or to diversify our overall investment portfolio. These equity securities are held for purposes other than trading. To manage our exposure to changes in the fair value of certain equity securities, we may enter into equity derivatives designated as hedging instruments. As of January 26, 2019, the total fair value of our investments in marketable equity securities was \$62 million.

**Non-marketable Equity and Other Investments** These investments are recorded in other assets in our Consolidated Balance Sheets. As of January 26, 2019, the total carrying amount of our investments in non-marketable equity and other investments was \$1.25 billion, compared with \$1.1 billion at July 28, 2018. Some of these companies in which we invested are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. We could lose our entire investment in these companies. Our evaluation of non-marketable equity and other investments is based on the fundamentals of the businesses invested in, including, among other factors, the nature of their technologies and potential for financial return.

**Foreign Currency Exchange Risk**

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

|                    | January 26, 2019   |            | July 28, 2018      |            |
|--------------------|--------------------|------------|--------------------|------------|
|                    | Notional<br>Amount | Fair Value | Notional<br>Amount | Fair Value |
| Forward contracts: |                    |            |                    |            |
| Purchased          | \$2,170            | \$ —       | \$1,850            | \$ (2 )    |

|                   |         |         |       |      |
|-------------------|---------|---------|-------|------|
| Sold              | \$1,361 | \$ (1 ) | \$845 | \$ 2 |
| Option contracts: |         |         |       |      |
| Purchased         | \$155   | \$ 1    | \$—   | \$ — |
| Sold              | \$146   | \$ (1 ) | \$—   | \$ — |

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

Approximately 70% of our operating expenses are U.S.-dollar denominated. In the first six months of fiscal 2019, foreign currency fluctuations, net of hedging, decreased our combined R&D, sales and marketing, and G&A expenses by approximately \$102 million, or 1.2%, compared with the first six months of fiscal 2018. To reduce variability in operating expenses and service cost of sales caused by non-U.S.-dollar denominated operating expenses and costs, we may hedge certain forecasted foreign currency transactions with currency options and forward contracts. These hedging programs are not designed to provide foreign currency protection over long time horizons. In designing a specific hedging approach, we consider several factors, including offsetting exposures, significance of exposures, costs associated with entering into a particular hedge instrument, and potential effectiveness of the hedge. The gains and losses on foreign exchange contracts mitigate the effect of currency movements on our operating expenses and service cost of sales.

We also enter into foreign exchange forward and option contracts to reduce the short-term effects of foreign currency fluctuations on receivables and payables that are denominated in currencies other than the functional currencies of the entities. The market risks associated with these foreign currency receivables, investments, and payables relate primarily to variances from our forecasted foreign currency transactions and balances. We do not enter into foreign exchange forward or option contracts for speculative purposes.

### Item 4. Controls and Procedures

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

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our second quarter of fiscal 2019 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

For a description of our material pending legal proceedings, see Note 13 "Commitments and Contingencies—(g) Legal Proceedings" of the Notes to Consolidated Financial Statements included in Item 1 of this Form 10-Q.

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Item 1A. Risk Factors

Set forth below and elsewhere in this report and in other documents we file with the SEC are descriptions of the risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in “Part I, Item 1A. Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended July 28, 2018.

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

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

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

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

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

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

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

The global macroeconomic environment has been challenging and inconsistent. Instability in the global credit markets, the impact of uncertainty regarding global central bank monetary policy, the instability in the geopolitical environment in many parts of the world including as a result of the pending United Kingdom “Brexit” withdrawal from the European Union, the current economic challenges in China, including global economic ramifications of Chinese economic difficulties, and other disruptions may continue to put pressure on global economic conditions. If global economic and market conditions, or economic conditions in key markets, remain uncertain or deteriorate further, we may experience material impacts on our business, operating results, and financial condition.

Our operating results in one or more segments may also be affected by uncertain or changing economic conditions particularly germane to that segment or to particular customer markets within that segment. For example, emerging countries in the aggregate experienced a decline in product orders in certain prior periods.

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

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

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

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

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



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Our revenue may grow at a slower rate than in past periods or decline as it did in the first quarter of fiscal 2018, and in certain prior periods on a year-over-year basis. Our ability to meet financial expectations could also be adversely affected if the nonlinear sales pattern seen in some of our past quarters recurs in future periods. We have experienced periods of time during which shipments have exceeded net bookings or manufacturing issues have delayed shipments, leading to nonlinearity in shipping patterns. In addition to making it difficult to predict revenue for a particular period, nonlinearity in shipping can increase costs, because irregular shipment patterns result in periods of underutilized capacity and periods in which overtime expenses may be incurred, as well as in potential additional inventory management-related costs. In addition, to the extent that manufacturing issues and any related component shortages result in delayed shipments in the future, and particularly in periods in which our contract manufacturers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters occur and are not remediated within the same quarter.

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

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

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

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

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

Our product gross margins declined in the second quarter of fiscal 2019 and in certain prior periods on a year-over-year basis, and could decline in future quarters due to adverse impacts from various factors, including:

- Changes in customer, geographic, or product mix, including mix of configurations within each product group
- Introduction of new products, including products with price-performance advantages, and new business models including the transformation of our business to deliver more software and subscription offerings
- Our ability to reduce production costs
- Entry into new markets or growth in lower margin markets, including markets with different pricing and cost structures, through acquisitions or internal development
- Sales discounts
- Increases in material, labor or other manufacturing-related costs, which could be significant especially during periods of supply constraints such as those impacting the market for memory components
- Excess inventory and inventory holding charges
- Obsolescence charges
- Changes in shipment volume



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

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

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

Sales to the service provider market have been characterized by large and sporadic purchases, especially relating to our router sales and sales of certain other Infrastructure Platforms and Applications products, in addition to longer sales cycles. Service provider product orders decreased in the second quarter of fiscal 2019, and in certain prior periods, and at various times in the past we have experienced significant weakness in product orders from service providers. Product orders from the service provider market could continue to decline and, as has been the case in the past, such weakness could persist over extended periods of time given fluctuating market conditions. Sales activity in this industry depends upon the stage of completion of expanding network infrastructures; the availability of funding; and the extent to which service providers are affected by regulatory, economic, and business conditions in the country of operations. Weakness in orders from this industry, including as a result of any slowdown in capital expenditures by service providers (which may be more prevalent during a global economic downturn, or periods of economic, political or regulatory uncertainty), could have a material adverse effect on our business, operating results, and financial condition. Such slowdowns may continue or recur in future periods. Orders from this industry could decline for many reasons other than the competitiveness of our products and services within their respective markets. For example, in the past, many of our service provider customers have been materially and adversely affected by slowdowns in the general economy, by overcapacity, by changes in the service provider market, by regulatory developments, and by constraints on capital availability, resulting in business failures and substantial reductions in spending and expansion plans. These conditions have materially harmed our business and operating results in the past, and some of these or other conditions in the service provider market could affect our business and operating results in any future period. Finally, service provider customers typically have longer implementation cycles; require a broader range of services, including design services; demand that vendors take on a larger share of risks; often require acceptance provisions, which can lead to a delay in revenue recognition; and expect financing from vendors. All these factors can add further risk to business conducted with service providers.

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

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

A substantial portion of our products and services is sold through our channel partners, and the remainder is sold through direct sales. Our channel partners include systems integrators, service providers, other resellers, and distributors. Systems integrators and service providers typically sell directly to end users and often provide system installation, technical support, professional services, and other support services in addition to network equipment sales. Systems integrators also typically integrate our products into an overall solution, and a number of service providers are also systems integrators. Distributors stock inventory and typically sell to systems integrators, service providers, and other resellers. We refer to sales through distributors as our two-tier system of sales to the end customer. These distributors are generally given business terms that allow them to return a portion of inventory,

receive credits for changes in selling prices, and participate in various cooperative marketing programs. If sales through indirect channels increase, this may lead to greater difficulty in forecasting the mix of our products and, to a degree, the timing of orders from our customers.

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

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

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

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

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

As we continue to expand globally, we may see new competition in different geographic regions. In particular, we have experienced price-focused competition from competitors in Asia, especially from China, and we anticipate this will continue. Our competitors include Amazon Web Services LLC; Arista Networks, Inc.; ARRIS Group, Inc.; Check Point Software Technologies Ltd.; Dell Technologies Inc.; Extreme Networks, Inc.; F5 Networks, Inc.; FireEye, Inc.; Fortinet, Inc.; Hewlett-Packard Enterprise Company; Huawei Technologies Co., Ltd.; Juniper Networks, Inc.; Lenovo Group Limited; Microsoft Corporation; New Relic, Inc.; Nokia Corporation; Nutanix, Inc.; Palo Alto Networks, Inc.; Symantec Corporation; Ubiquiti Networks and VMware, Inc.; among others.

Some of our competitors compete across many of our product lines, while others are primarily focused in a specific product area. Barriers to entry are relatively low, and new ventures to create products that do or could compete with our products are regularly formed. In addition, some of our competitors may have greater resources, including technical and engineering resources, than we do. As we expand into new markets, we will face competition not only from our existing competitors but also from other competitors, including existing companies with strong technological, marketing, and sales positions in those markets. We also sometimes face competition from resellers and distributors of our products. Companies with which we have strategic alliances in some areas may be competitors in other areas, and in our view this trend may increase.

For example, the enterprise data center is undergoing a fundamental transformation arising from the convergence of technologies, including computing, networking, storage, and software, that previously were segregated. Due to several factors, including the availability of highly scalable and general purpose microprocessors, ASICs offering advanced services, standards based protocols, cloud computing and virtualization, the convergence of technologies within the enterprise data center is spanning multiple, previously independent, technology segments. Also, some of our current and potential competitors for enterprise data center business have made acquisitions, or announced new strategic alliances, designed to position them to provide end-to-end technology solutions for the enterprise data center. As a

result of all of these developments, we face greater competition in the development and sale of enterprise data center technologies, including competition from entities that are among our long-term strategic alliance partners. Companies that are strategic alliance partners in some areas of our business may acquire or form alliances with our competitors, thereby reducing their business with us.

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

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

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

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

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

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

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

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

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- Industry consolidation occurring within one or more component supplier markets, such as the semiconductor market, could either limit supply or increase costs

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

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

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

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

Manufacturing capacity and component supply constraints could continue to be significant issues for us. We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to improve manufacturing lead-time performance and to help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining

our requirements. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. When facing component supply-related challenges we have increased our efforts in procuring components in order to meet customer expectations, which in turn contributes to an increase in purchase commitments. Increases in our purchase commitments to shorten lead times could also lead to excess and obsolete inventory charges if the demand for our products is less than our expectations. If we fail to anticipate customer demand properly, an oversupply of parts could result in excess or obsolete components that could adversely affect our gross margins. For additional information regarding our purchase commitments with contract manufacturers and suppliers, see Note 13 to the Consolidated Financial Statements.

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

The markets for our products are characterized by rapidly changing technology, evolving industry standards, new product introductions, and evolving methods of building and operating networks. Our operating results depend on our ability to develop and introduce new products into existing and emerging markets and to reduce the production costs of existing products. Many of our strategic initiatives and investments we have made, and our architectural approach, are designed to enable the increased use of the network as the platform for automating, orchestrating, integrating, and delivering an ever-increasing array of IT-based products and services. For example, in June 2017 we announced our Catalyst 9000 series of switches which represent the initial foundation of our intent-based networking capabilities. Other current initiatives include our focus on security; the market transition related to digital transformation and IoT; the transition in cloud; and the move towards more programmable, flexible and virtual networks.

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

Our strategy is to lead our customers in their digital transition with solutions that deliver greater agility, productivity, security and other advanced network capabilities, and that intelligently connect nearly everything that can be connected. Over the last few years, we have been transforming our business to move from selling individual products and services to selling products and services integrated into architectures and solutions, and we are seeking to meet the evolving needs of customers which include offering our products and solutions in the manner in which customers wish to consume them. As a part of this transformation, we continue to make changes to how we are organized and how we build and deliver our technology, including changes in our business models with customers. If our strategy for addressing our customer needs, or the architectures and solutions we develop do not meet those needs, or the changes we are making in how we are organized and how we build and deliver or technology is incorrect or ineffective, our business could be harmed.

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

success we anticipate, and we may not successfully identify and invest in other emerging or new products.  
**CHANGES IN INDUSTRY STRUCTURE AND MARKET CONDITIONS COULD LEAD TO CHARGES RELATED TO DISCONTINUANCES OF CERTAIN OF OUR PRODUCTS OR BUSINESSES, ASSET IMPAIRMENTS AND WORKFORCE REDUCTIONS OR RESTRUCTURINGS**

In response to changes in industry and market conditions, we may be required to strategically realign our resources and to consider restructuring, disposing of, or otherwise exiting businesses. Any resource realignment, or decision to limit investment in or dispose of or otherwise exit businesses, may result in the recording of special charges, such as inventory and technology-related write-offs, workforce reduction or restructuring costs, charges relating to consolidation of excess facilities, or claims from third parties who were resellers or users of discontinued products. Our estimates with respect to the useful life or ultimate recoverability of our carrying basis of assets, including purchased intangible assets, could change as a result of such assessments and decisions. Although

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in certain instances our supply agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed, our loss contingencies may include liabilities for contracts that we cannot cancel with contract manufacturers and suppliers. Further, our estimates relating to the liabilities for excess facilities are affected by changes in real estate market conditions. Additionally, we are required to perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances, and future goodwill impairment tests may result in a charge to earnings.

We initiated a restructuring plan in the third quarter of fiscal 2018 and expanded it in the first quarter of fiscal 2019. The implementation of this restructuring plan may be disruptive to our business, and following completion of the restructuring plan our business may not be more efficient or effective than prior to implementation of the plan. Our restructuring activities, including any related charges and the impact of the related headcount restructurings, could have a material adverse effect on our business, operating results, and financial condition.

### **OVER THE LONG TERM WE INTEND TO INVEST IN ENGINEERING, SALES, SERVICE AND MARKETING ACTIVITIES, AND THESE INVESTMENTS MAY ACHIEVE DELAYED, OR LOWER THAN EXPECTED, BENEFITS WHICH COULD HARM OUR OPERATING RESULTS**

While we intend to focus on managing our costs and expenses, over the long term, we also intend to invest in personnel and other resources related to our engineering, sales, service and marketing functions as we realign and dedicate resources on key priority and growth areas, such as Security and Applications, and we also intend to focus on maintaining leadership in Infrastructure Platforms and in Services. We are likely to recognize the costs associated with these investments earlier than some of the anticipated benefits, and the return on these investments may be lower, or may develop more slowly, than we expect. If we do not achieve the benefits anticipated from these investments, or if the achievement of these benefits is delayed, our operating results may be adversely affected.

### **OUR BUSINESS SUBSTANTIALLY DEPENDS UPON THE CONTINUED GROWTH OF THE INTERNET AND INTERNET-BASED SYSTEMS**

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

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

### **WE HAVE MADE AND EXPECT TO CONTINUE TO MAKE ACQUISITIONS THAT COULD DISRUPT OUR OPERATIONS AND HARM OUR OPERATING RESULTS**

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

- Difficulties in integrating the operations, systems, technologies, products, and personnel of the acquired companies, particularly companies with large and widespread operations and/or complex products
- Diversion of management's attention from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions
- Potential difficulties in completing projects associated with in-process research and development intangibles
- Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions
- Initial dependence on unfamiliar supply chains or relatively small supply partners

- Insufficient revenue to offset increased expenses associated with acquisitions

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- The potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans

Acquisitions may also cause us to:

- Issue common stock that would dilute our current shareholders' percentage ownership
- Use a substantial portion of our cash resources, or incur debt
- Significantly increase our interest expense, leverage and debt service requirements if we incur additional debt to pay for an acquisition
- Assume liabilities
- Record goodwill and intangible assets that are subject to impairment testing on a regular basis and potential periodic impairment charges
- Incur amortization expenses related to certain intangible assets
- Incur tax expenses related to the effect of acquisitions on our legal structure
- Incur large and immediate write-offs and restructuring and other related expenses
- Become subject to intellectual property or other litigation

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

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

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

As we focus on new market opportunities and key priority and growth areas, we will increasingly compete with large telecommunications equipment suppliers as well as startup companies. Several of our competitors may have greater resources, including technical and engineering resources, than we do. Additionally, as customers in these markets complete infrastructure deployments, they may require greater levels of service, support, and financing than we have provided in the past, especially in emerging countries. Demand for these types of service, support, or financing contracts may increase in the future. There can be no assurance that we can provide products, service, support, and financing to effectively compete for these market opportunities.

Further, provision of greater levels of services, support and financing by us may result in a delay in the timing of revenue recognition. In addition, entry into other markets has subjected and will subject us to additional risks, particularly to those markets, including the effects of general market conditions and reduced consumer confidence. For example, as we add direct selling capabilities globally to meet changing customer demands, we will face increased legal and regulatory requirements.

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

There has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. For example, some of our current and potential competitors for enterprise data center business have made acquisitions, or announced new strategic alliances, designed to position them with the ability to provide end-to-end technology solutions for the enterprise data center. Companies that are strategic alliance partners in some areas of our business may acquire or form alliances with our competitors, thereby reducing their business with us. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This could lead to more variability in our operating results and could have a material adverse effect on our business, operating results, and financial condition.

Furthermore, particularly in the service provider market, rapid consolidation will lead to fewer customers, with the effect that loss of a major customer could have a material impact on results not anticipated in a customer marketplace composed of more numerous participants.

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

We produce highly complex products that incorporate leading-edge technology, including both hardware and software. Software typically contains bugs that can unexpectedly interfere with expected operations. There can be no assurance that our pre-shipment testing programs will be adequate to detect all defects, either ones in individual products or ones that could affect numerous shipments, which might interfere with customer satisfaction, reduce sales opportunities, or affect gross margins. From time to time, we have had to replace certain components and provide remediation in response to the discovery of defects or bugs in products that we had shipped. There can be no assurance that such remediation, depending on the product involved, would not have a material impact. An inability to cure a product defect could result in the failure of a product line, temporary or permanent withdrawal from a product or market, damage to our reputation, inventory costs, or product reengineering expenses, any of which could have a material impact on our revenue, margins, and net income. For example, in the second quarter of fiscal 2017 we recorded a charge to product cost of sales of \$125 million related to the expected remediation costs for anticipated failures in future periods of a widely-used component sourced from a third party which is included in several of our products, and in the second quarter of fiscal 2014 we recorded a pre-tax charge of \$655 million related to the expected remediation costs for certain products sold in prior fiscal years containing memory components manufactured by a single supplier between 2005 and 2010.

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

We conduct significant sales and customer support operations in countries around the world. As such, our growth depends in part on our increasing sales into emerging countries. We also depend on non-U.S. operations of our contract manufacturers, component suppliers and distribution partners. Our business in emerging countries in the aggregate experienced a decline in orders in certain prior periods. We continue to assess the sustainability of any improvements in our business in these countries and there can be no assurance that our investments in these countries will be successful. Our future results could be materially adversely affected by a variety of political, economic or other factors relating to our operations inside and outside the United States, including impacts from global central bank monetary policy; issues related to the political relationship between the United States and other countries that can affect the willingness of customers in those countries to purchase products from companies headquartered in the United States; government-related disruptions or shutdowns; and the challenging and inconsistent global macroeconomic environment, any or all of which could have a material adverse effect on our operating results and financial condition, including, among others, the following:

- Foreign currency exchange rates
- Political or social unrest

Economic instability or weakness or natural disasters in a specific country or region, including the current economic challenges in China and global economic ramifications of Chinese economic difficulties; instability as a result of

- Brexit; environmental protection measures, trade protection measures such as tariffs, and other legal and regulatory requirements, some of which may affect our ability to import our products, to export our products from, or sell our products in various countries
- Political considerations that affect service provider and government spending patterns
- Health or similar issues, such as a pandemic or epidemic

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- Difficulties in staffing and managing international operations
- Adverse tax consequences, including imposition of withholding or other taxes on our global operations

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

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

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

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

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

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

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

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



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

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Historically, our primary exposures have related to nondollar-denominated sales in Japan, Canada, and Australia and certain nondollar-denominated operating expenses and service cost of sales in Europe, Latin America, and Asia, where we sell primarily in U.S. dollars. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. An increase in the value of the dollar could increase the real cost to our customers of our products in those markets outside the United States where we sell in dollars and a weakened dollar could increase the cost of local operating expenses and procurement of raw materials to the extent that we must purchase components in foreign currencies.

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

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

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

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

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

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

the customer, or if we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, operating results, and financial condition could be materially and adversely affected. For additional information regarding our indemnification obligations, see Note 13(f) to the Consolidated Financial Statements contained in this report.

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

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

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

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

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

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

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

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

Changes in telecommunications requirements, or regulatory requirements in other industries in which we operate, in the United States or other countries could affect the sales of our products. In particular, we believe that there may be future changes in U.S. telecommunications regulations that could slow the expansion of the service providers' network infrastructures and materially adversely affect our business, operating results, and financial condition, including "net neutrality" rules to the extent they impact decisions on investment in network infrastructure.

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

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

Our success has always depended in large part on our ability to attract and retain highly skilled technical, managerial, sales, and marketing personnel. Competition for these personnel is intense, especially in the Silicon Valley area of Northern California. Stock incentive plans are designed to reward employees for their long-term contributions and provide incentives for them to remain with us. Volatility or lack of positive performance in our stock price or equity incentive awards, or changes to our overall compensation program, including our stock incentive program, resulting from the management of share dilution and share-based compensation expense or otherwise, may also adversely affect our ability to retain key employees. As a result of one or more of these factors, we may increase our hiring in

geographic areas outside the United States, which could subject us to additional geopolitical and exchange rate risk. The loss of services of any of our key personnel; the inability to retain and attract qualified personnel in the future; or delays in hiring required personnel, particularly engineering and sales personnel, could make it difficult to meet key objectives, such as timely and effective product introductions. In addition, companies in our industry whose employees accept positions with competitors frequently claim that competitors have engaged in improper hiring practices. We have received these claims in the past and may receive additional claims to this effect in the future.

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

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. For example, Brazilian authorities have investigated our Brazilian subsidiary and certain of its former employees, as well as a Brazilian importer of our products, and its affiliates and employees, relating to alleged evasion of import taxes and alleged improper transactions involving the subsidiary and the importer. Brazilian tax authorities have assessed claims against our Brazilian subsidiary based on a theory of joint liability with the Brazilian importer for import taxes, interest, and penalties. The asserted claims by Brazilian federal tax authorities which remain are for calendar years 2003 through 2007, and the asserted claims by the tax authorities from the state of Sao Paulo are for calendar years 2005 through 2007. The total asserted claims by Brazilian state and federal tax authorities aggregate to \$215 million for the alleged evasion of import and other taxes, \$1.4 billion for interest, and \$1.0 billion for various penalties, all determined using an exchange rate as of January 26, 2019. We have completed a thorough review of the matters and believe the asserted claims against our Brazilian subsidiary are without merit, and we are defending the claims vigorously. While we believe there is no legal basis for the alleged liability, due to the complexities and uncertainty surrounding the judicial process in Brazil and the nature of the claims asserting joint liability with the importer, we are unable to determine the likelihood of an unfavorable outcome against our Brazilian subsidiary and are unable to reasonably estimate a range of loss, if any. We do not expect a final judicial determination for several years. An unfavorable resolution of lawsuits or governmental investigations could have a material adverse effect on our business, operating results, or financial condition. For additional information regarding certain of the matters in which we are involved, see Note 13 to the Consolidated Financial Statements, subsection (g) "Legal Proceedings."

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

Our provision for income taxes is subject to volatility and could be adversely affected by earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates; by changes in the valuation of our deferred tax assets and liabilities; by changes to domestic manufacturing deduction, foreign-derived intangible income, global intangible low-tax income and base erosion and anti-abuse tax laws, regulations, or interpretations thereof; by expiration of or lapses in tax incentives; by transfer pricing adjustments, including the effect of acquisitions on our legal structure; by tax effects of nondeductible compensation; by tax costs related to intercompany realignments; by changes in accounting principles; or by changes in tax laws and regulations, treaties, or interpretations thereof, including changes to the taxation of earnings of our foreign subsidiaries, the deductibility of expenses attributable to foreign income, and the foreign tax credit rules. Significant judgment is required to determine the recognition and measurement attribute prescribed in the accounting guidance for uncertainty in income taxes. The Organisation for Economic Co-operation and Development (OECD), an international association comprised of 36 countries, including the United States, has made changes to numerous long-standing tax principles. There can be no assurance that these changes, once adopted by countries, will not have an adverse impact on our provision for income taxes. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain countries is subject to reduced tax rates. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial condition.

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

Our corporate headquarters, including certain of our research and development operations are located in the Silicon Valley area of Northern California, a region known for seismic activity. Additionally, a certain number of our facilities are located near rivers that have experienced flooding in the past. Also certain of our suppliers and logistics centers are located in regions that have been or may be affected by earthquake, tsunami and flooding activity which in

the past has disrupted, and in the future could disrupt, the flow of components and delivery of products. A significant natural disaster, such as an earthquake, a hurricane, volcano, or a flood, could have a material adverse impact on our business, operating results, and financial condition.

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**CYBER-ATTACKS, DATA BREACHES OR MALWARE MAY DISRUPT OUR OPERATIONS, HARM OUR OPERATING RESULTS AND FINANCIAL CONDITION, AND DAMAGE OUR REPUTATION, AND CYBER-ATTACKS OR DATA BREACHES ON OUR CUSTOMERS' NETWORKS, OR IN CLOUD-BASED SERVICES PROVIDED BY OR ENABLED BY US, COULD RESULT IN CLAIMS OF LIABILITY AGAINST US, DAMAGE OUR REPUTATION OR OTHERWISE HARM OUR BUSINESS**

Despite our implementation of security measures, the products and services we sell to customers, and our servers, data centers and the cloud-based solutions on which our data, and data of our customers, suppliers and business partners are stored, are vulnerable to cyber-attacks, data breaches, malware, and similar disruptions from unauthorized access or tampering by malicious actors or inadvertent error. Any such event could compromise our products, services, and networks or those of our customers, and the information stored on our systems or those of our customers could be improperly accessed, processed, disclosed, lost or stolen, which could subject us to liability to our customers, suppliers, business partners and others, give rise to legal/regulatory action, and could have a material adverse effect on our business, operating results, and financial condition and may cause damage to our reputation. Efforts to limit the ability of malicious actors to disrupt the operations of the Internet or undermine our own security efforts may be costly to implement and meet with resistance, and may not be successful. Breaches of security in our customers' networks, or in cloud-based services provided by or enabled by us, regardless of whether the breach is attributable to a vulnerability in our products or services, could result in claims of liability against us, damage our reputation or otherwise harm our business.

**VULNERABILITIES AND CRITICAL SECURITY DEFECTS, PRIORITIZATION DECISIONS REGARDING REMEDYING VULNERABILITIES OR SECURITY DEFECTS, FAILURE OF THIRD PARTY PROVIDERS TO REMEDY VULNERABILITIES OR SECURITY DEFECTS, OR CUSTOMERS NOT DEPLOYING SECURITY RELEASES OR DECIDING NOT TO UPGRADE PRODUCTS, SERVICES OR SOLUTIONS COULD RESULT IN CLAIMS OF LIABILITY AGAINST US, DAMAGE OUR REPUTATION OR OTHERWISE HARM OUR BUSINESS**

The products and services we sell to customers, and our cloud-based solutions, inevitably contain vulnerabilities or critical security defects which have not been remedied and cannot be disclosed without compromising security. We may also make prioritization decisions in determining which vulnerabilities or security defects to fix, and the timing of these fixes, which could result in an exploit which compromises security. Customers also need to test security releases before they can be deployed which can delay implementation. In addition, we rely on third-party providers of software and cloud-based service and we cannot control the rate at which they remedy vulnerabilities. Customers may also not deploy a security release, or decide not to upgrade to the latest versions of our products, services or cloud-based solutions containing the release, leaving them vulnerable. Vulnerabilities and critical security defects, prioritization errors in remedying vulnerabilities or security defects, failure of third-party providers to remedy vulnerabilities or security defects, or customers not deploying security releases or deciding not to upgrade products, services or solutions could result in claims of liability against us, damage our reputation or otherwise harm our business.

**TERRORISM AND OTHER EVENTS MAY HARM OUR BUSINESS, OPERATING RESULTS AND FINANCIAL CONDITION**

The continued threat of terrorism and heightened security and military action in response to this threat, or any future acts of terrorism, may cause further disruptions to the economies of the United States and other countries and create further uncertainties or otherwise materially harm our business, operating results, and financial condition. Likewise, events such as loss of infrastructure and utilities services such as energy, transportation, or telecommunications could have similar negative impacts. To the extent that such disruptions or uncertainties result in delays or cancellations of customer orders or the manufacture or shipment of our products, our business, operating results, and financial condition could be materially and adversely affected.

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

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

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**OUR STOCK PRICE MAY BE VOLATILE**

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

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

As of the end of the second quarter of fiscal 2019, we have senior unsecured notes outstanding in an aggregate principal amount of \$25.8 billion that mature at specific dates from calendar year 2019 through 2040. We have also established a commercial paper program under which we may issue short-term, unsecured commercial paper notes on a private placement basis up to a maximum aggregate amount outstanding at any time of \$10.0 billion, we had no commercial paper notes outstanding under this program as of January 26, 2019, and as of February 18, 2019, we had approximately \$2 billion of commercial paper notes outstanding. The outstanding senior unsecured notes bear fixed-rate interest payable semiannually, except \$1.0 billion of the notes which bears interest at a floating rate payable quarterly. The fair value of the long-term debt is subject to market interest rate volatility. The instruments governing the senior unsecured notes contain certain covenants applicable to us and our wholly-owned subsidiaries that may adversely affect our ability to incur certain liens or engage in certain types of sale and leaseback transactions. In addition, we will be required to have available in the United States sufficient cash to service the interest on our debt and repay all of our notes on maturity. There can be no assurance that our incurrence of this debt or any future debt will be a better means of providing liquidity to us than would our use of our existing cash resources. Further, we cannot be assured that our maintenance of this indebtedness or incurrence of future indebtedness will not adversely affect our operating results or financial condition. In addition, changes by any rating agency to our credit rating can negatively impact the value and liquidity of both our debt and equity securities, as well as the terms upon which we may borrow under our commercial paper program or future debt issuances.

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

(a) None.

(b) None.

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

| Period                                 | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid<br>per Share | Total Number of Shares<br>Purchased as Part of<br>Publicly Announced<br>Plans or Programs | Approximate Dollar<br>Value of Shares<br>That May Yet<br>Be Purchased<br>Under the Plans or<br>Programs |
|--|---|------------------------------------|---|---|
| October 28, 2018 to November 24, 2018  | 37  | \$ 45.76                           | 37  | \$ 12,325   |
| November 25, 2018 to December 22, 2018 | 36  | \$ 46.13                           | 36  | \$ 10,674   |
| December 23, 2018 to January 26, 2019  | 38  | \$ 43.49                           | 38  | \$ 8,994  |
| Total                                  | 111                                       | \$ 45.09                           | 111   |   |

On September 13, 2001, we announced that our Board of Directors had authorized a stock repurchase program. On February 13, 2019, our Board of Directors authorized a \$15 billion increase to the stock repurchase program. The remaining authorized amount for stock repurchases under this program, including the additional authorization, is approximately \$24 billion, with no termination date.

For the majority of restricted stock units granted, the number of shares issued on the date the restricted stock units vest is net of shares withheld to meet applicable tax withholding requirements. Although these withheld shares are not issued or considered common stock repurchases under our stock repurchase program and therefore are not included in the preceding table, they are treated as common stock repurchases in our financial statements as they reduce the number of shares that would have been issued upon vesting (see Note 14 to the Consolidated Financial Statements).

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

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## Item 6. Exhibits

The following documents are filed as exhibits to this report:

| Exhibit Number | Exhibit Description  | Incorporated by Reference |           |                     | Filed Herewith |
|----------------|--|---------------------------|-----------|---------------------|----------------|
|                |  | Form                      | File No.  | Exhibit Filing Date |                |
| 10.1           | <u>Cisco Systems, Inc. Employee Stock Purchase Plan</u>                      | 8-K                       | 000-18225 | 10.1 12/13/2018     |                |
| 10.2           | <u>Cisco Systems, Inc. Deferred Compensation Plan, as amended</u>            |                           |           |                     | X              |
| 31.1           | <u>Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer</u> |                           |           |                     | X              |
| 31.2           | <u>Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer</u> |                           |           |                     | X              |
| 32.1           | <u>Section 1350 Certification of Principal Executive Officer</u>             |                           |           |                     | X              |
| 32.2           | <u>Section 1350 Certification of Principal Financial Officer</u>             |                           |           |                     | X              |
| 101.INS        | XBRL Instance Document   |                           |           |                     | X              |
| 101.SCH        | XBRL Taxonomy Extension Schema Document                                      |                           |           |                     | X              |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document                        |                           |           |                     | X              |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document                         |                           |           |                     | X              |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document                              |                           |           |                     | X              |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document                       |                           |           |                     | X              |

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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Cisco Systems, Inc.

Date: February 19, 2019    **BS**/ Kelly A. Kramer  
Kelly A. Kramer  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer and duly authorized signatory)