REALNETWORKS INC
Form 10-Q
November 09, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended September 30, 2006

OR

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

Commission File Number 0-23137
REALNETWORKS, INC.
(Exact name of registrant as specified in its charter)

Washington	**91-1628146**
(State of incorporation)	**(I.R.S. Employer Identification Number)**
2601 Elliott Avenue, Suite 1000	**98121**
Seattle, Washington	**(Zip Code)**
(Address of principal executive offices)	

(206) 674-2700
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No þ

The number of shares of the registrant s Common Stock outstanding as of October 31, 2006 was 161,595,952.

TABLE OF CONTENTS
RealNetworks, Inc.
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2006
TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 693,057	$ 651,971
Short-term investments	151,745	129,356
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	24,481	16,721
Deferred tax assets, net, current portion	7,046	54,204
Prepaid expenses and other current assets	11,488	11,933
Total current assets	887,817	864,185
Equipment, software and leasehold improvements, at cost:		
Equipment and software	65,551	56,402
Leasehold improvements	29,139	27,964
Total equipment, software and leasehold improvements	94,690	84,366
Less accumulated depreciation and amortization	60,235	51,228
Net equipment, software and leasehold improvements	34,455	33,138
Restricted cash equivalents	17,300	17,300
Equity investments	26,269	46,163
Other assets	4,177	2,397
Deferred tax assets, net, non-current portion	15,967	19,147
Goodwill	132,789	123,330
Other intangible assets, net	7,386	7,337
Total assets	$ 1,126,160	$ 1,112,997
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 14,905	$ 11,397
Accrued and other liabilities	72,105	112,340
Deferred revenue, current portion	25,469	25,021
Accrued loss on excess office facilities, current portion	4,053	4,623
Total current liabilities	116,532	153,381

Deferred revenue, non-current portion	340	276
Accrued loss on excess office facilities, non-current portion	11,323	13,393
Deferred rent	4,472	4,018
Convertible debt	100,000	100,000
Other long-term liabilities	1,679	196
Total liabilities	234,346	271,264
Shareholders equity:		
Preferred stock, $0.001 par value, no shares issued and outstanding		
Series A: authorized 200 shares		
Undesignated series: authorized 59,800 shares		
Common stock, $0.001 par value Authorized 1,000,000 shares; issued and outstanding 161,108 shares in 2006 and 166,037 shares in 2005	161	166
Additional paid-in capital	760,347	805,067
Deferred stock compensation		(19)
Accumulated other comprehensive income	15,597	26,724
Retained earnings	115,709	9,795
Total shareholders equity	891,814	841,733
Total liabilities and shareholders equity	$ 1,126,160	$ 1,112,997

See accompanying notes to unaudited condensed consolidated financial statements

3

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In thousands, except per share data)

	Quarters ended September 30,		Nine Months ended September 30,	
	2006	**2005**	**2006**	**2005**
Net revenue (A)	$ 93,676	$ 82,233	$ 269,687	$ 241,491
Cost of revenue (B)	28,389	24,695	81,788	74,273
Gross profit	65,287	57,538	187,899	167,218
Operating expenses:				
Research and development	18,344	16,354	55,127	45,381
Sales and marketing	37,560	30,745	111,604	93,809
General and administrative	14,043	7,037	41,586	21,120
Loss on excess office facilities			738	
Subtotal operating expenses	69,947	54,136	209,055	160,310
Antitrust litigation expenses (benefit), net	(61,861)	3,531	(159,554)	11,925
Total operating expenses, net	8,086	57,667	49,501	172,235
Operating income (loss)	57,201	(129)	138,398	(5,017)
Other income (expense), net:				
Interest income, net	10,618	2,904	27,978	7,499
Equity in net loss of MusicNet				(1,068)
Gain on sale of equity investments		11,740	2,286	19,330
Other, net	242	124	432	(276)
Other income, net	10,860	14,768	30,696	25,485
Net income before income taxes	68,061	14,639	169,094	20,468
Income tax provision	(25,908)	(3,457)	(63,180)	(3,763)
Net income	$ 42,153	$ 11,182	$ 105,914	$ 16,705
Basic net income per share	$ 0.26	$ 0.07	$ 0.66	$ 0.10
Diluted net income per share	$ 0.24	$ 0.06	$ 0.59	$ 0.09
Shares used to compute basic net income per share	160,578	170,797	160,466	170,761
Shares used to compute diluted net income per share	178,913	184,180	178,551	184,276
Comprehensive income:				
Net income	$ 42,153	$ 11,182	$ 105,914	$ 16,705
Unrealized holding gains (losses) on investments, net of tax	28	16,321	(12,887)	21,831
Adjustments for gains reclassified to net income		(4,052)		(4,052)

Foreign currency translation gains (losses)	388	(109)	1,760	(1,400)
Comprehensive income	$ 42,569	$ 23,342	$ 94,787	$ 33,084
(A) Components of net revenue:				
License fees	$ 22,528	$ 19,596	$ 68,014	$ 60,605
Service revenue	71,148	62,637	201,673	180,886
	$ 93,676	$ 82,233	$ 269,687	$ 241,491
(B) Components of cost of revenue:				
License fees	$ 9,675	$ 8,666	$ 28,865	$ 24,888
Service revenue	18,714	16,029	52,923	49,385
	$ 28,389	$ 24,695	$ 81,788	$ 74,273

See accompanying notes to unaudited condensed consolidated financial statements

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30, 2006	2005
Cash flows from operating activities:		
Net income	$ 105,914	$ 16,705
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,480	11,869
Stock-based compensation	12,332	109
Equity in net losses of MusicNet		1,068
Changes in accrued loss on excess office facilities and content agreement	(2,640)	(6,230)
Loss on disposal of equipment	76	250
Gain on sale of equity investments	(2,286)	(19,330)
Deferred income taxes	56,508	3,324
Other	73	48
Net change in certain operating assets and liabilities, net of balances acquired	(48,496)	6,127
Net cash provided by operating activities	133,961	13,940
Cash flows from investing activities:		
Purchases of equipment and leasehold improvements	(9,316)	(10,728)
Purchases of intangible assets		(1,000)
Purchases of short-term investments	(177,868)	(121,540)
Proceeds from sales and maturities of short-term investments	156,006	127,790
Decrease in restricted cash equivalents		2,095
Proceeds from sale of equity investments	2,286	19,530
Purchases of cost based investments	(834)	(647)
Payment of acquisition costs, net of cash acquired	(7,086)	(14,705)
Net cash provided by (used in) investing activities	(36,812)	795
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	41,976	4,926
Repayment of long-term note payable		(648)
Repurchase of common stock	(98,869)	(29,275)
Net cash used in financing activities	(56,893)	(24,997)
Effect of exchange rate changes on cash and cash equivalents	830	(492)
Net increase (decrease) in cash and cash equivalents	41,086	(10,754)
Cash and cash equivalents at beginning of period	651,971	219,426

Cash and cash equivalents at end of period	$ 693,057	$ 208,672
Supplemental disclosure of non-cash investing and financing activities:		
Cash paid for income taxes	$ 14,181	$
Non-cash consideration in business combinations:		
Accrued acquisition payments	$ 2,079	$
Accrued acquisition costs	$	$ 1
Long-term notes payable acquired in business combination	$	$ 863

See accompanying notes to unaudited condensed consolidated financial statements

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Description of Business

RealNetworks, Inc. and subsidiaries (RealNetworks or Company) is a leading creator of digital media services and software, such as Rhapsody, RealArcade and RealPlayer. Consumers use the Company s services and software to find, play, purchase and manage free and premium digital content, including music, games and video. Broadcasters, network operators, media companies and enterprises use the Company s products and services to create, secure and deliver digital media to PCs, mobile phones and other consumer electronics devices.

Inherent in the Company s business are various risks and uncertainties, including the limited history of certain of its product and service offerings and its limited history of offering premium subscription services on the Internet. The Company s success will depend on, among other things, the acceptance of the Company s technology, products and services and the ability to generate related revenue.

(b) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, and an entity in which the Company has a variable interest (see item (d) below for a further discussion of the variable interest entity). All significant intercompany balances and transactions have been eliminated in consolidation.

These financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company s management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2006. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

(c) Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments are comprised of the following (in thousands):

	September 30, 2006	December 31, 2005
Cash and cash equivalents	$ 693,057	$ 651,971
Short-term investments	151,745	129,356
Total cash, cash equivalents and short-term investments	$ 844,802	$ 781,327
Restricted cash equivalents	$ 17,300	$ 17,300

Restricted cash equivalents at September 30, 2006 represent (a) cash equivalents pledged as collateral against a $10.0 million letter of credit in connection with a lease agreement for the Company s corporate headquarters, and (b) cash equivalents pledged as collateral against a $7.3 million letter of credit with a bank which represents collateral on the lease of a building located near the Company s corporate headquarters.

The majority of short-term investments mature within twelve months from the date of purchase. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations.

The Company has classified as available-for-sale all marketable debt and equity securities for which there is a determinable fair market value and on which the Company has no restrictions to sell within the next 12 months.

Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a component of shareholders   equity, net of applicable income taxes. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in other

Table of Contents

income (expense), net. The cost basis for determining realized gains and losses on available-for-sale securities is determined using the specific identification method.

(d) Equity Investments

The Company has certain equity investments that are accounted for under the cost method of accounting. The cost method is used to account for equity investments in companies in which the Company holds less than a 20 percent voting interest, does not exercise significant influence and for which the related securities do not have a quoted market price.

The Company has certain equity investments in which the Company holds less than a 20 percent voting interest in companies that are publicly traded. The investments are accounted for at market value. Changes in the market value of the investments are recognized as unrealized gains (losses), net of tax and are recorded in the accompanying unaudited condensed consolidated balance sheets as a component of Accumulated Other Comprehensive Income.

The Company s equity investment in MusicNet, Inc. (MusicNet) was accounted for under the equity method of accounting. Under the equity method of accounting, the Company s share of the investee s earnings or loss was included in the Company s consolidated operating results. In certain cases where the Company had loaned the investee funds, the Company may have recorded more than its relative equity share of the investee s losses. During the quarter ended June 30, 2005, the Company disposed of all of its preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. There was no investment in MusicNet during 2006.

During the quarter ended March 31, 2006, the Company established Beijing RealNetworks Technology Co., Ltd, a Wholly Owned Foreign Entity (WOFE) which operates an Internet retail website in the People s Republic of China (PRC) in cooperation with a PRC affiliate. The results of operations of the WOFE have been included in the Company s consolidated results since the establishment date of the WOFE. The PRC regulates the WOFE s business through regulations and license requirements restricting: (i) the scope of foreign investment in the Internet, retail and delivery sectors; (ii) Internet content; and (iii) the sale of certain media products. In order to meet the PRC local ownership and regulatory licensing requirements, the WOFE s business is operated through a PRC affiliate which is owned by nominee shareholders who are PRC nationals and are RealNetworks employees. The WOFE does not own any capital stock of the PRC affiliate, but is the primary beneficiary of future losses or profits through contractual rights. As a result, the Company consolidates the results of the PRC affiliate in accordance with Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). The net assets and operating results for the PRC affiliate were not significant during the quarter and nine months ended September 30, 2006.

(e) Other Assets

Other assets primarily consist of offering costs and other long-term deposits. The Company incurred the offering costs as a result of its convertible debt offering in 2003. These costs are deferred and are being amortized using the straight-line method, which approximates the effective interest method, over a 5-year period.

(f) Goodwill and Other Intangible Assets, net

Goodwill represents the excess of the purchase price over the fair value of identifiable tangible and intangible assets acquired and liabilities assumed in business combinations accounted for under the purchase method. Goodwill and intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. Other intangible assets, net primarily consist of trade names, technology and patents that were acquired through certain of the Company s acquisitions, as well as other purchased technology. The intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from one to five years. The Company evaluates the recoverability of intangible assets periodically and takes into account events or circumstances that warrant revised estimates of useful lives or that may indicate that impairment exists. All of the Company s intangible assets are subject to amortization. No impairments of intangible assets have been identified during any of the periods presented.

Table of Contents

(g) Revenue Recognition

The Company recognizes revenue in accordance with the following authoritative literature: SEC Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements (SAB 104); Emerging Issues Task Force (EITF) 00-21 Revenue Arrangements with Multiple Deliverables (EITF 00-21); Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2); SOP 98-9 Software Revenue Recognition with Respect to Certain Arrangements (SOP 98-9); SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1); and EITF 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19). In general, the Company recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

The Company has arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. The Company applies significant judgment in establishing the fair value of multiple elements within revenue arrangements.

The Company recognizes revenue on a gross or net basis, in accordance with EITF 99-19. In most arrangements, the Company contracts directly with its end user customers, is the primary obligor and carries all collectibility risk. Revenue in these arrangements is recorded on a gross basis. In some cases, the Company utilizes third party distributors to sell products or services directly to end user customers and carries no collectibility risk. In those instances, in accordance with EITF 99-19, the Company reports the revenue on a net basis.

The Company recognizes revenue in connection with its software products pursuant to the requirements of SOP 97-2, as amended by SOP 98-9. If the Company provides consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1. Revenue from these arrangements is recognized under the percentage of completion method based on the ratio of direct labor hours incurred to total projected labor hours. Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating the Company s software to the end user.

Revenue generated from advertising appearing on the Company s websites and from advertising included in its products is recognized as revenue as the delivery of the advertising occurs.

(h) Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive potential common shares outstanding during the period.

The share count used to compute basic and diluted net income per share is calculated as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Weighted average common shares outstanding	160,578	170,797	160,466	170,761
Shares used to compute basic net income per share	160,578	170,797	160,466	170,761
Dilutive potential common shares				
Stock options	7,585	2,633	7,335	2,765
Convertible debt	10,750	10,750	10,750	10,750

Shares used to compute diluted net income per share	178,913	184,180	178,551	184,276

Table of Contents

Approximately 9.2 million and 7.6 million shares of common stock potentially issuable from stock options for the quarter and nine months ended September 30, 2006, respectively, and 24.1 million shares of common stock for both the quarter and nine months ended September 30, 2005, respectively, are excluded from the calculation of diluted net income per share because the exercise price per share was greater than the average per share market price of the common stock for the respective period.

(i) Derivative Financial Instruments

During the quarter ended September 30, 2006, the Company entered into foreign currency forward contracts to manage the foreign currency risk of certain intercompany balances denominated in a foreign currency. Although these instruments are effective as a hedge from an economic perspective, they do not meet the criteria for hedge accounting under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended.

At September 30, 2006, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)	Contract Amount (US Dollars)	Fair Value
Japanese Yen (YEN) (contracts to pay YEN/receive US$)	(YEN) 151,300	$ 1,293	$ 3

At December 31, 2005, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)	Contract Amount (US Dollars)	Fair Value
British Pounds (GBP) (contracts to receive GBP/pay US$)	(GBP) 1,000	$ 1,736	$ (15)
Euro (EUR) (contracts to pay EUR/receive US$)	(EUR) 1,260	$ 1,514	$ 23
Japanese Yen (YEN) (contracts to receive YEN/pay US$)	(YEN) 30,000	$ 251	$ 4

No derivative instruments designated as hedges for accounting purposes were outstanding at September 30, 2006 or December 31, 2005.

(j) Accumulated Other Comprehensive Income

The Company s accumulated other comprehensive income at September 30, 2006 and December 31, 2005 consisted of net unrealized gains on investments and the net amount of foreign currency translation adjustments. The tax effect of the foreign currency translation adjustments and unrealized gains and losses on investments has been taken into account if applicable. The components of accumulated other comprehensive income are as follows (in thousands):

	September 30, 2006	December 31, 2005
Unrealized gains on investments, net of taxes of $6,278 in 2006 and $13,592 in 2005	$ 15,829	$ 28,717
Foreign currency translation adjustments	(232)	(1,993)
Total accumulated other comprehensive income	$ 15,597	$ 26,724

(k) Stock-Based Compensation

On January 1, 2006, the Company adopted the provisions of, and began accounting for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards

No. 123 revised 2004, Share Based Payment (SFAS 123R), which replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under the fair value provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards under SFAS 123R, consistent with that used for pro forma disclosures under SFAS 123. The Company utilized the modified prospective transition method, which requires that stock-based compensation expense be recorded for all new and unvested stock options and employee stock purchase plan shares that are ultimately expected to vest as the requisite service is rendered beginning on January 1, 2006, the first day of the Company s 2006 fiscal year. Stock-based compensation expense for awards granted prior to January 1, 2006 is based on the grant date fair-value as determined under the pro forma provisions of SFAS 123.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, including the contractual terms, vesting schedules and expectations of future employee behavior. For the quarter and nine months ended September 30, 2006, expected stock price volatility is based on a combination of historical volatility of the Company s stock for the related expected term and the implied volatility of its traded options. Prior to the adoption of SFAS 123R, expected stock price volatility was estimated using only historical volatility. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a term equivalent to the expected term of the stock options or four years. The Company has not paid dividends in the past.

In accordance with SFAS 123R the Company presents excess tax benefits from the exercise of stock-based compensation awards as a financing activity in the Condensed Consolidated Statement of Cash Flows for quarters in which a tax benefit is recorded. No such benefit was recorded for the quarter or nine months ended September 30, 2006 and as a result there were no differences in net cash provided by (used in) operating and financing activities due to the implementation of SFAS 123R.

The Company recognizes compensation cost related to stock options granted prior to the adoption of SFAS 123R on an accelerated basis over the applicable vesting period using the methodology described in Financial Accounting Standards Board (FASB) Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28). The Company recognizes compensation cost related to options granted subsequent to the adoption of SFAS 123R on a straight-line basis over the applicable vesting period. At September 30, 2006, the Company had options outstanding under six stock-based compensation plans. The Company issues new shares of its common stock to satisfy stock option exercises.

During the quarter and nine months ended September 30, 2006, the Company recognized approximately $5.0 million and $12.3 million, respectively, related to stock-based compensation. The amounts are classified in the Company s unaudited condensed consolidated statements of operations as follows (in thousands):

	Quarter Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenue	$ 57	$ 148
Research and development	1,878	4,565
Sales and marketing	1,920	4,713
General and administrative	1,166	2,906
Total stock-based compensation	$ 5,021	$ 12,332

No stock-based compensation was capitalized as part of the cost of an asset as of September 30, 2006. As of September 30, 2006, $20.8 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options is expected to be recognized over a weighted-average period of approximately two years.

Prior to the adoption of SFAS 123R, the Company measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by APB 25. The Company applied the disclosure provisions of SFAS 123 as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure as if the fair-value-based method had been applied in measuring compensation expense. Under APB 25, when the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

The following table presents the impact of the Company s adoption of SFAS 123R on selected line items from the unaudited condensed consolidated statement of operations for the quarter and nine months ended September 30, 2006 (in thousands, except per share amounts):

	Quarter Ended September 30, 2006		Nine Months Ended September 30, 2006	
	As Reported Following	If Reported Following	As Reported Following	If Reported Following

	SFAS 123(R)	APB 25	SFAS 123(R)	APB 25
Operating income	$ 57,201	$ 62,222	$ 138,398	$ 150,730
Income before income taxes	68,061	73,082	169,094	181,426
Net income	$ 42,153	$ 45,263	$ 105,914	$ 113,713
Basic net income per share	$ 0.26	$ 0.28	$ 0.66	$ 0.71
Diluted net income per share	$ 0.24	$ 0.25	$ 0.59	$ 0.64

Table of Contents

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation during the quarter and nine months ended September 30, 2005 (in thousands, except per share data):

	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income as reported	$ 11,182	$ 16,705
Plus: stock-based employee compensation expense included in reported net income, net of related tax effects	25	109
Less: stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(3,720)	(10,134)
Pro forma net income	$ 7,487	$ 6,680
Net income per share:		
Basic as reported	$ 0.07	$ 0.10
Diluted as reported	$ 0.06	$ 0.09
Basic pro forma	$ 0.04	$ 0.04
Diluted pro forma	$ 0.04	$ 0.04

For further information related to the Company s equity compensation plans, refer to NOTE 10 EQUITY COMPENSATION PLANS.

(l) Reclassifications

Certain reclassifications have been made to the September 30, 2005 unaudited condensed consolidated financial statements, and footnotes thereto, to conform to the September 30, 2006 presentation.

(m) Recently Issued Accounting Pronouncements

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective beginning the first fiscal quarter in 2007. The Company has not yet evaluated the impact of implementation of FIN 48 on its condensed consolidated financial statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* (EITF 06-3). The scope of EITF 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *Accounting Changes and Error Corrections* . The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF 06-3 is effective for interim and annual periods beginning after December 15, 2006. The Company does not expect the adoption of EITF 06-3 to have a material impact on our condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the potential impact that the adoption of SFAS 157 will have on its condensed consolidated financial statements.

In September 2006, the SEC issued SAB No. 108, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, must be quantified on the current year financial statements. When a current year misstatement has been quantified, SAB No. 99, *Financial Statements Materiality* should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. SAB 108 also discusses the implications of misstatements uncovered upon the application of SAB 108 in situations when a registrant has historically been using either the iron curtain approach or the rollover approach as described in the SAB. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in their annual financial statements covering the first fiscal year ending after November 15, 2006. The Company is evaluating what impact the adoption of SAB 108 will have on its condensed consolidated financial statements.

NOTE 2 SEGMENT INFORMATION

The Company operates in two business segments for which the Company receives revenue from its customers: Consumer Products and Services and Technology Products and Solutions. The Company s Chief Operating Decision Maker is considered to be the Company s CEO Staff (CEOS), which is comprised of the Company s Chief Executive Officer, Chief Financial Officer, Executive Vice President and Senior Vice Presidents. The CEOS reviews financial information presented on both a consolidated basis and on a business segment basis, accompanied by disaggregated information about products and services and geographical regions for purposes of making decisions and assessing financial performance. The CEOS reviews discrete financial information regarding profitability of the Company s Consumer Products and Services segment and Technology Products and Solutions segment and, therefore, the Company reports these as operating segments as defined by Statement of Financial Accounting Standards No. 131, Disclosure About Segments of an Enterprise and Related Information (SFAS 131).

Table of Contents

The Company s customers consist primarily of business customers and individual consumers located in the United States and various foreign countries. Revenue by geographic region is as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
United States	$ 69,433	$ 63,478	$ 201,675	$ 184,678
Europe	15,895	10,937	45,725	33,547
Rest of the world	8,348	7,818	22,287	23,266
Total net revenue	$ 93,676	$ 82,233	$ 269,687	$ 241,491

The Company s segment revenue is defined as follows:

Consumer Products and Services primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass; sales and distribution of third party software and services; sales of digital content such as music and game downloads; sales of premium versions of our RealPlayer and related products; and advertising. These products and services are sold and provided primarily through the Internet and the Company charges customers credit cards at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased.

Technology Products and Solutions primarily includes revenue from: sales of media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through OEM channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers. These products and services are primarily sold to corporate, educational and governmental customers.

Net revenue by segment is as follows (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Consumer Products and Services	$ 82,497	$ 71,750	$ 234,750	$ 206,549
Technology Products and Solutions	11,179	10,483	34,937	34,942
Total net revenue	$ 93,676	$ 82,233	$ 269,687	$ 241,491

Consumer Products and Services revenue is comprised of the following (in thousands):

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Music	$ 30,375	$ 26,193	$ 89,411	$ 74,009
Media Software and Services	29,586	30,858	82,990	92,004
Games	22,536	14,699	62,349	40,536
Total Consumer Products and Services revenue	$ 82,497	$ 71,750	$ 234,750	$ 206,549

Long-lived assets, net by geographic region are as follows (in thousands):

	September 30, 2006	December 31, 2005
United States	$ 147,820	$ 149,247
Europe	26,134	14,256
Rest of world	676	302
Total long-lived assets, net	$ 174,630	$ 163,805

Goodwill is assigned to the Company s segments as follows (in thousands):

	September 30, 2006	December 31, 2005
Consumer Products and Services	$ 126,799	$ 117,340
Technology Products and Solutions	5,990	5,990
Total goodwill	$ 132,789	$ 123,330

Table of Contents

Reconciliation of segment operating income (loss) to net income (loss) before income taxes is as follows (in thousands):

For the Quarter Ended September 30, 2006	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 82,497	$ 11,179	$	$ 93,676
Cost of revenue	26,302	2,087		28,389
Gross profit	56,195	9,092		65,287
Antitrust litigation expense (benefit)			(61,861)	(61,861)
Other operating expenses	56,881	13,066		69,947
Operating income (loss)	(686)	(3,974)	61,861	57,201
Total non-operating income, net			10,860	10,860
Net income (loss) before income taxes	$ (686)	$ (3,974)	$ 72,721	$ 68,061

For the Nine Months Ended September 30, 2006	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 234,750	$ 34,937	$	$ 269,687
Cost of revenue	75,468	6,320		81,788
Gross profit	159,282	28,617		187,899
Antitrust litigation expense (benefit)			(159,554)	(159,554)
Loss on excess office facilities			738	738
Other operating expenses	167,223	41,094		208,317
Operating income (loss)	(7,941)	(12,477)	158,816	138,398
Total non-operating income, net			30,696	30,696
Net income (loss) before income taxes	$ (7,941)	$ (12,477)	$ 189,512	$ 169,094

For the Quarter Ended September 30, 2005	Consumer Products and Services	Technology Products and Solutions	Reconciling Amounts	Consolidated
Net revenue	$ 71,750	$ 10,483	$	$ 82,233
Cost of revenue	22,770	1,925		24,695
Gross profit	48,980	8,558		57,538
Antitrust litigation expense (benefit)			3,531	3,531
Other operating expenses	43,016	11,120		54,136

Operating income (loss)		5,964		(2,562)		(3,531)		(129)
Total non-operating income, net						14,768		14,768
Net income (loss) before income taxes	$	5,964	$	(2,562)	$	11,237	$	14,639

For the Nine Months Ended September 30, 2005		**Consumer Products and Services**		**Technology Products and Solutions**		**Reconciling Amounts**		**Consolidated**
Net revenue	$	206,549	$	34,942	$		$	241,491
Cost of revenue		68,133		6,140				74,273
Gross profit		138,416		28,802				167,218
Antitrust litigation expense (benefit)						11,925		11,925
Other operating expenses		125,049		35,261				160,310
Operating income (loss)		13,367		(6,459)		(11,925)		(5,017)
Total non-operating income, net						25,485		25,485
Net income (loss) before income taxes	$	13,367	$	(6,459)	$	13,560	$	20,468

Operating expenses of both Consumer Products and Services and Technology Products and Solutions include costs directly attributable to those segments and an allocation of general and administrative expenses and other corporate overhead costs. General and administrative and other corporate overhead costs are allocated to the segments and are generally based on the relative headcount of each segment. The accounting policies used to derive segment results are generally the same as those described in Note 1.

NOTE 3 ACQUISITION

On January 31, 2006, the Company acquired all of the outstanding securities of Zylom Media Group BV (Zylom) in exchange for approximately $7.9 million in cash payments. Included in the purchase price are $0.3 million in estimated acquisition-related expenditures consisting primarily of professional fees. The Company is also obligated to pay an additional $2.0 million, through individual payments of approximately $1.0 million on the first and second anniversaries of the acquisition date. In addition, the Company may be obligated to pay up to $10.9 million over a three-year period, dependent on whether certain performance criteria are achieved. Such amounts are not included in the initial aggregate purchase price and, to the extent earned, will be recorded as goodwill when it is probable that the individual payments will be made.

Zylom is located in Eindhoven, the Netherlands and is a distributor, developer and publisher of PC-based games in Europe. The Company believes that combining Zylom s assets and distribution network with the Company s downloadable, PC-based games assets and distribution platform will enhance the Company s presence in the European games market. The results of Zylom s operations are included in the Company s condensed consolidated financial statements starting from the date of acquisition.

A summary of the purchase price for the acquisition is as follows (in thousands):

Cash paid at acquisition	$ 7,922
Additional future payments related to initial purchase price	2,000
Estimated direct acquisition costs	293
Total	$ 10,215

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third party appraisal at the acquisition date and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $8.2 million. Goodwill in the amount of $8.2 million is not deductible for tax purposes. Pro forma results are not presented, because they are not material to the Company s overall financial statements.

A summary of the allocation of the purchase price is as follows (in thousands):

Current assets	$ 1,830
Property and equipment	166
Technology/Games	570
Tradenames/Trademarks	560
Distributor/Customer Relationships	1,290
Non-compete agreements	180
Goodwill	8,168
Current liabilities	(1,781)
Net deferred tax liabilities	(768)
Net assets acquired	$ 10,215

Technology/Games and Tradenames/Trademarks have weighted average estimated useful lives of three years. Distributor and customer relationships have weighted average estimated useful lives of approximately five years. Non-compete agreements have a weighted average estimated useful life of four years.

NOTE 4 GOODWILL

Goodwill is the excess of the purchase price (including liabilities assumed and direct acquisition related costs) over the fair value of the tangible and identifiable intangible assets acquired through acquisitions of businesses.

Goodwill changed during 2006 as follows (in thousands):

Goodwill at December 31, 2005	$ 123,330
Acquisition of Zylom	8,168
Effects of foreign currency translation	1,291
Goodwill at September 30, 2006	$ 132,789

NOTE 5 EQUITY INVESTMENTS

The Company has made minority equity investments for business and strategic purposes through the purchase of voting capital stock of certain companies. The Company s investments in publicly traded companies are accounted for as available-for-sale, carried at current market value and are classified as long-term. The Company periodically evaluates whether declines in fair value, if any, of its investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent of which the quoted market price is less than its accounting basis. The Company also considers other factors to determine whether declines in fair value are other-than-temporary, such as the investee s financial condition, results of operations and operating trends. The evaluation also considers publicly available information regarding the investee companies. For investments in private companies with no quoted market price, the Company considers similar qualitative and quantitative factors and also considers the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances at September 30, 2006, the Company determined that there were no other-than-temporary declines in fair value for the quarter and nine months then ended.

As of September 30, 2006, the Company owned marketable equity securities of J-Stream, a Japanese media services company, representing approximately 10.6% of the investee s outstanding shares, accounted for as available-for-sale securities. The market value of these shares has increased from the Company s original cost of approximately $0.9 million, resulting in a carrying value of $22.7 million and $43.4 million at September 30, 2006 and December 31, 2005, respectively. The increase over the Company s cost basis, net of tax effects, was $15.5 million and $28.9 million at September 30, 2006 and December 31, 2005, respectively, and is reflected as a component of accumulated other comprehensive income. The market for this company s shares is relatively limited and the share price is volatile. Accordingly, there can be no assurance that a gain of this magnitude, or any gain, can be realized through the disposition of these shares.

NOTE 6 INVESTMENT IN MUSICNET

The Company s investment in MusicNet, a joint venture with several media companies to create a platform for online music subscription services, was accounted for under the equity method of accounting. During the quarter ended June 30, 2005, the Company disposed of all of its preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. The Company received approximately $7.2 million of cash proceeds in connection with the closing of the transaction and received an additional $0.4 million in connection with the expiration of an escrow arrangement in August 2005. During the quarter ended June 30, 2006, the Company received an additional $2.3 million in cash due to the expiration of an indemnity escrow arrangement which expired on the one-year anniversary of the transaction date.

The Company recorded in its statement of operations its equity share of MusicNet s net loss through the date of disposition, which was not significant during the quarter ended September 30, 2005 and was $1.1 million for the nine months ended September 30, 2005. No amounts were recorded during 2006. For purposes of calculating the Company s equity in net loss of MusicNet, the convertible notes were treated on an as if converted basis due to the nature and terms of the convertible notes. As a result, the losses recorded by the Company represented approximately 36.1% of MusicNet s net losses through the date of disposition in 2005.

NOTE 7 LOSS ON EXCESS OFFICE FACILITIES

In October 2000, the Company entered into a 10-year lease agreement for additional office space located near its corporate headquarters in Seattle, Washington. Due to a subsequent decline in the market for office space in Seattle and the Company s re-assessment of its facilities requirements, the Company has accrued for estimated future losses on excess office facilities. The loss estimate currently includes $11.8 million of sublease income, which is committed under current sublease contracts. During the quarter ended March 31, 2006, the Company increased its loss estimate by $0.7 million due to building operating expenses that are not expected to be recovered under the terms of the existing sublease agreements. Although the Company believes its estimates are reasonable, additional losses may result if actual experience differs from projections.

A summary of activity for the accrued loss on excess office facilities is as follows (in thousands):

Accrued loss at December 31, 2005	$ 18,016
Less amounts paid, net of sublease income	(3,378)
Revisions to estimates in accrued loss on excess office facilities in 2006	738
Accrued loss at September 30, 2006	$ 15,376

NOTE 8 CONVERTIBLE DEBT

During 2003, the Company issued $100 million aggregate principal amount of zero coupon convertible subordinated notes due July 1, 2010, pursuant to Rule 144A under the Securities Act of 1933, as amended. The notes are subordinated to any Company senior debt, and are also effectively subordinated in right of payment to all indebtedness and other liabilities of its subsidiaries. The notes are convertible into shares of the Company s common stock based on an initial effective conversion price of approximately $9.30 per share if (1) the closing sale price of the Company s common stock exceeds $10.23, subject to certain restrictions, (2) the notes are called for redemption, (3) the Company makes a significant distribution to its shareholders or becomes a party to a transaction that would result in a change in control, or (4) the trading price of the notes falls below 95% of the value of common stock that the notes are convertible into, subject to certain restrictions; one of which allows the Company, at its discretion, to issue cash or common stock or a combination thereof upon conversion. On or after July 1, 2008, the Company has the option to redeem all or a portion of the notes that have not been previously purchased, repurchased or converted, in exchange for cash at 100% of the principal amount of the notes. The purchasers may require the Company to purchase all or a portion of the notes in cash on July 1, 2008 at 100% of the principal amount of the notes. As a result of this issuance, the Company received proceeds of $97.0 million, net of offering costs. The offering costs are included in other assets and are being amortized over a five-year period. Interest expense from the amortization of offering costs in the amount of $0.2 million and $0.5 million is recorded in interest income, net for the quarter and nine months ended September 30, 2006 and 2005, respectively. The net proceeds of the issuance are to be used for general corporate purposes, acquisitions, other strategic transactions including joint ventures, and other working capital requirements.

NOTE 9 REPURCHASE OF COMMON STOCK

In November 2005, the Company announced a share repurchase program to repurchase up to an aggregate of $100.0 million of the Company s outstanding common stock. During the quarter ended March 31, 2006, the Company repurchased approximately 9.5 million shares for an aggregate value of approximately $77.0 million at an average cost of $8.09 per share. From the inception of the November 2005 repurchase program through March 31, 2006, the Company repurchased 12.4 million shares under the November 2005 program for an aggregate value of $100.4 million (inclusive of transaction costs) at an average price of $8.11 per share. At March 31, 2006, no amounts authorized were outstanding under the November 2005 repurchase program.

In April 2006, the Company announced a new share repurchase program, in which the Company s Board of Directors authorized the repurchase of up to an aggregate of $100.0 million of the Company s outstanding common stock. During the quarter ended September 30, 2006, the Company repurchased approximately 0.2 million shares for an aggregate value of approximately $1.9 million at an average cost of $9.51 per share. Since the inception of the April 2006 repurchase program, the Company has repurchased approximately 2.3 million shares for an aggregate value of approximately $21.9 million at an average cost of $9.44 per share. At September 30, 2006, the remaining amount authorized under the April 2006 repurchase program was approximately $78.1 million.

NOTE 10 EQUITY COMPENSATION PLANS

The Company has options outstanding under six equity compensation plans (Plans) to compensate its employees and directors for past and future services. Of the Plans, the RealNetworks Inc. 2005 Stock Incentive Plan (2005 Plan) and the RealNetworks Inc. Director Compensation Stock Plan (Director Plan) remain active and are available for future grants. The Company has reserved 23.6 million shares under the 2005 Plan, which includes a total of 5.1 million shares cancelled from prior Plans and transferred to the 2005 Plan, and 0.4 million shares under the Director Plan. As of September 30, 2006, 8.8 million shares were available for grant under the 2005 Plan and 0.3 million shares were available for grant under the Director Plan. Generally, options vest based on continuous employment, over a four- or five-year period. The options expire in either seven, ten or twenty years from the date of grant and are exercisable at the fair market value of the common stock at the grant date. Shares that lapse due to forfeiture or expiration are available for re-issuance.

A summary of stock option related activity is as follows:

	Shares Available for Grant in (000 s)	Options Outstanding: Number of Shares in (000 s)	Options Outstanding: Weighted Average Exercise Price	Weighted Average Fair Value-Grants
Balance at December 31, 2005	14,473	35,622	$ 6.95	
Options granted at common stock price	(8,629)	8,629	9.52	$ 4.30
Options exercised		(6,773)	6.04	
Options canceled	3,003	(3,003)	6.41	

Balance at September 30, 2006	8,847	34,475	$ 7.82

The weighted average fair value of options granted during the nine months ended September 30, 2005 was $2.41. Pursuant to the provisions of the 2005 Stock Incentive Plan, Shares Available for Grant as of December 31, 2005 were adjusted to reflect an additional 3.1 million available shares which were cancelled from previously expired Plans during 2005.

Table of Contents

The fair value of options granted was determined using the Black-Scholes model. The following assumptions were used to perform the calculations:

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.68-5.06%	3.17%	4.35-5.07%	2.83 3.17%
Expected life (years)	4.3	4.4	4.3	4.4
Volatility	49%	56%	48-49%	48-56%

The following table summarizes information about stock options outstanding at September 30, 2006:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Shares (in 000 s)	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Shares (in 000 s)	Weighted Average Exercise Price
$0.02 $5.01	5,779	10.06	$ 4.19	2,493	$ 3.42
$5.03 $5.89	5,713	14.56	5.52	1,463	5.58
$5.90 $6.74	4,631	16.37	6.17	2,287	6.11
$6.75 $7.22	4,718	15.37	7.15	4,063	7.19
$7.24 $8.58	4,579	7.88	7.97	1,120	7.89
$8.69 $10.06	6,064	7.65	9.85	869	9.55
$10.06 $46.00	2,981	10.71	18.41	1,861	23.24
$46.19 $46.19	10	12.95	46.19	10	46.19
	34,475	11.72	$ 7.82	14,166	$ 8.52

At September 30, 2005, there were approximately 18.1 million exercisable options outstanding with a weighted average exercise price of $8.10.

The aggregate intrinsic value of options outstanding and options exercisable at September 30, 2006 was $120.1 million and $53.5 million, respectively. The aggregate intrinsic value represents the difference between the Company s closing stock price on the last day of trading during the quarter, which was $10.61 per share as of September 30, 2006, and the exercise price multiplied by the number of applicable options. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was $31.0 million and $4.4 million, respectively.

NOTE 11 GUARANTEES

In the ordinary course of business, the Company is not subject to potential obligations under guarantees that fall within the scope of FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others (FIN 45) an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB interpretation No. 34, except for standard indemnification and warranty provisions that are contained within many of the Company s customer license and service agreements, and give rise only to the disclosure requirements prescribed by FIN 45.

Indemnification and warranty provisions contained within the Company s customer license and service agreements are generally consistent with those prevalent in the Company s industry. The duration of the Company s product warranties generally does not exceed 90 days following delivery of the Company s products. The Company has not incurred significant obligations under customer indemnification or warranty provisions historically and does not expect to incur significant obligations in the future. Accordingly, the Company does not maintain accruals for potential customer indemnification or warranty-related obligations.

NOTE 12 LITIGATION

In August 2005, a lawsuit was filed against the Company in the U.S. District Court for the District of Maryland by Ho Keung Tse, an individual residing in Hong Kong. The suit alleges that certain of the Company s products and services infringe the plaintiff s patent relating to the distribution of digital files, including sound tracks, music, video and executable software in a manner which restricts unauthorized use. The plaintiff seeks to enjoin the Company from the allegedly infringing activity and to recover treble damages for the alleged infringement. In October 2005, the Company s co-defendant moved to transfer the lawsuit from the District of Maryland to the Northern District of California. The Company disputes the plaintiff s allegations in the action and intends to vigorously defend itself.

Table of Contents

In June 2003, a lawsuit was filed against the Company and Listen.com, Inc. (Listen) in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of the Company s and Listen s products and services willfully infringe certain patents relating to allowing users to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously. Friskit seeks to enjoin the Company from the alleged infringing activity and to recover treble damages from the alleged infringement. The Company has filed its answer and a counterclaim against Friskit challenging the validity of the patents at issue. The trial court has also granted the Company s motion to transfer the action to the Northern District of California. The Company disputes Friskit s allegations in this action and intends to vigorously defend itself.

From time to time the Company is, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of its business, including employment claims, contract-related claims and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. These claims, including those described above, even if not meritorious, could force the Company to spend significant financial and managerial resources. The Company is not aware of any legal proceedings or claims that the Company believes will have, individually or taken together, a material adverse effect on the Company s business, prospects, financial condition or results of operations. However, the Company may incur substantial expenses in defending against third party claims and certain pending claims are moving closer to trial. The Company expects that its potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability, and/or be required to change its business practices. Either of these could have a material adverse effect on the Company s financial position and results of operations.

NOTE 13 SUBSEQUENT EVENT

On September 12, 2006, the Company entered into a definitive agreement to acquire all of the issued and outstanding common shares and American Depository Shares (ADSs) of WiderThan Co., Ltd. (WiderThan), through a cash tender offer for approximately $350.0 million. The tender offer was made pursuant to the Offer to Purchase and Letter of Transmittal, each filed with the Securities and Exchange Commission on September 29, 2006, as amended and supplemented. WiderThan, based in Seoul, South Korea, is a provider of integrated mobile music and entertainment solutions, including ringback tones and music-on-demand services. On October 31, 2006, the Company successfully completed the tender offer pursuant to which the Company acquired 2,840,329 common shares and 15,905,999 ADSs, together representing approximately 95% of WiderThan s outstanding common shares, including common shares underlying ADSs, for an aggregate value of $319.6 million.

The Company announced a subsequent offering period of ten business days, expiring on November 10, 2006, unless otherwise extended. During the subsequent offering period, holders of WiderThan common shares and ADSs that were not previously tendered in the offer may tender their common shares and ADSs on the same terms that applied prior to the initial expiration of the tender offer.

Table of Contents

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

The discussion in this report contains forward-looking statements that involve risks and uncertainties. RealNetworks actual results could differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Report. You should also carefully review the risk factors set forth in other reports or documents that RealNetworks files from time to time with the Securities and Exchange Commission, particularly RealNetworks Annual Reports on Form 10-K, other Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K. You should also read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and related notes included in this report.

Overview

RealNetworks, Inc. is a leading creator of digital media services and software, such as Rhapsody, RealArcade and RealPlayer. Consumers use our services and software to find, play, purchase and manage free and premium digital content, including music, games and video. Broadcasters, network operators, media companies and enterprises use our products and services to create, secure and deliver digital media to PCs, mobile phones and other consumer electronics devices.

Over the last several years, we have focused on the development of our consumer businesses through both internal initiatives and strategic acquisitions of businesses and technologies. These efforts have resulted in increases in the number of subscribers to our music and games subscription offerings and increased sales of our digital music and games content. This shift in focus and the increases in subscribers and sales of digital media content have resulted in a significantly higher percentage of our total revenue arising from our consumer businesses. Our Consumer Products and Services segment accounted for approximately 88% and 87% of our total revenue for the quarter and nine months ended September 30, 2006, respectively. In addition, we have increased our focus on free-to-consumer products and services, such as Rhapsody 25, our Rhapsody.com website and our RealArcade game service, which generate advertising revenue and are designed to increase the exposure of our paid digital music and games products and services to consumers. Our Technology Products and Solutions revenue in dollar terms has remained relatively consistent over the last several years; however, it has decreased as a percentage of total revenue.

In the quarter ended September 30, 2006, we recorded the highest total quarterly revenue in our history due to the significant growth in our Consumer Products and Services segment. This growth, as compared to the same quarter in 2005, was driven primarily by increased revenue from our Games and Music businesses, including increased sales resulting from our acquisition of Zylom in January 2006. Media Software and Services revenue declined for the quarter and nine months ended September 30, 2006 from the same periods ended September 30, 2005, primarily due to a decline in subscribers to our SuperPass subscription service and a decline in our stand-alone subscription products. Although total revenue for the quarter and nine months ended September 30, 2006 grew approximately 14% and 12% over the respective periods in 2005, our quarterly sequential revenue growth rate has fluctuated in recent periods.

In October 2005, we entered into an agreement to settle all of our antitrust disputes worldwide with Microsoft. Upon settlement of the legal disputes, we also entered into two commercial agreements with Microsoft that provide for collaboration in digital music and casual games. The remaining contractual payments to be made subsequent to the quarter ended September 30, 2006 by Microsoft to us over the remaining term of the commercial agreements, or through 2007, are approximately $122.3 million in cash and services in support of our music and games businesses. Microsoft can earn credits at pre-determined market rates for music subscribers and users delivered to us through its MSN network during the contract period which will be netted against the quarterly contractual payments in the music agreement. Pursuant to these commercial agreements we received a payment of approximately $62.3 million during the quarter ended September 30, 2006 and received a total of approximately $160.7 million during the nine months ended September 30, 2006.

On September 12, 2006, we entered into a definitive agreement to acquire WiderThan Co., Ltd. (WiderThan), through a cash tender offer for approximately $350.0 million. WiderThan is a provider of integrated mobile music and entertainment solutions, including ringback tones and music-on-demand services. On October 31, 2006, we successfully completed the tender offer pursuant to which we acquired approximately 95% of WiderThan s outstanding common shares and American Depository shares. We believe the acquisition of WiderThan will enhance our mobile entertainment products and services, and increase our revenue in our Technology Products and Solutions segment as well as increase our revenue arising from our international operations. We will include WiderThan s results of operations from the date of the acquisition in our consolidated financial statements for the quarter ending December 31, 2006.

We manage our business, and correspondingly report revenue, based on our two operating segments: Consumer Products and Services and Technology Products and Solutions.

- Consumer Products and Services primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass; sales and distribution of third party software and services; sales of digital content such as music and game downloads; sales of premium versions of our RealPlayer and related products; and advertising.

- Technology Products and Solutions includes revenue from: sales of our media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through original equipment manufacturer (OEM) channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers.

Critical Accounting Policies and Estimates

The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Our critical accounting policies and estimates are as follows:

- Revenue recognition;

- Estimating music publishing rights and music royalty accruals;

- Stock-based compensation;

- Estimating sales returns and the allowance for doubtful accounts;

- Estimating losses on excess office facilities;

- Determining whether declines in the fair value of investments are other-than-temporary and estimating fair market value of investments in privately held companies;

- Valuation of goodwill;

- Accounting for income taxes; and

- Determining the loss on a purchase commitment.

Revenue Recognition. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

We recognize revenue in accordance with the following authoritative literature: Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements (SAB 104); Emerging Issues Task Force (EITF) 00-21 Revenue Arrangements with Multiple Deliverables (EITF 00-21); Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2); SOP 98-9 Software Revenue Recognition with Respect to Certain Arrangements (SOP 98-9); SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1); and EITF 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19). In general, we recognize revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the products or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and individual games are recognized at the time the music or game is made available, digitally, to the end user.

We have arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. Management applies significant judgment in establishing the fair value of multiple elements within revenue arrangements.

We recognize revenue on a gross or net basis, in accordance with EITF 99-19. In most arrangements, we contract directly with our end user customers, are the primary obligor and carry all collectibility risk. Revenue in these arrangements is recorded on a gross basis. In some cases, we utilize third party distributors to sell products or services directly to end user customers and carry no collectibility risk. In those instances, in accordance with EITF 99-19, we report the revenue on a net basis.

We recognize revenue in connection with our software products pursuant to the requirements of SOP 97-2, as amended by SOP 98-9. If we provide consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1. Revenue from these arrangements is recognized under the percentage of completion method based on the ratio of direct labor hours incurred to total projected labor hours. Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating our software to the end user.

Revenue generated from advertising appearing on our websites and from advertising included in our products is recognized as revenue as the delivery of the advertising occurs.

Music Publishing Rights and Music Royalty Accruals. We must make estimates of amounts owed related to our music publishing rights and music royalties owed for our domestic and international music services. Material differences may result in the amount and timing of our expense for any period if our management made different judgments or utilized different estimates. Under copyright law, we may be required to pay licensing fees for digital sound recordings and compositions we deliver. Copyright law generally does not specify the rate and terms of the licenses, which are determined by voluntary negotiations among the parties or, for certain compulsory licenses where voluntary negotiations are unsuccessful, by arbitration. There are certain geographies and agencies for which we have not yet completed negotiations with regard to the royalty rate to be applied to the current or historic sales of our digital music offerings. Our estimates are based on contracted or statutory rates, when established, or management s best estimates based on facts and circumstances regarding the specific music services and agreements in similar geographies or with similar agencies. While our management bases its estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, actual results may differ materially from these estimates under different assumptions or conditions.

Stock-Based Compensation. We account for stock-based compensation in accordance with Statement of Financial Accounting Standards, Share-Based Payment (SFAS 123R). Under the provisions of SFAS 123R, which we adopted as of January 1, 2006, stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes option-pricing model and is recognized as expense over the requisite service period, which is the vesting period. The Black-Scholes model requires various highly judgmental assumptions including volatility and expected option life. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from the amounts recorded in our condensed consolidated statement of operations. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. Prior to the adoption of SFAS 123R, we measured compensation expense for our employee stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25 (APB 25). Under APB 25, when the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

Sales Returns and the Allowance for Doubtful Accounts. We must make estimates of potential future product returns related to current period revenue. We analyze historical returns, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns and other allowances. Similarly, we must make estimates of the uncollectibility of our accounts receivable. We specifically analyze the age of accounts receivable and analyze historical bad debts, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. Significant judgments and estimates must be made and used in connection with establishing allowances for sales returns and the allowance for doubtful accounts in any accounting period. Material differences may result in the amount and timing of our revenue for any period if we were to make different judgments or utilize different estimates.

Accrued Loss On Excess Office Facilities. We made significant estimates in determining the appropriate amount of accrued loss on excess office facilities. If we made different estimates, our loss on excess office facilities could be significantly different from that recorded, which could have a material impact on our operating results. We have revised our original estimate four times in the last four years, increasing the accrual for loss on excess office facilities each time. The first two revisions were the result of changes in the market for commercial real estate where we operate. The third revision, which took place in 2003, resulted from adding an additional tenant at a sublease rate lower than the rate used in previous estimates. The fourth revision, which took place during the quarter ended March 31, 2006, resulted from incremental increases in the building operating expenses which were greater than the amounts previously estimated as not recoverable. The significant factors we considered in making our estimates are discussed in the section entitled Loss on Excess Office Facilities.

Impairment of Investments. As part of the process of preparing our consolidated financial statements we periodically evaluate whether any declines in the fair value of our investments are other-than-temporary. Significant judgments and estimates must be made to assess whether an other-than-temporary decline in fair value of investments has occurred and to estimate the fair value of investments in privately held companies. See Other Income (Expense), Net in the following pages for a discussion of the factors we considered in evaluating whether declines in fair value of our investments were other-than-temporary and the factors we considered in estimating the fair value of investments in private companies.

Valuation of Goodwill. We assess the impairment of goodwill on an annual basis or whenever events or changes in circumstances indicate that the fair value of the reporting unit to which goodwill relates is less than the carrying value. Factors we consider important which could trigger an impairment review include the following:

- poor economic performance relative to historical or projected future operating results;
- significant negative industry, economic or company specific trends;
- changes in the manner of our use of the assets or the plans for our business; and
- loss of key personnel.

If we were to determine that the fair value of a reporting unit was less than its carrying value, including goodwill, based upon the annual test or the existence of one or more of the above indicators of impairment, we would measure impairment based on a comparison of the implied fair value of reporting unit goodwill with the carrying amount of goodwill. The implied fair value of goodwill is determined by allocating the fair value of a reporting unit to its assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of reporting unit goodwill. To the extent the carrying amount of reporting unit goodwill is greater than the implied fair value of reporting unit goodwill, we would record an impairment charge for the difference. Judgment is required in determining what our reporting units are for the purpose of assessing fair value compared to carrying value. There were no impairments related to goodwill for any of the periods presented.

Accounting for Income Taxes. We use the asset and liability method of accounting for income taxes. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year. In addition, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for operating losses and tax credit carryforwards. Deferred tax assets and liabilities and operating loss and tax credit carryforwards are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences and operating loss and tax credit carryforwards are expected to be recovered or settled. Management must make assumptions, judgments and estimates to determine our current provision for income taxes, our deferred tax assets and liabilities and any valuation allowance to be recorded against a deferred tax asset. Our judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of future audits conducted by foreign and domestic tax authorities. Changes in tax law or our interpretation of tax laws and future tax audits could significantly impact the amounts provided for income taxes in our consolidated financial statements.

We must periodically assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not likely, a valuation allowance must be established. The establishment of a valuation allowance and increases to such an allowance result in either increases to income tax expense or reduction of income tax benefits in the statement of operations. Factors we consider in making such an assessment include, but are not limited to: past performance and our expectation of future taxable income, macro-economic conditions and issues facing our industry, existing contracts, our ability to project future results and any appreciation of our investments and other assets.

In 2005, we reduced our valuation allowance by $220 million, as we determined at year-end that it is more likely than not that the results of our future operations, as a result of the settlement with Microsoft, will generate sufficient taxable income to realize certain of our deferred tax assets. As of September 30, 2006, we have a valuation allowance of $36.6 million relating primarily to net operating losses that are restricted under Internal Revenue Code Section 382 and losses not yet realized for tax purposes on certain equity investments.

Table of Contents

Determining the loss on a purchase commitment. We may from time-to-time enter into purchase commitments that commit us to the purchase of certain products and services. We periodically evaluate, based on market conditions, product plans and other factors, the future benefit of these purchase commitments. If it is determined that the purchase commitments do not have a future benefit, then a reserve is established for the amount of the commitment in excess of the estimated future benefit. Significant judgments and estimates must be made to determine such reserves.

Revenue by Segment

We operate our business in two segments: Consumer Products and Services and Technology Products and Solutions. Revenue by segment is as follows:

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Consumer Products and Services	$ 82,497	$ 71,750	15%	$ 234,750	$ 206,549	14%
Technology Products and Solutions	11,179	10,483	7	34,937	34,942	(0)
Total net revenue	$ 93,676	$ 82,233	14%	$ 269,687	$ 241,491	12%

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(As a percentage of total net revenue)			
Consumer Products and Services	88%	87%	87%	86%
Technology Products and Solutions	12	13	13	14
Total net revenue	100%	100%	100%	100%

Consumer Products and Services. Consumer Products and Services primarily includes revenue from: digital media subscription services such as Rhapsody, RadioPass, GamePass and SuperPass and stand-alone subscriptions; sales and distribution of third party software and services; sales of digital content such as music and game downloads; sales of premium versions of our RealPlayer and related products; and advertising. These products and services are sold and provided primarily through the Internet and we charge customers credit cards at the time of sale. Billing periods for subscription services typically occur monthly, quarterly or annually, depending on the service purchased. Consumer Products and Services revenue increased in the quarter and nine months ended September 30, 2006 primarily due to increased revenue from: (1) increased sales of individual PC-based and mobile games, including increased sales resulting from our acquisition of Zylom; (2) growth in the number of subscribers to our Rhapsody and GamePass subscription services; (3) increased advertising revenue; and (4) increased revenue related to the distribution of third party products. Additional factors contributing to the increase are discussed below in the sections included within Consumer Products and Services revenue. We believe the growth in our music and games subscription services is due in part to the continued shift in our marketing and promotional efforts to these services as well as product improvements and increasing consumer acceptance and adoption of digital media products and services. While revenue and the aggregate number of subscribers related to our digital media subscription services have increased on a year-over-year basis, the number of subscribers and revenue growth for individual subscription services has fluctuated on a sequential quarterly basis. We cannot predict with accuracy how these subscription offerings will perform in the future, at what rate digital media subscription service revenue and number of subscribers will grow, if at all, or the nature or potential impact of anticipated competition.

Technology Products and Solutions. Technology Products and Solutions primarily includes revenue from: sales of media delivery system software, including Helix system software and related authoring and publishing tools, both directly to customers and indirectly through OEM channels; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting services; and consulting services we offer to our customers. These products and services are primarily sold to corporate, educational and governmental customers. Technology Products and Solutions revenue increased in the quarter ended September 30, 2006 due primarily to an increase in sales of upgrade and support services related to our system software products and an increase in sales through original equipment manufacturers (OEMs). This increase was partially offset by a decreases in revenue from the licensing of custom versions of our software and a decrease in sales of our system software products. Technology Products and Services revenue decreased slightly in the nine months ended September 30, 2006 due primarily to a decrease in revenue from sales of our system software products, which was partially offset by an increase in revenue from the licensing of custom versions of our software. We believe that sales of our business software products were substantially affected by Microsoft s continuing practice of bundling its competing Windows Media Player and server software for free with its Windows operating system products. No

Table of Contents

assurance can be given when, or if, we will experience increased sales of our Technology Products and Solutions to customers in these markets.

Consumer Products and Services Revenue

A further analysis of our Consumer Products and Services revenue is as follows:

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
			(Dollars in thousands)			
Music	$ 30,375	$ 26,193	16%	$ 89,411	$ 74,009	21%
Media Software and Services	29,586	30,858	(4)	82,990	92,004	(10)
Games	22,536	14,699	53	62,349	40,536	54
Total Consumer Products and Services revenue	$ 82,497	$ 71,750	15%	$ 234,750	$ 206,549	14%

Music. Music revenue primarily includes revenue from: our Rhapsody and RadioPass subscription services; sales of digital music content through our Rhapsody service and our RealPlayer music store; and advertising from our music websites. The increase in Music revenue during the quarter ended September 30, 2006 was due primarily to an increase in revenue from: (1) the increased number of subscribers to our Rhapsody subscription service, including our Rhapsody To Go service; (2) advertising on our music related web properties; and (3) the distribution of our Rhapsody radio product through internet service providers. These increases were partially offset by a decrease in revenue associated with our RadioPass subscription service and the online sale of individual tracks through our Rhapsody subscription service and through our RealPlayer Music Store. The increase in Music revenue during the nine months ended September 30, 2006 is due primarily to an increase in revenue from: (1) growth in subscribers to our Rhapsody subscription service, including our Rhapsody To Go service; (2) advertising on our music related web properties; (3) the distribution of our Rhapsody radio product through internet service providers; and (4) the online sale of individual tracks through our Rhapsody subscription service and our RealPlayer Music Store. These increases were partially offset by a decrease in revenue associated with our RadioPass subscription service. We believe the growth of our Music revenue during the first nine months of 2006 was due primarily to the broader acceptance of paid online music services and increased focus of our marketing efforts on our music offerings. While revenue and the aggregate number of subscribers related to our digital media subscription services have increased on a year-over-year basis, the number of subscribers and revenue growth for individual subscription services has fluctuated on a sequential quarterly basis. We cannot predict with accuracy how these subscription offerings will perform in the future, at what rate digital media subscription service revenue and number of subscribers will grow, if at all, or the nature or potential impact of anticipated competition.

Media Software and Services. Media Software and Services revenue primarily includes revenue from: our SuperPass and stand-alone premium video subscription services; RealPlayer Plus and related products; sales and distribution of third-party software products; and all advertising other than that related directly to our Music and Games businesses. The decrease in revenue in the quarter and nine months ended September 30, 2006 was due primarily to the decrease in revenue from: (1) our SuperPass subscription service, resulting from a decrease in the number of subscribers; (2) discontinuation of certain stand-alone subscription services; and (3) certain of our premium and third-party consumer license products. These decreases were partially offset by an increase in revenue from advertising on our non-Music and non-Games related web properties and the increased revenue related to the distribution of certain third-party products. We believe that the decreases were due primarily to a shift in our marketing and promotional efforts towards our music and games subscription services, which we believe represent a greater growth opportunity for us.

Games. Games revenue primarily includes revenue from: the sale of individual games through our RealArcade service and our games related websites including GameHouse, Mr. Goodliving and Zylom; our GamePass subscription service; and advertising through RealArcade and our games related websites. The increase in Games revenue during the quarter and nine months ended September 30, 2006 was due primarily to an increase in revenue from: (1) increased sales of individual games through our RealArcade service and our websites, including Zylom (subsequent to our acquisition of Zylom in January 2006); (2) growth in the number of subscribers to our GamePass subscription service; and (3) increased advertising on our Games related web properties. In addition, during the nine months ended September 30, 2006, Games revenue increased due to increased sales of games for mobile phones, primarily through our Mr. Goodliving product offerings (subsequent to our acquisition of Mr. Goodliving in May 2005). Additionally, we believe the growth in our Games revenue is due to the increased focus of our marketing efforts on our Games business and the addition of new game titles to our RealArcade and GamePass offerings.

Table of Contents

Geographic Revenue

	Quarters Ended September 30, 2006	2005	Change	Nine Months Ended September 30, 2006	2005	Change
	(Dollars in thousands)					
United States	$ 69,433	$ 63,478	9%	$ 201,675	$ 184,678	9%
Europe	15,895	10,937	45	45,725	33,547	36
Rest of the World	8,348	7,818	7	22,287	23,266	(4)
Total net revenue	$ 93,676	$ 82,233	14%	$ 269,687	$ 241,491	12%

	Quarters Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
	(As a percentage of total net revenue)			
United States	74%	77%	75%	76%
Europe	17	13	17	14
Rest of the World	9	10	8	10
Total	100%	100%	100%	100%

Revenue generated in the United States increased for the quarter and nine months ended September 30, 2006 primarily due to the growth of our Music and Games businesses and increased revenue from distribution of third party products. See Consumer Products and Services Revenue *Games* and *Music* above for further discussion of the changes.

Revenue generated in Europe increased for the quarter and nine months ended September 30, 2006 primarily due to the continued growth of our games business in Europe. The growth in our European games business was driven primarily by additional revenue from our Mr. Goodliving and Zylom product offerings subsequent to our acquisitions in May 2005 and January 2006, respectively. This increase was partially offset by a decrease in subscribers to our SuperPass subscription service. Revenue generated in Rest of the World increased for the quarter ended September 30, 2006 primarily due to an increase from the distribution of third party products, which was partially offset by a decrease in revenue from our SuperPass subscription service due to a decrease in subscribers. Revenue generated in Rest of the World decreased for the nine months ended September 30, 2006 primarily due to a decrease in subscribers to our SuperPass subscription service, which was partially offset by an increase in revenue from the distribution of third party products. Overall international revenue, which includes revenue from Europe and Rest of the World, increased as a percentage of overall revenue for the quarter and nine months ended September 30, 2006 driven mainly by the growth in our European games business.

Revenue

In accordance with SEC regulations, we present our revenue based on License Fees and Service Revenue as set forth below.

	Quarters Ended September 30, 2006	2005	Change	Nine Months Ended September 30, 2006	2005	Change
	(Dollars in thousands)					
License fees	$ 22,528	$ 19,596	15%	$ 68,014	$ 60,605	12%
Service revenue	71,148	62,637	14	201,673	180,886	11
Total net revenue	$ 93,676	$ 82,233	14%	$ 269,687	$ 241,491	12%

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(As a percentage of total net revenue)			
License fees	24%	24%	25%	25%
Service revenue	76	76	75	75
Total net revenue	100%	100%	100%	100%

License Fees. License fees primarily includes revenue from: sales of content such as game downloads and digital music tracks; sales of our media delivery system software; sales of premium versions of our RealPlayer Plus and related products; and sales of third-party products. License fees includes revenue from both our Consumer Products and Services and Technology Products and Solutions segments. The increase in license fees in the quarter and nine months ended September 30, 2006 was primarily due to an increase in revenue from the sale of individual games through our RealArcade service and our websites, including Zylom (which we acquired in January 2006). In addition, during the nine months ended September 30, 2006, license fee revenue increased due to the sale of individual games for mobile phones, primarily through our Mr. Goodliving product offerings (subsequent to our acquisition of Mr. Goodliving in May 2005) and the online sale of individual tracks through our Rhapsody music subscription service and our RealPlayer Music Store. The increase in license fee revenue was partially offset by a decrease in sales of our system software. See Revenue by

Table of Contents

Segment Consumer Products and Services and Revenue by Segment Technology Products and Solutions above for further explanation of changes.

Service Revenue. Service revenue primarily includes revenue from: digital media subscription services such as SuperPass, Rhapsody, RadioPass, GamePass and stand-alone subscriptions; support and maintenance services that we sell to customers who purchase our software products; broadcast hosting and consulting services that we offer to our customers; distribution of third party software; and advertising. Service revenue includes revenue from both our Consumer Products and Services and Technology Products and Solutions segments. The increase in service revenue in the quarter and nine months ended September 30, 2006 was primarily attributable to an increase in revenue from: (1) the increase in the number of subscribers to our music and games subscription services; (2) advertising through our web properties; (3) increases in the revenue related to the distribution of certain third-party products; and (4) consulting services provided to our corporate customers. These increases were partially offset by a decrease in revenue related to: (1) the decrease in the number of subscribers to our SuperPass subscription service; (2) sales of stand-alone subscription services and (3) the decrease in the number of subscribers to our RadioPass subscription service. Our subscription services accounted for approximately \$50.9 million and \$47.3 million of service revenue during the quarters ended September 30, 2006 and 2005, respectively, and \$146.2 million and \$139.6 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in revenue related to our subscription services was primarily due to an increase in the number of subscribers to our Rhapsody and GamePass subscription services. These increases were partially offset by a decrease in revenue resulting from a decrease in the number of subscribers to our SuperPass, RadioPass and stand-alone subscription service.

Deferred Revenue

Deferred revenue is comprised of the unrecognized revenue related to unearned subscription services, support contracts, prepayments under OEM arrangements and other prepayments for which the earnings process has not been completed. Deferred revenue at September 30, 2006 was \$25.8 million compared to \$25.3 million at December 31, 2005. The increase in deferred revenue was primarily due to an increase in prepayments related to support and maintenance services related to certain of our server software products. This increase was partially offset by a decrease in the aggregate number of subscribers and the related prepayments for our SuperPass subscription service, a decrease in sales and related prepayments to standalone subscription services, and an overall decrease in prepayment receipts related to certain of our Technology Products and Solutions customers. The slower rate of prepayment receipts has been largely due to the decrease in the number of new contracts in our Technology Products and Solutions business segment in recent periods, which historically represented a significant portion of deferred revenue. We believe the decrease in the number of new contracts in our Technology Products and Solutions business segment results primarily from the conditions described in Revenue by Segment Technology Products and Solutions above.

Cost of Revenue by Segment

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Consumer Products and Services	$ 26,303	$ 22,770	16%	$ 75,469	$ 68,133	11%
Technology Products and Solutions	2,086	1,925	8	6,319	6,140	3
Total cost of revenue	$ 28,389	$ 24,695	15%	$ 81,788	$ 74,273	10%

Cost of Revenue as a percent of Segment Revenue

	Quarters Ended September 30,	Nine Months Ended September 30,

	2006	2005	2006	2005
Consumer Products and Services	32%	32%	32%	33%
Technology Products and Solutions	19%	18%	18%	18%
Total cost of revenue	30%	30%	30%	31%

Cost of Consumer Products and Services. Cost of Consumer Products and Services revenue includes cost of content, delivery of the content included in our digital media subscription service offerings, royalties paid on sales of games, music and other third-party products, amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment and support services. The increase in dollars of Cost of Consumer Products and Services revenue for the quarter and nine months ended September 30, 2006 resulted primarily from: (1) an increase in content costs associated with the increase in our music subscription revenue; and (2) an increase in licensing costs associated with the increase in sales of online games through RealArcade and our other partner sites. In addition, the increase for the nine month period ended September 30, 2006 resulted from an increase in licensing costs associated with increased sales of individual tracks online. The Cost of Consumer Products and Services as a percentage of revenue for the quarter ended September 30, 2006 was consistent with the same period in 2005. The decrease in Cost of Consumer Products and Services for the nine months ended September 30, 2006 as a percentage of Consumer Products and Services revenue was primarily due to: (1) the renegotiation of certain content agreements with more favorable financial terms; (2) the discontinuation of certain content offerings; and (3) a shift in revenue mix to higher margin products such as advertising. The decrease was partially offset by increases related to content costs associated with our music subscription services and an increase in licensing costs associated with the online sale of individual tracks.

Cost of Technology Products and Solutions. Cost of Technology Products and Solutions revenue includes amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, fees paid to third-party vendors for order fulfillment, cost of in-house and contract personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services. Cost of Technology Products and Solutions revenue in dollar terms for the quarter and nine months ended September 30, 2006 increased primarily from increased customer support costs. Cost of Technology Products and Solutions revenue as a percentage of Technology Products and Solutions revenue for the quarter and nine months ended September 20, 2006 was consistent with the same period in 2005.

Cost of Revenue

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
			(Dollars in thousands)			
License fees	$ 9,675	$ 8,666	12%	$ 28,865	$ 24,888	16%
Service revenue	18,714	16,029	17	52,923	49,385	7
Total cost of revenue	$ 28,389	$ 24,695	15%	$ 81,788	$ 74,273	10%

Cost of Revenue as a percent of Revenue

	Quarters Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
License fees	43%	44%	42%	41%
Service revenue	26%	26%	26%	27%
Total cost of revenue	30%	30%	30%	31%

Cost of License Fees. Cost of license fees includes royalties paid on sales of games, music and other third-party products, amounts paid for licensed technology, costs of product media, duplication, manuals, packaging materials, and fees paid to third-party vendors for order fulfillment. The increase in cost of license fees in dollar terms for the quarter ended September 30, 2006 is primarily due to increased licensing costs associated with the increase in the online sale of games through RealArcade and our partner sites. The decrease in cost of license fees as a percentage of license revenue for the quarter ended September 30, 2006 was primarily due to decreased licensing costs associated with the decrease in online sales of individual songs through our Rhapsody subscription service and our RealPlayer Music Store. The increases in cost of license fees in dollar terms and as a percentage of license revenue for the nine months ended September 30, 2006 were primarily due to increased licensing costs associated with the increase in the online sale of games through RealArcade and our other partner sites and the online sale of individual songs through our Rhapsody subscription service and our RealPlayer Music Store.

Cost of Service Revenue. Cost of service revenue includes the cost of content and delivery of the content included in our digital media subscription service offerings, cost of in-house and contract personnel providing support and consulting services, and expenses incurred in providing our streaming media hosting services. The increase of cost of service revenue in dollars for the quarter and nine months ended September 30, 2006 was primarily due to an increase in content costs associated with the increase in revenue from our Rhapsody subscription services. The cost of service revenue as a percentage of service revenue for the quarter ended September 30, 2006 was consistent with the same period in 2005. The decrease in cost of service revenue as a percentage of service revenue for the nine months ended September 30, 2006 was due primarily to the renegotiation of certain content agreements and the discontinuation of certain content offerings related to our SuperPass and stand-alone subscription services. This decrease was partially offset by an increase in costs of content included in our digital media subscription services, primarily Rhapsody, due to an increase in paying subscribers.

Our digital media subscription services, including Rhapsody, are a growing portion of our business and, to date, have been characterized by higher costs of revenue than our other products and services, primarily due to the cost of licensing media content to provide these services. As a result, if our digital media subscription services continue to grow as a percentage of net revenue, our cost of service revenue may grow at an increased rate relative to net revenue, which will result in reductions in our gross margin percentages in the future.

Operating Expenses

Research and Development

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Research and development	$18,344	$16,354	12%	$55,127	$45,381	21%
As a percentage of total net revenue	20%	20%		20%	19%	

Research and development expenses consist primarily of salaries and related personnel costs, expense associated with stock option awards and employee purchases of stock through our employee stock purchase plan (ESPP) and consulting fees associated with product development. To date, all research and development costs have been expensed as incurred because technological feasibility for software products is generally not established until substantially all development is complete. The increases in research and development expenses for the quarter and nine months ended September 30, 2006 were primarily due to: (1) increases in headcount and the related expenses, partially attributable to our acquisitions of Mr. Goodliving and Zylom; and (2) expenses associated with stock option awards and stock purchased through our ESPP program due to our adoption of SFAS 123R on January 1, 2006. These increases were partially offset by a gain from the recovery of a previously cancelled purchase commitment in excess of the expected residual value.

Sales and Marketing

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Sales and marketing	$37,560	$30,745	22%	$111,604	$93,809	19%
As a percentage of total net revenue	40%	37%		41%	39%	

Sales and marketing expenses consist primarily of salaries and related personnel costs, expense associated with stock option awards and employee purchases of stock through our ESPP, sales commissions, credit card fees, subscriber acquisition costs, consulting fees, trade show expenses, advertising costs and costs of marketing collateral. Sales and marketing expense increased in the quarter and nine months ended September 30, 2006 in dollars and as a percentage of total net revenue primarily due to: (1) increased advertising costs, including costs associated with our ongoing direct marketing programs; (2) expenses associated with stock option awards and stock purchased through our ESPP due to our adoption of SFAS 123R on January 1, 2006; (3) increases in sales and marketing personnel and the related costs in order to support the continued growth in our Consumer Products and Services business and (4) increases in costs from our acquisitions of Mr. Goodliving and Zylom. We expect that our sales and marketing expenses will increase as we continue to grow our consumer businesses and as we continue to shift the focus of our marketing efforts to our Consumer Products and Services businesses.

General and Administrative

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
General and administrative	$14,043	$7,037	100%	$41,586	$21,120	97%
As a percentage of total net revenue	15%	9%		15%	9%	

General and administrative expenses consist primarily of salaries and related personnel costs, expense associated with stock option awards and employee purchases of stock through our ESPP, charitable contributions, fees for professional, temporary services and contractor costs and other general corporate costs. General and administrative expenses increased in the quarter and nine months ended September 30, 2006 in dollars and as a percentage of total net revenue primarily due to: (1) increased headcount and the related costs; (2) increased litigation defense costs, including the costs of our jury trial for the successful defense of the Ethos patent claim (excluding antitrust litigation expenses); (3) charitable contributions resulting from our practice of donating 5% of our annual net income to charity; and (4) the expense associated with stock option awards and stock purchased through our ESPP due to our adoption of SFAS 123R on January 1, 2006.

Antitrust Litigation Expenses (Benefit), Net

Antitrust litigation expenses (benefit), net of ($61.9) million and ($159.6) million for the quarter and nine months ended September 30, 2006, respectively, and $3.5 million and $11.9 million for the quarter and nine months ended September 30, 2005, respectively, consist of legal fees, personnel costs, communications, equipment, technology and other professional services costs incurred directly attributable to our antitrust case against Microsoft, as well as our participation in various international antitrust proceedings against Microsoft, including the European Union, net of payments received from Microsoft. On October 11, 2005, we entered into a settlement agreement with Microsoft pursuant to which we agreed to settle all antitrust disputes worldwide with Microsoft, including the United States litigation. The amounts for antitrust litigation expenses (benefit), net reflected the impact of payments received of $62.3 million and $160.7 million in the quarter and nine months ended September 30, 2006, respectively. Only the benefit and costs that are directly attributable to these antitrust complaints are included in antitrust litigation expenses (benefit), net.

Other Income (Expense), Net

	Quarters Ended September 30,			Nine Months Ended September 30,		
	2006	2005	Change	2006	2005	Change
	(Dollars in thousands)					
Interest income, net	$ 10,618	$ 2,904	266%	$ 27,978	$ 7,499	273%
Equity in net loss of MusicNet			n/a		(1,068)	n/a
Gain on sale of equity investments		11,740	n/a	2,286	19,330	(88)
Other, net	242	124	95	432	(276)	257
Other income, net	$ 10,860	$ 14,768	(26)%	$ 30,696	$ 25,485	20%

Other income (expense), net consists primarily of interest earnings on our cash, cash equivalents and short-term investments, which are net of interest expense due to the amortization of offering costs related to our convertible debt, gains related to the sales of certain of our equity investments, and equity in net loss of MusicNet, Inc. Other income (expense), net decreased in the quarter ended September 30, 2006 primarily due to the gain on sales of a portion of our equity investments during 2005, which was partially offset by an increase in interest income during 2006 resulting from our overall higher investment balances and a general increase in our effective interest rates in 2006. Other income (expense), net increased in the nine months ended September 30, 2006 primarily due to an increase in interest income resulting from our overall higher investment balances and a general increase in our effective interest rates, which was partially offset by the gain on sales of a larger portion of our equity investments during 2005.

Our investment in MusicNet, a joint venture with several media companies to create a platform for online music subscription services, was accounted for under the equity method of accounting. In the quarter ended June 30, 2005, we disposed of all of our preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. We received approximately $7.2 million of cash proceeds in connection with the closing of the transaction and received an additional $0.4 million in connection with the expiration of an escrow arrangement in August 2005. During the quarter ended June 30, 2006, we received an additional $2.3 million in cash due to the expiration of an indemnity escrow arrangement which expired on the one-year anniversary of the transaction date.

We recorded in our statement of operations our equity share of MusicNet s net loss through the date of disposition, which was $1.1 million for the quarter ended March 31, 2005. No amounts were recorded for the quarter or six months ended September 30, 2006. For purposes of calculating our equity in net loss of MusicNet, the convertible notes were treated on an as if converted basis due to the nature and terms of the convertible notes. As a result, the losses we recorded represented approximately 36.1% of MusicNet s net losses through the date of disposition in 2005. We did not hold an ownership interest in MusicNet during 2006.

We have made minority equity investments for business and strategic purposes through the purchase of voting capital stock of several companies. Our investments in publicly traded companies are accounted for as available-for-sale, carried at current market value and are classified as long-term as they are strategic in nature. We periodically evaluate whether any declines in fair value of our investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors. For investments with publicly quoted market prices, these factors include the time period and extent by which its accounting basis exceeds its quoted market price. We consider additional factors to determine whether declines in fair value are other-than-temporary, such as the investee s financial condition, results of operations and operating trends. The evaluation also considers publicly available information regarding the investee companies. For investments in private companies with no quoted market price, we consider similar qualitative and quantitative factors and also consider the implied value from any recent rounds of financing completed by the investee. Based upon an evaluation of the facts and circumstances at September 30, 2006, we determined that there were no other-than-temporary declines in fair value for the quarter or nine months then ended.

As of September 30, 2006, we owned marketable equity securities of J-Stream, a Japanese digital media services company. We own approximately 10.6% of the outstanding shares and this investment is accounted for as an available-for-sale security. The market value of these shares has significantly increased from our original cost of approximately $0.9 million, resulting in a carrying value of $22.7 million and $43.4 million at September 30, 2006 and December 31, 2005, respectively. The increase over our cost basis, net of tax effects is $15.5 million and $28.9 million at September 30, 2006 and December 31, 2005, respectively, and is reflected as a component of accumulated other comprehensive income. The market for this company s shares is relatively limited and the share price is volatile. Although the carrying value of our investment in J-Stream was approximately $22.7 million at September 30, 2006, there can be no assurance that a gain of this magnitude, or any gain, can be realized through the disposition of these shares.

Income Taxes

We recognized income tax expense of $25.9 million and $63.2 million for the quarter and nine months ended September 30, 2006, respectively, and $3.5 million and $3.8 million for the quarter and nine months ended September 30, 2005, respectively. We must assess the likelihood that our deferred tax assets will be recovered from future taxable income. In making this assessment, all available evidence must be considered including the current economic climate, our expectations of future taxable income and our ability to project such income and the appreciation of our investments and other assets. In 2005, we reduced our valuation allowance by $220 million, as we determined at year-end that it is more likely than not that the results of our future operations, as a result of the settlement with Microsoft, will generate sufficient taxable income to realize certain of our deferred tax assets. As of September 30, 2006, we have a valuation allowance of $36.6 million relating primarily to net operating losses that are restricted under Internal Revenue Code Section 382, and losses not yet realized for tax purposes on certain equity investments. We estimate that our effective tax rate for fiscal year 2006 will be approximately 37%.

Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective beginning the first quarter in 2007. We have not yet evaluated the impact of implementation of FIN 48 on our condensed consolidated financial statements.

In June 2006, the FASB ratified the consensus reached on Emerging Issues Task Force Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation)* (EITF 06-3). The scope of EITF 06-3 includes any transaction-based tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. The scope does not include taxes that are based on gross receipts or total revenues imposed during the inventory procurement process. Gross versus net income statement classification of that tax is an accounting policy decision and a voluntary change would be considered a change in accounting policy requiring the application of SFAS No. 154, *Accounting Changes and Error Corrections* . The following disclosures will be required for taxes within the scope of this issue that are significant in amount: (1) the accounting policy elected for these taxes and (2) the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis for all periods presented. The EITF 06-3 is effective for interim and annual periods beginning after December 15, 2006. We do not expect the adoption of EITF 06-3 to have a material impact on our condensed consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the potential impact that the adoption of SFAS 157 will have on our condensed consolidated financial statements.

In September 2006, the SEC issued SAB No. 108, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, must be quantified on the current year financial statements. When a current year misstatement has been quantified, SAB No. 99, *Financial Statements Materiality* should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements. SAB 108 also discusses the implications of misstatements uncovered upon the application of SAB 108 in situations when a registrant has historically been using either the iron curtain approach or the rollover approach as described in the SAB. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in their annual financial statements covering the first fiscal year ending after November 15, 2006. We are evaluating what impact the adoption of SAB 108 will have on our condensed consolidated financial statements.

Liquidity and Capital Resources

Net cash provided by operating activities was $134.0 million and $13.9 million for the nine months ended September 30, 2006 and 2005, respectively. Net cash provided by operating activities in 2006 was primarily the result of net income of $105.9 million, which includes cash receipts of $160.7 million from Microsoft related to the Antitrust Litigation Settlement, and non-cash expenses including depreciation and amortization of $12.5 million, deferred taxes of $56.5 million and stock-based compensation of $12.3 million. These non-cash expenses were offset by: (1) a net decrease in certain operating assets and liabilities of $48.5 million, due primarily to the timing of cash receipts or payments at the beginning and end of the period, which includes a decrease in accrued legal fees related to the Antitrust Litigation Settlement of $14.0 million, a decrease in accrued donations of $14.1 million, a decrease in accrued income taxes of $9.0 million, and a decrease in accrual of a loss on purchase commitment of $6.6 million; and (2) payments related to the accrued loss on excess office facilities and content agreement of $3.4 million, which was partially offset by a $0.7 million increase in the accrual. Net cash provided by operating activities in 2005 was primarily the result of: (1) net income of $16.7 million; (2) net increase in certain operating assets and liabilities of $6.1 million, which includes a decrease in deferred revenue of $3.3 million, due primarily to the timing of cash receipts or payments at the beginning and end of the period; (3) depreciation and amortization of $11.9 million; (4) payments related to the accrued loss on excess office facilities of $4.0 million; (5) payments related to the accrued loss on content agreement of $2.2 million; and (6) equity in net losses of MusicNet of $1.1 million.

Net cash used in investing activities was $36.8 million in the nine months ended September 30, 2006 and net cash provided by investing activities was $0.8 million for the nine months ended September 30, 2005. Net cash used in investing activities in 2006 was primarily due to net purchases of short-term investments of $21.9 million, cash payments related to our acquisition of Zylom net of cash acquired of $7.1 million, and purchases of equipment and leasehold improvements of $9.3 million. Net cash provided by investing activities in 2005 was primarily due to: (1) net sales and maturities of short-term investments of $6.3 million; (2) proceeds of $7.6 million from the sale of our equity investment in MusicNet; and (3) proceeds of $11.9 million from the sale of a portion of our investment in J-Stream, which were partially offset by cash payments, net of cash acquired, of $14.7 million related to the acquisition of Mr. Goodliving, and purchases of equipment and leasehold improvements of $10.7 million.

Net cash used in financing activities was $56.9 million and $25.0 million in the nine months ended September 30, 2006 and 2005, respectively. Net cash used in financing activities during 2006 was due to repurchases of our common stock of $98.9 million, which was partially offset by the proceeds from the exercise of stock options of $42.0 million. Net cash used in financing activities in 2005 was primarily due to proceeds from the exercise of stock options partially offset by a cash payment related to the repayment of a long-term note payable in connection with the acquisition of Mr. Goodliving.

In November 2005, our Board of Directors authorized a share repurchase program for the repurchase of up to an aggregate value of $100 million of our outstanding common stock. The repurchases were made from time to time, depending on market conditions, share price and other factors. Repurchases were made in the open market or through private transactions in accordance with Securities and Exchange Commission requirements and we entered into a Rule 10(b)5-1 plan designed to facilitate the repurchase of the authorized repurchase amount. During the quarter ended March 31, 2006, we repurchased approximately 9.5 million shares for an aggregate value of approximately $77.0 million at an average cost of $8.09 per share. From the inception of the November 2005 repurchase program through March 31, 2006, we had repurchased 12.4 million shares for an aggregate value of $100.4 million (inclusive of transaction costs) at an average price of $8.11 per share. As of March 31, 2006, we had repurchased all authorized amounts under the November 2005 repurchase program.

In April 2006, our Board of Directors authorized a new share repurchase program for the repurchase of up to an aggregate of $100.0 million of our outstanding common stock. The repurchases may be made from time to time, depending on market conditions, share price, trading volume and other factors. Repurchases may be made in the open market or through private transactions, in accordance with Securities and Exchange Commission requirements and we entered into a Rule 10(b)5-1 plan designed to facilitate the repurchase of the authorized repurchase amount. The repurchase program does not require us to acquire a specific number of shares and may be terminated under certain conditions. During the quarter ended September 30, 2006, we repurchased approximately 0.2 million shares for an aggregate value of approximately $1.9 million at an average cost of $9.51 per share. Since the inception of the April 2006 repurchase program, we have repurchased approximately 2.3 million shares for an aggregate value of approximately $21.9 million at an average cost of $9.44 per share. At September 30, 2006, the remaining amount authorized under the April 2006 repurchase program was approximately $78.1 million. We currently intend to continue our stock repurchase program depending on market conditions and other factors until we reach the $100.0 million limit authorized by our Board of Directors, which will be a further use of cash.

On September 12, 2006, we entered into a definitive agreement to acquire all of the issued and outstanding common shares and American Depository Shares (ADSs) of WiderThan, through a cash tender offer for approximately $350.0 million. On October 31, 2006, we successfully completed the tender offer pursuant to which we acquired approximately 95% of WiderThan s outstanding common shares, including common shares underlying ADSs, for an aggregate value of $319.6 million which will be a further use of cash subsequent to the quarter ended September 30, 2006.

We announced a subsequent offering period of ten business days, expiring on November 10, 2006, unless otherwise extended. During the subsequent offering period, holders of WiderThan common shares and ADSs that were not previously tendered in the offer may tender their common shares and ADSs on the same terms that applied prior to the initial expiration of the tender offer. The subsequent tender offer may result in a further use of cash subsequent to the quarter ended September 30, 2006.

We currently have no planned significant capital expenditures for the remainder of 2006 other than those in the ordinary course of business. In the future, we may seek to raise additional funds through public or private equity financing, or through other sources such as credit facilities. The sale of additional equity securities could result in dilution to our shareholders. In addition, in the future, we may enter into cash or stock acquisition transactions or other strategic transactions that could reduce cash available to fund our operations or result in dilution to shareholders.

At September 30, 2006, we had approximately $862.1 million in cash, cash equivalents, short-term investments and restricted cash equivalents. Our principal commitments include office leases and contractual payments due to content and other service providers. We believe that our current cash, cash equivalents and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months.

We do not hold derivative financial instruments or equity securities in our short-term investment portfolio. Our cash equivalents and short-term investments consist of high quality securities, as specified in our investment policy guidelines. The policy limits the amount of credit exposure to any one non-U.S. Government or non-U.S. Agency issue or issuer to a maximum of 5% of the total portfolio. These securities are subject to interest rate risk and will decrease in value if interest rates increase. Because we have historically had the ability to hold our fixed income investments until maturity, we would not expect our operating results or cash flows to be significantly affected by a sudden change in market interest rates in our securities portfolio.

We conduct our operations in eleven primary functional currencies: the United States dollar, the Japanese yen, the British pound, the Euro, the Mexican peso, the Brazilian real, the Australian dollar, the Hong Kong dollar, the Singapore dollar, the Korean won and the Chinese yuan. Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact on our financial condition or results of operations. We currently do not hedge the majority of our foreign currency exposures and are therefore subject to the risk of exchange rate fluctuations. For foreign currency exposures we do hedge, these transactions do not meet the criteria for hedge accounting under Statement of Financial Accounting Standards No. 133 Accounting for Derivative Instruments and Hedging Activities , as amended. We invoice our international customers primarily in U.S. dollars, except in Japan, Germany, France, the United Kingdom, Australia and China, where we invoice our customers primarily in yen, euros (for Germany and France), pounds, Australian dollars and Chinese yuan, respectively. We are exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. Our exposure to foreign exchange rate fluctuations also arises from intercompany payables and receivables to and from our foreign subsidiaries. Foreign exchange rate fluctuations did not have a material impact on our financial results in either of the quarters or six months ended September 30, 2006 and 2005.

Off-Balance Sheet Agreements

Our only significant off-balance sheet arrangements relate to operating lease obligations for office facility leases and other contractual obligations related primarily to minimum contractual payments due to content and other service providers.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion about our market risk involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements.

Interest Rate Risk. Our exposure to interest rate risk from changes in market interest rates relates primarily to our short-term investment portfolio. We do not hold derivative financial instruments or equity investments in our short-term investment portfolio. Our short-term investments consist of high quality securities as specified in our investment policy guidelines. Investments in both fixed and floating rate instruments carry a degree of interest rate risk. The fair value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Additionally, a falling rate environment creates reinvestment risk because as securities mature the proceeds are reinvested at a lower rate, generating less interest income. Due in part to these factors, our future interest income may be adversely impacted due to changes in interest rates. In addition, we may incur losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. Because we have historically had the ability to hold our short-term investments until maturity and the substantial majority of our short-term investments mature within one year of purchase, we would not expect our operating results or cash flows to be significantly impacted by a sudden change in market interest rates. There has been no material change in our investment methodology regarding our cash equivalents and short-term investments in 2006, and as such, the descriptions under the captions Interest Rate Risk remain unchanged from those included in our Annual Report on Form 10-K for the year ended December 31, 2005.

Investment Risk. As of September 30, 2006, we had investments in voting capital stock of both publicly-traded and privately-held technology companies for business and strategic purposes. Some of these securities do not have a quoted market price. Our investments in publicly-traded companies are carried at current market value and are classified as long-term as they are strategic in nature. We periodically evaluate whether any declines in fair value of our investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors. Equity price fluctuations of plus or minus 10% of prices at September 30, 2006 would have had an impact of approximately $2.3 million on the value of our investments in publicly-traded companies at September 30, 2006, related primarily to our investment in J-Stream, a publicly-traded Japanese company.

Foreign Currency Risk. International revenue accounted for approximately 26% and 25% of total net revenue for the quarter and nine months ended September 30, 2006, respectively. Our international subsidiaries incur most of their expenses in their respective local currencies. Accordingly, all foreign subsidiaries use their local currency as their functional currency.

Our exposure to foreign exchange rate fluctuations arises in part from: (1) translation of the financial results of foreign subsidiaries into U.S. dollars in consolidation; (2) the re-measurement of non-functional currency assets, liabilities and intercompany balances into U.S. dollars for financial reporting purposes; and (3) non-U.S. dollar denominated sales to foreign customers.

We manage a portion of these risks through the use of financial derivatives, but fluctuations could impact our results of operations and financial position.

Generally, our practice is to manage foreign currency risk for the majority of material short-term intercompany balances through the use of foreign currency forward contracts. These contracts require us to exchange currencies at rates agreed upon at the contract s inception. Because the impact of movements in currency exchange rates on forward contracts offsets the related impact on the short-term intercompany balances, these financial instruments help alleviate the risk that might otherwise result from certain changes in currency exchange rates. We do not designate our foreign exchange forward contracts related to short-term intercompany accounts as hedges and, accordingly, we adjust these instruments to fair value through results of operations. We may, however, periodically hedge a portion of our foreign exchange exposures associated with material firmly committed transactions, long-term investments, highly predictable anticipated exposures and net investments in foreign subsidiaries.

Our foreign currency risk management program reduces, but does not entirely eliminate, the impact of currency exchange rate movements.

Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact on our financial condition or results of operations. Foreign exchange rate fluctuations did not have a material impact on our financial results for the quarters or nine months ended September 30, 2006 and 2005.

Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Based on their evaluation as of the end of the period covered by this report, the Company s principal executive officer and principal financial officer have concluded that the Company s 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)) were sufficiently effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act (1) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (2) is accumulated and communicated to the Company s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

(b) *Changes in Internal Controls.* There have not been any changes in the Company s internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In August 2005, a lawsuit was filed against us in the U.S. District Court for the District of Maryland by Ho Keung Tse, an individual residing in Hong Kong. The suit alleges that certain of our products and services infringe the plaintiff s patent relating to the distribution of digital files, including sound tracks, music, video and executable software in a manner which restricts unauthorized use. The plaintiff seeks to enjoin us from the allegedly infringing activity and to recover treble damages for the alleged infringement. In October 2005, our co-defendant moved to transfer the lawsuit from the District of Maryland to the Northern District of California. We dispute the plaintiff s allegations in the action and intend to vigorously defend ourselves.

In June 2003, a lawsuit was filed against us and Listen.com, Inc. (Listen) in federal district court for the Northern District of Illinois by Friskit, Inc. (Friskit), alleging that certain features of our and Listen s products and services willfully infringe certain patents relating to allowing users to search for streaming media files, to create custom playlists, and to listen to the streaming media file sequentially and continuously. Friskit seeks to enjoin us from the alleged infringing activity and to recover treble damages from the alleged infringement. We have filed our answer and a counterclaim against Friskit challenging the validity of the patents at issue. The trial court has also granted our motion to transfer the action to the Northern District of California. We dispute Friskit s allegations in this action and intend to vigorously defend ourselves.

Table of Contents

From time to time we are, and expect to continue to be, subject to legal proceedings and claims in the ordinary course of our business, including employment claims, contract-related claims and claims of alleged infringement of third-party patents, trademarks and other intellectual property rights. These claims, including those described above, even if not meritorious, could force us to spend significant financial and managerial resources. We are not aware of any legal proceedings or claims that we believe will have, individually or taken together, a material adverse effect on our business, prospects, financial condition or results of operations. However, we may incur substantial expenses in defending against third party claims and certain pending claims are moving closer to trial. We expect that our potential costs of defending these claims may increase as the disputes move into the trial phase of the proceedings. In the event of a determination adverse to us, we may incur substantial monetary liability, and/or be required to change its business practices. Either of these could have a material adverse effect on our financial position and results of operations.

Item 1A. *Risk Factors*

You should carefully consider the risks described below together with all of the other information included in this quarterly report on Form 10-Q. The risks and uncertainties described below are not the only ones facing our company. If any of the following risks actually occurs, our business, financial condition or operating results could be harmed. In such case, the trading price of our common stock could decline, and investors in our common stock could lose all or part of their investment.

Risks Related To Completed and Potential Acquisitions

Our recent acquisition of WiderThan could expose us to new risks, disrupt our business and adversely impact our results of operations.

On October 30, 2006, we announced the results of our tender offer for WiderThan pursuant to which we acquired approximately 95% of the outstanding common shares and American Depository Shares of WiderThan. We expect to acquire additional securities of WiderThan during the subsequent offering period which is scheduled to expire on November 10, 2006.

As a result of this acquisition, we will be entering new markets, both technologically and geographically. WiderThan provides ringback tones, music-on-demand and other mobile entertainment services to wireless carriers in more than 25 countries. Because the acquisition has just recently occurred, we do not yet know the specific risks that the combined business will face. We expect, however, that such risks will include, but not be limited to:

- the loss or deterioration of WiderThan s relationship with SK Telecom, the largest wireless carrier in Korea, which provided approximately 65% of WiderThan s revenues in 2005 and which owns certain intellectual property utilized by WiderThan in its music-on-demand carrier application service;
- intense competition for mobile entertainment services;
- the dynamics of the wireless carrier market and WiderThan s reliance on carrier customers;
- changes in government regulation in the various countries in which WiderThan operates, and the regulatory environment of the media and wireless communications industries in particular;
- foreign currency fluctuations;
- economic changes in the various countries in which WiderThan operates, specifically, Korea, which was the source of approximately 65% of WiderThan s revenues in 2005; and
- increased tensions with North Korea.

In addition, our acquisition of WiderThan may divert the attention of management and other key personnel from our core business operations, which could adversely impact our financial performance in the near term. Moreover, the integration of WiderThan s operations into the Company will require expansions to our system of internal controls over financial reporting. Any failure to successfully operate and integrate WiderThan could have an adverse effect on our results of operations.

Potential acquisitions involve risks that could harm our business and impair our ability to realize potential benefits from acquisitions.

As part of our business strategy, we have acquired technologies and businesses in the past, and expect that we will continue to do so in the future. The failure to adequately address the financial, legal and operational risks raised by acquisitions of technology and businesses could harm our business and prevent us from realizing the benefits of the acquisitions. Financial risks related to acquisitions may harm our financial position, reported operating results or stock price.

Acquisitions also involve operational risks that could harm our existing operations or prevent realization of anticipated benefits from an acquisition. These operational risks include:

- difficulties and expenses in assimilating the operations, products, technology, information systems or personnel of the acquired company and difficulties in retaining key management or employees of the acquired company;

- entrance into unfamiliar markets or industry segments;

- impairment of relationships with employees, affiliates, advertisers or content providers of our business or the acquired business; and

- the assumption of known and unknown liabilities of the acquired company, including intellectual property claims.

Risks Related to Our Consumer Products and Services Business

Our online consumer businesses have grown substantially in recent periods and these businesses compete in rapidly evolving markets, which makes their prospects difficult to evaluate.

Our Consumer Products and Services segment in the quarter and nine months ended September 30, 2006 represented approximately 88% and 87% of total revenue, respectively. These consumer businesses compete in new and rapidly evolving markets and face substantial competitive threats. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by businesses in new and fiercely competitive markets. Our Consumer Products and Services revenue and subscriber and user base have grown substantially in the past two years and it is unlikely that we will be able to sustain our recent growth rates.

Our online consumer businesses have generally lower margins than our traditional software license business.

The gross margin for our Consumer Products and Services segment is lower than the gross margins in our Technology Products and Solutions segment. The cost of third party content, in particular, is a substantial percentage of net revenue and is unlikely to decrease significantly over time as a percentage of net revenue. Our Consumer Products and Services businesses represent a substantial majority of our revenue and include our music subscriptions and sales, video subscription services and games subscription and sales as well as advertising revenue across our web properties. If our Consumer Products and Services revenue continues to grow as a percentage of our overall revenue, our margins may further decrease which may affect our ability to sustain profitability. We are also increasingly acquiring music subscribers through wholesale relationships with broadband service providers and other distribution partners, such as our agreement with Comcast for the distribution of our radio products. Our gross margins could be negatively impacted if usage of our radio products by these subscribers significantly exceeds our forecasts.

Our subscription levels may vary due to seasonality.

Our subscription businesses are rapidly evolving and we are still determining the impact of seasonality on these businesses, including our music and games subscription businesses. In addition, some of the most popular premium content that we have offered in our premium video subscription services is seasonal or periodic in nature and we are experimenting with different types of content to determine what consumers prefer. We have limited experience with these types of offerings and cannot predict how the seasonal or periodic nature of these offerings will impact our subscriber growth rates for these products, future subscriber retention levels or our quarterly financial results.

The success of our subscription services businesses depends upon our ability to add new subscribers and minimize subscriber churn.

Our operating results could be adversely impacted by subscriber churn. Internet subscription businesses are a relatively new media delivery model and we cannot predict with accuracy our long-term ability to retain subscribers or add new subscribers. Subscribers may cancel their subscriptions to our services for many reasons, including a perception that they do not use the services sufficiently or that the service does not provide enough value, a lack of attractive or exclusive content generally or as compared to competitive service offerings (including Internet piracy), or because customer service issues are not satisfactorily resolved. In addition, the costs of marketing and promotional activities necessary to add new subscribers and the costs of obtaining content that customers desire may adversely impact our margins and operating results. In recent periods, we have seen an increase in the number of gross customer cancellations of our subscription services due in part to our increasingly large subscriber base. We are also increasingly acquiring music subscribers through alternative marketing channels, including direct marketing and third party distribution. We believe that subscribers obtained through these channels are likely to have higher cancellation rates.

Our digital content subscription businesses depend on our continuing ability to license compelling content on commercially reasonable terms.

We must continue to obtain compelling digital media content for our video, music and games subscription services in order to maintain and increase subscription service revenue and overall customer satisfaction for these products. In some cases, we pay substantial fees to obtain premium content. In particular, we pay substantial royalty fees to the music labels to license content. If we cannot obtain premium digital content for any of our digital content subscription services on commercially reasonable terms, or at all, our business will be harmed.

Our online music services depend upon our licensing agreements with the major music label and music publishing companies.

Our online music service offerings depend on music licenses from the major music labels and publishers. The current license agreements are for relatively short terms and we cannot be sure that the music labels will renew the licenses on commercially viable terms, or at all. Due to the increasing importance of our music services to our overall revenue, the failure of any major music label or publisher to renew these licenses under terms that are acceptable to us will harm our ability to offer successful music subscription services and would harm our operating results. In addition, the failure of the major music labels to agree to new or innovative license terms or arrangements may harm our ability to offer consumers compelling digital music products and services.

Music publishing royalty rates for music subscription services are not yet fully established; a determination of high royalty rates could negatively impact our operating results.

Publishing royalty rates associated with music subscription services in the U.S. and abroad are not fully established. Public performance licenses are negotiated individually, and we have not yet agreed to rates with all of the performing rights societies for all of our music subscription service activities. We may be required to pay a rate that is higher than we expect, as the issue was recently submitted to a Rate Court by ASCAP for judicial determination. We have a license agreement with the Harry Fox Agency, an agency that represents music publishers, to reproduce musical compositions as required in the creation and delivery of on-demand streams and tethered downloads, but this license agreement does not include a rate. The license agreement anticipates industry-wide agreement on rates, or, if no industry-wide agreement can be reached, determination by a copyright royalty board (CARB), an administrative judicial proceeding supervised by the United States Copyright Office. If the rates agreed to or determined by a CARB or by Congress are higher than we expect, this expense could negatively impact our operating results. The publishing rates associated with our international music streaming services are also not yet determined and may be higher than our current estimates.

Our consumer businesses face substantial competitive challenges that may prevent us from being successful in those businesses.

Music. Our online music services face significant competition from traditional offline music distribution competitors and from other online digital music services. Some of these competing online services have spent substantial amounts on marketing and have received significant media attention, including Apple s iTunes music download service, which it markets closely with its extremely popular iPod line of portable digital audio players, Napster s music subscription service and Yahoo!, which offers certain of its competing music subscription products at a lower price than our similar products. Microsoft has also begun offering premium music services in conjunction with its Windows Media Player and MSN services and also now markets a portable music player and related download software called Zune. We also expect increasing competition from media companies such as MTV, and from online retailers such as Amazon.com, which is also reportedly planning to develop and market a digital music player and a related digital

music subscription service. Our current music service offerings may not be able to compete effectively in this highly competitive market, particularly if new or existing competitors continue to price their competing digital music products and services lower than ours or increase the costs of customer acquisition through their marketing efforts.
Our online music services also face significant competition from free peer-to-peer services which allow consumers to directly access an expansive array of free content without securing licenses from content providers. Enforcement efforts have not effectively shut down these services and there can be no assurance that these services will ever be shut down. The ongoing presence of these free services substantially impairs the marketability of legitimate services like ours.

Media Software and Services. Our media software and services (primarily our SuperPass subscription service) face competition from existing competitive alternatives and other emerging services and technologies, such as user generated content services like YouTube and Google Video. Content owners are increasingly marketing their content on their own websites rather than licensing to other distributors such as us. We face competition in these markets from traditional media outlets such as television, radio, CDs, DVDs, videocassettes and others. We also face competition from emerging Internet media sources and established companies entering into the Internet media content market, including Time Warner s AOL subsidiary, Microsoft, Apple, Yahoo! and broadband Internet service providers. We expect this competition to become more intense as the market and business models for Internet video content mature and more competitors enter these new markets. Competing services may be able to obtain better or more favorable access to compelling video content than us, may develop better offerings than us and may be able to leverage other assets to promote their offerings successfully.

Games. Our RealArcade service competes with other online distributors of downloadable casual PC games. Some of these distributors have high volume distribution channels and greater financial resources than us, including Yahoo! Games, MSN Gamezone, Pogo.com and Shockwave. We expect competition to intensify in this market from these and other competitors and no assurance can be made that we will be able to continue to grow our revenue. We also own and operate GameHouse, a developer and distributor of downloadable casual PC games, and we recently acquired Mr. Goodliving, a developer and publisher of mobile games primarily in the European market. Game development is a new business for us, and we may not be able to successfully develop and market software games in the future. GameHouse competes primarily with other developers of downloadable casual PC games and must continue to develop popular and high-quality game titles to maintain its competitive position. In addition, certain competitors of our RealArcade service also distribute and promote games developed by GameHouse. These distributors may not continue to distribute and promote our games in the same manner as a result of our ownership of GameHouse.
Mr. Goodliving faces intense competition from a wide variety of mobile game developers and publishers, many of which are larger and devote substantially more resources to the mobile games business than we do. We also recently acquired Zylom, a developer and distributor of casual PC games in Europe. Combining Zylom s European business with our European games business could result in cannibalization of customer revenue and in developers distributing their games through alternative sources.

We may not be successful in maintaining and growing our distribution of digital media products.

We cannot predict whether consumers will adopt or maintain our digital media products, especially in light of the fact that Microsoft bundles its competing Windows Media Player with its Windows operating system. Our inability to maintain continued high volume distribution of our digital media products could hold back the growth and development of related revenue streams from these market segments, including the distribution of third party products and therefore could harm our business and our prospects.

Our consumer businesses depend upon effective digital rights management solutions.

Our consumer businesses depend upon effective digital rights management solutions that control accessibility to digital content. These solutions are important to address concerns of content providers regarding online piracy. We cannot be certain that we can develop, license or acquire such solutions, or that content licensors, electronic device makers or consumers will accept them. In addition, consumers may be unwilling to accept the use of digital rights management technologies that limit their use of content, especially with large amounts of free content readily available. If digital rights management solutions are not effective, or are perceived as not effective, content providers may not be willing to include content in our services, which would harm our business and operating results. If our digital rights management technology is compromised or otherwise malfunctions, we could be subject to lawsuits seeking compensation for any harm caused and our business could be harmed.

Our Harmony Technology may not achieve consumer or market acceptance.

Our Harmony technology enables consumers to securely transfer purchased music to portable digital music devices, including certain versions of the market leading iPod line of digital music players made by Apple Computer, as well as certain devices that use Microsoft Windows Media DRM. Harmony is designed to enable consumers to transfer music purchased from our RealPlayer Music Store to a wide variety of portable music devices, rather than being restricted to a specific portable device. We do not know whether consumers will accept Harmony or whether it will lead to increased sales of any of our consumer products or services or increased usage of our media player products. There are other risks associated with our Harmony technology, including the risk that Apple will continue to modify its technology to break the interoperability that Harmony provides to consumers, which Apple has done in connection with the release of certain new products. This could result in substantial costs or lower customer satisfaction.

The success of our music services depend, in part, on interoperability with our customer s music playback hardware.

In order for our digital music services to continue to grow we must design services that interoperate effectively with a variety of hardware products, including home stereos, car stereos, portable digital audio players, mobile handsets and PCs. We depend on significant cooperation with manufacturers of these products and with software manufacturers that create the operating systems for such hardware devices to achieve our objectives. To date, Apple has not agreed to design its popular iPod line of portable digital audio players to function with our music services and users of our music services must rely on our Harmony technology for interoperability with iPods. If we cannot successfully design our service to interoperate with the music playback devices that our customers own, either through relationships with manufacturers or through our Harmony technology, our business will be harmed.

Risks Related to Our Technology Products and Solutions Business

Our system software business has been negatively impacted by the effects of our competitors and our recent settlement agreement with Microsoft may not improve our sales of our system software products.

We believe that our system software sales have been negatively impacted primarily by the competitive effects of Microsoft, which markets and often bundles its competing technology with its market leading operating systems and server software. In December 2003, we filed suit against Microsoft in U.S. District Court to redress what we believed were illegal, anticompetitive practices by Microsoft. In October 2005, we entered into a settlement agreement with Microsoft regarding these claims and we also entered into two commercial agreements related to our digital music and casual games businesses. Although the settlement agreement contains a substantial cash payment to us and a series of technology agreements between the two companies, Microsoft will continue to be an aggressive competitor with our systems software business. We cannot be sure if the parts of the settlement agreement designed to limit Microsoft s ability to leverage its market power will be effective and we cannot predict when, or if, we will experience increased demand for our system software products.

Our Helix open source initiative is subject to risks associated with open source technology.

There are a number of risks associated with our Helix Community initiative, including risks associated with market and industry acceptance, development processes and software licensing practices, and business models. The broader media technology and product industry may not adopt the Helix DNA Platform and/or the Helix Community as a development platform for media delivery and playback products and third parties may not enhance, develop or introduce technologies or products based on Helix DNA technology. While we have invested substantial resources in the development of the underlying technology within the Helix DNA technology and the Helix Community process itself, the market and industry may not accept them and we may not derive royalty or support revenue from them. The introduction of the Helix DNA Platform open source and community source licensing schemes may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business and non-business organizations. In those areas where adoption of the Helix Community and Helix DNA occurs, our community and open source approach means that we no longer exercise sole control over many aspects of the development of the Helix DNA technology.

Sales of our commercial system products could be negatively affected by open source technologies.

Competitive technologies to our commercial system software products have been made available under open source license terms. The introduction of such technologies under broadly available open source software license terms may adversely affect sales of our commercial system software products to mobile operators, broadband providers, corporations, government agencies, educational institutions and other business organizations.

Our recently issued Click-to-Stream patent and our other patents may not improve our business prospects.

We recently announced that we have been granted a fundamental patent for streaming media technology and applications. The patent (known as Click-to-Stream) covers the core methods used when consumers select links to stream audio-visual media via web browsers and other media players. Our primary strategy is to use our patent portfolio, including the Click-to-Stream patent, to increase licensing and usage of our Helix products. We do not know if the Click-to-Stream patent or any of our other patents will ultimately be deemed enforceable, valid or infringed. Accordingly, we cannot predict whether our patent strategy will be successful or will improve our financial results. Moreover, we may be forced to litigate to determine the validity and scope of our patents, including the Click to-Stream patent. Any such litigation could be costly and may not achieve the desired results.

Our mobile digital media products and services are new and innovative and might not be successful.

Mobile operators may select technology from our competitors or our mobile consumer services might not generate significant revenue. In order for our investments in the development of mobile products to be successful, consumers must adopt and use mobile devices for consumption of digital media and utilize our products and services. To date, consumers have not widely adopted these mobile digital media products and services.

Risks Related to Our Business in General

We have a history of losses, and we cannot be sure that we will be able to sustain profitability in the future.

With the exception of 2005 and the first nine months of 2006, we have incurred losses in every year since our inception. Our profit in 2005 and the first nine months of 2006 was primarily related to cash payments from Microsoft related to our antitrust litigation settlement and commercial agreements. Due to our cost structure, we may not generate sufficient revenue to be profitable on a quarterly or annual basis in the future.

Our operating results are difficult to predict and may fluctuate, which may contribute to fluctuations in our stock price.

As a result of the rapidly changing markets in which we compete, our operating results may fluctuate from period-to-period. In past periods, our operating results have been affected by personnel reductions and related charges, charges relating to losses on excess office facilities, and impairment charges for certain of our equity investments. Our operating results may be adversely affected by similar or other charges or events in future periods, which could cause the trading price of our stock to decline. Certain of our expense decisions (for example, research and development and sales and marketing efforts) are based on predictions regarding our business and the markets in which we compete. To the extent that these predictions prove inaccurate, our revenue may not be sufficient to offset these expenditures, and our operating results may be harmed.

Our settlement agreement with Microsoft may not improve our business prospects.

In 2003, we filed suit against Microsoft in the U.S. District Court for the Northern District of California, alleging that Microsoft violated U.S. and California antitrust laws. In our lawsuit, we alleged that Microsoft had illegally used its monopoly power to restrict competition, limit consumer choice and attempt to monopolize the field of digital media. In October 2005, we entered into a settlement agreement with Microsoft regarding these claims and we also entered into two commercial agreements with Microsoft related to our digital music and casual games businesses. The settlement agreement consists of a series of substantial cash payments to us and a series of technology agreements between the two companies. We cannot be sure that we will be able to apply the proceeds of the settlement in a way that will improve our operating results or otherwise increase the value of our shareholders investments in our stock. Under the music and games agreements, Microsoft is scheduled to pay us approximately $122.3 million over the next two quarters. Microsoft can earn credits at pre-determined market rates for subscribers and users delivered to us through marketing and promotional efforts of its MSN network of websites, which will be applied against the quarterly contractual payments in the music agreement. The rate at which Microsoft may deliver subscribers and users to us and the rate at which Microsoft may earn the related credits is unpredictable and we do not know whether these agreements will have a substantial impact on our music and games businesses. In addition, our music and games agreements are fixed-term arrangements that require joint collaborative efforts to be successful and may not result in a sustainable favorable impact on our business or financial results during or beyond the term of the agreements.

Our products and services must compete with the products and services of strong or dominant competitors.

Our software and services must compete with strong existing competitors, and new competitors may enter with competitive new products, services and technologies. These market conditions have in the past resulted in, and could likely continue to result in the following consequences, any of which could adversely affect our business, our operating results and the trading price of our stock:

- reduced prices, revenue and margins;

- increased expenses in responding to competitors;

- loss of current and potential customers, market share and market power;
- lengthened sales cycles;
- degradation of our stature in the market and reputation;
- changes in our business and distribution and marketing strategies;
- changes to our products, services, technology, licenses and business practices, and other disruption of our operations;
- strained relationships with partners; and
- pressure to prematurely release products or product enhancements.

Many of our current and potential competitors have longer operating histories, greater name recognition, more employees and significantly greater resources than we do. Our competitors across the breadth of our product lines include a number of large and powerful companies, such as Microsoft, Apple Computer, and Yahoo!. Some of our competitors have in the past and may in the future enter into collaborative arrangements with each other that enable them to better compete with our business.

Microsoft is one of our strongest competitors, and employs highly aggressive tactics against us.

Microsoft is one of our principal competitors in the development and distribution of digital media and media distribution technology. Microsoft s market power in related markets such as personal computer operating systems, office software suites and web browser software gives it unique advantages in the digital media markets. Despite the settlement of our antitrust litigation with Microsoft, we expect that Microsoft will continue to compete vigorously in the digital media markets in the future. Microsoft s dominant position in certain parts of the computer and software markets, and its aggressive activities have had, and in the future will likely continue to have, adverse effects on our business and operating results.

Any development delays or cost overruns may affect our operating results.

We have experienced delays and cost overruns in our development efforts in the past and we may encounter such problems in the future. Delays and cost overruns could affect our ability to respond to technological changes, evolving industry standards, competitive developments or customer requirements. Also, our products may contain undetected errors that could cause increased development costs, loss of revenue, adverse publicity, reduced market acceptance of our products or services or lawsuits by customers.

Our business is dependent in part on third party vendors whom we do not control.

Certain of our products and services are dependent in part on the licensing and incorporation of technology from third party vendors. If the technology of these vendors fails to perform as expected or if a key vendor does not continue to support its technology, then we may incur substantial costs in replacing the products and services, or we may fall behind in our development schedule while we search for a replacement. These costs or the potential delay in the development of our products and services could harm our business and our prospects.

If our products are not able to support the most popular digital media formats, our business will be substantially impaired.

We may not be able to license technologies, like codecs or digital rights management technology, that obtain widespread consumer and developer use, which would harm consumer and developer acceptance of our products and services. In addition, our codecs and formats may not continue to be in demand or as desirable as other third party codecs and formats, including codecs and formats created by Microsoft or industry standard formats created by MPEG.

We depend on key personnel who may not continue to work for us.

Our success depends on the continued employment of certain executive officers and key employees, particularly Robert Glaser, our founder, Chairman of the Board and Chief Executive Officer. The loss of the services of Mr. Glaser or other key executive officers or employees could harm our business. If any of these individuals were to leave, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any such successor obtains the necessary training and experience. If we do not succeed in retaining and motivating existing personnel, our business and prospects could be harmed.

Table of Contents

Our industry is experiencing consolidation that may cause us to lose key relationships and intensify competition.

The Internet and media distribution industries are undergoing substantial change, which has resulted in increasing consolidation and formation of strategic relationships. Acquisitions or other consolidating transactions could harm us in a number of ways, including:

- the loss of strategic relationships if our strategic partners are acquired by or enter into relationships with a competitor (which could cause us to lose access to distribution, content, technology and other resources);

- the loss of customers if competitors or users of competing technologies consolidate with our current or potential customers; and

- our current competitors could become stronger, or new competitors could form, from consolidations.

Any of these events could put us at a competitive disadvantage, which could cause us to lose customers, revenue and market share. Consolidation in our industry, or in related industries such as broadband carriers, could force us to expend greater resources to meet new or additional competitive threats, which could also harm our operating results.

Our recent acquisitions create unique challenges for us and if we fail to integrate and successfully operate the acquired companies, our business will be harmed.

We acquired Listen in 2003 and the operations associated with Listen have remained in San Francisco. This is our first experience operating and integrating a substantial acquired business in a remote location. We also acquired GameHouse in 2004, Mr. Goodliving in 2005 and Zylom in 2006. The acquisition of GameHouse is our first attempt to operate and manage a content creation business and we may not be successful in operating this type of business. Mr. Goodliving is a game developer and also competes in the mobile games market which is a new business for us and is a highly competitive market. No assurance can be made that we will be able to leverage Mr. Goodliving s European assets and distribution network to compete successfully in the global mobile games market.

Our two most recent acquisitions, Mr. Goodliving and Zylom, are based in Finland and the Netherlands, respectively. These acquisitions represent our first attempts at acquiring and integrating businesses abroad. We have no prior experience in managing businesses in these countries and in certain cases we will have to adjust our operating procedures to conform to local cultural and legal issues, many of which are unfamiliar to us. No assurance can be made that we will be able to successfully manage businesses in these countries.

Acquisition-related costs could cause significant fluctuation in our net income (loss).

Previous acquisitions have resulted in significant expenses, including amortization of purchased technology, charges for in-process research and development and amortization of acquired identifiable intangible assets, which are reflected in our operating expenses. New acquisitions and any potential future impairment of the value of purchased assets could have a significant negative impact on our future operating results.

Our strategic investments may not be successful and we may have to recognize expenses in our income statement in connection with these investments.

We have made, and in the future we may continue to make, strategic investments in other companies, including joint ventures. These investments often involve immature and unproven businesses and technologies, and involve a high degree of risk. We could lose the entire amount of our investment. We also may be required to record on our financial statements significant charges from reductions in the value of our strategic investments, and, potentially from the net losses of the companies in which we invest. We have taken these charges in the past, and these charges could adversely impact our reported operating results in the future. No assurance can be made that we will realize the anticipated benefits from any strategic investment.

We need to develop relationships and technical standards with manufacturers of non-PC media and communication devices to grow our business.

Access to the Internet through devices other than a personal computer, such as personal digital assistants, cellular phones, television set-top devices, game consoles, Internet appliances and portable music and games devices has increased dramatically and is expected to continue to increase. Manufacturers of these types of products are increasingly investing in digital media-related applications. If a substantial number of alternative device manufacturers do not license and incorporate our technology into their devices, we may fail to capitalize on the opportunity to deliver digital media to non-PC devices which could harm our business prospects. We do not believe that complete standards have emerged with respect to non-PC wireless and cable-based systems and if our technologies are not adopted, our results could suffer. If we do not successfully make our products and technologies compatible with emerging standards and the most popular devices used to access digital media, we may miss market opportunities and our business and results will suffer.

If we are not successful in maintaining, managing and adding to our strategic relationships, our business and operating results will be adversely affected.

We rely on strategic relationships with third parties in connection with our business, including relationships providing for content acquisition and distribution of our products. The loss of current strategic relationships, the inability to find other strategic partners, our failure to effectively manage these relationships or the failure of our existing relationships to achieve meaningful positive results could harm our business. We may not be able to replace these relationships with others on acceptable terms, or at all, or find alternative sources for resources that these relationships provide.

Our business and operating results will suffer if our systems or networks fail, become unavailable, unsecure or perform poorly so that current or potential users do not have adequate access to our products, services and websites.

Our ability to provide our products and services to our customers and operate our business depends on the continued operation of our information systems and networks. A significant or repeated reduction in the performance, reliability or availability of our information systems and network infrastructure could harm our ability to conduct our business, and harm our reputation and ability to attract and retain users, customers, advertisers and content providers. Also, any compromise of our ability to transmit data securely could damage our business, hurt our ability to distribute products and services and collect revenue. We have on occasion experienced system errors and failures that cause interruption in availability of products or content or an increase in response time. Problems with our systems and networks could result from our failure to adequately maintain and enhance these systems and networks, natural disasters and similar events, power failures, intentional actions to disrupt our systems and networks and many other causes. The vulnerability of our computer and communications infrastructure is enhanced because it is located at a single leased facility in Seattle, Washington, an area that is at heightened risk of earthquake, flood, and volcanic events. We do not currently have fully redundant systems or a formal disaster recovery plan, and we may not have adequate business interruption insurance to compensate us for losses that may occur from a system outage.

Table of Contents

We rely on the continued reliable operation of third parties systems and networks and, if these systems and networks fail to operate or operate poorly, our business and operating results will be harmed.

Our operations are in part dependent upon the continued reliable operation of the information systems and networks of third parties. If these third parties do not provide reliable operation, our ability to service our customers will be impaired and our business, reputation and operating results could be harmed.

Our network is subject to security risks that could harm our business and reputation and expose us to litigation or liability.

Online commerce and communications depend on the ability to transmit confidential information and licensed intellectual property securely over private and public networks. Any compromise of our ability to transmit and store such information and data securely, and any costs associated with preventing or eliminating such problems, could damage our business, hurt our ability to distribute products and services and collect revenue, threaten the proprietary or confidential nature of our technology, harm our reputation, and expose us to litigation or liability. We also may be required to expend significant capital or other resources to protect against the threat of security breaches or hacker attacks or to alleviate problems caused by such breaches or attacks. Any successful attack or breach of our security could hurt consumer demand for our products and services, expose us to consumer class action lawsuits and harm our business.

The growth of our business is dependent in part on successfully implementing our international expansion strategy.

A key part of our strategy is to develop localized products and services in international markets through subsidiaries, branch offices and joint ventures. If we do not successfully implement this strategy, we may not recoup our international investments and we may fail to develop or lose worldwide market share. In addition, our recent acquisitions of Zylom and Mr. Goodliving have increased our revenue from our international operations. Our international operations involve risks inherent in doing business on an international level, including difficulties in managing operations due to distance, language and cultural differences, different or conflicting laws and regulations and exchange rate fluctuations. Any of these factors could harm operating results and financial condition. Our foreign currency exchange risk management program reduces, but does not eliminate, the impact of currency exchange rate movements.

As part of our international expansion strategy, we intend to grow our business in the People s Republic of China (the PRC). The PRC government regulates our business in the PRC through regulations and license requirements restricting (i) the scope of foreign investment in the Internet, retail and delivery sectors, (ii) Internet content and (iii) the sale of certain media products. In order to meet the PRC local ownership and regulatory licensing requirements, our business in the PRC will be operated through a PRC subsidiary which acts in cooperation with PRC companies owned by nominee shareholders who are PRC nationals. Although we believe this structure complies with existing PRC laws, it involves unique risks. There are substantial uncertainties regarding the interpretation of PRC laws and regulations, and it is possible that the PRC government will ultimately take a view contrary to ours. If any of our PRC entities were found to be in violation of existing or future PRC laws or regulations or if interpretations of those laws and regulations were to change, the business could be subject to fines and other financial penalties, have its licenses revoked or be forced to shut down entirely. In addition, if we are unable to enforce our contractual relationships with respect to management and control of our PRC business, we might be unable to continue to operate the business or we may lose the ability to effectively control the operations of the local PRC company.

We may be unable to adequately protect our proprietary rights.

Our ability to compete partly depends on the superiority, uniqueness and value of our technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of patent, trademark, copyright and trade secret laws, confidentiality agreements with our employees and third parties, and protective contractual provisions. Despite these efforts, any of the following occurrences may reduce the value of our intellectual property:

- Our applications for patents and trademarks relating to our business may not be granted and, if granted, may be challenged or invalidated;

Issued patents and trademarks may not provide us with any competitive advantages;

Our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology;

Our efforts may not prevent the development and design by others of products or technologies similar to or competitive with, or superior to those we develop; or

Another party may obtain a blocking patent and we would need to either obtain a license or design around the patent in order to continue to offer the contested feature or service in our products.

We may be forced to litigate to defend our intellectual property rights, or to defend against claims by third parties against us relating to intellectual property rights.

Disputes regarding the ownership of technologies and rights associated with streaming media, digital distribution and online businesses are common and likely to arise in the future. We may be forced to litigate to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of other parties proprietary rights. Any such litigation could be very costly and could distract our management from focusing on operating our business. The existence and/or outcome of any such litigation could harm our business.

From time to time we receive claims and inquiries from third parties alleging that our internally developed technology or technology we license from third parties may infringe the third parties proprietary rights, especially patents. Third parties have also asserted and most likely will continue to assert claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights. We are now investigating a number of such pending claims, some of which are described in Part I of this report under the heading Legal Proceedings.

Interpretation of existing laws that did not originally contemplate the Internet could harm our business and operating results.

The application of existing laws governing issues such as property ownership, copyright and other intellectual property issues to the Internet is not clear. Many of these laws were adopted before the advent of the Internet and do not address the unique issues associated with the Internet and related technologies. In many cases, the relationship of these laws to the Internet has not yet been interpreted. New interpretations of existing laws may increase our costs, require us to change business practices or otherwise harm our business.

It is not yet clear how laws designed to protect children that use the Internet may be interpreted, and such laws may apply to our business in ways that may harm our business.

The Child Online Protection Act and the Child Online Privacy Protection Act impose civil and criminal penalties on persons distributing material harmful to minors (e.g., obscene material) over the Internet to persons under the age of 17, or collecting personal information from children under the age of 13. We do not knowingly distribute harmful materials to minors or collect personal information from children under the age of 13. The manner in which these Acts may be interpreted and enforced cannot be fully determined, and future legislation similar to these Acts could subject us to potential liability if we were deemed to be non-compliant with such rules and regulations, which in turn could harm our business.

We may be subject to market risk and legal liability in connection with the data collection capabilities of our products and services.

Many of our products are interactive Internet applications that by their very nature require communication between a client and server to operate. To provide better consumer experiences and to operate effectively, our products send information to our servers. Many of the services we provide also require that a user provide certain information to us. We post an extensive privacy policy concerning the collection, use and disclosure of user data involved in interactions between our client and server products. Any failure by us to comply with our posted privacy policy and existing or new legislation regarding privacy issues could impact the market for our products and services, subject us to litigation and harm our business.

We may be subject to legal liability for the provision of third-party products, services or content.

We periodically enter into arrangements to offer third-party products, services, content or advertising under our brands or via distribution on our websites or in our products or service offerings. We may be subject to claims concerning these products, services, content or advertising by virtue of our involvement in marketing, branding, broadcasting or providing access to them. Our agreements with these third parties may not adequately protect us from these potential liabilities. It is also possible that, if any information provided directly by us contains errors or is otherwise negligently provided to users, third parties could make claims against us, including, for example, claims for intellectual property infringement. Investigating and defending any of these types of claims is expensive, even if the claims do not result in liability. If any of these claims result in liability, we could be required to pay damages or other penalties, which could harm our business and our operating results.

We account for employee stock options using the fair value method, which may have a material adverse affect on our results of operations.

On January 1, 2006, we adopted the provisions of, and accounted for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards No. 123 revised 2004, Share Based Payment (SFAS 123R), which requires a company to recognize, as an expense, the fair value of stock options and other stock-based compensation. We are required to record an expense for our stock-based compensation plans using the fair value method as described in SFAS 123R, which results in the recognition of significant and ongoing accounting charges, for which we recorded an expense of $5.0 million and $12.3 million for the quarter and nine months ended September 30, 2006, respectively, in our condensed consolidated statement of operations related to our stock-based compensation plans. Stock options are also a key part of the compensation packages that we offer our employees. If we are forced to curtail our broad-based option program due to these additional charges, it may become more difficult for us to attract and retain employees.

We may be subject to assessment of sales and other taxes for the sale of our products, license of technology or provision of services.

We do not currently collect sales or other taxes on the sale of our products, license of technology or provision of services in states and countries other than those in which we have offices or employees. Our business would be harmed if one or more states or any foreign country were to require us to collect sales or other taxes from past sales or income related to products, licenses of technology or provision of services.

Effective July 1, 2003, we began collecting Value Added Tax, or VAT, on sales of electronically supplied services provided to European Union residents, including software products, games, data, publications, music, video and fee-based broadcasting services. There can be no assurance that the European Union will not make further modifications to the VAT collection scheme, the effects of which could require significant enhancements to our systems and increase the cost of selling our products and services into the European Union. The collection and remittance of VAT subjects us to additional currency fluctuation risks.

The Internet Tax Freedom Act, or ITFA, which Congress extended until November 2007, among other things, imposed a moratorium on discriminatory taxes on electronic commerce. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

We donate a portion of our net income to charity.

In periods where we achieve profitability, we intend to donate 5% of our annual net income to charitable organizations, which will reduce our net income for those periods. The non-profit RealNetworks Foundation manages our charitable giving efforts.

Risks Related to the Securities Markets and Ownership of Our Common Stock

Our directors and executive officers beneficially own approximately one third of our stock, which gives them significant control over certain major decisions on which our shareholders may vote, may discourage an acquisition of us, and any significant sales of stock by our officers and directors could have a negative effect on our stock price.

Our executive officers, directors and affiliated persons beneficially own more than one third of our common stock. Robert Glaser, our Chief Executive Officer and Chairman of the Board, beneficially owns the majority of that stock. As a result, our executive officers, directors and affiliated persons will have significant influence to:

- elect or defeat the election of our directors;
- amend or prevent amendment of our articles of incorporation or bylaws;
- effect or prevent a merger, sale of assets or other corporate transaction; and
- control the outcome of any other matter submitted to the shareholders for vote.

Table of Contents

Management s stock ownership may discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of RealNetworks, which in turn could reduce our stock price or prevent our shareholders from realizing a premium over our stock price.

Provisions of our charter documents, Shareholder Rights Plan, and Washington law could discourage our acquisition by a third party.

Our articles of incorporation provide for a strategic transaction committee of the board of directors. Without the prior approval of this committee, and subject to certain limited exceptions, the board of directors does not have the authority to:

adopt a plan of merger;

authorize the sale, lease, exchange or mortgage of assets representing more than 50% of the book value of our assets prior to the transaction or on which our long-term business strategy is substantially dependent;

authorize our voluntary dissolution; or

take any action that has the effect of any of the above.

RealNetworks also entered into an agreement providing Mr. Glaser with certain contractual rights relating to the enforcement of our charter documents and Mr. Glaser s roles and authority within RealNetworks.

We have adopted a shareholder rights plan that provides that shares of our common stock have associated preferred stock purchase rights. The exercise of these rights would make the acquisition of RealNetworks by a third party more expensive to that party and has the effect of discouraging third parties from acquiring RealNetworks without the approval of our board of directors, which has the power to redeem these rights and prevent their exercise.

Washington law imposes restrictions on some transactions between a corporation and certain significant shareholders. The foregoing provisions of our charter documents, shareholder rights plan, our agreement with Mr. Glaser, our zero coupon convertible subordinated notes and Washington law, as well as our charter provisions that provide for a classified board of directors and the availability of blank check preferred stock, could have the effect of making it more difficult or more expensive for a third party to acquire, or of discouraging a third party from attempting to acquire, control of us. These provisions may therefore have the effect of limiting the price that investors might be willing to pay in the future for our common stock.

We are exposed to potential risks from recent legislation requiring companies to evaluate controls under Section 404 of the Sarbanes-Oxley Act of 2002.

We have evaluated our internal controls in order to allow management to report on, and our registered independent public accounting firm to attest to, our internal controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002. We have performed the system and process evaluation and testing required in an effort to comply with the management certification and auditor attestation requirements of Section 404. The requirements and processes associated with Section 404 are relatively new and still evolving and we cannot be certain that the measures we have taken will be sufficient to meet the Section 404 requirements as changes occur to the guidance and our reporting environment or that we will be able to implement and maintain adequate controls over financial reporting processes and reporting in the future. Moreover, we cannot be certain that the costs associated with such measures will not exceed our estimates, which could impact our overall level of profitability. Any failure to meet the Section 404 requirements or to implement required new or improved controls, or difficulties or unanticipated costs encountered in their implementation, could cause investors to lose confidence in our reported financial information or could harm our financial results, which could have a negative effect on the trading price of our stock.

Our stock price has been volatile in the past and may continue to be volatile.

The trading price of our common stock has been highly volatile. For example, during the 52-week period ended September 30, 2006, the price of our common stock ranged from $11.20 to $5.63 per share. Our stock price could be subject to wide fluctuations in response to factors such as actual or anticipated variations in quarterly operating results, changes in financial estimates, recommendations by securities analysts, changes in the competitive environment, as well as any of the other risk factors described above.

Table of Contents

Financial forecasting of our operating results will be difficult because of the changing nature of our products and business, and our actual results may differ from forecasts.

As a result of the dynamic markets in which we compete, it is difficult to accurately forecast our operating results and metrics. Our inability or the inability of the financial community to accurately forecast our operating results could result in our reported net income (losses) in a given quarter to differ from expectations, which could cause a decline in the trading price of our common stock.

Special Note Regarding Forward-Looking Statements

We have made forward-looking statements in this document, all of which are subject to risks and uncertainties. When we use words such as may , anticipate, expect, intend, plan, believe, seek and estimate or similar making forward-looking statements. Forward-looking statements include information concerning our possible or assumed future business success or financial results. Such forward-looking statements include, but are not limited to, statements as to our expectations regarding:

- the impact of our acquisition of WiderThan on our digital entertainment product and service offerings and our international presence and revenue;
- increasing competition to our video content services;
- future competitive activities of Microsoft in the overall market for digital media and media distribution products and services;
- future cash payments from Microsoft related to our antitrust settlement;
- anticipated increased cancellation rates of subscribers to our internet subscription services who we obtain through alternative marketing channels;
- increasing competition to our online music services from media companies, online retailers and Internet portals;
- increasing competition to our online game distribution business;
- the growth of our business in China;
- the impact on our gross margins if revenue from our digital media subscription services continues to grow as a percentage of our net revenue;
- the increase of our sales and marketing expenses in dollars and as a percentage of total net revenue as we grow our consumer business and shift our marketing efforts to consumer products and services;
- our future activities under our stock repurchase program;
- future capital needs and expenditures;
- plans for future acquisitions of technologies and businesses;
- the future impact of a sudden change in market interest rates on our operating results and cash flows; and
- the impact and duration of current litigation in which we are involved.

You should note that an investment in our common stock involves certain risks and uncertainties that could affect our future business success or financial results. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in Risk Factors and elsewhere in our Quarterly Report on Form 10-Q.

We believe that it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. Before you invest in our common stock, you should be aware that the occurrence of the events described in the Risk Factors and elsewhere in our Quarterly Report on Form 10-Q could materially and adversely affect our business, financial condition and operating results. We undertake no obligation to publicly update any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

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

(a) Between July 1, 2006 and September 30, 2006, the Company has issued and sold unregistered securities as follows:

(1) On September 30, 2006, the Company issued an aggregate of 2,332 shares of Common Stock to three non-employee directors as compensation for board service during the second quarter of 2006 pursuant to the RealNetworks, Inc. Director Compensation Stock Plan. The aggregate value of the shares was approximately $24,753. The shares were issued in reliance on Section 4(2) under the Securities Act of 1933, as amended, on the basis that the transactions did not involve a public offering.

(b) Not applicable

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers (in thousands, except per share amounts)

Below is a summary of share repurchases for the quarter ended September 30, 2006. See Note 9 of our Notes to Unaudited Condensed Consolidated Financial Statements for information regarding our share repurchase plan.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs(1)
7/1/2006 7/31/2006	200	$ 9.51	200	$ 78,117
Total	200	$ 9.51	200	

(1) In April 2006, the Company announced a share repurchase program in which the Company s Board of Directors authorized the repurchase of up to an aggregate of $100.0 million of the Company s outstanding common stock. All of the repurchases in

the table above were made through that program.

Item 3. Default Upon Senior Securities

None

Item 4. Submission of Matters to a Vote for Security Holders

None

Item 5. Other Information

None

Table of Contents

Item 6. Exhibits

Exhibits Required by Item 601 of Regulation S-K:

Exhibit Number	Description
2.1	Combination Agreement dated as of September 12, 2006, by and between RealNetworks, RN International Holdings B.V. and WiderThan Co., Ltd. (incorporated by reference from Exhibit 2.1 to RealNetworks Current Report on Form 8-K filed with the Securities and Exchange Commission on September 14, 2006).
2.2	Form of Shareholder Tender and Voting Agreement dated as of September 12, 2006, by and between RealNetworks, RN International Holdings B.V., WiderThan Co., Ltd. and certain shareholders of WiderThan Co., Ltd. (incorporated by reference to the Schedule 13D filed with respect to WiderThan Co., Ltd. securities by RealNetworks with the Securities and Exchange Commission on September 22, 2006).
31.1	Certification of Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Michael Eggers, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Robert Glaser, Chairman and Chief Executive Officer of RealNetworks, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Michael Eggers, Senior Vice President, Chief Financial Officer and Treasurer of RealNetworks, Inc., Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURES

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, on November 8, 2006.

REALNETWORKS, INC.

By: /s/ Michael Eggers

Michael Eggers
Title: Senior Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Table of Contents

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related to a legal realignment during 2013. Excluding the Italy realignment, adjusted noncontrolling interest in 2014 was $52 million compared to $65 million in 2013. This decrease was due primarily to the acquisition of the noncontrolling interest in a U.S. packaged gas business during the first quarter of 2014.

Reported net income - Praxair, Inc. in 2014 was $1,694 million, or $61 million lower than net income - Praxair, Inc. of $1,755 million in 2013. Adjusted net income – Praxair, Inc. of $1,852 million in 2014 was $80 million, or 5% higher than adjusted net income – Praxair, Inc. of $1,772 million in 2013. This increase was primarily due to higher adjusted operating profit.

Table of Contents

Reported diluted earnings per share ("EPS") of $5.73 in 2014 decreased $0.14 per diluted share, or 2% from $5.87 in 2013. Adjusted diluted EPS of $6.27 in 2014 increased $0.34 per diluted share, or 6%, from adjusted diluted EPS of $5.93 in 2013. The increase in adjusted diluted EPS was primarily due to higher adjusted net income – Praxair, Inc. and a 1.1% decrease in the number of diluted shares outstanding as a result of the company's net repurchases of common stock during 2014.

Other comprehensive loss at December 31, 2014 of $1,257 million includes negative currency translation adjustments of $1,096 million, a negative adjustment of $164 million related to the funded status of retirement obligations and a positive adjustment of $3 million related to derivative instruments. The translation adjustments reflect the impact of translating local currency foreign subsidiary financial statements to U.S. dollars and resulted from currency movements, primarily $369 million in Europe, $331 million in South America, and $238 million in North America. The negative pension funded status adjustment resulted primarily from after-tax actuarial losses from lower discount rates and the adoption of new mortality rate assumptions, both of which increased the pension benefit obligation ("PBO"). See the "Currency" section of the MD&A, and Notes 7 and 16 to the consolidated financial statements.

The number of employees at December 31, 2014 was 27,780, reflecting an increase of 220 employees from December 31, 2013. This increase primarily reflects the impact of acquisitions during the current year.

2013 Compared With 2012

Sales increased 6% to $11,925 million during 2013 compared to $11,224 million in 2012. Higher volumes, primarily in North and South America and in Asia, higher overall pricing and growth from acquisitions were partially offset by negative currency translation impacts, primarily resulting from the strengthening of the U.S. dollar against the Brazilian Real. Cost pass-through had minimal impact due to lower precious metal prices offsetting energy cost inflation.

Gross margin increased $353 million, or 7%, versus 2012. The increase was due to higher volumes and higher pricing, resulting in an increase in the gross margin percentage to 43.4%, versus 43.0% in the prior year.

Selling, general and administrative ("SG&A") expenses in 2013 were $1,349 million, or 11.3% of sales, versus $1,270 million, or 11.3% of sales, for 2012. The increase in SG&A expense of $79 million was primarily due to the impact of acquisitions ($56 million). In addition, pension expense increased $26 million due to an increase in the amortization of net actuarial losses, primarily attributable to lower discount rates. Currency effects reduced SG&A expense by $14 million.

Depreciation and amortization expense increased $108 million versus 2012. This increase was primarily due to an increase of $42 million from acquisitions and approximately $70 million from plant start-ups and asset additions, partially offset by currency effects of $13 million.

Other income (expenses) – net in 2013 was a $32 million benefit versus a $43 million benefit in 2012. Other income was higher in 2012 primarily due to a larger favorable litigation settlements in South America. See Note 7 to the consolidated financial statements for a summary of the major components of Other income (expenses) – net.

Reported operating profit of $2,625 million in 2013 was $188 million, or 8% higher than reported operating profit of $2,437 million in 2012. As a percentage of sales, reported operating profit increased to 22.0% in 2013 from 21.7% in 2012. This is primarily due to the attainment of price increases in most geographies. The 2013 period includes a $23 million charge related to the Venezuela currency devaluation and $9 million charge related to a pension settlement. The 2012 period also included a pension settlement charge of $9 million as well as a $56 million charge for cost reduction programs. Adjusted operating profit of $2,657 million in 2013 was $155 million, or 6% higher than adjusted operating profit of $2,502 million in 2012. A discussion of operating profit by segment is included in the segment discussion that follows.

Reported interest expense – net in 2013 increased $37 million, versus 2012. The increase included an $18 million charge recognized upon the early redemption of the $400 million 5.25% Notes due in 2014. Excluding this charge, adjusted interest expense increased $19 million. Higher overall debt levels increased interest expense by about $45 million, and reduced benefits from the amortization of interest rate swap gains increased interest expense by $11 million versus 2012. Lower interest rates reduced interest expense by approximately $37 million dollars. See Note 7 to the consolidated financial statements for further information relating to interest expense.

The effective tax rate for 2013 was 26.5% versus 25.5% in 2012. 2013 included a $40 million benefit as a result of a realignment of Praxair's Italian legal structure, and 2012 included a $55 million income tax benefit related to the loss on a liquidated subsidiary (See Note 5 to the consolidated financial statements). The adjusted effective tax rate for both 2012 and 2013 was 28.0%.

Praxair’s significant equity investments are in the United States, China, Italy, and the Middle East. Equity income increased $4 million in 2013 related primarily to higher equity income in China.

At December 31, 2013, reported noncontrolling interests consisted primarily of noncontrolling shareholders’ investments in Asia (primarily in China and India), Europe (primarily in Italy and Scandinavia), and North America (primarily within the U.S. packaged gas business). The $29 million increase in reported noncontrolling interests in 2013 was primarily due to the minority shareholder's portion of the income tax benefit in Italy related to the company's legal realignment. Adjusted noncontrolling interest in 2013 was $65 million compared to $54 million in 2012. This increase is primarily driven by improved performance by the U.S. packed gas and Italian investments.

Reported net income - Praxair, Inc. in 2013 was $1,755 million, or $63 million above net income - Praxair, Inc. of $1,692 million in 2012. Adjusted net income – Praxair, Inc. of $1,772 million in 2013 was $91 million, or 5% higher than adjusted net income – Praxair, Inc. of $1,681 million in 2012. This increase was primarily due to higher adjusted operating profit partially offset by higher interest expense and increased income tax expense.

Reported diluted earnings per share ("EPS") of $5.87 in 2013 increased $0.26 per diluted share, or 5% from $5.61 in 2012. Adjusted diluted EPS of $5.93 in 2013 increased $0.36 per diluted share, or 6%, from adjusted diluted EPS of $5.57 in 2012. The increase in adjusted diluted EPS was primarily due to higher net income – Praxair, Inc. and a 1.0% decrease in the number of diluted shares outstanding as a result of the company’s net repurchases of common stock during 2013.

Other comprehensive loss at December 31, 2013 of $123 million includes negative currency translation adjustments of $447 million, a positive after-tax adjustment of $323 million related to the funded status of retirement obligations and a positive adjustment of $1 million related to derivative instruments. The negative translation adjustment primarily resulted from currency movements of $342 million in South America and $137 million in North America. The positive pension funded status impact is driven principally by actuarial gains and losses of $395 million. Of this amount $165 million relates to asset returns in excess of assumed returns. The remaining $230 million primarily relates to the impact of higher discount rates. See the “Currency” section of the MD&A, and Notes 7 and 16 to the consolidated financial statements.

The number of employees at December 31, 2013 was 27,560, reflecting an increase of 1,021 employees from December 31, 2012. This increase primarily reflects the impact of the $NuCO_2$ acquisition.

Related Party Transactions

The company’s related parties are primarily unconsolidated equity affiliates. The company did not engage in any material transactions involving related parties that included terms or other aspects that differ from those which would be negotiated with independent parties.

Environmental Matters

Praxair’s principal operations relate to the production and distribution of atmospheric and other industrial gases, which historically have not had a significant impact on the environment. However, worldwide costs relating to environmental protection may continue to grow due to increasingly stringent laws and regulations, and Praxair's ongoing commitment to rigorous internal standards.

Climate Change

Praxair operates in jurisdictions that have, or are developing, laws and/or regulations to reduce or mitigate the perceived adverse effects of greenhouse gas ("GHG") emissions and faces a highly uncertain regulatory environment in this area. For example, the U.S. Environmental Protection Agency ("EPA") has promulgated rules requiring reporting of GHG emissions, and Praxair and many of its suppliers and customers are subject to these rules. EPA has also promulgated regulations to restrict GHG emissions, including final rules regulating GHG emissions from light-duty vehicles and certain large manufacturing facilities, many of which are Praxair suppliers or customers. EPA recently proposed carbon dioxide regulations for both new and existing power plants, which will require controls on GHG emissions from certain suppliers of power to Praxair’s operations. In addition to these developments in the United States, there has been regulation of GHGs in the European Union under the Emissions Trading System, which have wide implications for our customers and may impact certain operations of Praxair in Europe. Also, climate change and energy efficiency laws and policies are being widely embraced by jurisdictions throughout Latin America and Mexico.. There are also requirements for mandatory reporting in Quebec, Canada, which apply to certain Praxair operations and will be used in developing cap-and-trade regulations on GHG emissions, which are expected to impact certain Praxair facilities. China has also announced plans to launch a national carbon emissions trading system in 2016, though it does not appear the regulations will have a direct

Table of Contents

impact on GHG emissions from Praxair facilities. Among other impacts, such regulations are expected to raise the costs of energy, which is a significant cost for Praxair. Nevertheless, Praxair's customer contracts routinely provide rights to recover increased electricity, natural gas, and other costs that are incurred by the company.

Praxair anticipates continued growth in its hydrogen business, as hydrogen is essential to refineries which use it to remove sulfur from transportation fuels in order to meet ambient air quality standards in the United States. Hydrogen production plants and a large number of other manufacturing and electricity-generating plants have been identified under California law as a source of carbon dioxide emissions and these plants have also become subject to recently promulgated cap-and-trade regulations in that state. Praxair believes it will be able to mitigate the costs of these regulations through the terms of its product supply contracts. However, legislation that limits GHG emissions may impact growth by increasing operating costs and/or decreasing demand.

To manage these potential business risks from potential GHG emission regulation, Praxair actively monitors current developments, evaluates the direct and indirect business risks, and takes appropriate actions. Among others, actions include: increasing relevant resources and training; consulting with vendors, insurance providers and industry experts; incorporating GHG provisions in commercial agreements; and conducting regular reviews of the business risks with management. Although there are considerable uncertainties, Praxair believes that the business risk from potential regulations can be effectively managed through its commercial contracts. Additionally, Praxair does not anticipate any material effects regarding its plant operations or business arising from potential physical risks of climate change. Also, Praxair continuously seeks opportunities to reduce its own energy use and GHG footprint through rigorous energy efficiency as well as purchasing hydrogen as a chemical byproduct where feasible..

At the same time, Praxair may benefit from business opportunities arising from governmental regulation of GHG and other emissions; rising costs of many energy and natural resources; new technologies to extract natural gas; and the development of renewable energy alternatives. Praxair continues to develop new applications technologies that can lower emissions, including GHG emissions, in Praxair's processes and help customers lower energy consumption and increase product throughput. Stricter regulation of water quality in emerging economies such as China provide a growing market for a number of gases, e.g., oxygen for wastewater treatment. Renewable fuel standards in the European Union and U.S. create a market for second-generation biofuels which are users of industrial gases such as oxygen, carbon dioxide, and hydrogen.

Costs Relating to the Protection of the Environment

Environmental protection costs in 2014 included approximately $12 million in capital expenditures and $29 million of expenses. Praxair anticipates that future annual environmental protection expenditures will be similar to 2014, subject to any significant changes in existing laws and regulations. Based on historical results and current estimates, management does not believe that environmental expenditures will have a material adverse effect on the consolidated financial position, the consolidated results of operations or cash flows in any given year.

Legal Proceedings

See Note 17 to the consolidated financial statements for information concerning legal proceedings.

Retirement Benefits

Pensions

The net periodic benefit cost for the U.S. and International pension plans was $82 million in 2014, $119 million in 2013 and $93 million in 2012. Consolidated net periodic benefit cost included settlement charges of $7 million, $9 million and $10 million in 2014, 2013 and 2012, respectively.

The funded status (pension benefit obligation ("PBO") less the fair value of plan assets) for the U.S. plans was a deficit of $443 million as December 31, 2014 versus a deficit of $171 million at December 31, 2013. This increase was due to lower discount rates and new mortality assumptions which both increased the PBO.

Global pension contributions were $18 million in 2014, $52 million in 2013 and $184 million in 2012. At a minimum, Praxair contributes to its pension plans to comply with local regulatory requirements (e.g., ERISA in the United States). Discretionary contributions in excess of the local minimum requirements are made based on many factors, including long-term projections of the plans' funded status, the economic environment, potential risk of overfunding, pension insurance costs and alternative uses of the cash. Changes to these factors can impact the timing of discretionary

23

contributions from year to year. Estimated required contributions for 2015 are currently expected to be in the area of $15 million.

Praxair assumes an expected return on plan assets for 2015 in the United States of 8.00%, which is consistent with the long-term expected return on its investment portfolio.

Excluding the impact of any settlements, 2015 consolidated pension expense is expected to be approximately $95 million. The increase is due primarily to higher net actuarial losses to be amortized as a result of a decrease in the discount rates and new mortality assumptions. The amortization is recognized based on the amount of net actuarial gains/losses above certain thresholds and over the periods of either the average remaining service lives or the average remaining life expectancies of the retirees.

OPEB

The net periodic benefit cost for OPEB plans was $7 million in 2014, $11 million in 2013 and $9 million in 2012. The funded status deficit decreased $28 million during 2014 primarily due to favorable plan experience.

In 2015, consolidated net periodic benefit costs for the OPEB plans is expected to be approximately $8 million.

See the Critical Accounting Policies section and Note 16 to the consolidated financial statements for a more detailed discussion of the company's retirement benefits, including a description of the various retirement plans and the assumptions used in the calculation of net periodic benefit cost and funded status.

Insurance

Praxair purchases insurance to limit a variety of property and casualty risks, including those related to property, business interruption, third-party liability and workers' compensation. Currently, the company self-retains the first $5 million per occurrence for workers' compensation, general and vehicle liability in the United States and retains $2.5 million to $5 million per occurrence at its various properties worldwide. To mitigate its aggregate loss potential above these retentions, the company purchases insurance coverage from highly rated insurance companies. The company does not currently operate or participate in any captive insurance companies.

At December 31, 2014 and 2013, the company had recorded a total of $33 million representing an estimate of the retained liability for the ultimate cost of claims incurred and unpaid as of the balance sheet dates. The estimated liability is established using statistical analysis and is based upon historical experience, actuarial assumptions and professional judgment. These estimates are subject to the effects of trends in loss severity and frequency and are subject to a significant degree of inherent variability. If actual claims differ from the company's estimates, they will be adjusted at that time and financial results could be impacted.

Praxair recognizes estimated insurance proceeds relating to damages at the time of loss only to the extent of incurred losses. Any insurance recoveries for business interruption and for property damages in excess of the net book value of the property are recognized only when realized.

SEGMENT DISCUSSION

The following summary of sales and operating profit by segment provides a basis for the discussion that follows (for additional information concerning Praxair's segments, see Note 18 to the consolidated financial statements). Praxair evaluates the performance of its reportable segments based on operating profit, excluding the items not indicative of ongoing business trends (See Note 2 to the consolidated financial statements).

Table of Contents

(Dollar amounts in millions)				Variance	
Year Ended December 31,	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales					
North America	$6,436	$6,164	$5,598	4 %	10 %
Europe	1,546	1,542	1,474	— %	5 %
South America	1,993	2,042	2,082	(2)%	(2)%
Asia	1,619	1,525	1,414	6 %	8 %
Surface Technologies	679	652	656	4 %	(1)%
	$12,273	$11,925	$11,224	3 %	6 %
Operating Profit					
North America	$1,580	$1,538	$1,465	3 %	5 %
Europe	291	270	256	8 %	5 %
South America	449	467	429	(4)%	9 %
Asia	303	271	246	12 %	10 %
Surface Technologies	123	111	106	11 %	5 %
Segment operating profit	2,746	2,657	2,502	3 %	6 %
Venezuela currency devaluation and other charges	(138)	(32)	(65)		
Consolidated operating profit	$2,608	$2,625	$2,437		

North America

(Dollar amounts in millions)				Variance	
Year Ended December 31,	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales	$6,436	$6,164	$5,598	4 %	10 %
Cost of sales, exclusive of depreciation and amortization	3,514	3,301	2,968		
Gross margin	2,922	2,863	2,630		
Operating expenses	731	759	667		
Depreciation and amortization	611	566	498		
Operating profit	$1,580	$1,538	$1,465	3 %	5 %
Margin %	24.5 %	25.0 %	26.2 %		

25

	2014 vs. 2013 % Change		2013 vs. 2012 % Change	
	Sales	Operating Profit	Sales	Operating Profit
Factors Contributing to Changes				
Volume	3 %	1 %	2 %	1 %
Price	1 %	5 %	2 %	8 %
Cost pass-through	1 %	— %	1 %	— %
Currency	(2)%	(2)%	— %	— %
Acquisitions/Divestitures	1 %	1 %	5 %	5 %
Other	— %	(2)%	— %	(9)%
	4 %	3 %	10 %	5 %

The following tables provide sales by end-market and distribution method:

	% of Sales			% Change*	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales by End Markets					
Manufacturing	30 %	30 %	32 %	3 %	3 %
Metals	12 %	13 %	14 %	1 %	1 %
Energy	20 %	19 %	17 %	9 %	13 %
Chemicals	10 %	10 %	11 %	3 %	4 %
Electronics	4 %	5 %	5 %	7 %	(8)%
Healthcare	7 %	7 %	7 %	2 %	— %
Food & Beverage	8 %	8 %	5 %	4 %	(1)%
Aerospace	1 %	1 %	1 %	(1)%	14 %
Other	8 %	7 %	8 %	8 %	— %
	100 %	100 %	100 %		

* Excludes impact of currency, natural gas/precious metals cost pass-through and acquisitions/divestitures.

	% of Sales		
	2014	2013	2012
Sales by Distribution Method			
On-Site	30 %	28 %	27 %
Merchant	36 %	36 %	35 %
Packaged Gas	32 %	34 %	36 %
Other	2 %	2 %	2 %
	100 %	100 %	100 %

The North America segment includes Praxair’s industrial gases operations in the United States, Canada and Mexico. Sales for 2014 increased $272 million, or 4%, versus 2013. Organic sales growth was 4% driven primarily by higher pricing and higher volumes. Volume growth came from higher on-site volumes from new project start-ups including hydrogen supply to refinery customers in the United States, and higher merchant and packaged gas volumes. Sales growth was strongest in the energy, manufacturing, and food and beverage end-markets. The strong sales growth to the energy end-market was primarily due to hydrogen project start-ups. Acquisitions, primarily $NuCO_2$ and several packaged gas distributors in the U.S., added 1% sales growth. Higher cost pass-through, primarily higher natural gas prices passed through to hydrogen customers, increased sales by 1%. Packaged gases sales were higher for 2014, primarily due to growth in the U.S. business, however are lower as a percentage of total sales for the segment as compared to the prior-year period, due to strong growth in on-site sales.

Table of Contents

Operating profit for 2014 increased $42 million, or 3% from 2013. Operating profit grew 5% excluding currency translation impacts primarily driven by higher pricing. The increase was due to higher gross margin and lower operating expenses, partially offset by $45 million increase in depreciation and amortization expense due to new project start-ups and acquisitions. Operating profit during 2014 included a $9 million benefit related to a change in accounting principle for LIFO inventories in the United States (see notes 1 and 7 to the consolidated financial statements). Operating profit in 2013 included a $23 million customer contract settlement.

Sales for 2013 increased $566 million, or 10%, versus 2012. Underlying sales growth was 4% driven primarily by higher on-site volumes from new project start-ups for hydrogen supply to refinery customers in the United States, higher merchant volumes and higher pricing. Sales grew to the energy, chemicals, manufacturing, and food and beverage end-markets. Strong sales growth to the energy end-market was primarily due to hydrogen project start-ups. Acquisitions, primarily $NuCO_2$, added 5% sales growth and contributed to the 3% increase of total sales represented by the food and beverage end-market in 2013. Higher cost pass-through, primarily higher natural gas prices passed through to hydrogen customers, increased sales by 1%. North American packaged gas sales were above prior year due to solid growth in the US business. However, with the growth in on-site sales due to the start-up of new hydrogen projects and the growth in merchant sales due to the acquisition of $NuCO_2$, packaged gas sales decreased as a percentage of total sales for the segment.

Operating profit for 2013 increased $73 million, or 5% from 2012. Higher pricing, higher volumes from project start-ups and acquisitions contributed to the growth in operating profit. Operating profit included a contract settlement for $23 million. The growth was partially offset by higher operating costs and the impact of a gain on asset sale in the prior year. Depreciation and amortization increased $68 million in 2013 due to acquisitions and new project start-ups.

Europe

(Dollar amounts in millions)				Variance	
Year Ended December 31,	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales	$1,546	$1,542	$1,474	— %	5 %
Cost of sales, exclusive of depreciation and amortization	868	881	841		
Gross margin	678	661	633		
Operating expenses	219	222	228		
Depreciation and amortization	168	169	149		
Operating profit	$291	$270	$256	8 %	5 %
Margin %	18.8 %	17.5 %	17.4 %		

	2014 vs. 2013 % Change		2013 vs. 2012 % Change	
	Sales	Operating Profit	Sales	Operating Profit
Factors Contributing to Changes				
Volume	— %	2 %	(1)%	(12)%
Price	1 %	5 %	1 %	6 %
Cost pass-through	(1)%	— %	(1)%	— %
Currency	(1)%	— %	3 %	3 %
Acquisitions/Divestitures	1 %	3 %	3 %	3 %
Other	— %	(2)%	— %	5 %
	— %	8 %	5 %	5 %

Table of Contents

The following tables provide sales by end-market and distribution method:

	% of Sales			% Change*	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales by End Markets					
Manufacturing	22 %	22 %	23 %	4 %	(4)%
Metals	16 %	16 %	16 %	3 %	2 %
Energy	7 %	6 %	4 %	(4)%	7 %
Chemicals	15 %	16 %	17 %	(9)%	— %
Electronics	7 %	7 %	8 %	(3)%	5 %
Healthcare	11 %	11 %	11 %	(1)%	(2)%
Food & Beverage	9 %	9 %	9 %	5 %	— %
Aerospace	— %	1 %	1 %	(11)%	— %
Other	13 %	12 %	11 %	2 %	(6)%
	100 %	100 %	100 %		

* Excludes impact of currency, natural gas/precious metals cost pass-through and acquisitions/divestitures.

	% of Sales		
	2014	2013	2012
Sales by Distribution Method			
On-Site	19 %	20 %	20 %
Merchant	35 %	34 %	34 %
Packaged Gas	43 %	43 %	42 %
Other	3 %	3 %	4 %
	100 %	100 %	100 %

Praxair's European industrial gases business operates in Spain, Italy, Germany, Russia, the United Kingdom, Scandinavia and the Benelux region.

Sales for 2014 increased $4 million, versus 2013. Excluding unfavorable currency impacts and lower cost pass-through, sales increased 2% year-over-year. The increase came from higher pricing to merchant and packaged gas customers, and acquisitions primarily Dominion Technology Gases Investment Limited acquired in 2013.

Operating profit of $291 million increased 8% from 2013 primarily driven by higher pricing, volumes and acquisitions. The strong operating leverage came from price attainment across the region coupled with strong productivity and cost initiatives. In addition, the acquisition of an industrial gas business in Italy and a divestiture in France contributed to the higher operating profit and margin.

Sales for 2013 increased $68 million, or 5% versus 2012. Sales growth was primarily driven by higher pricing, acquisitions, primarily Dominion Technology Gases Investment Limited, and favorable currency effects. Underlying sales were unchanged from the prior year as volumes were higher year over year in Germany, Russia, and Scandinavia but overall volumes in Spain and Italy were below the prior year.

Operating profit for 2013 of $270 million grew 5% from 2012. Higher pricing, favorable currency effects, acquisitions, and lower costs from prior-year cost reduction actions more than offset the impact of lower volumes, primarily in Spain.

Table of Contents

South America

(Dollar amounts in millions)				Variance	
Year Ended December 31,	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales	$1,993	$2,042	$2,082	(2)%	(2)%
Cost of sales, exclusive of depreciation and amortization	1,101	1,134	1,202		
Gross margin	892	908	880		
Operating expenses	266	260	267		
Depreciation and amortization	177	181	184		
Operating profit	$449	$467	$429	(4)%	9%
Margin %	22.5%	22.9%	20.6%		

	2014 vs. 2013 % Change		2013 vs. 2012 % Change	
	Sales	Operating Profit	Sales	Operating Profit
Factors Contributing to Changes				
Volume	2%	(2)%	4%	7%
Price	4%	19%	3%	13%
Cost pass-through	1%	—%	—%	—%
Currency	(9)%	(10)%	(9)%	(9)%
Acquisitions/Divestitures	—%	—%	—%	—%
Other	—%	(11)%	—%	(2)%
	(2)%	(4)%	(2)%	9%

The following tables provide sales by end-market and distribution method:

	% of Sales			% Change*	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales by End Markets					
Manufacturing	21%	21%	22%	3%	3%
Metals	27%	29%	28%	2%	10%
Energy	2%	2%	4%	23%	(4)%
Chemicals	9%	9%	6%	10%	20%
Electronics	—%	—%	—%	—%	—%
Healthcare	18%	17%	16%	9%	10%
Food & Beverage	13%	12%	12%	16%	8%
Aerospace	—%	—%	—%	—%	—%
Other	10%	10%	12%	2%	(1)%
	100%	100%	100%		

* Excludes impact of currency, natural gas/precious metals cost pass-through and acquisitions/divestitures.

Table of Contents

	% of Sales		
	2014	2013	2012
Sales by Distribution Method			
On-Site	26 %	25 %	23 %
Merchant	43 %	43 %	43 %
Packaged Gas	29 %	30 %	31 %
Other	2 %	2 %	3 %
	100 %	100 %	100 %

Praxair's South American industrial gases operations are conducted by its subsidiary, White Martins Gases Industriais Ltda. ("White Martins"), the largest industrial gases company in Brazil. White Martins also manages Praxair's operations in Argentina, Bolivia, Chile, Colombia, Paraguay, Peru, Uruguay and Venezuela.

Sales in 2014 decreased $49 million, or 2%, versus 2013. Unfavorable currency translation impacts reduced sales by 9%. Organic sales grew 6% primarily due to higher pricing and modest volume growth. Sales growth came primarily from the food and beverage and healthcare end-markets.

Operating profit decreased $18 million or 4% versus 2013. Excluding negative currency effects, operating profit increased 6% due to higher pricing partially offset by cost inflation primarily in Brazil, Argentina and Venezuela. The 2013 period included the impact of a $10 million positive litigation settlement in Brazil.

In 2015, the adoption of the SICAD II exchange rate in Venezuela (see Note 2 to the consolidated financial statements) will have the impact of reducing reported segment sales by an estimated $125 million.

Sales in 2013 decreased $40 million, or 2%, versus 2012. Excluding unfavorable currency translation impacts, underlying sales grew 7% from broad-based volume growth and higher pricing. Sales growth came from metals, chemicals, food and beverage and healthcare customers.

Operating profit in 2013 increased $38 million or 9% versus 2012 and 18% excluding currency effects. Operating leverage was primarily due to higher volumes and pricing across the region. Operating profit included a $10 million litigation settlement in Brazil. Depreciation and amortization increased in 2013 due to the start up of new on-site production facilities but was more than offset by the impacts of currency translation.

Asia

(Dollar amounts in millions)				Variance	
Year Ended December 31,	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales	$1,619	$1,525	$1,414	6 %	8 %
Cost of sales, exclusive of depreciation and amortization	1,041	1,005	952		
Gross margin	578	520	462		
Operating expenses	105	99	89		
Depreciation and amortization	170	150	127		
Operating profit	$303	$271	$246	12 %	10 %
Margin %	18.7 %	17.8 %	17.4 %		

Table of Contents

	2014 vs. 2013 % Change		2013 vs. 2012 % Change	
	Sales	Operating Profit	Sales	Operating Profit
Factors Contributing to Changes				
Volume / Equipment	7 %	6 %	10 %	14 %
Price	1 %	5 %	(1)%	(4)%
Cost pass-through	(1)%	— %	(1)%	— %
Currency	(1)%	(1)%	— %	— %
Other	— %	2 %	— %	— %
	6 %	12 %	8 %	10 %

The following tables provide sales by end-market and distribution method:

	% of Sales			% Change*	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales by End Markets					
Manufacturing	10 %	11 %	12 %	(2)%	1 %
Metals	28 %	27 %	25 %	13 %	15 %
Energy	3 %	2 %	1 %	57 %	172 %
Chemicals	12 %	13 %	11 %	(2)%	19 %
Electronics	31 %	34 %	37 %	— %	— %
Healthcare	1 %	1 %	1 %	— %	— %
Food & Beverage	2 %	2 %	3 %	1 %	(18)%
Aerospace	— %	— %	— %	— %	— %
Other	13 %	10 %	10 %	35 %	18 %
	100 %	100 %	100 %		

* Excludes impact of currency, natural gas/precious metals cost pass-through and acquisitions/divestitures.

	% of Sales		
	2014	2013	2012
Sales by Distribution Method			
On-Site	51 %	48 %	43 %
Merchant	29 %	29 %	29 %
Packaged Gas	12 %	11 %	12 %
Other	8 %	12 %	16 %
	100 %	100 %	100 %

The Asia segment includes Praxair’s industrial gases operations in China, India, Korea and Thailand, with smaller operations in Taiwan and the Middle East.

Asia segment sales for 2014 increased $94 million, or 6%, as compared to the prior year. Volume growth of 7% came from new project start-ups primarily in India and Korea and included the sale of an air separation plant to a joint venture in China. By end-market, the strongest sales growth came from energy and metals customers. Strong growth in on-site volumes due to new plant start-ups accounted for the increase in on-site sales as a percentage of total sales. Merchant volumes in India and China also showed solid growth versus the prior year. Cost pass-through decreased sales 1% and relates to the contractual pass through of precious metals and power costs fluctuations, with minimal impact on operating profit. Higher helium pricing increased sales by 1%.

Table of Contents

Asia segment operating profit for 2014 increased $32 million, or 12%, as compared to the prior year. Strong on-site volume growth contributed to a 6% increase in operating profit. Pricing increased operating profit by 5% primarily due to higher merchant and packaged gas pricing for helium sales. Depreciation and amortization expense increased $20 million as compared to the prior year primarily due to new plant start-ups. In the fourth quarter 2014, operating profit included a $14 million gain related to the acquisition of an equity investment. In the fourth quarter 2013, operating profit included a $13 million gain related to a land sale in Korea.

Asia segment sales for 2013 increased $111 million, or 8%, versus 2012. Volume growth increased sales by 10% due to new on-site sales plant start-ups in China, India and Korea. By end-market, the strongest sales growth came from metals, energy and chemicals customers. Strong growth in on-site volumes due to new plant start-ups accounted for the increase in on-site sales as a percentage of total sales. Merchant volumes in China, India and Korea also showed solid growth versus the prior year. Cost pass-through decreased sales 1% and relates to the contractual pass through of precious metals and power costs fluctuations, with minimal impact on operating profit. Lower merchant pricing, primarily due to the electronics end-market, reduced sales by 1%.

Asia segment operating profit for 2013 increased $25 million, or 10%, versus 2012. Strong on-site volume growth was partially offset by the effects of lower pricing in the electronics end-market. Operating profit included a gain related to a land sale in Korea in the fourth quarter of $13 million. Pricing reduced operating profit by 4% primarily due to lower pricing for liquid argon sales in China and electronic gas customers. Operating expenses increased $10 million primarily due to new plant start-ups, salary increases and other benefit costs. Depreciation and amortization expense increased $23 million as compared to the prior year primarily due to new plant start-ups.

Surface Technologies

(Dollar amounts in millions)				Variance	
Year Ended December 31,	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales	$679	$652	$656	4 %	(1)%
Cost of sales, exclusive of depreciation and amortization	438	423	433		
Gross margin	241	229	223		
Operating expenses	75	75	74		
Depreciation and amortization	43	43	43		
Operating profit	$123	$111	$106	11 %	5 %
	18.1 %	17.0 %	16.2 %		

	2014 vs. 2013 % Change		2013 vs. 2012 % Change	
	Sales	Operating Profit	Sales	Operating Profit
Factors Contributing to Changes				
Volume/Price	1 %	6 %	— %	2 %
Cost pass-through	— %	— %	(1)%	— %
Currency	— %	— %	— %	— %
Acquisitions/Divestitures	— %	— %	— %	— %
Other*	3 %	5 %	— %	3 %
	4 %	11 %	(1)%	5 %

* Other primarily relates to business transfers for 2014 vs. 2013.

32

Table of Contents

The following table provides sales by end-market:

	% of Sales			% Change*	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Sales by End Markets					
Manufacturing	13 %	13 %	14 %	1 %	(2)%
Metals	8 %	8 %	8 %	3 %	4 %
Energy	28 %	28 %	28 %	2 %	— %
Chemicals	2 %	2 %	3 %	— %	(9)%
Electronics	1 %	1 %	— %	— %	— %
Healthcare	— %	— %	— %	1 %	— %
Food & Beverage	3 %	3 %	3 %	3 %	(3)%
Aerospace	34 %	34 %	34 %	3 %	(1)%
Other	11 %	11 %	10 %	9 %	2 %
	100 %	100 %	100 %		

* Excludes impact of currency, precious metals cost pass-through, acquisitions/divestitures and business transfers.

Surface technologies provides high-performance coatings and thermal-spray powders and equipment in the Americas, Europe, and Asia.

Sales increased $27 million, or 4% versus 2013 due to modest organic sales growth primarily to the metals and aerospace end-markets, and business transfers.

Operating profit increased $12 million, or 11% versus 2013 primarily due to higher pricing and productivity gains which more than offset cost inflation.

Sales decreased $4 million, or 1% versus 2012 due primarily to lower cost pass-through for metals for thermal-spray powders. Lower industrial coating and aviation volumes were offset by higher pricing.

Operating profit increased $5 million, or 5% versus 2012. The impact of higher pricing and lower costs, primarily due to the prior-year cost reduction program in Europe and productivity gains, offset the impact of modestly lower overall volumes.

Table of Contents

Currency

The results of Praxair's non-U.S. operations are translated to the company's reporting currency, the U.S. dollar, from the functional currencies used in the countries in which the company operates. For most foreign operations, Praxair uses the local currency as its functional currency. There is inherent variability and unpredictability in the relationship of these functional currencies to the U.S. dollar and such currency movements may materially impact Praxair's results of operations in any given period.

To help understand the reported results, the following is a summary of the significant currencies underlying Praxair's consolidated results and the exchange rates used to translate the financial statements (rates of exchange expressed in units of local currency per U.S. dollar):

Currency	Percent of 2014 Consolidated Sales		Statements of Income Average Year Ended December 31, 2014	2013	2012	Balance Sheets December 31, 2014	2013
Brazilian real	13	%	2.35	2.15	1.95	2.66	2.34
Euro	12	%	0.75	0.75	0.78	0.83	0.73
Canadian dollar	8	%	1.10	1.03	1.00	1.16	1.06
Mexican peso	6	%	13.30	12.76	13.24	14.75	13.04
Chinese yuan	5	%	6.16	6.16	6.31	6.21	6.05
Indian rupee	3	%	61.03	58.31	53.46	63.04	61.80
Korean won	3	%	1,053	1,094	1,132	1,094	1,050
Norwegian krone	1	%	6.28	5.87	5.81	7.45	6.07
Colombia peso	1	%	1,994	1,868	1,797	2,392	1,927
Venezuelan bolivar fuerte ("VEF") (a)	1	%	6.30	5.97	4.30	50.00	6.30
Argentine peso	<1%		8.10	5.45	4.54	8.55	6.52
Russian ruble	<1%		37.77	31.82	31.02	60.74	32.87
Thailand bhat	<1%		32.48	30.69	31.11	32.91	32.71

(a) At December 31, 2014 Praxair changed the exchange rate used to translate the monetary assets and liabilities of its Venezuelan subsidiary to the SICAD II rate of 50 VEF per U.S. dollar (see Note 2 to the consolidated financial statements). On February 10, 2015, the Venezuelan government initiated a new foreign exchange platform referred to as SIMADI which replaced the SICAD II exchange control mechanism. The SIMADI exchange rate was initially set at 170 VEF per U.S. dollar. This change will not have a material impact on Praxair.

Table of Contents

LIQUIDITY, CAPITAL RESOURCES AND OTHER FINANCIAL DATA

(Millions of dollars) Year Ended December 31,	2014	2013	2012
Net Cash Provided by (Used for)			
Operating Activities			
Net Income (including noncontrolling interests)	$1,746	$1,836	$1,744
Non-cash charges (credits):			
Add: Venezuela devaluations and other charges (a)	138	23	43
Add: Depreciation and amortization	1,170	1,109	1,001
Add: Deferred income taxes	55	101	258
Add: Other non-cash charges	(65)	(18)	(57)
Net Income adjusted for non-cash charges	3,044	3,051	2,989
Less: Pension payments	(18)	(52)	(184)
Less: Working capital	(129)	(100)	(105)
Other	(29)	18	52
Net cash provided from operating activities	$2,868	$2,917	$2,752
Investing Activities			
Capital expenditures	$(1,689)	$(2,020)	$(2,180)
Acquisitions, net of cash acquired	(206)	(1,323)	(280)
Divestitures and asset sales	92	106	82
Total used for investing	$(1,803)	$(3,237)	$(2,378)
Financing Activities			
Debt increases – net	$589	$1,461	$807
Purchases of common stock – net	(759)	(436)	(459)
Cash dividends – Praxair, Inc. shareholders	(759)	(708)	(655)
Excess tax benefit on stock based compensation	31	46	60
Noncontrolling interest transactions and other	(110)	(35)	(56)
Total provided (used) for financing	$(1,008)	$328	$(303)
Effect of exchange rate changes on cash	$(69)	$(27)	$(4)
Cash and cash equivalents	$126	$138	$157
Other Financial Data (b)			
Debt-to-capital ratio	59.6%	54.3%	51.9%
After-tax return on capital ("ROC")	12.7%	12.8%	13.9%
Return on Praxair, Inc. shareholder's equity ("ROE")	28.7%	28.6%	28.9%
Adjusted EBITDA	$3,958	$3,804	$3,537
Debt-to-Adjusted EBITDA	2.3	2.2	1.9

(a) See Note 2 to the consolidated financial statements.

(b) Non-GAAP measures. See the “Non-GAAP Financial Measures” section for definitions and reconciliations to reported amounts.

Cash decreased $12 million in 2014 versus 2013. The primary sources of cash in 2014 were cash flows from operations of $2,868 million, and debt increases net of repayments of $589 million. The major uses of cash were capital expenditures of $1,689 million, acquisitions of $206 million, purchases of Praxair common stock net of issuances of $759 million, and cash dividends to shareholders of $759 million. The effect of exchange rate changes on cash and cash

equivalents relates primarily to the currency devaluations in Venezuela (see Note 2 to the consolidated financial statements).

Cash Flows From Operations

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* Includes Spanish income tax settlement payment of $481 million.

2014 compared with 2013

Cash flows from operations was $2,868 million, or 23% of sales, a decrease of $49 million from $2,917 million in 2013. Cash flows provided from net income decreased $90 million, but decreased $7 million after adjusting for the year-over-year change in non-cash items included in net income. Pension contributions decreased $34 million versus 2013 while cash used for working capital requirements increased $29 million versus 2013.

2013 compared with 2012

Cash flows from operations increased $165 million to a record $2,917 million in 2013, or 24% of sales, from $2,752 million in 2012. Cash flows provided from net income increased $92 million versus 2012 but decreased $62 million after adjusting for the impact of non-cash items included in net income. Pension contributions decreased $132 million versus 2012 while cash used for working capital requirements remained essentially flat.

Table of Contents

Investing

2014 compared with 2013
Net cash used for investing activities of $1,803 million decreased $1,434 million versus 2013 primarily due to lower acquisition, net of cash acquired and capital expenditures.
Acquisition expenditures in 2014 were $206 million, a decrease of $1,117 million from 2013. Acquisitions in 2014 consisted primarily of an industrial gases business in Italy, packaged gases businesses in North and South America and the controlling interest of an equity investment in China (see Note 3 to the consolidated financial statements).
Capital expenditures in 2014 were $1,689 million, a decrease of $331 million from 2013. Capital expenditures during 2014 related primarily to growth capital investments. Approximately half of the capital expenditures were in North America, about 20% in South America and the rest evenly between Asia and Europe.
Divestitures and asset sales in 2014 totaled $92 million, which included the sale of Praxair's industrial gas business in France during the first quarter.
2013 compared with 2012
Net cash used for investing activities of $3,237 million increased $859 million versus 2012 primarily due to higher acquisitions, net of cash acquired.
Acquisition expenditures in 2013 were $1,323 million, an increase of $1,043 million from 2012. Acquisitions in 2013 consisted primarily of the acquisition of $NuCO_2$, Inc., Dominion Technology Gases, US packaged gas distributors, and an acquisition in Russia (see Note 3 to the consolidated financial statements).
Capital expenditures in 2013 were $2,020 million, a decrease of $160 million from 2012. Capital expenditures during 2013 related largely to new production plants under contract for customers globally. Approximately half of the capital expenditures were in North American and about 20% were in Asia.
Divestitures and asset sales in 2013 totaled $106 million, which included the sale of a service business and other assets in the United States and proceeds related to a land sale in Korea.

Table of Contents

Financing

Praxair’s financing strategy is to secure long-term committed funding by issuing public notes and debentures and commercial paper backed by a long-term bank credit agreement. Praxair’s international operations are funded through a combination of local borrowing and inter-company funding to minimize the total cost of funds and to manage and centralize currency exchange exposures. As deemed necessary, Praxair manages its exposure to interest-rate changes through the use of financial derivatives (see Note 12 to the consolidated financial statements and Item 7A. Quantitative and Qualitative Disclosures About Market Risk).

The company believes that it has sufficient operating flexibility, cash reserves, and funding sources to maintain adequate amounts of liquidity to meet its business needs around the world. At December 31, 2014, the company’s credit ratings as reported by Standard & Poor’s and Moody’s were A-1 and P-1 for short-term debt, respectively, and A and A2 for long-term debt, respectively. Additionally, the company plans to maintain its undistributed earnings of foreign subsidiaries to support foreign growth opportunities and reduce local debt.

Note 11 to the consolidated financial statements includes information with respect to the company’s debt refinancing in 2014, current debt position, debt covenants and the available credit facility; and Note 12 includes information relating to derivative financial instruments. Praxair's credit facility is with major financial institutions and is non-cancellable until maturity. Therefore, the company believes the risk of the financial institutions being unable to make required loans under the credit facility, if requested, to be low. Praxair’s major bank credit and long-term debt agreements contain standard covenants. The company was in compliance with these covenants at December 31, 2014 and expects to remain in compliance for the foreseeable future.

Praxair’s total debt outstanding at December 31, 2014 was $9,258 million, $447 million higher than $8,811 million at December 31, 2013. The December 31, 2014 debt balance includes $9,002 million in public securities and $256 million representing primarily worldwide bank borrowings. Praxair’s global effective borrowing rate was approximately 2.4% for 2014.

In March 2014, Praxair issued €600 million ($824 million cash proceeds at issuance) of 1.50% Euro-denominated notes due 2020; and in December 2014, Praxair issued €500 million ($616 million cash proceeds at issuance) of 1.625% Euro-denominated notes due 2025. Praxair has designated these Euro-denominated notes as hedges of the net investment position in its European operations (see Note 12 to the consolidated financial statements).

In March 2014, Praxair repaid $300 million of 4.375% notes that became due. In December 2014, Praxair redeemed $400 million of 5.375% notes due in 2016 (see Note 11 to the consolidated financial statements).

Cash used by financing activities was $1,008 million in 2014 compared to cash provided by financing of $328 million in 2013. Net purchases of common stock of $759 million increased $323 million and cash dividends of $759 million increased $51 million from 2013. The noncontrolling interests and other payments relate primarily to the acquisition of the remaining noncontrolling interests in a U.S. packaged gas business during the first quarter 2014. The cash received from debt issuances-net of $589 million was less than $1,461 million in 2013 primarily due to lower acquisition expenditures. The Euro-denominated notes reflected in the consolidated balance sheet is lower than the cash proceeds reflected in the statement of cash flows primarily due to currency movements of $125 million since the note issuances.

On February 5, 2015, Praxair issued $150 million of floating rate notes that bear interest at the Federal funds effective rate plus 0.33% due 2017, $400 million of 2.65% fixed rate notes due 2025 and $200 million of 3.550% fixed rates notes due in 2042. The proceeds will be used for general corporate purposes, including the repayment of outstanding indebtedness.

Other Financial Data

Praxair's debt-to-capital ratio was 59.6% at December 31, 2014 versus 54.3% at December 31, 2013. Although net debt increased $459 million during 2014, the increase in debt-to-capital is due primarily to lower capital. The equity component of capital was reduced by a $1,257 million loss in other comprehensive income, primarily from currency impacts and the funded status of benefit plans. The increase in 2013 is attributable to higher debt levels, primarily to fund acquisitions.

After-tax return on capital ("ROC") of 12.7% at December 31, 2014 was slightly below 12.8% at year-end 2013, and ROC was 13.9% in 2012. The decrease in both years is primarily related to capital projects and acquisitions.

Return on equity ("ROE") was strong and consistent for 2014, 2013 and 2012.

Adjusted EBITDA increased $154 million in 2014 and $267 million in 2013 versus the respective prior year amounts. The increases primarily reflect the higher adjusted net income levels and depreciation and amortization from the start-up of new plants and other assets, and from acquisitions; partially offset by negative currency impacts.

Debt-to-Adjusted EBITDA increased slightly in 2014 primarily because debt increased more than adjusted EBITDA. Praxair's debt is largely denominated in U.S. dollars and, therefore, is not impacted by currency movements. In 2013 the increase was largely due to increased debt incurred to fund acquisitions.

See the "Non-GAAP Financial Measures" section for definitions and reconciliation of these non-GAAP measures to reported amounts.

CONTRACTUAL OBLIGATIONS

The following table sets forth Praxair's material contract obligations and other commercial commitments as of December 31, 2014:

(Millions of dollars)	Due or expiring by December 31,						
	2015	2016	2017	2018	2019	Thereafter	Total
Long-term debt obligations:							
Debt and capitalized lease maturities (Note 11)*	$2	$407	$775	$1,083	$2,008	$4,396	$8,671
Contractual interest	209	191	176	159	130	600	1,465
Operating leases (Note 4)*	122	109	91	75	60	60	517
Retirement obligations	55	32	34	35	37	163	356
Unconditional purchase obligations (Note 17)*	543	491	460	445	393	3,021	5,353
Construction commitments (Note 17)*	954	404	27	—	—	—	1,385
Total Contractual Obligations	$1,885	$1,634	$1,563	$1,797	$2,628	$8,240	$17,747

* See Notes to the consolidated financial statements for additional information.

Contractual interest on long-term debt of $1,465 million represents interest the company is contracted to pay on outstanding long-term debt, current portion of long-term debt and capital lease obligations, calculated on a basis consistent with planned debt maturities, excluding the interest impact of interest rate swaps. At December 31, 2014, Praxair had fixed-rate debt of $7,626 million and floating-rate debt of $1,632 million. The rate assumed for floating-rate debt was the rate in effect at December 31, 2014.

39

Retirement obligations of $356 million include estimates of pension plan contributions and expected future benefit payments for unfunded pension and OPEB plans. Pension plan contributions are forecast for 2015 only. For purposes of the table, $15 million of estimated required contributions have been included for 2015. Expected future unfunded pension and OPEB benefit payments are forecast only through 2024. Contribution and unfunded benefit payment estimates are based upon current valuation assumptions. Estimates of pension contributions after 2015 and unfunded benefit payments after 2024 are not included in the table because the timing of their resolution cannot be estimated. Retirement obligations are more fully described in Note 16 to the consolidated financial statements.

Liabilities for uncertain tax positions totaling $71 million, including interest and penalties, are not included in the table because the timing of their resolution cannot be estimated. See Note 5 to the consolidated financial statements for disclosures surrounding uncertain income tax positions.

OFF-BALANCE SHEET ARRANGEMENTS

As discussed in Note 17 to the consolidated financial statements, at December 31, 2014, Praxair had entered into various guarantees and other arrangements, and had undrawn outstanding letters of credit from financial institutions. These arrangements were entered into in connection with normal business operations and they are not reasonably likely to have a material impact on Praxair’s consolidated financial condition, results of operations, or liquidity.

CRITICAL ACCOUNTING POLICIES

The policies discussed below are considered by management to be critical to understanding Praxair’s financial statements and accompanying notes prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). Their application places significant importance on management’s judgment as a result of the need to make estimates of matters that are inherently uncertain. Praxair’s financial position, results of operations and cash flows could be materially affected if actual results differ from estimates made. These policies are determined by management and have been reviewed by Praxair’s Audit Committee.

Depreciable Lives of Property, Plant and Equipment

Praxair’s net property, plant and equipment at December 31, 2014 was $11,997 million, representing 61% of the company’s consolidated total assets. Depreciation expense for the year ended December 31, 2014 was $1,123 million, or 12% of total operating costs. Management judgment is required in the determination of the estimated depreciable lives that are used to calculate the annual depreciation expense and accumulated depreciation.

Property, plant and equipment are recorded at cost and depreciated over the assets’ estimated useful lives on a straight-line basis for financial reporting purposes. The estimated useful life represents the projected period of time that the asset will be productively employed by the company and is determined by management based on many factors, including historical experience with similar assets, technological life cycles, geographic locations and contractual supply relationships with on-site customers. Circumstances and events relating to these assets, such as on-site contract modifications, are monitored to ensure that changes in asset lives or impairments (see “Asset Impairments”) are identified and prospective depreciation expense or impairment expense is adjusted accordingly. Praxair’s largest asset values relate to cryogenic air-separation production plants with depreciable lives of principally 15 years.

Based upon the assets as of December 31, 2014, if depreciable lives of machinery and equipment, on average, were increased or decreased by one year, annual depreciation expense would be decreased by approximately $73 million or increased by approximately $84 million, respectively.

Pension Benefits

Pension benefits represent financial obligations that will be ultimately settled in the future with employees who meet eligibility requirements. Because of the uncertainties involved in estimating the timing and amount of future payments, significant estimates are required to calculate pension expense and liabilities related to the company’s plans. The company utilizes the services of several independent actuaries, whose models are used to facilitate these calculations.

Several key assumptions are used in actuarial models to calculate pension expense and liability amounts recorded in the financial statements. Management believes the three most significant variables in the models are the expected long-term rate of return on plan assets, the discount rate, and the expected rate of compensation increase. The actuarial models also use assumptions for various other factors, including employee turnover, retirement age, and mortality.

Praxair management believes the assumptions used in the actuarial calculations are reasonable, reflect the company's experience and expectations for the future and are within accepted practices in each of the respective geographic locations in which it operates. Actual results in any given year will often differ from actuarial assumptions because of economic and other factors.

40

Table of Contents

The weighted-average expected long-term rates of return on pension plan assets were 8.00% for U.S. plans and 8.10% for international plans for the years ended December 31, 2014 (8.00% and 7.50%, respectively at December 31, 2013). These rates are determined annually by management based on a weighted average of current and historical market trends, historical and expected portfolio performance and the current and expected portfolio mix of investments. A 0.50% change in these expected long-term rates of return, with all other variables held constant, would change Praxair's pension expense by approximately $10 million.

The company has consistently used a market-related value of assets rather than the fair value at the measurement date to determine annual pension expense. The market-related value recognizes investment gains or losses over a five-year period. As a result, changes in the fair value of assets from year to year are not immediately reflected in the company's annual pension expense. Instead, annual pension expense in future periods will be impacted as deferred investment gains or losses are recognized in the market-related value of assets over the five-year period. The consolidated market-related value of assets was $2,051 million, or $117 million lower than the fair value of assets of $2,168 million at December 31, 2014. These net deferred investment gains of $117 million will be recognized in the calculation of the market-related value of assets ratably over the next four years and will impact future pension expense. Future actual investment gains or losses will impact the market-related value of assets and, therefore, will impact future annual pension expense in a similar manner.

The weighted-average discount rates for pension plan liabilities were 3.95% for U.S. plans and 5.36% for international plans at December 31, 2014 (4.80% and 6.30%, respectively, at December 31, 2013). These rates are used to calculate the present value of plan liabilities and are determined annually by management. The discount rate for the U.S. plans is established utilizing a cash flow matching model provided by the company's independent actuaries. The model includes a portfolio of corporate bonds graded Aa or better by at least half of the ratings agencies and matches the U.S. plan's projected cash flows to the calculated spot rates and develops the single equivalent discount rate which produces the same present value. The discount rates for the remaining international plans are based on market yields for high-quality fixed income investments representing the approximate duration of the pension liabilities on the measurement date. A 0.50% change in discount rates, with all other variables held constant, would decrease/increase Praxair's pension expense by approximately $12 million and would impact the PBO by approximately $185 million.

The weighted-average expected rate of compensation increase was 3.25% for U.S. plans and 3.72% for international plans at December 31, 2014 (3.25% and 4.00%, respectively, at December 31, 2013). The estimated annual compensation increase is determined by management every year and is based on historical trends and market indices. A 0.50% change in the expected rate of compensation increase, with all other variables held constant, would change Praxair's pension expense by approximately $5 million and would impact the PBO by approximately $34 million.

Asset Impairments

Goodwill

At December 31, 2014, the company had goodwill of $3,121 million, which represents the aggregate of the excess purchase price for acquired businesses over the fair value of the net assets acquired.

The company performs a goodwill impairment test annually in the second quarter or more frequently if events or circumstances indicate that an impairment loss may have been incurred, and no impairments were indicated. The company has continuously re-evaluated the likelihood of goodwill impairments in its reporting units subsequent to the second quarter test, and does not believe there is indication of impairment for any of its reporting units. At December 31, 2014, Praxair's enterprise value was approximately $47 billion (outstanding shares multiplied by the year-end stock price plus debt, and without any control premium) while its total capital was approximately $15 billion.

The impairment test allows an entity to first assess qualitative factors to determine if it is more likely than not that the fair value of a reporting unit is less than carrying value. If it is determined that it is more likely than not that the fair value of a reporting unit is less than carrying value then the company will estimate and compare the fair value of its reporting units to their carrying value, including goodwill. Reporting units are determined based on one level below the operating segment level. Fair value is determined through the use of projected future cash flows, multiples of earnings and sales and other factors.

Such analysis requires the use of certain market assumptions and discount factors, which are subjective in nature. As applicable, estimated values can be affected by many factors beyond the company's control such as business and economic trends, government regulation, and technological changes. Management believes that the qualitative factors used to perform its annual goodwill impairment assessment are appropriate and reasonable. Although the 2014 qualitative assessment indicated that it is more likely than not that the fair value of each reporting unit substantially exceeded its carrying value, changes in circumstances or conditions affecting this analysis could have a significant impact on the fair value determination, which could then result in a material impairment charge to the company's results of operations.

See Note 9 to the consolidated financial statements for disclosures concerning the carrying value of goodwill by reportable segment.

Property, Plant and Equipment

Property, plant and equipment is tested for impairment whenever events or changes in circumstances indicate that the carrying amount of an individual asset or asset group may not be recoverable. For purposes of this test, asset groups are determined based upon the lowest level for which there are identifiable cash flows. Based upon Praxair's business model, an asset group may be a single plant and related assets used to support on-site, merchant and packaged gas customers. Alternatively, the asset group may be a pipeline complex which includes multiple interdependent plants and related assets connected by pipelines within a geographic area used to support the same distribution methods.

Income Taxes

At December 31, 2014, Praxair had deferred tax assets of $991 million (net of valuation allowances of $106 million), and deferred tax liabilities of $1,902 million. At December 31, 2014, uncertain tax positions totaled $71 million (see Notes 1 and 5 to the consolidated financial statements). Income tax expense was $691 million for the year ended December 31, 2014, or about 28.9% of pre-tax income.

In the preparation of consolidated financial statements, Praxair estimates income taxes based on diverse legislative and regulatory structures that exist in various jurisdictions where the company conducts business. Deferred income tax assets and liabilities represent tax benefits or obligations that arise from temporary differences due to differing treatment of certain items for accounting and income tax purposes. Praxair evaluates deferred tax assets each period to ensure that estimated future taxable income will be sufficient in character (e.g. capital gain versus ordinary income treatment), amount and timing to result in their recovery. A valuation allowance is established when management determines that it is more likely than not that a deferred tax asset will not be realized to reduce the assets to their realizable value. Considerable judgments are required in establishing deferred tax valuation allowances and in assessing exposures related to tax matters. As events and circumstances change, related reserves and valuation allowances are adjusted to income at that time. Praxair’s tax returns are subject to audit and local taxing authorities could challenge the company’s tax positions. The company’s practice is to review tax filing positions by jurisdiction and to record provisions for uncertain income tax positions, including interest and penalties when applicable. Praxair believes it records and/or discloses such potential tax liabilities as appropriate and has reasonably estimated its income tax liabilities and recoverable tax assets. If new information becomes available, adjustments are charged or credited against income at that time. Management does not anticipate that such adjustments would have a material adverse effect on the company’s consolidated financial position or liquidity; however, it is possible that the final outcomes could have a material impact on the company’s reported results of operations.

Contingencies

The company accrues liabilities for non-income tax contingencies when management believes that a loss is probable and the amounts can be reasonably estimated, while contingent gains are recognized only when realized. If new information becomes available or losses are sustained in excess of recorded amounts, adjustments are charged against income at that time. Management does not anticipate that in the aggregate such losses would have a material adverse effect on the company’s consolidated financial position or liquidity; however, it is possible that the final outcomes could have a material impact on the company’s reported results of operations.

Praxair is subject to various claims, legal proceedings and government investigations that arise from time to time in the ordinary course of business. These actions are based upon alleged environmental, tax, antitrust and personal injury claims, among others (see Note 17 to the consolidated financial statements). Such contingencies are significant and the accounting requires considerable management judgments in analyzing each matter to assess the likely outcome and the need for establishing appropriate liabilities and providing adequate disclosures. Praxair believes it records and/or discloses such potential contingencies as appropriate and has reasonably estimated its liabilities.

NEW ACCOUNTING STANDARDS

See Note 1 to the consolidated financial statements for information concerning new accounting standards and the impact of the implementation of these standards on the company’s financial statements.

Table of Contents

FAIR VALUE MEASUREMENTS

Praxair does not expect changes in the aggregate fair value of its financial assets and liabilities to have a material impact on the consolidated financial statements. See Note 13 to the consolidated financial statements.

NON-GAAP FINANCIAL MEASURES

The company presents the following non-GAAP financial measures in the discussion of financial condition, results of operations and liquidity throughout the MD&A. These measures are intended to supplement investors' understanding of the company's financial information by providing information which investors, financial analysts and management use to help evaluate the company's financial leverage, return on capital employed and operating performance. Special items which the company does not believe to be indicative of on-going business performance are excluded from these calculations so that investors can better evaluate and analyze historical and future business trends on a consistent basis. Definitions of these non-GAAP measures may not be comparable to similar definitions used by other companies and are not a substitute for similar GAAP measures.

The following are the non-GAAP measures presented in the Selected Financial Data (Item 6) or this MD&A:

(Dollar amounts in millions, except for per share data)	2014		2013		2012		2011		2010	
Year ended December 31,										
Performance Measures:										
After-tax return on capital ("ROC")	12.7	%	12.8	%	13.9	%	14.8	%	14.5	%
Return on equity ("ROE")	28.7	%	28.6	%	28.9	%	28.1	%	26.4	%
Debt-to-capital	59.6	%	54.3	%	51.9	%	51.8	%	47.3	%
Debt-to-adjusted EBITDA	2.3		2.2		1.9		1.7		1.6	
Adjusted Amounts:										
Operating profit	$2,746		$2,657		$2,502		$2,469		$2,167	
As a percent of sales	22.4	%	22.3	%	22.3	%	21.9	%	21.4	%
EBITDA	$3,958		$3,804		$3,537		$3,512		$3,130	
EBITDA Margin	32.2	%	31.9	%	31.5	%	31.2	%	30.9	%
Interest expense - net	$177		$160		$141		$145		$118	
Effective tax rate	27.5	%	28.0	%	28.0	%	27.8	%	27.9	%
Noncontrolling interests	$(52	)	$(65	)	$(54	)	$(51	)	$(39	)
Net income – Praxair, Inc.	$1,852		$1,772		$1,681		$1,666		$1,476	
Diluted earnings per share	$6.27		$5.93		$5.57		$5.43		$4.74	

Table of Contents

After-tax Return on Capital ("ROC")

After-tax return on capital is a measure used by investors, financial analysts and management to evaluate the return on capital employed in the business. ROC measures the after-tax operating profit that the company was able to generate with the investments made by all parties in the business (debt, noncontrolling interests and Praxair, Inc. shareholders' equity).

(Dollar amounts in millions) Year Ended December 31,	2014	2013	2012	2011	2010
Adjusted operating profit (see below)	$2,746	$2,657	$2,502	$2,469	$2,167
Less: adjusted income taxes (see below)	(707)	(698)	(660)	(647)	(572)
Less: tax benefit on adjusted interest expense (a)	(50)	(44)	(39)	(41)	(33)
Add: income from equity investments	42	38	34	40	38
Net operating profit after-tax ("NOPAT")	$2,031	$1,953	$1,837	$1,821	$1,600
Beginning capital	$15,983	$13,878	$12,489	$11,663	$10,658
First quarter ending capital	$16,319	$15,344	$13,248	$12,289	$10,758
Second quarter ending capital	$16,492	$15,548	$13,017	$12,809	$10,745
Third quarter ending capital	$16,083	$15,757	$13,617	$12,306	$11,336
Year-end ending capital	$15,318	$15,983	$13,878	$12,489	$11,663
Five-quarter average capital	$16,039	$15,302	$13,250	$12,311	$11,032
After-tax return on capital	12.7%	12.8%	13.9%	14.8%	14.5%

(a) Tax benefit on adjusted interest expense is computed using the effective rate adjusted for non-recurring income tax benefits and charges. The effective tax rates used for all periods was 28%.

Return on Praxair, Inc. Shareholders' Equity ("ROE")

Return on Praxair, Inc. shareholders' equity is a measure used by investors, financial analysts and management to evaluate operating performance from a Praxair shareholder perspective. ROE measures the net income attributable to Praxair, Inc. that the company was able to generate with the money shareholders have invested.

(Dollar amounts in millions) Year Ended December 31,	2014	2013	2012	2011	2010
Adjusted net income – Praxair, Inc. (see below)	$1,852	$1,772	$1,681	$1,666	$1,476
Beginning Praxair, Inc. shareholders' equity	$6,609	$6,064	$5,488	$5,792	$5,315
First quarter ending Praxair, Inc. shareholders' equity	$6,600	$6,169	$5,940	$6,165	$5,398
Second quarter ending Praxair, Inc. shareholders' equity	$6,911	$5,928	$5,615	$6,400	$5,452
Third quarter ending Praxair, Inc. shareholders' equity	$6,552	$6,210	$6,015	$5,753	$5,991
Year-End ending Praxair, Inc. shareholders' equity	$5,623	$6,609	$6,064	$5,488	$5,792
Five-quarter average Praxair, Inc. shareholders' equity	$6,459	$6,196	$5,824	$5,920	$5,590
Return on Praxair, Inc. Shareholders' Equity	28.7%	28.6%	28.9%	28.1%	26.4%

44

Table of Contents

Debt-to-Capital Ratio

The debt-to-capital ratio is a measure used by investors, financial analysts and management to provide a measure of financial leverage and insights into how the company is financing its operations.

(Dollar amounts in millions) Year Ended December 31,	2014	2013	2012	2011	2010
Total debt	$9,258	$8,811	$7,362	$6,562	$5,557
Less: cash and cash equivalents	(126)	(138)	(157)	(90)	(39)
Net debt	9,132	8,673	7,205	6,472	5,518
Equity and redeemable noncontrolling interests					
Redeemable noncontrolling interests	176	307	252	220	—
Praxair, Inc. shareholders’ equity	5,623	6,609	6,064	5,488	5,792
Noncontrolling interests	387	394	357	309	353
Total equity and redeemable noncontrolling interests	6,186	7,310	6,673	6,017	6,145
Total capital	$15,318	$15,983	$13,878	$12,489	$11,663
Debt-to-capital ratio	59.6%	54.3%	51.9%	51.8%	47.3%

45

Table of Contents

Adjusted EBITDA, Adjusted EBITDA Margin and Debt-to-Adjusted EBITDA Ratio

(Dollar amounts in millions) Year Ended December 31,	2014	2013	2012	2011	2010
Adjusted net income - Praxair, Inc. (see below)	$1,852	$1,772	$1,681	$1,666	$1,476
Add: adjusted noncontrolling interests (see below)	52	65	54	51	39
Add: adjusted interest expense - net	177	160	141	145	118
Add: adjusted income taxes (see below)	707	698	660	647	572
Add: depreciation and amortization	1,170	1,109	1,001	1,003	925
Adjusted EBITDA	$3,958	$3,804	$3,537	$3,512	$3,130
Reported Sales	$12,273	$11,925	$11,224	$11,252	$10,116
Adjusted EBITDA Margin	32.2 %	31.9 %	31.5 %	31.2 %	30.9 %
Beginning Praxair, Inc. net debt	$8,673	$7,205	$6,472	$5,518	$5,010
First quarter ending Praxair, Inc. net debt	$9,126	$8,563	$6,749	$5,752	$5,028
Second quarter ending Praxair, Inc. net debt	$8,992	$9,004	$6,891	$6,039	$4,978
Third quarter ending Praxair, Inc. net debt	$8,953	$8,892	$7,028	$6,185	$5,006
Year-End ending Praxair, Inc. net debt	$9,132	$8,673	$7,205	$6,472	$5,518
Five-quarter average Praxair, Inc. net debt	$8,975	$8,467	$6,869	$5,993	$5,108
Debt-to- adjusted EBITDA ratio	2.3	2.2	1.9	1.7	1.6

Adjusted Amounts

2014 amounts are adjusted for the impact of the Venezuela currency devaluation, a pension settlement and a bond redemption. 2013 amounts are adjusted for the impact of Venezuela currency devaluation, a pension settlement, an income tax benefit related to the realignment of Praxair's Italian legal structure and a bond redemption. 2012 amounts are adjusted for the impact of the cost reduction program, a pension settlement and an income tax benefit related to US homecare divestiture. 2011 amounts are adjusted for the impact of a net gain on acquisition and the cost reduction program. 2010 amounts are adjusted for the impact of the Spanish income tax settlement, US homecare divestiture, repatriation tax benefit and Venezuela currency devaluation. The company does not believe these items are indicative of on-going business performance and, accordingly, their impacts are excluded from the reported amounts so that investors can better evaluate and analyze historical and future business trends on a consistent basis.

(Dollar amounts in millions, except per share data) Year Ended December 31,	2014	2013	2012	2011	2010
Adjusted Operating Profit and Margin					
Reported operating profit	$2,608	$2,625	$2,437	$2,468	$2,082
Add: Pension settlement charge	7	9	9	—	—
Add: Venezuela currency devaluation	131	23	—	—	27
Add: Cost reduction program	—	—	56	40	—
Less: Net gain on acquisition	—	—	—	(39)	—
Add: US homecare divestiture	—	—	—	—	58
Total adjustments	138	32	65	1	85
Adjusted operating profit	$2,746	$2,657	$2,502	$2,469	$2,167
Reported percent change	(1)%	8 %	(1)%	19 %	32 %
Adjusted percent change	3 %	6 %	1 %	14 %	15 %
Reported sales	$12,273	$11,925	$11,224	$11,252	$10,116
Reported operating profit margin	21.2 %	22.0 %	21.7 %	21.9 %	20.6 %
Adjusted operating profit margin	22.4 %	22.3 %	22.3 %	21.9 %	21.4 %

(Dollar amounts in millions, except per share data)	2014	2013	2012	2011	2010
Year Ended December 31,					
Adjusted Interest Expense - Net					
Reported interest expense	213	178	141	145	118
Less: Bond redemption	(36)	(18)	—	—	—
Adjusted interest expense - net	$177	$160	$141	$145	$118
Adjusted Income Taxes and Effective Tax Rate					
Reported income taxes	$691	$649	$586	$641	$768
Add: Bond redemption	14	6	—	—	—
Add: Income tax benefits	—	40	55	—	—
Add: Pension settlement charge	2	3	3	—	—
Add: Venezuela currency devaluation	—	—	—	—	1
Add: Cost reduction program	—	—	16	9	—
Less: Spanish income tax settlement	—	—	—	—	(250)
Less: Net gain on acquisition	—	—	—	(3)	—
Add: US homecare divestiture	—	—	—	—	18
Add: Repatriation tax benefit	—	—	—	—	35
Total adjustments	16	49	74	6	(196)
Adjusted income taxes	$707	$698	$660	$647	$572
Reported income before income taxes and equity investments	$2,395	$2,447	$2,296	$2,323	$1,964
Add: Bond redemption	36	18	—	—	—
Add: Pension settlement charge	7	9	9	—	—
Add: Venezuela currency devaluation	131	23	—	—	27
Add: Cost reduction program	—	—	56	40	—
Less: Net gain on acquisition	—	—	—	(39)	—
Add: US homecare divestiture	—	—	—	—	58
Total adjustments	174	50	65	1	85
Adjusted income before income taxes and equity investments	$2,569	$2,497	$2,361	$2,324	$2,049
Adjusted effective tax rate	27.5%	28.0%	28.0%	27.8%	27.9%
Adjusted Noncontrolling Interests					
Reported noncontrolling interests	$52	$81	$52	$50	$39
Less: Income tax benefits	—	(16)	—	—	—
Add: Cost reduction program	—	—	2	—	—
Add: Net gain on acquisition	—	—	—	1	—
Total adjustments	—	(16)	2	1	—
Adjusted noncontrolling interests	$52	$65	$54	$51	$39
Adjusted Net Income – Praxair, Inc.					
Reported net income – Praxair, Inc.	$1,694	$1,755	$1,692	$1,672	$1,195
Add: Bond redemption	22	12	—	—	—
Less: Income tax benefits	—	(24)	(55)	—	—
Add: Pension settlement charge	5	6	6	—	—
Add: Venezuela currency devaluation	131	23	—	—	26

Add: Cost reduction program	—	—	38	31	—
Less: Net gain on acquisition	—	—	—	(37)	—
Add: Spanish tax settlement	—	—	—	—	250
Add: US homecare divestiture	—	—	—	—	40

Table of Contents

(Dollar amounts in millions, except per share data)	2014	2013	2012	2011	2010
Year Ended December 31,					
Less: Repatriation tax benefit	—	—	—	—	(35)
Total adjustments	158	17	(11)	(6)	281
Adjusted net income – Praxair, Inc.	$1,852	$1,772	$1,681	$1,666	$1,476
Reported percent change	(3)%	4%	1%	40%	(5)%
Adjusted percent change	5%	5%	1%	13%	18%

(Dollar amounts in millions, except per share data)	2014	2013	2012	2011	2010
Year Ended December 31,					
Adjusted Diluted Earnings Per Share					
Reported diluted earnings per share	$5.73	$5.87	$5.61	$5.45	$3.84
Add: Bond redemption	0.07	0.04	—	—	—
Less: Income tax benefits	—	(0.08)	(0.18)	—	—
Add: Pension settlement charge	0.02	0.02	0.02	—	—
Add: Venezuela currency devaluation	0.45	0.08	—	—	0.08
Add: Cost reduction program	—	—	0.12	0.10	—
Less: Net gain on acquisition	—	—	—	(0.12)	—
Add: Spanish income tax settlement	—	—	—	—	0.80
Add: US homecare divestiture	—	—	—	—	0.13
Less: Repatriation tax benefit	—	—	—	—	(0.11)
Total adjustments	0.54	0.06	(0.04)	(0.02)	0.90
Adjusted diluted earnings per share	$6.27	$5.93	$5.57	$5.43	$4.74
Reported percent change	(2)%	5%	3%	42%	(4)%
Adjusted percent change	6%	6%	3%	15%	19%

2015 Diluted Earnings Per Share Outlook

	Low End	High End
2015 diluted EPS outlook	$6.15	$6.50
2014 adjusted diluted EPS (see above)	$6.27	$6.27
Percentage change	(2)%	4%

FORWARD-LOOKING STATEMENTS

This document contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on management’s reasonable expectations and assumptions as of the date the statements are made but involve risks and uncertainties. These risks and uncertainties include, without limitation: the performance of stock markets generally; developments in worldwide and national economies and other international events and circumstances; changes in foreign currencies and in interest rates; the cost and availability of electric power, natural gas and other raw materials; the ability to achieve price increases to offset cost increases; catastrophic events including natural disasters, epidemics and acts of war and terrorism; the ability to attract, hire, and retain qualified personnel; the impact of changes in financial accounting standards; the impact of changes in pension plan liabilities; the impact of tax, environmental, healthcare and other legislation and government regulation in jurisdictions in which the company operates; the cost and outcomes of investigations, litigation and regulatory proceedings; continued timely development and market acceptance of new products and applications; the impact of competitive products and pricing; future financial and operating performance of major customers and industries served; the impact of information technology system failures, network disruptions and breaches in data security; and the effectiveness and speed of integrating new acquisitions into the business. These risks and uncertainties may cause actual future results or circumstances to differ materially from the projections or estimates contained in the forward-looking statements. Additionally, financial projections or estimates exclude the impact of special items which the company believes are not indicative of ongoing business performance.The company assumes no

48

Table of Contents

obligation to update or provide revisions to any forward-looking statement in response to changing circumstances. The above listed risks and uncertainties are further described in Item 1A (Risk Factors) in this report which should be reviewed carefully. Please consider the company's forward-looking statements in light of those risks.

Table of Contents

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Praxair is exposed to market risks relating to fluctuations in interest rates and currency exchange rates. The objective of financial risk management at Praxair is to minimize the negative impact of interest rate and foreign exchange rate fluctuations on the company’s earnings, cash flows and equity.

To manage these risks, Praxair uses various derivative financial instruments, including interest-rate swaps, treasury rate locks, currency swaps, forward contracts, currency options and commodity contracts. Praxair only uses commonly traded and non-leveraged instruments. These contracts are entered into primarily with major banking institutions thereby minimizing the risk of credit loss. Also, see Notes 1 and 12 to the consolidated financial statements for a more complete description of Praxair’s accounting policies and use of such instruments.

The following discussion presents the sensitivity of the market value, earnings and cash flows of Praxair’s financial instruments to hypothetical changes in interest and exchange rates assuming these changes occurred at December 31, 2014. The range of changes chosen for these discussions reflects Praxair’s view of changes which are reasonably possible over a one-year period. Market values represent the present values of projected future cash flows based on interest rate and exchange rate assumptions.

Interest Rate and Debt Sensitivity Analysis

At December 31, 2014, Praxair had debt totaling $9,258 million ($8,811 million at December 31, 2013). At December 31, 2014 there were two interest-rate swap agreements outstanding with notional amounts totaling $875 million that converts fixed-rate interest to variable-rate interest on the $400 million 3.25% notes that mature in 2015 and the $475 million 1.25% notes that mature in 2018. When considered necessary, interest-rate swaps are entered into as hedges of underlying financial instruments to effectively change the characteristics of the interest rate without actually changing the underlying financial instrument.

For fixed-rate instruments, interest-rate changes affect the fair market value but do not impact earnings or cash flows. Conversely, for floating-rate instruments, interest-rate changes generally do not affect the fair market value but impact future earnings and cash flows, assuming other factors are held constant.

At December 31, 2014, Praxair had fixed-rate debt of $7,626 million and floating-rate debt of $1,632 million, representing 82% and 18%, respectively, of total debt. At December 31, 2013, Praxair had fixed-rate debt of $7,004 million and floating-rate debt of $1,807 million, representing 79% and 21%, respectively, of total debt. Holding other variables constant (such as foreign exchange rates, swaps and debt levels), a one-percentage-point decrease in interest rates would increase the unrealized fair market value of the fixed-rate debt by approximately $440 million ($421 million in 2013). At December 31, 2014 and 2013, the after-tax earnings and cash flows impact for the subsequent year resulting from a one-percentage-point increase in interest rates would be approximately $11 million and $12 million, respectively, holding other variables constant.

Exchange Rate Sensitivity Analysis

Praxair’s exchange-rate exposures result primarily from its investments and ongoing operations in South America (primarily Brazil, Argentina and Colombia), Europe (primarily Germany, Italy, Russia, Scandinavia and Spain), Canada, Mexico, Asia (primarily China, India, Korea and Thailand) and other business transactions such as the procurement of equipment from foreign sources. From time to time, Praxair utilizes foreign exchange forward contracts to hedge these exposures. At December 31, 2014, Praxair had $2,427 million notional amount ($2,197 million at December 31, 2013) of foreign exchange contracts all of which were to hedge recorded balance sheet exposures. See Note 12 to the consolidated financial statements.

Holding other variables constant, if there were a 10% adverse change in foreign-currency exchange rates for the portfolio, the fair market value of foreign-currency contracts outstanding at December 31, 2014 and 2013 would decrease by approximately $86 million and $46 million, respectively, which would be largely offset by an offsetting gain or loss on the foreign-currency fluctuation of the underlying exposure being hedged.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Table of Contents

MANAGEMENT'S STATEMENT OF RESPONSIBILITY FOR FINANCIAL STATEMENTS

Praxair's consolidated financial statements are prepared by management, which is responsible for their fairness, integrity and objectivity. The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America applied on a consistent basis, except for accounting changes as disclosed, and include amounts that are estimates and judgments. All historical financial information in this annual report is consistent with the accompanying financial statements.

Praxair maintains accounting systems, including internal accounting controls, monitored by a staff of internal auditors, that are designed to provide reasonable assurance of the reliability of financial records and the protection of assets. The concept of reasonable assurance is based on recognition that the cost of a system should not exceed the related benefits. The effectiveness of those systems depends primarily upon the careful selection of financial and other managers, clear delegation of authority and assignment of accountability, inculcation of high business ethics and conflict-of-interest standards, policies and procedures for coordinating the management of corporate resources, and the leadership and commitment of top management. In compliance with Section 404 of the Sarbanes-Oxley Act of 2002, Praxair assessed its internal control over financial reporting and issued a report (see below).

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has completed an integrated audit of Praxair's 2014, 2013 and 2012 consolidated financial statements and of its internal control over financial reporting as of December 31, 2014 in accordance with the standards of the Public Company Accounting Oversight Board (United States) as stated in their report.

The Audit Committee of the Board of Directors, which consists solely of non-employee directors, is responsible for overseeing the functioning of the accounting system and related controls and the preparation of annual financial statements. The Audit Committee periodically meets with management, internal auditors and the independent accountants to review and evaluate their accounting, auditing and financial reporting activities and responsibilities, including management's assessment of internal control over financial reporting. The independent registered public accounting firm and internal auditors have full and free access to the Audit Committee and meet with the committee, with and without management present.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Praxair's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including the company's principal executive officer and principal financial officer, the company conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (often referred to as COSO). Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of December 31, 2014.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has issued their opinion on the company's internal control over financial reporting as of December 31, 2014 as stated in their report.

/s/ STEPHEN F. ANGEL
Stephen F. Angel
Chairman, President and
Chief Executive Officer

/s/ MATTHEW J. WHITE
Matthew J. White
Senior Vice President and
Chief Financial Officer

/s/ ELIZABETH T. HIRSCH
Elizabeth T. Hirsch
Vice President and Controller

Danbury, Connecticut
February 25, 2015

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To The Board of Directors and Shareholders of Praxair, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, comprehensive income (loss), equity and cash flows present fairly, in all material respects, the financial position of Praxair and its subsidiaries at December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

/s/ PricewaterhouseCoopers LLP
PricewaterhouseCoopers
Stamford, Connecticut
February 25, 2015

Table of Contents

CONSOLIDATED STATEMENTS OF INCOME
PRAXAIR, INC. AND SUBSIDIARIES
(Dollar amounts in millions, except per share data)

Year Ended December 31,	2014	2013	2012
Sales	$12,273	$11,925	$11,224
Cost of sales, exclusive of depreciation and amortization	6,962	6,744	6,396
Selling, general and administrative	1,308	1,349	1,270
Depreciation and amortization	1,170	1,109	1,001
Research and development	96	98	98
Venezuela currency devaluation and other charges – net	138	32	65
Other income (expenses) – net	9	32	43
Operating Profit	2,608	2,625	2,437
Interest expense – net	213	178	141
Income Before Income Taxes and Equity Investments	2,395	2,447	2,296
Income taxes	691	649	586
Income Before Equity Investments	1,704	1,798	1,710
Income from equity investments	42	38	34
Net Income (Including Noncontrolling Interests)	1,746	1,836	1,744
Less: noncontrolling interests	(52)	(81)	(52)
Net Income – Praxair, Inc.	$1,694	$1,755	$1,692
Per Share Data – Praxair, Inc. Shareholders			
Basic earnings per share	$5.79	$5.94	$5.67
Diluted earnings per share	$5.73	$5.87	$5.61
Weighted Average Shares Outstanding (000's):			
Basic shares outstanding	292,494	295,523	298,316
Diluted shares outstanding	295,608	298,965	301,845

The accompanying Notes on pages 60 to 100 are an integral part of these financial statements.

Table of Contents

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
PRAXAIR, INC. AND SUBSIDIARIES
(Dollar amounts in millions)

Year Ended December 31,	2014	2013	2012
NET INCOME (INCLUDING NONCONTROLLING INTERESTS)	$1,746	$1,836	$1,744
OTHER COMPREHENSIVE INCOME (LOSS)			
Translation adjustments:			
Foreign currency translation adjustments	(1,087)	(474)	(13)
Reclassifications to net income	(5)	—	—
Income Taxes	(4)	27	17
Translation adjustments	(1,096)	(447)	4
Funded status - retirement obligations (Note 16):			
Retirement program remeasurements	(318)	408	(228)
Reclassifications to net income	59	95	71
Income taxes	95	(180)	49
Funded status - retirement obligations	(164)	323	(108)
Derivative instruments (Note 12):			
Current year unrealized gain (loss)	4	1	(1)
Reclassifications to net income	—	—	—
Income taxes	(1)	—	1
Derivative instruments	3	1	—
TOTAL OTHER COMPREHENSIVE LOSS	(1,257)	(123)	(104)
COMPREHENSIVE INCOME (INCLUDING NONCONTROLLING INTERESTS)	489	1,713	1,640
Less: noncontrolling interests	1	(76)	(54)
COMPREHENSIVE INCOME - PRAXAIR, INC.	$490	$1,637	$1,586

The accompanying Notes on pages 60 to 100 are an integral part of these financial statements.

Table of Contents

CONSOLIDATED BALANCE SHEETS
PRAXAIR, INC. AND SUBSIDIARIES
(Dollar amounts in millions)

December 31,	2014	2013
Assets		
Cash and cash equivalents	$126	$138
Accounts receivable – net	1,796	1,892
Inventories	551	506
Prepaid and other current assets	366	380
Total Current Assets	2,839	2,916
Property, plant and equipment – net	11,997	12,278
Equity investments	693	702
Goodwill	3,121	3,194
Other intangible assets – net	603	596
Other long-term assets	549	569
Total Assets	$19,802	$20,255
Liabilities and Equity		
Accounts payable	$864	$921
Short-term debt	587	782
Current portion of long-term debt	2	3
Accrued taxes	119	168
Other current liabilities	918	790
Total Current Liabilities	2,490	2,664
Long-term debt	8,669	8,026
Other long-term liabilities	1,176	859
Deferred credits	1,281	1,396
Total Liabilities	13,616	12,945
Commitments and contingencies (Note 17)		
Redeemable noncontrolling interests	176	307
Praxair, Inc. Shareholders' Equity:		
Common stock $0.01 par value, authorized – 800,000,000 shares, issued 2014 and 2013 – 383,230,625 shares	4	4
Additional paid-in capital	3,994	3,970
Retained earnings	11,461	10,528
Accumulated other comprehensive income (loss)	(3,185)	(1,981)
Less: Treasury stock, at cost (2014 – 93,969,017 shares and 2013 – 89,096,761 shares)	(6,651)	(5,912)
Total Praxair, Inc. Shareholders' Equity	5,623	6,609
Noncontrolling interests	387	394
Total Equity	6,010	7,003
Total Liabilities and Equity	$19,802	$20,255

The accompanying Notes on pages 60 to 100 are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS
PRAXAIR, INC. AND SUBSIDIARIES
(Millions of dollars)

Year Ended December 31,	2014	2013	2012
Increase (Decrease) in Cash and Cash Equivalents			
Operations			
Net income – Praxair, Inc.	$1,694	$1,755	$1,692
Noncontrolling interests	52	81	52
Net income (including noncontrolling interests)	$1,746	$1,836	$1,744
Adjustments to reconcile net income to net cash provided by operating activities:			
Venezuela currency devaluation and other charges-net, net of payments	138	23	43
Depreciation and amortization	1,170	1,109	1,001
Deferred income taxes	55	101	258
Share-based compensation	51	70	70
Non-cash charges and other	(116)	(88)	(127)
Working capital			
Accounts receivable	(80)	(84)	(36)
Inventory	(42)	(54)	(18)
Prepaid and other current assets	(20)	(69)	(17)
Payables and accruals	13	107	(34)
Pension contributions	(18)	(52)	(184)
Long-term assets, liabilities and other	(29)	18	52
Net cash provided by operating activities	2,868	2,917	2,752
Investing			
Capital expenditures	(1,689)	(2,020)	(2,180)
Acquisitions, net of cash acquired	(206)	(1,323)	(280)
Divestitures and asset sales	92	106	82
Net cash used for investing activities	(1,803)	(3,237)	(2,378)
Financing			
Short-term debt borrowings (repayments) – net	(193)	149	293
Long-term debt borrowings	1,546	2,659	2,036
Long-term debt repayments	(764)	(1,347)	(1,522)
Issuances of common stock	103	154	164
Purchases of common stock	(862)	(590)	(623)
Cash dividends – Praxair, Inc. shareholders	(759)	(708)	(655)
Excess tax benefit on stock based compensation	31	46	60
Noncontrolling interest transactions and other	(110)	(35)	(56)
Net cash used for financing activities	(1,008)	328	(303)
Effect of exchange rate changes on cash and cash equivalents	(69)	(27)	(4)
Change in cash and cash equivalents	(12)	(19)	67
Cash and cash equivalents, beginning-of-period	138	157	90
Cash and cash equivalents, end-of-period	$126	$138	$157
Supplemental Data			
Income taxes paid	$606	$532	$277
Interest paid, net of capitalized interest (Note 7)	$210	$184	$153

The accompanying Notes on pages 60 to 100 are an integral part of these financial statements.

57

Table of Contents

CONSOLIDATED STATEMENTS OF EQUITY
PRAXAIR, INC. AND SUBSIDIARIES
(Dollar amounts in millions, except per share data, shares in thousands)

	Praxair, Inc. Shareholders' Equity									
	Common Stock					Treasury Stock				
Activity	Shares	Amounts	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss) (Note 7)	Shares	Amounts	Praxair, Inc. Shareholders' Equity	Noncontrolling Interests	Total Equity
Balance, December 31, 2011	382,854	$ 4	$ 3,809	$ 8,510	$ (1,746)	84,324	$ (5,089)	$ 5,488	$ 309	$ 5,797
Net Income				1,692				1,692	34	1,726
Other comprehensive income (loss)					(106)			(106)	2	(104)
Noncontrolling interests:										
Dividends and other capital reductions								—	(48)	(48)
Additions (Reductions)								—	44	44
Reclassification to redeemable noncontrolling interests (Note 14)								—	16	16
Redemption value adjustments (Note 14)				(13)				(13)		(13)
Dividends to Praxair, Inc. common stock ($2.20 per share)				(655)				(655)		(655)
Issuances of common stock:										
For the dividend reinvestment and stock purchase plan	66		7					7		7
For employee savings and incentive plans	153		(60)			(3,298)	208	148		148
Purchases of common stock						5,818	(630)	(630)		(630)
Tax benefit from stock options			63					63		63
Share-based compensation			70					70		70

Balance, December 31, 2012	383,073	$ 4	$ 3,889	$ 9,534	$ (1,852)	86,844	$ (5,511)	$ 6,064	$ 357	$ 6,421
Net Income				1,755				1,755	57	1,812
Other comprehensive income (loss)					(129)			(129)	6	(123)
Noncontrolling interests:										
Dividends and other capital reductions								—	(41)	(41)
Additions (Reductions)								—	15	15
Redemption value adjustments (Note 14)				(53)				(53)		(53)
Dividends to Praxair, Inc. common stock ($2.40 per share)				(708)				(708)		(708)

Table of Contents

Activity	Praxair, Inc. Shareholders' Equity Common Stock Shares	Amounts	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss) (Note 7)	Treasury Stock Shares	Amounts	Praxair, Inc. Shareholders' Equity	Noncontrolling Interests	Total Equity
Issuances of common stock:										
For the dividend reinvestment and stock purchase plan	47		5			(14)	2	7		7
For employee savings and incentive plans	111		(41)			(2,767)	180	139		139
Purchases of common stock						5,034	(583)	(583)		(583)
Tax benefit from stock options			47					47		47
Share-based compensation			70					70		70
Balance, December 31, 2013	383,231	$ 4	$ 3,970	$ 10,528	$ (1,981)	89,097	$ (5,912)	$ 6,609	$ 394	$ 7,003
Net Income				1,694				1,694	40	1,734
Other comprehensive loss					(1,204)			(1,204)	(29)	(1,233)
Noncontrolling interests:										
Dividends and other capital reductions								—	(28)	(28)
Purchases of noncontrolling interests			(24)					(24)	2	(22)
Additions (Reductions)								—	8	8
Redemption value adjustments (Note 14)				(2)				(2)		(2)
Dividends to Praxair, Inc. common stock ($2.60 per share)				(759)				(759)		(759)
Issuances of common stock:										
						(56)	7	7		7

For the dividend reinvestment and stock purchase plan										
For employee savings and incentive plans			(36)			(1,830)	122	86		86
Purchases of common stock						6,758	(868)	(868)		(868)
Tax benefit from stock options			33					33		33
Share-based compensation			51					51		51
Balance, December 31, 2014	383,231	$ 4	$ 3,994	$ 11,461	$ (3,185)	93,969	$ (6,651)	$ 5,623	$ 387	$ 6,010

The accompanying Notes on pages 60 to 100 are an integral part of these financial statements

59

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
PRAXAIR, INC. AND SUBSIDIARIES
NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Operations – Praxair, Inc. and its subsidiaries ("Praxair" or "the company") comprise one of the largest industrial gases companies worldwide, and the largest in North and South America. Praxair produces, sells and distributes atmospheric, process and specialty gases, and high-performance surface coatings to a diverse group of industries including aerospace, chemicals, food and beverage, electronics, energy, healthcare, manufacturing, and metals.
Principles of Consolidation – The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America (" U.S. GAAP") and include the accounts of all significant subsidiaries where control exists and, in limited situations, variable-interest entities where the company is the primary beneficiary. Intercompany transactions and balances are eliminated in consolidation and any significant related-party transactions have been disclosed.
Equity investments generally consist of 20% to 50% owned operations where the company exercises significant influence, but does not have control. Equity income from equity investments in corporations is reported on an after-tax basis. Pre-tax income from equity investments that are partnerships or limited-liability corporations ("LLC") is included in other income (expenses) – net with related taxes included in Income taxes. Equity investments are reviewed for impairment whenever events or circumstances reflect that an impairment loss may have incurred. Operations less than 20% owned, where the company does not exercise significant influence, are generally carried at cost.
Changes in ownership interest that result either in consolidation or deconsolidation of an investment are recorded at fair value through earnings, including the retained ownership interest, while changes that do not result in either consolidation or deconsolidation of a subsidiary are treated as equity transactions.
Use of Estimates – The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. While actual results could differ, management believes such estimates to be reasonable.
Revenue Recognition – Product sales represent approximately 89% of consolidated sales while all other sources of revenue are approximately 11% in the aggregate. Revenue is recognized when a firm sales agreement exists, collectability of a fixed or determinable sales price is reasonably assured, and when title and risks of ownership transfer to the customer for product sales or, in the case of other revenues when obligations are satisfied or services are performed. Sales returns and allowances are not a normal practice in the industry and are not significant.
A small portion of the company’s revenues relate to long-term construction contracts and are generally recognized using the percentage-of-completion method. Under this method, revenues from sales of major equipment, such as large air-separation facilities, are recognized based primarily on cost incurred to date compared with total estimated cost. Changes to total estimated cost and anticipated losses, if any, are recognized in the period determined.
For contracts that contain multiple products and/or services, amounts assigned to each component are based on its objectively determined fair value, such as the sales price for the component when it is sold separately or competitor prices for similar components.
Certain of the company’s facilities that are built to provide product to a specific customer are required to be accounted for as leases. The associated revenue streams are classified as rental revenue and are not significant.
Amounts billed for shipping and handling fees are recorded as sales, generally on FOB destination terms, and costs incurred for shipping and handling are recorded as cost of sales.
Amounts billed for sales and use taxes, value-added taxes, and certain excise and other specific transactional taxes imposed on revenue producing transactions are presented on a net basis and are not included in sales in the consolidated statement of income.
Cash Equivalents – Cash equivalents are considered to be highly liquid securities with original maturities of three months or less.
Inventories – Inventories are stated at the lower of cost or market. Cost is determined using the average-cost method. Effective July 1, 2014, the Company changed its method of accounting for all remaining U.S. operations that were

using the last-in, first-out (“LIFO”) method to the average-cost method. See Note 7.

Property, Plant and Equipment – Net – Property, plant and equipment are carried at cost, net of accumulated depreciation. The company capitalizes interest as part of the cost of constructing major facilities (see Note 7). Depreciation is calculated on the straight-line method based on the estimated useful lives of the assets, which range from 3 years to 40 years (see Note 8). Praxair uses accelerated depreciation methods for tax purposes where appropriate. Maintenance of property, plant and equipment is generally expensed as incurred.

The company performs a test for impairment whenever events or changes in circumstances indicate that the carrying amount of an individual asset or asset group may not be recoverable. Should projected undiscounted future cash flows be less than the carrying amount of the asset or asset group, an impairment charge reducing the carrying amount to fair value is required. Fair value is determined based on the most appropriate valuation technique, including discounted cash flows.

Asset-Retirement Obligations – An asset-retirement obligation is recognized in the period in which sufficient information exists to determine the fair value of the liability with a corresponding increase to the carrying amount of the related property, plant and equipment which is then depreciated over its useful life. The liability is initially measured at discounted fair value and then accretion expense is recorded in each subsequent period. The company's asset-retirement obligations are primarily associated with its on-site long-term supply arrangements where the company has built a facility on land leased from the customer and is obligated to remove the facility at the end of the contract term. The company's asset-retirement obligations are not material to its consolidated financial statements.

Foreign Currency Translation – For most foreign operations, the local currency is the functional currency and translation gains and losses are reported as part of the accumulated other comprehensive income (loss) component of equity as a cumulative translation adjustment (see Note 7). For Venezuelan operations, the U.S. dollar is the functional currency and translation gains and losses are included in other income (expenses) – net.

Financial Instruments – Praxair enters into various derivative financial instruments to manage its exposure to fluctuating interest and currency exchange rates and energy costs. Such instruments primarily include interest-rate swap and treasury rate lock agreements; currency-swap agreements; forward contracts; currency options; and commodity-swap agreements. These instruments are not entered into for trading purposes. Praxair only uses commonly traded and non-leveraged instruments.

There are three types of derivatives the company enters into: (i) those relating to fair-value exposures, (ii) those relating to cash-flow exposures, and (iii) those relating to foreign currency net investment exposures. Fair-value exposures relate to recognized assets or liabilities, and firm commitments; cash-flow exposures relate to the variability of future cash flows associated with recognized assets or liabilities, or forecasted transactions; and net investment exposures relate to the impact of foreign currency exchange rate changes on the carrying value of net assets denominated in foreign currencies.

When a derivative is executed and hedge accounting is appropriate, it is designated as either a fair-value hedge, cash-flow hedge, or a net investment hedge. Currently, Praxair designates all interest-rate and treasury rate locks as hedges for accounting purposes; however, currency contracts are generally not designated as hedges for accounting purposes unless they are related to forecasted transactions. Whether designated as hedges for accounting purposes or not, all derivatives are linked to an appropriate underlying exposure. On an ongoing basis, the company assesses the hedge effectiveness of all derivatives designated as hedges for accounting purposes to determine if they continue to be highly effective in offsetting changes in fair values or cash flows of the underlying hedged items. If it is determined that the hedge is not highly effective, then hedge accounting will be discontinued prospectively.

Changes in the fair value of derivatives designated as fair-value hedges are recognized in earnings as an offset to the change in the fair values of the underlying exposures being hedged. The changes in fair value of derivatives that are designated as cash-flow hedges are deferred in accumulated other comprehensive income (loss) and are reclassified to earnings as the underlying hedged transaction affects earnings. Any ineffectiveness is recognized in earnings immediately. Hedges of net investments in foreign subsidiaries are recognized in the cumulative translation adjustment component of accumulated other comprehensive income (loss) on the consolidated balance sheets to offset translation gains and losses associated with the hedged net investment. Derivatives that are entered into for risk-management purposes and are not designated as hedges (primarily related to anticipated net income and currency derivatives other than for firm commitments) are recorded at their fair market values and recognized in current earnings.

See Note 12 for additional information relating to financial instruments.

Goodwill – Acquisitions are accounted for using the acquisition method which requires allocation of the purchase price to assets acquired and liabilities assumed based on estimated fair values. Any excess of the purchase price over the fair value of the assets and liabilities acquired is recorded as goodwill. Allocations of the purchase price are based on preliminary estimates and assumptions at the date of acquisition and are subject to revision based on final information received, including appraisals and other analyses which support underlying estimates.

The company performs a goodwill impairment test annually in the second quarter or more frequently if events or circumstances indicate that an impairment loss may have been incurred. The applicable guidance allows an entity to first assess qualitative factors to determine if it is more likely than not that the fair value of a reporting unit is less than carrying value. If it is determined that it is more likely than not that the fair value of a reporting unit is less than carrying value then the company will estimate and compare the fair value of its reporting units to their carrying value, including goodwill. Reporting units are determined based on one level below the operating segment level. As applicable, fair value is determined through the use of projected future cash flows, multiples of earnings and sales and other factors. Such analysis requires the use of certain market assumptions and discount factors, which are subjective in nature.

See Note 9 for additional information relating to goodwill.

Other Intangible Assets – Customer and license/use agreements, non-compete agreements and patents and other intangibles are amortized over the estimated period of benefit. The determination of the estimated period of benefit will be dependent upon the use and underlying characteristics of the intangible asset. Praxair evaluates the recoverability of its intangible assets subject to amortization when facts and circumstances indicate that the carrying value of the asset may not be recoverable. If the carrying value is not recoverable, impairment is measured as the amount by which the carrying value exceeds its estimated fair value. Fair value is generally estimated based on either appraised value or other valuation techniques.

See Note 10 for additional information relating to other intangible assets.

Income Taxes – Deferred income taxes are recorded for the temporary differences between the financial statement and tax bases of assets and liabilities using currently enacted tax rates. Valuation allowances are established against deferred tax assets whenever circumstances indicate that it is more likely than not that such assets will not be realized in future periods.

Under the guidance for accounting for uncertainty in income taxes, the company can recognize the benefit of an income tax position only if it is more likely than not (greater than 50%) that the tax position will be sustained upon tax examination, based solely on the technical merits of the tax position. Otherwise, no benefit can be recognized. The tax benefits recognized are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Additionally, the company accrues interest and related penalties, if applicable, on all tax exposures for which reserves have been established consistent with jurisdictional tax laws. Interest and penalties are classified as income tax expense in the financial statements.

See Note 5 for additional information relating to income taxes.

Retirement Benefits – Most Praxair employees participate in a form of defined benefit or contribution retirement plan, and additionally certain employees are eligible to participate in various post-employment health care and life insurance benefit plans. The cost of contribution plans is recognized in the year earned while the cost of other plans is recognized over the employees' expected service period to the company, all in accordance with the applicable accounting standards. The funded status of the plans is recorded as an asset or liability in the consolidated balance sheets. Funding of retirement benefits varies and is in accordance with local laws and practices.

See Note 16 for additional information relating to retirement programs.

Share-based Compensation– The company has granted share-based awards which consist of stock options, restricted stock and performance-based stock. Share-based compensation expense is generally recognized on a straight-line basis over the stated vesting period. For stock awards granted to full-retirement-eligible employees, compensation expense is recognized over the period from the grant date to the date retirement eligibility is achieved. For performance-based awards, compensation expense is recognized only if it is probable that the performance condition will be achieved.

See Note 15 for additional disclosures relating to share-based compensation.

Recently Issued Accounting Standards

Accounting Standards Implemented in 2014

The following standards were effective for Praxair in 2014 and their adoption did not have a significant impact on the condensed consolidated financial statements:

- Accounting for Cumulative Translation Adjustment - In March 2013, the Financial Accounting Standards Board ("FASB") issued updated guidance on the release of the cumulative translation adjustment into net income when a parent either sells a part or all of its investment in a foreign entity, or as a result of acquisitions achieved in stages. The adoption of this guidance did not have a significant impact on the condensed consolidated financial statements.

Table of Contents

- Presentation of Unrecognized Tax Benefits - In July 2013, the FASB issued updated guidance on the presentation of unrecognized tax benefits. The new guidance requires an entity to present certain unrecognized tax benefits, or a portion thereof, as a reduction to the related deferred tax asset, primarily for loss and tax credit carryforwards. The adoption of this guidance did not have a significant impact on the condensed consolidated financial statements.

Accounting Standards to Be Implemented

- Reporting Discontinued Operations – In April 2014, the FASB issued updated guidance on the reporting and disclosures of discontinued operations. The new guidance requires that the disposal of a component of an entity be reported as discontinued operations only if the action represents a strategic shift that will have a major effect on an entity's operations and financial results, and would require expanded disclosures. Praxair does not expect this requirement to have a significant impact on the consolidated financial statements. This guidance will be effective for Praxair beginning in the first quarter of 2015.
- Revenue Recognition – In May 2014, the FASB issued updated guidance on the reporting and disclosure of revenue. The new guidance requires the evaluation of contracts with customers to determine the recognition of revenue when or as the entity satisfies a performance obligation, and would require expanded disclosures. This guidance will be effective for Praxair beginning in the first quarter 2017 and can be adopted either retrospectively or as a cumulative-effect adjustment as of the date of adoption. Early adoption is not permitted. Praxair is currently evaluating the new guidance and the transition options and will provide updates on the expected impact to Praxair in future filings, as determined.
- Accounting for Share-based Compensation - In June 2014, the FASB issued updated guidance on the accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. Praxair does not expect this requirement to have a significant impact on the consolidated financial statements. This guidance will be effective for Praxair beginning in the first quarter 2016, with early adoption optional.

Reclassifications – Certain prior years' amounts have been reclassified to conform to the current year's presentation.

NOTE 2. VENEZUELA CURRENCY DEVALUATION AND OTHER CHARGES – NET

2014 Charges

Venezuela Currency Devaluation

In recent years, exchange control and other regulations in Venezuela have restricted the Company's operations in Venezuela. During 2014, the Venezuelan government introduced a new exchange control market-based mechanism (referred to as "SICAD II") which allows companies to apply for the conversion of VEF to the U.S. dollar. At December 31, 2014 the SICAD II rate was 50 VEF per U.S. Dollar versus the official rate of 6.3 (a devaluation of about 88%). After considerable analysis, Praxair concluded that the SICAD II rate more accurately reflects the economic reality of its business in Venezuela versus the official exchange rate. Currently, there is a lack of exchangeability between the Venezuelan bolivar fuerte ("VEF") and the U.S. dollar.

As a result, effective December 31, 2014 Praxair changed the exchange rate used to translate the monetary assets and liabilities of its Venezuelan subsidiary to the SICAD II rate of 50 VEF per U.S. Dollar. Also, the Company evaluated the carrying value of its non-monetary assets for impairment and lower of cost or market adjustments considering the new SICAD II rate. As a result, Praxair recorded a pre-tax charge of $131 million ($131 million after-tax, or $0.45 per diluted share) in the Company's consolidated statement of income for the year ended December 31, 2014. This charge includes $68 million related to translation of monetary assets and liabilities to the SICAD II rate and $63 million related primarily to long-lived asset impairments. As a result, Praxair's net asset position in Venezuela at December 31, 2014 was immaterial.

Pension Settlement Charge

During the fourth quarter of 2014, Praxair offered certain former employees who participate in either of the two U.S. qualified defined benefit pension plans, the option to receive a one-time lump sum benefit payment of their vested pension benefits under the plans rather than receiving lifetime annuity payments of these benefits. As a result, a pension settlement of the related pension obligation was triggered for one of the U.S. qualified defined benefit pension plans due to the

63

Table of Contents

acceptance rate of the lump sum payment option. Accordingly, Praxair recorded a pension settlement charge of $7 million ($5 million after-tax, or $0.02 per diluted share) in the fourth quarter of 2014 (refer to Note 16).

2013 Charges
Venezuela Currency Devaluation

On February 8, 2013, Venezuela announced a devaluation of the Venezuelan Bolivar from 4.30 to 6.30 (a 32% devaluation), effective on February 13, 2013. In the first quarter 2013 Praxair recorded a $23 million pre-tax charge ($23 million after-tax or $0.08 per diluted share) due primarily to the remeasurement of the local Venezuelan balance sheet to reflect the new official 6.30 exchange rate.

Pension Settlement Charge

In 2012, a number of senior managers retired. These retirees are covered by the U.S. supplemental pension plan which provides for a lump sum benefit payment option. Under certain circumstances, such lump sum payments must be accounted for as a settlement of the related pension obligation, but only when paid. Accordingly, Praxair recorded a settlement charge related to net unrecognized actuarial losses of $9 million ($6 million after-tax or $0.02 per diluted share) in the third quarter of 2013, when the cash payments were made to the retirees (refer to Note 16).

2012 Charges
Cost Reduction Program
In the third quarter of 2012, Praxair recorded pre-tax charges totaling $56 million ($38 million after taxes of $16 million and noncontrolling interests of $2 million or $0.12 per diluted share), relating to severance and business restructuring actions primarily in Europe within the industrial gases and surface technologies businesses. The cost reduction program was initiated primarily in response to the continuing economic downturn in Europe.
The following is a summary of the charges by reportable segment:

(Millions of dollars)	Severance Costs	Costs Associated with Exit or Disposal Activities	Total Cost Reduction Program
North America	$1	$—	$1
Europe	28	8	36
South America	1	—	1
Asia	2	—	2
Surface Technologies	11	5	16
Total	$43	$13	$56

The severance costs of $43 million are for the termination of approximately 410 employees, primarily in Europe (industrial gases and surface technologies). These actions reflected the continued business slow-down in Europe and resulted from a decision to eliminate and/or restructure operations and product lines. The actions are completed as of December 31, 2014 and the remaining liability associated with those actions is expected to be paid during the next twelve months.
The costs associated with exit or disposal activities of $13 million include asset write-downs and other costs associated with a decision to eliminate and/or restructure operations and product lines. In Europe the costs primarily relate to the elimination and consolidation of operations in Spain. In Surface Technologies, the costs relate to the consolidation/rationalization of operations and product lines, primarily in Germany and Italy.

64

Table of Contents

The following table summarizes the activities related to the company's cost reduction program through December 31, 2014:

(Millions of dollars)	Severance Costs	Costs Associated with Exit or Disposal Activities	Total Cost Reduction Program
Cost reduction program charges in the third quarter of 2012	$43	$13	$56
Less: Cash payments	(13)	—	(13)
Less: Non-cash asset write-offs	—	(9)	(9)
Balance December 31, 2012	$30	$4	$34
Less: Cash payments	(16)	(4)	(20)
Foreign currency translation	1	—	1
Balance, December 31, 2013	$15	$—	$15
Less: Cash payments	(4)	—	(4)
Foreign currency translation and other	(4)	—	(4)
Balance, December 31, 2014	$7	$—	$7

Pension Settlement Charge

During 2011, a number of senior managers retired. These retirees are covered by the U.S. supplemental pension plan which provides for a lump sum benefit payment option. Under certain circumstances, such lump sum payments must be accounted for as a settlement of the related pension obligation, but only when paid. Accordingly, Praxair recorded a settlement charge related to net unrecognized actuarial losses of $9 million ($6 million after-tax or $0.02 per diluted share) in the third quarter of 2012 when the cash payments were made (refer to Note 16).

Classification in the consolidated financial statements

The pre-tax net charges or benefits for each year are shown in operating profit in a separate line item on the consolidated statement of income. In the balance sheets, asset write-offs are recorded as a reduction to the carrying value of the related assets and unpaid amounts are recorded as short-term liabilities (See Note 7). On the consolidated statement of cash flows, the pre-tax impact of the net charges or benefits, net of cash payments, is shown as an adjustment to reconcile net income to net cash provided by operating activities. In Note 18 - Segment Information, Praxair excluded these items in its management definition of segment operating profit; a reconciliation of segment operating profit to consolidated operating profit is shown within the operating profit table.

NOTE 3. ACQUISITIONS

The results of operations of these businesses have been included in Praxair’s consolidated statements of income since their respective dates of acquisition. Proforma financial statements for the following acquisitions have not been provided as the acquisitions are not material individually or in the aggregate.

2014 Acquisitions

During the year-ended December 31, 2014 Praxair had acquisitions totaling $206 million. These acquisitions consisted primarily of an industrial gases business in Italy, packaged gas businesses in North and South America and an acquisition of a controlling interest of an equity investment in Asia. These transactions resulted in goodwill and other intangible assets of $86 million and $66 million, respectively (see Note 9 and Note 10). In each case, the allocation of the purchase price is based on preliminary estimates and assumptions, and are subject to revision based on final information received, including appraisals and other analyses that support the underlying estimates. Adjustments, if any, are not expected to be material.

2013 Acquisitions

$NuCO_2$

On March 1, 2013 Praxair acquired 100% of $NuCO_2$ Inc. ("$NuCO_2$") for $1,095 million. $NuCO_2$ is the leading national provider of beverage carbonation solutions in the United States to the restaurant and hospitality industries with 162,000 customer locations and 900 employees, and with 2012 sales of approximately $230 million. The $NuCO_2$ micro-

65

bulk beverage carbonation solution is the service model of choice for quick service restaurants and convenience stores offering fountain beverages and represents an extension of Praxair's core industrial gas business.

The acquisition of $NuCO_2$ was accounted for as a business combination. Following the acquisition date, 100% of $NuCO_2$'s results were consolidated in the North America business segment. Praxair's 2013 consolidated income statement includes sales of $208 million related to $NuCO_2$. Pro forma results for 2013 and 2012 have not been included as the impact of the acquisition is not material to the consolidated statements of income.

The following table summarizes the fair value of identifiable assets acquired and liabilities assumed in the acquisition of $NuCO_2$ as of the acquisition date. Purchase accounting has been finalized and adjustments made subsequent to the acquisition date were not material.

(Millions of dollars)	March 1, 2013	
Trade receivables, net	$17	
Property, plant and equipment	199	
Intangible assets	374	
Deferred income taxes	(85	)
Other assets and (liabilities)	(28	)
Goodwill	618	
Purchase price	$1,095	

The identifiable intangible assets primarily consist of customer relationships that will be amortized over their estimated useful life of 25 years. The deferred income taxes relate primarily to property, plant and equipment, intangibles and operating loss carryforwards. The goodwill resulting from the acquisition is attributable to (i) expected growth from market penetration into the quick service restaurants, convenience stores and themed restaurant chains in the United States and select international markets as we leverage Praxair's customer and distribution networks worldwide, and (ii) cost synergies related to the procurement of raw materials, distribution-related expenses and administrative costs as Praxair integrates and rationalizes administration tasks and leverages its purchasing scale. The goodwill is not expected to be deductible for income tax purposes.

Other Acquisitions

On May 29, 2013 Praxair acquired Dominion Technology Gases Investment Limited (“Dominion”), a leading global supplier of diving, welding, industrial, laboratory and calibration gases and associated equipment to the offshore oil and gas industry based in Aberdeen, Scotland. Dominion provides products and services to the expanding global offshore oil and gas market.

On June 3, 2013 Praxair acquired Volgograd Oxygen Factory (“VOF”), the largest independent industrial gas business in southern Russia, expanding Praxair's production and distribution capabilities in the Volgograd region. Additionally, during 2013, Praxair acquired several smaller independent packaged gas distributors in the United States, an industrial gas business in Italy and a customer contract with operating assets in China.

The aggregate purchase price for these acquisitions was $228 million and resulted in the recognition of $194 million of intangible assets, including $101 million of goodwill and $93 million of other intangible assets, which will be amortized over their estimated useful life.

2012 Acquisitions
In November 2012, Praxair acquired Acetylene Oxygen Company ("AOC"), one of the top ten independent gas and welding products distributors in the U.S, which operates throughout central and southern Texas. The acquisition of

AOC allows Praxair to further expand its packaged gases presence in this region. Also, during the twelve months ended December 31, 2012, Praxair completed a number of other smaller acquisitions, primarily North American packaged gas distributors, including PortaGas, located in Houston, Texas. The aggregate purchase price for all seventeen acquisitions was $280 million, and resulted in recognition of $122 million of goodwill.

Table of Contents

NOTE 4. LEASES

In the normal course of its business, Praxair enters into various leases as the lessee, primarily involving manufacturing and distribution equipment and office space. Total lease and rental expenses under operating leases were $148 million in 2014, $140 million in 2013 and $120 million in 2012. Capital leases are not significant and are included in property, plant and equipment – net. Related obligations are included in debt.

At December 31, 2014, minimum payments due under operating leases are as follows:

(Millions of dollars)	
2015	$122
2016	109
2017	91
2018	75
2019	60
Thereafter	60
	$517

The present value of these future lease payments under operating leases is approximately $439 million.

Praxair's leases where it is the lessor are not material.

NOTE 5. INCOME TAXES

Pre-tax income applicable to U.S. and foreign operations is as follows:

(Millions of dollars) Year Ended December 31,	2014	2013	2012
United States	$1,004	$890	$880
Foreign	1,391	1,557	1,416
Total income before income taxes	$2,395	$2,447	$2,296

67

Table of Contents

The following is an analysis of the provision for income taxes:

(Millions of dollars) Year Ended December 31,	2014	2013	2012
Current tax expense			
U.S. federal	$291	$94	$14
State and local	35	27	20
Foreign	310	427	294
	636	548	328
Deferred tax expense			
U.S. federal	14	164	198
State and local	12	8	17
Foreign	29	(71)	43
	55	101	258
Total income taxes	$691	$649	$586

An analysis of the difference between the provision for income taxes and the amount computed by applying the U.S. statutory income tax rate to pre-tax income follows:

(Dollar amounts in millions) Year Ended December 31,	2014		2013		2012	
U.S. statutory income tax rate	$838	35.0 %	$856	35.0 %	$804	35.0 %
State and local taxes – net of federal benefit	31	1.3 %	23	1.0 %	24	1.0 %
U.S. tax credits and deductions (a)	(37)	(1.5)%	(23)	(1.0)%	(22)	(1.0)%
Foreign tax differentials (b)	(186)	(7.8)%	(158)	(6.4)%	(159)	(6.9)%
Venezuela currency devaluation (c)	46	1.9 %	8	0.3 %	—	— %
Income tax benefit from realignment of Italian legal structure (d)	—	— %	(40)	(1.6)%	—	— %
Income tax benefit from liquidation of subsidiary (e)	—	— %	—	— %	(55)	(2.4)%
Other – net	(1)	— %	(17)	(0.8)%	(6)	(0.2)%
Provision for income taxes	$691	28.9 %	$649	26.5 %	$586	25.5 %

(a) U.S. tax credits and deductions relate to manufacturing deductions and to the research and experimentation tax credit.

(b) Primarily related to differences between the U.S. tax rate of 35% and the statutory tax rate in the countries where Praxair operates. 2014 includes $56 million of tax benefits related to a reduction of uncertain tax positions as a result of a lapse of statute of limitations. Other permanent items and tax rate changes were not significant.

(c) Impact related to non-deductible Venezuela currency devaluations in 2014 and 2013 (see Note 2).

(d) In December of 2013, Praxair's Italian legal structure was realigned. As a result of the new structure, an income tax benefit of $40 million ($24 million net of noncontrolling interests) was recorded. The benefit is recorded as $56 million in foreign current tax expense and $(96) million included in federal deferred tax expense.

(e) In 2011 Praxair requested a pre-filing agreement ("PFA") with the U.S. Internal Revenue Service ("IRS") related to a loss on a liquidated subsidiary resulting from the divestiture of the U.S. Homecare Business. During the third quarter of 2012, the IRS approved the PFA resulting in a net income tax benefit of $(55) million. The benefit is recorded in U.S. current federal tax expense.

Net deferred tax liabilities included in the consolidated balance sheet are comprised of the following:

(Millions of dollars) December 31,	2014	2013
Deferred tax liabilities		
Fixed assets	$1,402	$1,374
Exchange gains	85	61
Goodwill	144	127
Other intangible assets	125	112
Other	146	133
	$1,902	$1,807
Deferred tax assets		
Carryforwards	$333	$323
Benefit plans and related (a)	389	285
Inventory	18	20
Accruals and other (b)	357	312
	$1,097	$940
Less: Valuation allowances (c)	(106)	(85)
	$991	$855
Net deferred tax liabilities	$911	$952
Recorded in the consolidated balance sheets as (See Note 7):		
Prepaid and other current assets	$189	$181
Other long-term assets	98	72
Deferred credits	1,198	1,205
	$911	$952

(a) Includes deferred taxes of $342 million and $247 million in 2014 and 2013, respectively, related to pension / OPEB funded status (see Notes 7 and 16).

(b) Includes $179 million and $112 million in 2014 and 2013, respectively, related to research and development costs and $67 million and $70 million in 2014 and 2013, respectively, related to goodwill.

(c) Summary of valuation allowances relating to deferred tax assets follows (millions of dollars):

	2014	2013	2012
Balance, January 1,	$(85)	$(86)	$(107)
Income tax (charge) benefit	(20)	1	9
Translation adjustments	6	—	—
Other, including write-offs	(7)	—	12
Balance, December 31,	$(106)	$(85)	$(86)

Praxair evaluates deferred tax assets quarterly to ensure that estimated future taxable income will be sufficient in character (e.g., capital gain versus ordinary income treatment), amount and timing to result in their recovery. After considering the positive and negative evidence, a valuation allowance is established to reduce the assets to their realizable value when management determines that it is more likely than not (i.e., greater than 50% likelihood) that a deferred tax asset will not be realized. Considerable judgment is required in establishing deferred tax valuation allowances. At December 31, 2014, Praxair had $333 million of deferred tax assets relating to net operating losses ("NOLs") and tax credits and $106 million of valuation allowances. These deferred tax assets include $157 million relating to NOLs of which $56 million are in the United States primarily related to Praxair's $NuCo_2$ acquisition in 2013, and $101 million are in Brazil. The U.S. NOLs expire through 2032 and the Brazil NOLs have no expiration. These NOLs have no valuation allowances. The deferred tax assets as of December 31, 2014 also include $73 million relating to U.S. foreign tax credits

which expire in 2021 and have a $56 million valuation allowance. The utilization of the U.S. foreign tax credits is dependent on many factors including U.S. interest expense, future U.S. investment, foreign sales and earnings growth, foreign currency exchange rates, and acquisitions and dispositions. Management's assessment and judgment are highly dependent on these variables and any significant changes to any one of them can substantially impact the amount of foreign tax credit utilization over the ten-year carryforward period.

The remaining deferred tax assets of $103 million relate to U.S. state ($67 million) and other foreign ($36 million) NOLs and credit carryforwards, which expire through 2033, have valuation allowances totaling $50 million. These valuation allowances relate to certain foreign and U.S. state NOLs and are required because management has determined, based on financial projections and available tax strategies, that it is unlikely that the NOLs will be utilized before they expire. If events or circumstances change, valuation allowances are adjusted at that time resulting in an income tax benefit or charge.

A provision has not been made for additional U.S. federal or foreign taxes at December 31, 2014 on $10.4 billion of undistributed earnings of foreign subsidiaries because Praxair intends to reinvest these funds indefinitely to support foreign growth opportunities. It is not practicable to estimate the unrecognized deferred tax liability on these undistributed earnings. These earnings could become subject to additional tax if they are remitted as dividends, loaned to Praxair in the U.S., or upon sale of the subsidiary's stock.

Uncertain Tax Positions

Unrecognized income tax benefits represent income tax positions taken on income tax returns but not yet recognized in the consolidated financial statements. The company has unrecognized income tax benefits totaling $71 million, $121 million and $142 million as of December 31, 2014, 2013 and 2012, respectively. If recognized, essentially all of the unrecognized tax benefits and related interest and penalties would be recorded as a benefit to income tax expense on the consolidated statement of income.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

(Millions of dollars)	2014	2013	2012
Unrecognized income tax benefits, January 1	$121	$142	$163
Additions for tax positions of prior years	13	8	12
Reductions for tax positions of prior years	(2)	(24)	(17)
Additions for current year tax positions	3	10	—
Reductions for settlements with taxing authorities (a)	(3)	(2)	(1)
Reductions as a result of a lapse of an applicable statute of limitations (b)	(56)	(1)	(9)
Foreign currency translation and other	(5)	(12)	(6)
Unrecognized income tax benefits, December 31	$71	$121	$142

(a) Settlements are uncertain tax positions that were effectively settled with the taxing authorities, including positions where the company has agreed to amend its tax returns to eliminate the uncertainty.

(b) See note (b) to the effective tax rate reconciliation.

Praxair classifies interest income and expense related to income taxes as tax expense in the consolidated statement of income. Praxair recognized net interest income of $3 million in 2014 related to the reversal of uncertain tax positions; net interest income of $11 million in 2013 primarily related to refunds received from taxing authorities; and net interest expense of $1 million in 2012. Praxair had $8 million and $12 million of accrued interest and penalties as of December 31, 2014 and December 31, 2013, respectively which were recorded in other long-term liabilities in the consolidated balance sheets (see Note 7).

Table of Contents

As of December 31, 2014, the company remained subject to examination in the following major tax jurisdictions for the tax years as indicated below:

Major tax jurisdictions	Open Years
North America	
United States	2011 through 2014
Canada	2007 through 2014
Mexico	2009 through 2014
Europe	
Germany	2008 through 2014
Italy	2010 through 2014
Spain	2004 through 2014
South America	
Brazil	2003 through 2014
Asia	
China	2009 through 2014
India	2006 through 2014
Korea	2008 through 2014
Thailand	2008 through 2014

The company is currently under audit in a number of tax jurisdictions. As a result, it is reasonably possible that some of these audits will conclude or reach the stage where a change in unrecognized income tax benefits may occur within the next twelve months. At that time, the company will record any adjustment to income tax expense as required. In 2014, settlements were not material to the consolidated financial statements. The company is also subject to income taxes in many hundreds of state and local taxing jurisdictions that are open to tax examinations.

NOTE 6. EARNINGS PER SHARE – PRAXAIR, INC. SHAREHOLDERS

Basic earnings per share is computed by dividing Net income – Praxair, Inc. for the period by the weighted average number of Praxair common shares outstanding. Diluted earnings per share is computed by dividing Net income – Praxair, Inc. for the period by the weighted average number of Praxair common shares outstanding and dilutive common stock equivalents, as follows:

	2014	2013	2012
Numerator (Millions of dollars)			
Net income – Praxair, Inc.	$1,694	$1,755	$1,692
Denominator (Thousands of shares)			
Weighted average shares outstanding	291,987	294,994	297,746
Shares earned and issuable under compensation plans	507	529	570
Weighted average shares used in basic earnings per share	292,494	295,523	298,316
Effect of dilutive securities			
Stock options and awards	3,114	3,442	3,529
Weighted average shares used in diluted earnings per share	295,608	298,965	301,845
Basic Earnings Per Common Share	$5.79	$5.94	$5.67
Diluted Earnings Per Common Share	$5.73	$5.87	$5.61

There were no antidilutive shares for the years ended December 31, 2014 and 2013. There were 1,589,235 antidilutive shares for the year ended December 31, 2012.

Table of Contents

NOTE 7. SUPPLEMENTAL INFORMATION

Income Statement

(Millions of dollars)

Year Ended December 31,	2014	2013	2012
Selling, General and Administrative			
Selling	$572	$567	$547
General and administrative	736	782	723
	$1,308	$1,349	$1,270

Year Ended December 31,	2014	2013	2012
Depreciation and Amortization			
Depreciation	$1,123	$1,068	$980
Amortization of other intangibles (Note 10)	47	41	21
	$1,170	$1,109	$1,001

Year Ended December 31,	2014	2013	2012
Other Income (Expenses) – Net			
Currency related net gains (losses)	$1	$3	$(9)
Partnership income	16	7	10
Net legal settlements	—	10	24
Severance expense	(22)	(14)	(17)
Business divestitures and asset gains (losses) – net	36	43	49
Other – net	(22)	(17)	(14)
	$9	$32	$43

Year Ended December 31,	2014	2013	2012
Interest Expense – Net			
Interest incurred on debt	$215	$233	$226
Interest capitalized	(38)	(69)	(70)
Amortization of swap termination costs (Note 12)	—	(4)	(15)
Bond redemption (a)	36	18	—
	$213	$178	$141

Year Ended December 31,	2014	2013	2012
Income Attributable to Noncontrolling Interests			
Noncontrolling interests' operations	$40	$41	$34
Income tax benefit in Italy (Note 5)	—	16	—
Redeemable noncontrolling interests' operations (Note 14)	12	24	18
	$52	$81	$52

Table of Contents

Balance Sheet
(Millions of dollars)

December 31,	2014	2013
Accounts Receivable		
Trade	$1,746	$1,815
Other	152	175
	1,898	1,990
Less: allowance for doubtful accounts (b)	(102)	(98)
	$1,796	$1,892

December 31,	2014	2013
Inventories (c)		
Raw materials and supplies	$200	$167
Work in process	52	58
Finished goods	299	281
	$551	$506

December 31,	2014	2013
Prepaid and Other Current Assets		
Deferred income taxes (Note 5)	$189	$181
Prepaid (d)	116	145
Other	61	54
	$366	$380

December 31,	2014	2013
Other Long-term Assets		
Pension assets (Note 16)	$35	$42
Insurance contracts (e)	73	73
Long-term receivables, net (f)	43	36
Deposits	64	62
Investments carried at cost	8	7
Deferred charges	114	133
Deferred income taxes (Note 5)	98	72
Other	114	144
	$549	$569

73

Table of Contents

December 31,	2014	2013
Other Current Liabilities		
Accrued expenses	$296	$291
Payroll	177	184
Cost reduction program (Note 2)	7	15
Pension and postretirement (Note 16)	39	33
Interest payable	69	62
Employee benefit accrual	22	20
Severance	14	13
Insurance reserves	9	11
Other	285	161
	$918	$790

December 31,	2014	2013
Other Long-term Liabilities		
Pension and postretirement (Note 16)	$777	$498
Tax liabilities for uncertain tax positions	57	55
Interest and penalties for uncertain tax positions (Note 5)	8	12
Insurance reserves	23	22
Other	311	272
	$1,176	$859

December 31,	2014	2013
Deferred Credits		
Deferred income taxes (Note 5)	$1,198	$1,205
Other	83	191
	$1,281	$1,396

December 31,	2014	2013
Accumulated Other Comprehensive Income (Loss)		
Cumulative translation adjustment (includes $64 million and $60 million tax charges in 2014 and 2013, respectively)		
North America (g)	$(553)	$(315)
South America (g)	(1,510)	(1,179)
Europe (g)	(432)	(63)
Asia	(49)	21
Surface Technologies	(7)	28
	(2,551)	(1,508)
Derivatives – net of taxes	(1)	(4)
Pension/OPEB funded status obligation (net of $342 million and $247 million tax benefits in 2014 and 2013, respectively) (Note 16)	(633)	(469)
	$(3,185)	$(1,981)

(a) In December 2014, Praxair redeemed $400 million of 5.375% notes due November 2016 for $434 million resulting in a $36 million charge ($22 million after-tax, or $0.07 per diluted share). In December 2013, Praxair redeemed $400 million of 5.25% notes due November 2014 for $418 million resulting in an $18 million charge ($12 million after-tax, or $0.04 per diluted share).

(b) Provisions to the allowance for doubtful accounts were $39 million, $38 million, and $29 million in 2014, 2013, and 2012, respectively. The allowance activity in each period related primarily to write-offs of uncollectible amounts, net of recoveries and currency movements.

(c) Effective July 1, 2014, Praxair changed its method of accounting for all remaining U.S. operations that were using the last-in, first-out ("LIFO") method to the average-cost method, primarily raw materials. Prior to this change, approximately 6% of consolidated inventories were accounted for under the LIFO method. Praxair applied this change as a cumulative effect adjustment in the third quarter 2014 and did not restate prior periods because the impact was not material. The accounting change increased inventories by $9 million at July 1, 2014. The Company believes the change is preferable because it will better reflect the impact of current costs in both the consolidated balance sheets and consolidated statements of income. Had the Company not changed its accounting method, reported inventory amounts at December 31, 2014 would not have been significantly different than the amount disclosed above at July 1, 2014.

At December 31, 2013, approximately 6% of total inventories were valued using the LIFO method, all in the United States. If inventories had been valued at current costs, they would have been approximately $9 million higher than reported at December 31, 2013.

(d) Includes estimated income tax payments of $36 million in 2014 and $75 million in 2013.

(e) Consists primarily of insurance contracts and other investments to be utilized for non-qualified pension and OPEB obligations.

(f) Financing receivables is not normal practice for the company. The balances at December 31, 2014 and 2013 are net of reserves of $48 million and $51 million, respectively. The amounts in both periods relate primarily to government receivables in Brazil and other long-term notes receivable from customers, the majority of which are fully reserved. Collectibility is reviewed regularly and uncollectible amounts are written-off as appropriate. The account balance change during 2014 was primarily the result of additional receivables, net of reserves.

(g) North America consists primarily of currency translation adjustments in Canada and Mexico, South America relates primarily to Brazil and Argentina, and Europe relates primarily to Spain and Germany.

NOTE 8. PROPERTY, PLANT AND EQUIPMENT – NET

Significant classes of property, plant and equipment are as follows:

(Millions of dollars) December 31,	Depreciable Lives (Yrs)	2014	2013
Production plants (primarily 15-year life) (a)	10-20	$14,400	$14,378
Storage tanks	15-20	2,267	2,330
Transportation equipment and other	3-15	1,895	1,866
Cylinders (primarily 30-year life)	10-30	1,724	1,740
Buildings	25-40	1,089	1,108
Land and improvements (b)	0-20	499	493
Construction in progress		1,980	2,116
		23,854	24,031
Less: accumulated depreciation		(11,857)	(11,753)
		$11,997	$12,278

(a) - Depreciable lives of production plants related to long-term customer supply contracts are consistent with the contract lives.

(b) - Land is not depreciated.

75

Table of Contents

NOTE 9. GOODWILL

Changes in the carrying amount of goodwill for the years ended December 31, 2014 and 2013 were as follows:

(Millions of dollars)	North America	South America	Europe	Asia	Surface Technologies	Total
Balance, December 31, 2012	$1,499	$195	$645	$25	$ 143	$2,507
Acquisitions (Note 3)	625	—	94	—	—	719
Purchase adjustments & other	3	—	—	—	—	3
Foreign currency translation	(10)	(29)	4	(1)	1	(35)
Balance, December 31, 2013	$2,117	$166	$743	$24	$ 144	$3,194
Acquisitions (Note 3)	47	4	17	14	4	86
Purchase adjustments & other	1	—	(6)	—	5	—
Foreign currency translation	(26)	(23)	(100)	—	(10)	(159)
Balance, December 31, 2014	$2,139	$147	$654	$38	$ 143	$3,121

Praxair has performed its goodwill impairment tests annually during the second quarter of each year, and historically has determined that the fair value of each of its reporting units was substantially in excess of its carrying value. For the 2014 test Praxair applied the FASB's updated accounting guidance which allows the company to first assess qualitative factors to determine the extent of additional quantitative analysis, if any, that may be required to test goodwill for impairment. Based on the qualitative assessments performed, Praxair concluded that it was more likely than not that the fair value of each reporting unit substantially exceeded its carrying value and therefore, further quantitative analysis was not required. As a result, no impairment was recorded. There were no indicators of impairment through December 31, 2014.

76

NOTE 10. OTHER INTANGIBLE ASSETS

The following is a summary of Praxair's other intangible assets at December 31, 2014 and 2013:

(Millions of dollars) For the year ended December 31, 2014	Customer & License/Use Agreements	Non-compete Agreements	Patents & Other	Total
Cost:				
Balance, December 31, 2013	$661	$31	$43	$735
Additions (primarily acquisitions)	54	12	—	66
Foreign currency translation	(22)	(1)	(1)	(24)
Other *	—	(5)	5	—
Balance, December 31, 2014	693	37	47	777
Less: accumulated amortization:				
Balance, December 31, 2013	(118)	(16)	(5)	(139)
Amortization expense	(36)	(7)	(4)	(47)
Foreign currency translation	7	—	—	7
Other *	—	5	—	5
Balance, December 31, 2014	(147)	(18)	(9)	(174)
Net balance at December 31, 2014	$546	$19	$38	$603

(Millions of dollars) For the year ended December 31, 2013	Customer & License/Use Agreements	Non-compete Agreements	Patents & Other	Total
Cost:				
Balance, December 31, 2012	$232	$37	$20	$289
Additions (primarily acquisitions)	433	4	30	467
Foreign currency translation	3	—	—	3
Other *	(7)	(10)	(7)	(24)
Balance, December 31, 2013	661	31	43	735
Less: accumulated amortization:				
Balance, December 31, 2012	(89)	(20)	(7)	(116)
Amortization expense	(32)	(6)	(3)	(41)
Foreign currency translation	(1)	—	—	(1)
Other *	4	10	5	19
Balance, December 31, 2013	(118)	(16)	(5)	(139)
Net balance at December 31, 2013	$543	$15	$38	$596

* Other primarily relates to the write-off of fully amortized assets, purchase accounting adjustments and reclassifications.

There are no expected residual values related to these intangible assets. Amortization expense for the years ended December 31, 2014, 2013 and 2012 was $47 million, $41 million and $21 million, respectively. The remaining weighted-average amortization period for intangible assets is approximately 18 years.

77

Total estimated annual amortization expense is as follows:

(Millions of dollars)	
2015	$49
2016	48
2017	42
2018	37
2019	37
Thereafter	390
	$603

Table of Contents

NOTE 11. DEBT

The following is a summary of Praxair's outstanding debt at December 31, 2014 and 2013:

(Millions of dollars)	2014	2013
Short-term		
Commercial paper and U.S. bank borrowings	$514	$712
Other bank borrowings (primarily international)	73	70
Total short-term debt	587	782
Long-term		
U.S. borrowings		
4.375% Notes due 2014 (a)	—	300
4.625% Notes due 2015 (b)	500	500
3.25% Notes due 2015 (b, d)	408	418
0.75% Notes due 2016	400	400
5.375% Notes due 2016 (a)	—	400
5.20% Notes due 2017	325	325
1.05% Notes due 2017	400	400
1.20% Notes due 2018	500	500
1.25% Notes due 2018 (c, d)	481	478
4.50% Notes due 2019 (c)	599	598
1.90% Notes due 2019	500	500
1.50% Euro denominated notes due 2020 (c, e)	722	—
4.05% Notes due 2021 (c)	499	498
3.00% Notes due 2021 (c)	497	497
2.45% Notes due 2022 (c)	598	598
2.20% Notes due 2022 (c)	499	499
2.70% Notes due 2023 (c)	499	498
1.625% Euro denominated notes due 2025 (c, e)	599	—
3.55% Notes due 2042 (c)	466	466
Other	4	5
International bank borrowings	167	140
Obligations under capital lease	8	9
	8,671	8,029
Less: current portion of long-term debt	(2)	(3)
Total long-term debt	8,669	8,026
Total debt	$9,258	$8,811

(a) In March 2014, Praxair repaid $300 million of 4.375% notes that became due. In December of 2014, Praxair redeemed $400 million of 5.375% notes due November 2016 for $434 million resulting in an $36 million bond redemption charge (see Note 7).

(b) Classified as long-term because of the Company's intent to refinance this debt on a long-term basis and the availability of such financing under the terms of an existing $2.5 billion long-term credit facility.

(c) Amounts are net of unamortized discounts.

(d) December 31, 2014 and 2013 include a $14 million and $22 million fair value increase, respectively, related to hedge accounting. See Note 12 for additional information.

Table of Contents

(e) During 2014, Praxair issued the following Euro-denominated notes totaling €1.1 billion: €600 million of 1.50% Euro-denominated notes due 2020 and €500 million of 1.625% Euro-denominated notes due 2025. These debt issuances have been designated as a hedges of the net investment position in European operations where the Euro is the functional currency (see Note 12). The proceeds of this debt issuance were used for general corporate purposes, including acquisitions, repayment of debt and share repurchases under the company's share repurchase program. Since the time the Euro-denominated notes were first issued in March 2014 through December 31, 2014, exchange rate movements have reduced long-term debt by $125 million.

On February 5, 2015, Praxair issued $150 million of floating rate notes that bear interest at the Federal funds effective rate plus 0.33% due 2017, $400 million of 2.65% fixed rate notes due 2025 and $200 million of 3.550% fixed rates notes due in 2042. The proceeds will be used for general corporate purposes, including the repayment of outstanding indebtedness.

Credit Facilities

At December 31, 2014, the company has the following major credit facility available for future borrowing:

Millions of dollars	Total Facility	Borrowings Outstanding	Available for Borrowing	Expires
Senior Unsecured	$2,500	$—	$2,500	December 2019

In December 2014, the company entered into a $2.5 billion senior unsecured credit facility with a syndicate of major financial institutions. This facility replaced the company's $2.0 billion senior unsecured credit facility which was set to expire in 2016. The credit facility is non-cancellable by the issuing financial institutions until its maturity in December 2019. No borrowings were outstanding under the credit agreement at December 31, 2014.

Covenants

Praxair’s $2.5 billion senior unsecured credit facility and long-term debt agreements contain various covenants which may, among other things, restrict the ability of Praxair to merge with another entity, incur or guarantee debt, sell or transfer certain assets, create liens against assets, enter into sale and leaseback agreements, or pay dividends and make other distributions beyond certain limits. These agreements also require Praxair to not exceed a maximum 70% leverage ratio defined in the agreements as the ratio of consolidated total debt to the sum of consolidated total debt plus consolidated shareholders’ equity of the company. For purposes of the leverage ratio calculation, consolidated shareholders’ equity excludes changes in the cumulative foreign currency translation adjustments after June 30, 2011. At December 31, 2014, the actual leverage ratio, as calculated according to the agreement, was 54% and the company is in compliance with all financial covenants. Also, there are no material adverse change clauses or other subjective conditions that would restrict the company’s ability to borrow under the agreement.

Other Debt Information

As of December 31, 2014 and 2013, the weighted-average interest rate of short-term borrowings outstanding was 0.6% and 0.4%, respectively.

Expected maturities on long-term debt are as follows:

(Millions of dollars)		
2015	$2	*
2016	407	
2017	775	
2018	1,083	
2019	2,008	*
Thereafter	4,396	
	$8,671	

* $908 million of debt due in 2015 has been reflected in 2019 maturities due to the company’s intent to refinance this debt on a long-term basis and the ability to do so under the $2.5 billion senior unsecured credit facility with a syndicate of banks which expires in 2019.

80

Table of Contents

As of December 31, 2014, $9 million of Praxair's assets (principally international fixed assets) were pledged as collateral for $8 million of long-term debt, including the current portion of long-term debt.
See Note 13 for the fair value information related to debt.
NOTE 12. FINANCIAL INSTRUMENTS
In its normal operations, Praxair is exposed to market risks relating to fluctuations in interest rates, foreign currency exchange rates, energy costs and to a lesser extent precious metal prices. The objective of financial risk management at Praxair is to minimize the negative impact of such fluctuations on the company's earnings and cash flows. To manage these risks, among other strategies, Praxair routinely enters into various derivative financial instruments ("derivatives") including interest-rate swap and treasury rate lock agreements, currency-swap agreements, forward contracts, currency options, and commodity-swap agreements. These instruments are not entered into for trading purposes and Praxair only uses commonly traded and non-leveraged instruments.
There are three types of derivatives that the company enters into: (i) those relating to fair-value exposures, (ii) those relating to cash-flow exposures, and (iii) those relating to foreign currency net investment exposures. Fair-value exposures relate to recognized assets or liabilities, and firm commitments; cash-flow exposures relate to the variability of future cash flows associated with recognized assets or liabilities, or forecasted transactions; and net investment exposures relate to the impact of foreign currency exchange rate changes on the carrying value of net assets denominated in foreign currencies.
When a derivative is executed and hedge accounting is appropriate, it is designated as either a fair-value hedge, cash-flow hedge, or a net investment hedge. Currently, Praxair designates all interest-rate and treasury-rate locks as hedges for accounting purposes; however, currency contracts are generally not designated as hedges for accounting purposes unless they are related to forecasted transactions. Whether designated as hedges for accounting purposes or not, all derivatives are linked to an appropriate underlying exposure. On an ongoing basis, the company assesses the hedge effectiveness of all derivatives designated as hedges for accounting purposes to determine if they continue to be highly effective in offsetting changes in fair values or cash flows of the underlying hedged items. If it is determined that the hedge is not highly effective, then hedge accounting will be discontinued prospectively.
Counterparties to Praxair's derivatives are major banking institutions with credit ratings of investment grade or better and no collateral is required, and there are no significant risk concentrations. Management believes the risk of incurring losses on derivative contracts related to credit risk is remote and any losses would be immaterial.
The following table is a summary of the notional amount and fair value of derivatives outstanding at December 31, 2014 and 2013 for consolidated subsidiaries:

			Fair Value			
(Millions of dollars)	Notional Amounts		Assets		Liabilities	
December 31,	2014	2013	2014	2013	2014	2013
Derivatives Not Designated as Hedging Instruments:						
Currency contracts:						
Balance sheet items (a)	$2,427	$2,197	$5	$4	$13	$14
Derivatives Designated as Hedging Instruments:						
Currency contracts:						
Forecasted purchases (a)	$—	$5	$—	$—	$—	$—
Interest rate contracts:						
Interest rate swaps (b)	875	875	14	22	—	—
Total Hedges	$875	$880	$14	$22	$—	$—
Total Derivatives	$3,302	$3,077	$19	$26	$13	$14

(a) Assets are recorded in prepaid and other current assets, and liabilities are recorded in other current liabilities.
(b) Assets are recorded in other current and other long term assets.

81

Table of Contents

Currency Contracts

Balance Sheet Items

Foreign currency contracts related to balance sheet items consist of forward contracts entered into to manage the exposure to fluctuations in foreign-currency exchange rates on recorded balance sheet assets and liabilities denominated in currencies other than the functional currency of the related operating unit. The fair value adjustments on these contracts are offset by the fair value adjustments recorded on the hedged assets and liabilities.

Forecasted Purchases

Foreign currency contracts related to forecasted purchases consist of forward contracts entered into to manage the exposure to fluctuations in foreign-currency exchange rates on forecasted purchases of capital-related equipment and services denominated in currencies other than the functional currency of the related operating units. These forward contracts were designated and accounted for as cash flow hedges.

Net Investment Hedges

Praxair has designated the €600 million ($722 million million as of December 31, 2014)1.50% Euro-denominated notes due 2020 and the €500 million ($599 million as of December 31, 2014) 1.625% Euro-denominated notes due 2025 as hedges of the net investment position in its European operations. These Euro-denominated debt instruments reduce the company's exposure to changes in the currency exchange rate on investments in foreign subsidiaries with Euro functional currencies. Since the time the Euro-denominated notes were first issued in March 2014 through December 31, 2014, exchange rate movements have reduced long-term debt by $125 million, with the offsetting gain shown within the cumulative translation component of AOCI in the consolidated balance sheets and the consolidated statements of comprehensive income (loss).

Interest Rate Contracts

Outstanding Interest Rate Swaps

At December 31, 2014, Praxair had $875 million notional amount of interest-rate swap agreements outstanding related to the $400 million 3.25% fixed-rate notes that mature in 2015 and the $475 million 1.25% notes that mature 2018, which effectively convert fixed-rate interest to variable-rate interest. These swap agreements were designated as fair value hedges with the resulting fair value adjustments recognized in earnings along with an equally offsetting charge / benefit to earnings for the changes in the fair value of the underlying debt instruments. At December 31, 2014, $14 million was recognized as an increase in the fair value of this note ($22 million at December 31, 2013).

Terminated Interest Rate Swaps

During 2010, 2011 and 2012 Praxair terminated three interest rate swap agreements which were previously designated as fair value hedges related to fixed-rate notes due in 2012 and 2013. The unrecognized gain existing upon termination of the swaps was received in cash and shown as an increase to the respective long-term notes. This deferred gain was then recognized on a straight-line basis to interest expense – net over the term of the underlying debt agreements. During 2013 and 2012, $4 million and $15 million, respectively, was recognized as a reduction to interest expense – net.

Terminated Treasury Rate Locks

The following table summarizes the unrecognized gains (losses) related to terminated treasury rate locks contracts:

(Millions of dollars)	Year Terminated	Original Gain / (Loss)	Unrecognized Gain / (Loss) (a) December 31, 2014	Unrecognized Gain / (Loss) (a) December 31, 2013
Treasury Rate Locks				
Underlying debt instrument:				
$500 million 2.20% fixed-rate notes that mature in 2022 (b)	2012	$(2)	$ (1)	$ (2)
$500 million 3.00% fixed-rate notes that mature in 2021 (b)	2011	(11)	(8)	(9)
$600 million 4.50% fixed-rate notes that mature in 2019 (b)	2009	16	8	10
$500 million 4.625% fixed-rate notes that mature in 2015 (b)	2008	(7)	—	(1)
Total – pre-tax			$ (1)	$ (2)
Less: income taxes			—	1

After- tax amounts	$ (1)	$ (1)

82

Table of Contents

(a) The unrecognized gains / (losses) for the treasury rate locks are shown in accumulated other comprehensive income ("AOCI") and are being recognized on a straight line basis to interest expense – net over the term of the underlying debt agreements. Refer to the table below summarizing the impact of the company's consolidated statements of income and AOCI for current period gain (loss) recognition.

(b) The notional amount of the treasury rate lock contracts are equal to the underlying debt instrument with the exception of the treasury rate lock contract entered into to hedge the $600 million 4.50% fixed-rate notes that mature in 2019. The notional amount of this contract was $500 million.

The following table summarizes the impact of the company's derivatives not designated as hedging instruments on the consolidated statements of income:

(Millions of dollars)	Amount of Pre-Tax Gain (Loss) Recognized in Earnings *		
December 31,	2014	2013	2012
Derivatives Not Designated as Hedging Instruments			
Currency contracts:			
Balance sheet items:			
Debt-related	$(69)	$(46)	$33
Other balance sheet items	(2)	(9)	(1)
Anticipated net income	—	—	(4)
Total	$(71)	$(55)	$28

* The gains (losses) on balance sheet items are offset by gains (losses) recorded on the underlying hedged assets and liabilities. Accordingly, the gains (losses) for the derivatives and the underlying hedged assets and liabilities related to debt items are recorded in the consolidated statements of income as interest expense-net. Other balance sheet items and anticipated net income gains (losses) are recorded in the consolidated statements of income as other income (expenses)-net.

The following table summarizes the impact of the company's derivatives designated as hedging instruments that impact AOCI:

(Millions of dollars)	Amount of Gain (Loss) Recognized in AOCI		
December 31,	2014	2013	2012
Derivatives Designated as Hedging Instruments**			
Currency contracts:			
Net Investment hedge	$(6)	$—	$—
Forecasted purchases	$1	$1	$1
Interest rate contracts:			
Treasury rate locks	—	—	(2)
Total – Pre tax	$(5)	$1	$(1)
Less: income taxes	2	—	1
Total - Net of Taxes	$(3)	$1	$—

** The gains (losses) on net investment hedges are recorded as a component of AOCI within foreign currency translation adjustments in the condensed consolidated balance sheets and condensed consolidated statements of comprehensive income. The gains (losses) on forecasted purchases and treasury rate locks are recorded as a component of AOCI within derivative instruments in the condensed consolidated balance sheets and the condensed consolidated statements of comprehensive income. There was no ineffectiveness for these instruments during 2014 or 2013. The gains (losses) on net investment hedges are reclassified to earnings only when the related currency translation adjustments are required to be reclassified, usually upon sale or liquidation of the investment. The gains (losses) for interest rate contracts are reclassified to earnings as interest expense –net on a straight-line basis over the remaining maturity of the underlying debt. Net losses of less than $1 million are expected to be reclassified to earnings during 2015.

NOTE 13. FAIR VALUE DISCLOSURES

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels as follows:

83

Level 1 – quoted prices in active markets for identical assets or liabilities
Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable
Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions)

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table summarizes assets and liabilities measured at fair value on a recurring basis at December 31, 2014 and 2013:

	Fair Value Measurements Using					
(Millions of dollars)	Level 1		Level 2		Level 3	
	2014	2013	2014	2013	2014	2013
Assets						
Derivative assets	$—	$—	$19	$26	$—	$—
Liabilities						
Derivative liabilities	$—	$—	$13	$14	$—	$—

The fair values of the derivative assets and liabilities are based on market prices obtained from independent brokers or determined using quantitative models that use as their basis readily observable market parameters that are actively quoted and can be validated through external sources, including third-party pricing services, brokers and market transactions. Investments are marketable securities traded on an exchange.

The fair value of cash and cash equivalents, short-term debt, accounts receivables-net, and accounts payable approximate carrying value because of the short-term maturities of these instruments. The fair value of long-term debt is estimated based on the quoted market prices for the same or similar issues, which is deemed a Level 2 measurement. At December 31, 2014, the estimated fair value of Praxair's long-term debt portfolio was $8,753 million versus a carrying value of $8,671 million. At December 31, 2013, the estimated fair value of Praxair's long-term debt portfolio was $7,976 million versus a carrying value of $8,029 million. These differences are attributable to interest-rate changes subsequent to when the debt was issued.

Assets Measured at Fair Value on a Non-Recurring Basis

At December 31, 2014 in connection with the adoption of the SICAD II currency exchange system in Venezuela, Praxair reduced the value of certain assets in Venezuela, primarily long-lived assets, to estimated fair value which resulted in a $63 million pre-tax charge to income (see Note 2).

During the first quarter 2012, the company reduced the value of certain assets in Brazil, Colombia and Chile to estimated fair value which resulted in a $21 million pre-tax charge to other income (expense) – net.

The above fair value measurements were based on internal assessments of the best information available about the local business conditions and political environment, including the impact of foreign currency exchange restrictions that would be indicative of what the assets could be sold for and are considered to be Level 3 measurements.

NOTE 14. EQUITY AND REDEEMABLE NONCONTROLLING INTERESTS

Praxair, Inc. Shareholders' Equity

At December 31, 2014 and 2013, there were 800,000,000 shares of common stock authorized (par value $0.01 per share) of which 383,230,625 shares were issued and 289,261,608 were outstanding at December 31, 2014 (294,133,864 were outstanding at December 31, 2013).

At December 31, 2014 and 2013, there were 25,000,000 shares of preferred stock (par value $0.01 per share) authorized, of which no shares were issued and outstanding. Praxair's board of directors may from time to time authorize the issuance of one or more series of preferred stock and, in connection with the creation of such series, determine the characteristics of each such series including, without limitation, the preference and relative, participating, optional or other special rights, and the qualifications, limitations or restrictions of the series.

Redeemable Noncontrolling Interests

Noncontrolling interests with redemption features, such as put/sell options, that are not solely within the company's control ("redeemable noncontrolling interests") are reported separately in the consolidated balance sheets at the greater of carrying value or redemption value. For redeemable noncontrolling interests that are not yet exercisable, Praxair calculates the redemption value by accreting the carrying value to the redemption value over the period until exercisable. If the

84

redemption value is greater than the carrying value, any increase is adjusted directly to retained earnings and does not impact net income.

During 2011, Praxair acquired a controlling interest in Yara Praxair, a joint venture in Scandinavia that was previously accounted for as an equity investment (see Note 3). As part of the transaction, the noncontrolling shareholder obtained the right to sell its shares to Praxair starting in the first quarter 2015 for a period of 4 years at a formula price. Praxair also obtained the right to purchase the shares held by the noncontrolling shareholder starting in 2017 for a period of 2 years, also at a formula price. Accordingly, the noncontrolling interests related to Yara Praxair have been recorded in the consolidated balance sheets as redeemable noncontrolling interests. Other redeemable noncontrolling interests relate to three packaged gas distributors in the United States where the noncontrolling shareholders have put options.

The following is a summary of redeemable noncontrolling interests for the years ended December 31, 2014, 2013 and 2012:

(Millions of dollars)	2014	2013	2012
Beginning Balance	$307	$252	$220
Net income	12	24	18
Distributions to noncontrolling interest	(9)	(11)	(9)
Redemption value adjustment/accretion	2	53	13
Foreign currency translation and other	(24)	(11)	10
Purchase of noncontrolling interest *	(112)	—	—
Ending Balance	$176	$307	$252

* In January 2014, Praxair acquired the noncontrolling interests related to Praxair Distribution Mid-Atlantic, LLC. The cash payment is shown in the financing section of the condensed consolidated statements of cash flows under the caption "Noncontrolling interest transactions and other".

85

NOTE 15. SHARE-BASED COMPENSATION

Share-based compensation expense was $51 million in 2014, and $70 million in each of 2013 and 2012. The related income tax benefit recognized was $14 million in 2014, and $21 million in each of 2013 and 2012. The share-based compensation expense was primarily recorded in selling, general and administrative expenses and no share-based compensation expense was capitalized.

Summary of Plans

The 2009 Praxair, Inc. Long-Term Incentive Plan was initially adopted by the board of directors and shareholders of the company on April 28, 2009 and was amended and restated in its entirety by the board and shareholders on April 22, 2014 ("the 2009 Plan"). Prior to April 28, 2009, equity awards were granted under the 2002 Praxair, Inc. Long-Term Incentive Plan and the company's ability to make further equity awards under that plan ended with its adoption of the 2009 Plan. The 2009 Plan permits awards of stock options, stock appreciation rights, restricted stock and restricted stock units, performance-based stock units and other equity awards to eligible officer and non-officer employees and non-employee directors of the company and its affiliates. Under the 2009 Plan, as amended and restated in 2014, the aggregate number of shares available for option and other equity grants is 8,000,000 shares, of which up to 2,600,000 shares may be granted as awards other than options or stock appreciation rights. The 2009 Plan also provides calendar year per-participant limits on grants of stock options and stock appreciation rights and on other types of awards intended to qualify as Performance-Based Compensation under Section 162(m) of the Internal Revenue Code. As of December 31, 2014, 7,982,085 shares remained available for equity grants under the 2009 Plan.

In 2005, the board of directors and shareholders of the company adopted the 2005 Equity Compensation Plan for Non-Employee Directors of Praxair, Inc. ("the 2005 Plan"). Under the 2005 Plan, the aggregate number of shares available for option and other equity grants was limited to a total of 500,000 shares. The 2005 Plan expired on April 30, 2010, by its own terms, and no shares were available for grant thereafter.

Exercise prices for options granted under the 2009 Plan may not be less than the closing market price of the company's common stock on the date of grant and granted options may not be re-priced or exchanged without shareholder approval. Options granted under the 2009 Plan subject only to time vesting requirements may become partially exercisable after a minimum of one year after the date of grant but may not become fully exercisable until at least three years have elapsed from the date of grant, and all options have a maximum duration of ten years. Options granted under predecessor plans had similar terms.

The company has the ability to repurchase shares on the open market to satisfy share option exercises and issues shares from treasury stock upon the exercise of certain stock options.

Stock Option Fair Value

The company utilizes the Black-Scholes Options-Pricing Model to determine the fair value of stock options consistent with that used for pro forma disclosures in prior years. Management is required to make certain assumptions with respect to selected model inputs, including anticipated changes in the underlying stock price (i.e., expected volatility) and option exercise activity (i.e., expected life). Expected volatility is based on the historical volatility of the company's stock over the most recent period commensurate with the estimated expected life of the company's stock options and other factors. The expected life of options granted, which represents the period of time that the options are expected to be outstanding, is based primarily on historical exercise experience. The expected dividend yield is based on the company's most recent history and expectation of dividend payouts. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for a period commensurate with the estimated expected life. If factors change and result in different assumptions in future periods, the stock option expense that the company records for future grants may differ significantly from what the company has recorded in the current period.

The weighted-average fair value of options granted during 2014 was $14.62 per option ($16.31 in 2013 and $17.43 in 2012) based on the Black-Scholes Options-Pricing model. The following weighted-average assumptions were used for grants in 2014, 2013 and 2012:

Year Ended December 31,	2014		2013		2012	
Dividend yield	2.0	%	2.2	%	2.0	%
Volatility	15.2	%	21.7	%	22.5	%

Risk-free interest rate	1.57 %	0.76 %	0.86 %
Expected term years	5	5	5

86

Table of Contents

The following table summarizes option activity under the plans for 2014 (averages are calculated on a weighted basis; life in years; intrinsic value expressed in millions):

Activity	Number of Options (000's)	Average Exercise Price	Average Remaining Life	Aggregate Intrinsic Value
Outstanding at January 1, 2014	11,161	$81.42		
Granted	1,293	128.80		
Exercised	(1,380)	63.39		
Cancelled or expired	(93)	110.68		
Outstanding at December 31, 2014	10,981	$89.02	5.3	$445
Exercisable at December 31, 2014	8,400	$79.74	4.3	$418

The aggregate intrinsic value represents the difference between the company's closing stock price of $129.56 as of December 31, 2014 and the exercise price multiplied by the number of options outstanding as of that date. The total intrinsic value of stock options exercised during 2014 was $93 million ($143 million and $165 million for 2013 and 2012, respectively).

Cash received from option exercises under all share-based payment arrangements for 2014 was $88 million . The cash tax benefit realized from all share-based compensation totaled $48 million for 2014, of which $31 million in excess tax benefits was classified as financing cash flows.

As of December 31, 2014, $18 million of unrecognized compensation cost related to non-vested stock options is expected to be recognized over a weighted-average period of approximately 1 year.

Performance-Based and Restricted Stock Awards

In 2014, the company granted performance-based stock awards under the 2009 Plans to senior level executives of 328,082 shares that vest, subject to the attainment of pre-established minimum performance criteria, principally on the third anniversary of their date of grant. The actual number of shares issued in settlement of a vested award can range from zero to 200 percent of the target number of shares granted based upon the company's attainment of specified performance targets at the end of a three-year period. Compensation expense related to these awards is recognized over the three-year performance period based on the fair value of the closing market price of the company's common stock on the date of the grant and the estimated performance that will be achieved. Compensation expense will be adjusted during the three-year performance period based upon the estimated performance levels that will be achieved.

There were 94,988 restricted stock units granted to employees during 2014. In addition, the company had previously granted restricted stock to certain key employees that vest after a designated service period ranging from 2 to 10 years. Generally, restricted stock does not earn quarterly dividends while vesting. Compensation expense related to the restricted stock units and restricted stock is recognized on a straight-line basis over the vesting period.

The weighted-average fair value of performance-based stock units granted during 2014 was $121.16 per unit ($103.46 in 2013 and $103.13 in 2012). The weighted-average fair value of restricted stock units granted during 2014 was $122.55 per unit ($105.79 in 2013 and $104.71 in 2012). This is based on the closing market price of the company's common stock on the grant date adjusted for dividends that will not be paid during the vesting period.

The following table summarizes non-vested performance-based and restricted stock award activity as of December 31, 2014 and changes during the period then ended (shares based on target amounts, averages are calculated on a weighted basis):

Performance-Based and Restricted Stock Activity	Performance-Based Number of Shares (000's)	Performance-Based Average Grant Date Fair Value	Restricted Stock Number of Shares (000's)	Restricted Stock Average Grant Date Fair Value
Non-vested at January 1, 2014	867	$99.55	337	$100.41
Granted (a)	328	121.16	95	122.55
Vested	(338)	92.06	(109)	96.02
Cancelled	(24)	110.27	(16)	104.61
Non-vested at December 31, 2014	833	$109.09	307	$106.63

(a) Performance-based stock unit ("PSU") grants during 2014 include 49 thousand shares relating to the actual payout of the 2011 PSU grants in 2014.

As of December 31, 2014, based on current estimates of future performance, $32 million of unrecognized compensation cost related to performance-based awards and $14 million of unrecognized compensation cost related to the restricted stock awards is expected to be recognized on a straight-line basis primarily through the first quarter of 2017.

NOTE 16. RETIREMENT PROGRAMS

Defined Benefit Pension Plans

Praxair has two main U.S. retirement programs which are non-contributory defined benefit plans: the Praxair Pension Plan and the CBI Pension Plan. The latter program benefits primarily former employees of CBI Industries, Inc. which Praxair acquired in 1996. Effective July 1, 2002, the Praxair Pension Plan was amended to give participating employees a one-time choice to remain covered by the old formula or to elect coverage under a new formula. The old formula is based predominantly on years of service, age and compensation levels prior to retirement, while the new formula provides for an annual contribution to an individual account which grows with interest each year at a predetermined rate. Also, this new formula applies to all new employees hired after April 30, 2002 into businesses adopting this plan. The U.S. and international pension plan assets are comprised of a diversified mix of investments, including domestic and international corporate equities, government securities and corporate debt securities. Praxair has several plans that provide supplementary retirement benefits primarily to higher level employees that are unfunded and are nonqualified for federal tax purposes. Pension coverage for employees of certain of Praxair's international subsidiaries generally is provided by those companies through separate plans. Obligations under such plans are primarily provided for through diversified investment portfolios, with some smaller plans provided for under insurance policies or by book reserves.

Multi-employer Pension Plans

In the United States Praxair participates in seven multi-employer defined benefit pension plans ("MEP") pursuant to the terms of collective bargaining agreements covering approximately 200 union-represented employees. The collective bargaining agreements expire on different dates through 2019. In connection with such agreements, the Company is required to make periodic contributions to the MEPs in accordance with the terms of the respective collective bargaining agreements. Praxair's participation in these plans is not material either at the plan level or in the aggregate. Praxair's contributions to these plans were $2 million in 2014 and 2013, and $1 million in 2012 (the cost is not included in the tables that follow). For all MEPs Praxair's contributions were significantly less than 1% of the total contributions to each plan for 2013 and 2012. Total 2014 contributions were not yet available from the MEPs.

Praxair has obtained the most recently available Pension Protection Act ("PPA") zone status letters from the Trustees of the MEPs. The PPA classifies MEPs as either Red, Yellow or Green zone plans. Among other factors, plans in the Red zone are generally less than 65 percent funded; plans in the Yellow zone are generally 65 to 80 percent funded; and plans in the Green zone are generally at least 80 percent funded. According to the most current data available, four of the MEPs that the Company participates are in a Red zone status; one is in a Yellow zone status; and two are in a Green zone status. As of December 31, 2014, the five Red and Yellow Zone plans have pending or have implemented financial improvement or rehabilitation plans. Praxair does not currently anticipate significant future obligations due to the funding status of these plans. If Praxair determined it was probable that it would withdraw from an MEP, the Company would record a liability for its portion of the MEP's unfunded pension obligations, as calculated at that time. Historically, such withdrawal payments have not been significant.

Table of Contents

Defined Contribution Plans

Praxair’s U.S. business employees are eligible to participate in the Praxair defined contribution savings plan. Employees may contribute up to 40% of their compensation, subject to the maximum allowable by IRS regulations. For the US packaged gases business, company contributions to this plan are calculated as a percentage of salary based on age plus service. U.S. employees other than those in the packaged gases business have company contributions to this plan calculated on a graduated scale based on employee contributions to the plan. The cost for these defined contribution plans was $26 million in 2014, $25 million in 2013 and $24 million in 2012 (the cost is not included in the tables that follow).

The defined contribution plans includes a non-leveraged employee stock ownership plan ("ESOP") which covers all employees participating in this plan. The collective number of shares of Praxair common stock in the two ESOPs totaled 3,053,710 at December 31, 2014.

Certain international subsidiaries of the company also sponsor defined contribution plans where contributions are determined under various formulas. The expense for these plans was $17 million in 2014 and 2013, and $12 million in 2012 (the expense is not included in the tables that follow).

Postretirement Benefits Other Than Pensions (OPEB)

Praxair provides health care and life insurance benefits to certain eligible retired employees. These benefits are provided through various insurance companies and healthcare providers. Praxair is also obligated to make payments for a portion of postretirement benefits related to retirees of Praxair’s former parent. Additionally, as part of the CBI acquisition in 1996, Praxair assumed responsibility for healthcare and life insurance benefit obligations for CBI’s retired employees. All postretirement healthcare programs have cost caps that limit the company’s exposure to future cost increases. In addition, as part of the retirement elections made for July 1, 2002, eligible employees were given the choice of maintaining coverage in the current retiree medical design (as may be amended from time to time), or to move to a design whereby coverage would be provided, but with no Praxair subsidy whatsoever. Also, all new employees hired after April 30, 2002 into a business adopting these plans will not receive a company subsidy. Praxair does not currently fund its postretirement benefits obligations. Praxair’s retiree plans may be changed or terminated by Praxair at any time for any reason with no liability to current or future retirees.

Praxair uses a measurement date of December 31 for its pension and other post-retirement benefit plans.

Pension and Postretirement Benefit Costs

The components of net pension and OPEB costs for 2014, 2013 and 2012 are shown below:

(Millions of dollars)	Pensions			OPEB		
Year Ended December 31,	2014	2013	2012	2014	2013	2012
Service cost	$49	$56	$49	$4	$5	$4
Interest cost	121	112	119	11	11	12
Expected return on plan assets	(155)	(149)	(153)	—	—	—
Net amortization and deferral	60	91	68	(8)	(5)	(7)
Net periodic benefit cost before pension settlement charges	$75	$110	$83	$7	$11	$9
Pension settlement charges *	7	9	10	—	—	—
Net periodic benefit cost	$82	$119	$93	$7	$11	$9

* 2014 includes a $7 millions charge in the fourth quarter related to one-time lump sum benefit payment of vested pension benefits to certain former employees. 2012 and 2013 includes a $9 million charge in the third quarter primarily related to the retirement of senior managers in the United States (see Note 2).

Table of Contents

Funded Status

The changes in benefit obligation and plan assets for Praxair’s pension and OPEB programs, including reconciliation of the funded status of the plans to amounts recorded in the consolidated balance sheet, as of December 31, 2014 and 2013 are shown below:

(Millions of dollars) Year Ended December 31,	Pensions 2014 U.S.	International	2013 U.S.	International	OPEB 2014	2013
Change in Benefit Obligation ("PBO")						
Benefit obligation January 1	$1,791	$661	$1,926	$727	$208	$251
Service cost	34	15	38	18	4	5
Interest cost	85	36	74	38	11	11
Participant contributions	—	—	—	—	10	11
Actuarial loss (gain)	276	109	(148)	(43)	(21)	(39)
Benefits paid	(136)	(35)	(99)	(38)	(25)	(23)
Divestiture	—	(1)	—	—	—	—
Foreign currency translation	—	(66)	—	(41)	(7)	(8)
Benefit obligation, December 31	$2,050	$719	$1,791	$661	$180	$208
Accumulated benefit obligation ("ABO")	$1,944	$681	$1,712	$629		
Change in Plan Assets						
Fair value of plan assets, January 1	$1,620	$551	$1,391	$558	$—	$—
Actual return on plan assets	108	76	271	43	—	—
Company contributions	2	16	35	17	—	—
Benefits paid from plan assets	(123)	(30)	(77)	(33)	—	—
Foreign currency translation	—	(52)	—	(34)	—	—
Fair value of plan assets, December 31	$1,607	$561	$1,620	$551	$—	$—
Funded Status, End of Year	$(443)	$(158)	$(171)	$(110)	$(180)	$(208)
Recorded in the Balance Sheet						
Other long-term assets	$—	$35	$—	$42	$—	$—
Other current liabilities	(18)	(5)	(10)	(6)	(16)	(17)
Other long-term liabilities	(425)	(188)	(161)	(146)	(164)	(191)
Net amount recognized, December 31	$(443)	$(158)	$(171)	$(110)	$(180)	$(208)
Amounts recognized in accumulated other comprehensive income (loss) consist of:						
Net actuarial loss (gain)	$792	$193	$563	$145	$(24)	$(7)
Prior service cost (credit)	—	15	1	18	(1)	(4)
Deferred tax benefit (Note 5)	(303)	(50)	(215)	(38)	11	6
Amount recognized in accumulated other comprehensive income (loss) (Note 7)	$489	$158	$349	$125	$(14)	$(5)

90

Table of Contents

The changes in plan assets and benefit obligations recognized in other comprehensive income in 2014 and 2013 are as follows:

	Pensions		OPEB	
(Millions of dollars)	2014	2013	2014	2013
Current year net actuarial losses (gains)*	$356	$(356)	$(21)	$(39)
Amortization of net actuarial gains (losses)	(59)	(90)	2	(1)
Amortization of prior service credits (costs)	(1)	(1)	6	6
Pension settlements (Note 2)	(7)	(9)	—	—
Foreign currency translation and other	(16)	(12)	(1)	(1)
Total recognized in other comprehensive income	$273	$(468)	$(14)	$(35)

* The pension net actuarial losses in 2014 relates primarily to the decrease in discount rates, when compared to 2013 and updated mortality assumptions. The pension net actuarial gain in 2013 relates primarily to the increase in discount rates, when compared to 2012. The OPEB net actuarial gains in 2014 relates primarily to favorable plan experience, and the 2013 net actuarial gain relates primarily to higher discount rates.

The amounts in accumulated other comprehensive income (loss) that are expected to be recognized as components of net periodic benefit cost during 2015 are as follows:

(Millions of dollars)	Pension	OPEB
Net actuarial loss (gain)	$82	$(3)
Prior service cost (credit)	1	—
	$83	$(3)

The following table provides information for pension plans where the accumulated benefit obligation exceeds the fair value of the plan assets:

(Millions of dollars)	Pensions			
Year Ended December 31,	2014		2013	
	U.S.	International	U.S.*	International
Projected benefit obligation ("PBO")	$2,050	$428	$244	$360
Accumulated benefit obligation ("ABO")	$1,944	$412	$241	$352
Fair value of plan assets	$1,607	$234	$127	$207

* In 2013, plan assets related to the main U.S. retirement program exceeded the ABO by $23 million and was therefore excluded from the table above.

91

Table of Contents

Assumptions

The assumptions used to determine the benefit obligations are as of the respective balance sheet date and the assumptions used to determine the net benefit cost are at the previous year-end, as shown below:

	Pensions U.S.				International				OPEB			
	2014		2013		2014		2013		2014		2013	
Weighted average assumptions used to determine benefit obligations at December 31,												
Discount rate	3.95	%	4.80	%	5.36	%	6.30	%	4.48	%	5.87	%
Rate of increase in compensation levels	3.25	%	3.25	%	3.72	%	4.00	%	N/A		N/A	
Weighted average assumptions used to determine net periodic benefit cost for years ended December 31,												
Discount rate	4.80	%	3.90	%	6.30	%	5.80	%	5.87	%	5.00	%
Rate of increase in compensation levels	3.25	%	3.25	%	4.00	%	4.00	%	N/A		N/A	
Expected long-term rate of return on plan assets *	8.00	%	8.00	%	8.10	%	7.50	%	N/A		N/A	

* The expected long term rate of return on the U.S. and international plan assets is estimated based on the plans' investment strategy and asset allocation, historical capital market performance and, to a lesser extent, historical plan performance. For the U.S. plans, the expected rate of return of 8.00% was derived based on the target asset allocation of 50%-70% equity securities (approximately 9.5% expected return), 20%-40% fixed income securities (approximately 5.5% expected return) and 2% - 10% real estate funds (approximately 7% expected return). For the international plans, the expected rate of return was derived based on the weighted average target asset allocation of 30%-50% equity securities (approximately 10% expected return), 40%-60% fixed income securities (approximately 7.5% expected return), and 0%-10% alternative investments (approximately 7.5% expected return). For the U.S. plan assets, the actual annualized total returns for the most recent 10-year and 20-year periods ended December 31, 2014 were approximately 6.2% and 8.2%, respectively. For the international plan assets, the actual annualized total returns for the same two periods were approximately 8.3% and 9.7%, respectively. Changes to plan asset allocations and investment strategy over this time period limit the value of historical plan performance as factor in estimating the expected long term rate of return. For 2015, the expected long-term rate of return on plan assets will be 8.00% for the U.S. plans. Expected weighted average returns for international plans will vary.

	OPEB			
Assumed healthcare cost trend rates	2014		2013	
Healthcare cost trend assumed	7.50	%	8.00	%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00	%	5.00	%
Year that the rate reaches the ultimate trend rate	2020		2020	

These healthcare-cost trend rate assumptions have an impact on the amounts reported. However, cost caps limit the impact on the net OPEB benefit cost in the U.S. To illustrate the effect, a one-percentage point change in assumed healthcare cost trend rates would have the following effects:

	One-Percentage Point		
(Millions of dollars)	Increase	Decrease	
Effect on the total of service and interest cost components of net OPEB benefit cost	$—	$—	
Effect on OPEB benefit obligation	$3	$(2	)

Pension Plan Assets

The investments of the U.S. pension plan are managed to meet the future expected benefit liabilities of the plan over the long term by investing in diversified portfolios consistent with prudent diversification and historical and expected

92

capital market returns. When Praxair became an independent, publicly traded company in 1992, its former parent retained all liabilities for its term-vested and retired employees. Praxair's plan received assets and retained pension liabilities for its own active employee base. Therefore, the liabilities under the Praxair U.S. pension plan mature at a later date compared to pension funds of other similar companies. Investment strategies are reviewed by the Finance and Pension Committee of the company's Board of Directors and investment performance is tracked against appropriate benchmarks. There are no concentrations of risk as it relates to the assets within the plans.

The international pension plans are managed individually based on diversified investment portfolios, with different target asset allocations that vary for each plan. Praxair's U.S. and international pension plans' weighted-average asset allocations at December 31, 2014 and 2013, and the target asset allocation range for 2014, by major asset category are as follows:

	U.S.			International		
Asset Category	Target	2014	2013	Target	2014	2013
Equity securities	50%-70%	65 %	70 %	30%-50%	49 %	48 %
Fixed income securities	20%-40%	28 %	30 %	40%-60%	42 %	43 %
Other	2% - 10%	7 %	—	0%-10%	9 %	9 %

The following table summarizes pension assets measured at fair value by asset category at December 31, 2014 and 2013. During the years presented, there has been no transfer of assets between Levels 1, 2 & 3 (see Note 13 for definition of the levels):

	Fair Value Measurements Using							
	Level 1		Level 2		Level 3 *		Total	
(Millions of dollars)	2014	2013	2014	2013	2014	2013	2014	2013
Cash and cash equivalents	$1	$2	$—	$—	$—	$—	$1	$2
Equity securities:								
U.S. equities	340	285	—	—	—	—	340	285
International equities	82	82	—	—	—	—	82	82
Mutual funds	330	393	—	—	—	—	330	393
Pooled funds	—	—	565	630	—	—	565	630
Fixed income securities:								
U.S. government bonds	—	—	44	39	—	—	44	39
International government bonds	—	—	125	128	—	—	125	128
Mutual funds	253	308	—	—	—	—	253	308
Corporate bonds	—	—	175	176	—	—	175	176
Pooled funds	—	—	90	80	—	—	90	80
Other:								
Insurance contracts	—	—	—	—	53	48	53	48
Real Estate Funds	—	—	—	—	110	—	110	—
Fair value of plan assets, December 31,	$1,006	$1,070	$999	$1,053	$163	$48	$2,168	$2,171

Table of Contents

* The following table summarizes changes in fair value of the pension plan assets classified as level 3 for the periods ended December 31, 2014 and 2013:

(Millions of dollars)	Insurance Contracts	Real Estate Funds	Total
Balance, December 31, 2012	$48	$—	$48
Gain or losses for the period	—	—	—
Balance, December 31, 2013	48	—	48
Gain for the period	12	10	22
Acquisitions	—	100	100
Foreign currency translation	(7)	—	(7)
Balance, December 31, 2014	$53	$110	$163

The descriptions and fair value methodologies for the U.S. and international pension plan assets are as follows:
Cash and Cash Equivalents – This category includes cash and short-term interest bearing investments with maturities of three months or less. Investments are valued at cost plus accrued interest. Cash and cash equivalents are classified within level 1 of the valuation hierarchy.
Equity Securities – This category is comprised of shares of common stock in U.S. and international companies from a diverse set of industries and size. Common stock is valued at the closing market price reported on a U.S. or international exchange where the security is actively traded. Equity securities are classified within level 1 of the valuation hierarchy.
Mutual Funds and Pooled Funds – This category consists of publicly and privately managed funds that invest primarily in marketable equity and fixed income securities. The fair value of these investments is determined by reference to the net asset value of the underlying securities of the fund. Shares of publicly traded mutual funds are valued at the net asset value quoted on the exchange where the fund is traded and are classified as level 1 within the valuation hierarchy. Units of pooled funds are valued at the per unit net asset value determined by the fund manager and are classified as level 2 within the valuation hierarchy.
U.S. and International Government Bonds – This category includes U.S. treasuries, U.S. federal agency obligations and international government debt. The majority of these investments do not have quoted market prices available for a specific government security and so the fair value is determined using quoted prices of similar securities in active markets and is classified as level 2 within the valuation hierarchy.
Corporate Bonds – This category is comprised of corporate bonds of U.S. and international companies from a diverse set of industries and size. The fair values for U.S. and international corporate bonds are determined using quoted prices of similar securities in active markets and observable data or broker or dealer quotations. The fair values for these investments are classified as level 2 within the valuation hierarchy.
Insurance Contracts – The fair value of insurance contracts is determined based on the cash surrender value of the insurance contract, which is determined based on such factors as the fair value of the underlying assets and discounted cash flow. These contracts are with highly rated insurance companies. Insurance contracts are classified within level 3 of the valuation hierarchy.
Real Estate Funds – This category includes real estate properties, partnership equities and investments in operating companies. The fair value of the assets is determined using discounted cash flows by estimating an income stream for the property plus a reversion into a present value at a risk adjusted rate. Yield rates and growth assumptions utilized are derived from market transactions as well as other financial and industry data. The fair value for these investments are classified within level 3 of the valuation hierarchy.
Contributions
At a minimum, Praxair contributes to its pension plans to comply with local regulatory requirements (e.g., ERISA in the United States). Discretionary contributions in excess of the local minimum requirements are made based on many factors, including long-term projections of the plans' funded status, the economic environment, potential risk of overfunding, pension insurance costs and alternative uses of the cash. Changes to these factors can impact the timing of discretionary contributions from year to year. Pension contributions were $18 million in 2014, $52 million in 2013 and $184 million in 2012. Estimated required contributions for 2015 are currently expected to be in the area of $15

million.

Table of Contents

Estimated Future Benefit Payments

The following table presents estimated future benefit payments, net of participants contributions:

(Millions of dollars)	Pensions		
Year Ended December 31,	U.S.	International	OPEB
2015	$105	$36	$17
2016	101	36	16
2017	106	37	16
2018	111	38	15
2019	117	39	15
2020-2024	625	211	68

NOTE 17. COMMITMENTS AND CONTINGENCIES

The company accrues non income-tax liabilities for contingencies when management believes that a loss is probable and the amounts can be reasonably estimated, while contingent gains are recognized only when realized. In the event any losses are sustained in excess of accruals, they will be charged against income at that time. Attorney fees are recorded as incurred. Commitments represent obligations, such as those for future purchases of goods or services, that are not yet recorded on the company's balance sheet as liabilities. The company records liabilities for commitments when incurred (i.e., when the goods or services are received).

Contingent Liabilities

Praxair is subject to various lawsuits and government investigations that arise from time to time in the ordinary course of business. These actions are based upon alleged environmental, tax, antitrust and personal injury claims, among others. Praxair has strong defenses in these cases and intends to defend itself vigorously. However, it is possible that the company may incur losses in connection with some of these actions in excess of accrued liabilities. Management does not anticipate that in the aggregate such losses would have a material adverse effect on the company's consolidated financial position or liquidity; however, it is possible that the final outcomes could have a significant impact on the company's reported results of operations in any given period.

Significant matters are:

- During May 2009, the Brazilian government published Law 11941/2009 instituting a new voluntary amnesty program ("Refis Program") which allowed Brazilian companies to settle certain federal tax disputes at reduced amounts. During the 2009 third quarter, Praxair decided that it was economically beneficial to settle many of its outstanding federal tax disputes and such disputes were enrolled in the Refis Program, subject to final calculation and review by the Brazilian federal government. The Company recorded estimated liabilities based on the terms of the Refis Program. Since 2009, Praxair has been unable to reach final agreement on the calculations and recently initiated litigation against the government in an attempt to resolve certain items. Open issues relate to the following matters: (i) application of cash deposits and net operating loss carryforwards to satisfy obligations and (ii) the amount of tax reductions available under the Refis Program. Although it is difficult to estimate the timing of resolution of legal matters in Brazil, it is possible that individual disputed matters may be resolved during the next year.
- At December 31, 2014 the most significant non-income and income tax claims in Brazil, after enrollment in the Refis Program, relate to state VAT tax matters associated with procedural issues and a federal income tax matter where the taxing authorities are challenging the tax rate that should be applied to income generated by a subsidiary company. The total estimated exposure relating to such claims, including interest and penalties, as appropriate, is approximately $180 million. Praxair has not recorded any liabilities related to such claims based on management judgments, after considering judgments and opinions of outside counsel. Because litigation in Brazil historically takes many years to resolve, it is very difficult to estimate the timing of resolution of these matters; however, it is possible that certain of these matters may be resolved within the near term. The company is vigorously defending against the proceedings.
- On September 1, 2010, CADE ("Brazilian Administrative Council for Economic Defense") announced alleged anticompetitive activity on the part of five industrial gas companies in Brazil and imposed fines on all five companies. Originally, CADE imposed a civil fine of R$2.2 billion Brazilian reais (US$828 million) against White Martins, the Brazil-based subsidiary of Praxair, Inc. In response to a motion for clarification,

the fine was reduced to R$1.7 billion Brazilian reais (US$640 million) due to a calculation error made by CADE. The amount of the fine is subject to indexation using SELIC. On September 2, 2010, Praxair issued a press release and filed a report on Form 8-K rejecting all claims and stating that the fine represents a gross and arbitrary disregard of Brazilian law.

On October 19, 2010, White Martins filed an annulment petition ("appeal") with the Federal Court in Brasilia seeking to have the fine against White Martins entirely overturned. In order to suspend payment of the fine pending the completion of the appeal process, Brazilian law required that the company tender a form of guarantee in the amount of the fine as security. Currently, 50% of the guarantee is satisfied by letters of credit with a financial institution and 50% of the guarantee is satisfied by equity of a Brazilian subsidiary.

Praxair strongly believes that the allegations are without merit and that the fine will be entirely overturned during the appeal process. The company further believes that it has strong defenses and will vigorously defend against the allegations and related fine up to such levels of the Federal Courts in Brazil as may be necessary. Because appeals in Brazil historically take many years to resolve, it is very difficult to estimate when the appeal will be finally decided. Based on management judgments, after considering judgments and opinions of outside counsel, no reserve has been recorded for this proceeding as management does not believe that a loss is probable.

Contingent Asset - Resolution

Praxair's Brazilian-based subsidiary, White Martins, had a long-standing claim against a Brazilian power company, Bandeirante Energia SA, which had been successfully litigated, and in 2011 the courts released a cash deposit to White Martins, subject to completion of an appeal process. During the first quarter of 2012, White Martins was notified that the appeal process was favorably concluded, and accordingly, recognized a $24 million gain to other income (expense), net of legal fees and another litigation matter.

Commitments and Contractual Obligations

The following table sets forth Praxair's material commitments and contractual obligations as of December 31, 2014, excluding leases, tax liabilities for uncertain tax positions, long-term debt, other post retirement and pension obligations which are summarized elsewhere in the financial statements (see Notes 4, 7, 11, and 16):

(Millions of dollars) Expiring through December 31,	Unconditional Purchase Obligations	Construction Commitments	Guarantees and Other
2015	$543	$954	$12
2016	491	404	59
2017	460	27	—
2018	445	—	—
2019	393	—	—
Thereafter	3,021	—	—
	$5,353	$1,385	$71

Unconditional purchase obligations of $5,353 million represent contractual commitments under various long and short-term take-or-pay arrangements with suppliers and are not included on Praxair's balance sheet. These obligations are primarily minimum-purchase commitments for helium, electricity, natural gas and feedstock used to produce atmospheric and process gases. A significant portion of these obligations is passed on to customers through similar take-or-pay or other contractual arrangements. Purchase obligations that are not passed along to customers through such contractual arrangements are subject to market conditions, but do not represent a material risk to Praxair. During 2014, payments related to Praxair's unconditional purchase obligations totaled $1,021 million, including $481 million for electricity and $225 million for natural gas. Approximately $3,550 million of the purchase obligations relates to power and is intended to secure the uninterrupted supply of electricity and feedstock to Praxair's plants to reliably satisfy customer product supply obligations, and extend through 2030. Certain of the power contracts contain various cancellation provisions requiring supplier agreement which the company believes could reduce the reported obligation significantly, if desired, and many are subject to annual escalations based on local inflation factors. The purchase obligations also include a multi-year contract for silane, with a total purchase obligation of $142 million as of December 31, 2014. Since this contract was signed, the market for silane has not developed as expected and prices have decreased due to lower demand from the photovoltaics markets, primarily in Asia. At December 31, 2014, Praxair's current selling prices and estimated future demand for silane

96

are in excess of its contractual purchase obligations under the contract. The company is continually monitoring market developments.

Construction commitments of $1,385 million represent outstanding commitments to complete authorized construction projects as of December 31, 2014. A significant portion of Praxair's capital spending is related to the construction of new production facilities to satisfy customer commitments which may take a year or more to complete.

Guarantees and other of $71 million include $70 million related to Praxair's contingent obligations under guarantees of certain debt of unconsolidated affiliates and $1 million of various guarantees relating to outstanding receivables and repurchase agreements. Unconsolidated equity investees had total debt of approximately $245 million at December 31, 2014, which was non-recourse to Praxair with the exception of the guaranteed portions described above. Praxair has no significant financing arrangements with closely-held related parties.

At December 31, 2014, Praxair had undrawn outstanding letters of credit, bank guarantees and surety bonds valued at approximately $1,240 million from financial institutions, including $524 million relating to the CADE anti-trust litigation in Brazil. These relate primarily to customer contract performance guarantees (including plant construction in connection with certain on-site contracts), self-insurance claims and other commercial and governmental requirements, including foreign litigation matters.

NOTE 18. SEGMENT INFORMATION

The company's operations are organized into five reportable segments, four of which have been determined on a geographic basis of segmentation: North America, Europe, South America and Asia. In addition, Praxair operates its worldwide surface technologies business through its wholly-owned subsidiary, Praxair Surface Technologies, Inc., which represents the fifth reportable segment.

Praxair's operations consist of two major product lines: industrial gases and surface technologies. The industrial gases product line centers on the manufacturing and distribution of atmospheric gases (oxygen, nitrogen, argon, rare gases) and process gases (carbon dioxide, helium, hydrogen, electronic gases, specialty gases, acetylene). Many of these products are co-products of the same manufacturing process. Praxair manufactures and distributes nearly all of its products and manages its customer relationships on a regional basis. Praxair's industrial gases are distributed to various end markets within a regional segment through one of three basic distribution methods: on-site or tonnage; merchant or bulk; and packaged or cylinder gases. The distribution methods are generally integrated in order to best meet the customer's needs and very few of its products can be economically transported outside of a region. Therefore, the distribution economics are specific to the various geographies in which the company operates and are consistent with how management assesses performance.

Praxair evaluates the performance of its reportable segments based primarily on operating profit, excluding inter-company royalties and items not indicative of ongoing business trends. Corporate and globally managed expenses, and research and development costs relating to Praxair's global industrial gases business, are allocated to operating segments based on sales.

The table below presents information about reportable segments for the years ended December 31, 2014, 2013 and 2012.

(Millions of dollars)	2014	2013	2012
Sales (a)			
North America	$6,436	$6,164	$5,598
Europe	1,546	1,542	1,474
South America	1,993	2,042	2,082
Asia	1,619	1,525	1,414
Surface Technologies	679	652	656
	$12,273	$11,925	$11,224

Table of Contents

	2014	2013	2012
Operating Profit			
North America	$1,580	$1,538	$1,465
Europe	291	270	256
South America	449	467	429
Asia	303	271	246
Surface Technologies	123	111	106
Segment operating profit	2,746	2,657	2,502
Venezuela currency devaluation and other charges (Note 2)	(138)	(32)	(65)
Total operating profit	$2,608	$2,625	$2,437
	2014	2013	2012
Total Assets (b)			
North America	$10,205	$10,133	$8,491
Europe	3,000	3,408	2,957
South America	2,723	2,934	3,205
Asia	3,198	3,098	2,757
Surface Technologies	676	682	680
	$19,802	$20,255	$18,090
(Millions of dollars)	2014	2013	2012
Depreciation and Amortization			
North America	$611	$567	$498
Europe	168	169	149
South America	177	181	184
Asia	170	150	127
Surface Technologies	44	42	43
	$1,170	$1,109	$1,001
	2014	2013	2012
Capital Expenditures and Acquisitions			
North America	$837	$2,106	$1,303
Europe	319	451	322
South America	373	284	351
Asia	310	459	431
Surface Technologies	56	43	53
	$1,895	$3,343	$2,460
	2014	2013	2012
Sales by Product Group			
Atmospheric gases and related	$8,623	$8,451	$8,104
Process gases and other	2,971	2,822	2,464
Surface technologies	679	652	656
	$12,273	$11,925	$11,224

Table of Contents

	2014	2013	2012
Sales by Major Country			
United States	$5,171	$4,764	$4,305
Brazil	1,511	1,603	1,668
Other – foreign	5,591	5,558	5,251
	$12,273	$11,925	$11,224
	2014	2013	2012
Long-lived Assets by Major Country (c)			
United States	$4,817	$4,723	$4,255
Brazil	1,344	1,376	1,535
Other – foreign	5,836	6,179	5,663
	$11,997	$12,278	$11,453

(a) Sales reflect external sales only. Intersegment Sales, primarily from North America to other segments, were not material.

(b) Includes equity investments as of December 31, as follows:

(Millions of dollars)	2014	2013	2012
North America	$132	$128	$135
Europe	207	218	199
Asia	354	356	320
	$693	$702	$654

Changes primarily relate to equity investment earnings, dividends and currency impacts.

(c) Long-lived assets include property, plant and equipment – net.

NOTE 19. QUARTERLY DATA (UNAUDITED)

(Dollar amounts in millions, except per share data)

2014	1Q	2Q	3Q	4Q (a)	YEAR (a)
Sales	$3,026	$3,113	$3,144	$2,990	$12,273
Cost of sales, exclusive of depreciation and amortization	$1,726	$1,767	$1,780	$1,689	$6,962
Depreciation and amortization	$285	$293	$301	$291	$1,170
Operating profit	$675	$697	$711	$525	2,608
Net income – Praxair, Inc.	$448	$467	$477	$302	$1,694
Basic Per Share Data					
Net income	$1.52	$1.59	$1.63	$1.04	$5.79
Weighted average shares (000's)	294,195	292,945	292,170	290,667	292,494
Diluted Per Share Data					
Net income	$1.51	$1.58	$1.62	$1.03	$5.73
Weighted average shares (000's)	297,253	295,976	295,239	293,555	295,608

Table of Contents

2013	1Q (a)	2Q	3Q (a)	4Q (a)	YEAR (a)
Sales	$2,888	$3,014	$3,013	$3,010	$11,925
Cost of sales, exclusive of depreciation and amortization	$1,638	$1,710	$1,697	$1,699	$6,744
Depreciation and amortization	$266	$275	$281	$287	$1,109
Operating profit	$600	$665	$670	$690	$2,625
Net income – Praxair, Inc.	$391	$445	$445	$474	$1,755
Basic Per Share Data					
Net income	$1.32	$1.50	$1.51	$1.61	$5.94
Weighted average shares (000's)	296,604	295,668	295,124	294,697	295,523
Diluted Per Share Data					
Net income	$1.30	$1.49	$1.49	$1.59	$5.87
Weighted average shares (000's)	299,700	298,654	298,357	298,225	298,965

(a) 2014 and 2013 include the impact of the following benefits/(charges) (see Notes 2, 5 & 7):

(Millions of dollars)	Operating Profit/ (Loss)	Net Income/ (Loss)	Diluted Earnings Per Share
Venezuela currency devaluation - Q4	$(131)	$(131)	$(0.45)
Pension settlement charge - Q4	(7)	(5)	(0.02)
Bond redemption -Q4	—	(22)	(0.07)
Year 2014	$(138)	$(158)	$(0.54)
Venezuela currency devaluation – Q1	$(23)	$(23)	$(0.08)
Pension settlement charge – Q3	(9)	(6)	(0.02)
Income tax benefit - Q4	—	24	0.08
Bond redemption - Q4	—	(12)	(0.04)
Year 2013	$(32)	$(17)	$(0.06)

100

Table of Contents

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Based on an evaluation of the effectiveness of Praxair's disclosure controls and procedures, which was made under the supervision and with the participation of management, including Praxair's principal executive officer and principal financial officer, the principal executive officer and principal financial officer have each concluded that, as of the end of the annual period covered by this report, such disclosure controls and procedures are effective in ensuring that information required to be disclosed by Praxair in reports that it files under the Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and accumulated and communicated to management including Praxair's principal executive officer and principal financial officer, to allow timely decisions regarding required disclosure.

Management's Report on Internal Control Over Financial Reporting

Praxair's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including the company's principal executive officer and principal financial officer, Praxair conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (often referred to as COSO). Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of December 31, 2014.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has issued their opinion on the company's internal control over financial reporting as of December 31, 2014 as stated in their report in Item 8.

Changes in Internal Control over Financial Reporting

There were no changes in Praxair's internal control over financial reporting that occurred during the fourth quarter of 2014 that have materially affected, or are reasonably likely to materially affect, Praxair's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

Table of Contents

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Certain information required by this item is incorporated herein by reference to the sections captioned “The Board of Directors”, “Executive Officers” and “Corporate Governance And Board Practices-Section 16(a) Beneficial Ownership Reporting Compliance” in Praxair’s Proxy Statement for the Annual Meeting of Shareholders to be held on April 28, 2015.

Identification of the Audit Committee

Praxair has a separately-designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934 as amended (the “Exchange Act”). The members of that Audit Committee are Ira D. Hall, Chairman, Nance K. Dicciani, Raymond W. LeBoeuf, Larry D. McVay and Denise L. Ramos.

Audit Committee Financial Expert

The Praxair Board of Directors has determined that each of, Raymond W. LeBoeuf, Ira D. Hall and Denise L. Ramos is an “audit committee financial expert” as defined by Item 407(d)(5)(ii) of Regulation S-K of the Exchange Act and is independent within the meaning of the independence standards adopted by the Board of Directors and those of the New York Stock Exchange.

Code of Ethics

Praxair has adopted a code of ethics that applies to the company’s directors and all employees, including its Chief Executive Officer, Chief Financial Officer, and Controller. This code of ethics has been approved by the Praxair Board of Directors and is named the “Compliance with Laws and Business Integrity and Ethics Policy”. To assist employees and directors in complying with this code of ethics, management, from time to time, develops specific standards implementing certain provisions of the code which standards are contained in Praxair’s “Standards of Business Integrity.” Both documents are posted on the company’s public website, www.praxair.com.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this item is incorporated herein by reference to the sections captioned “Executive Compensation” and “Director Compensation” in Praxair’s Proxy Statement for the Annual Meeting of Shareholders to be held on April 28, 2015.

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

Equity Compensation Plans Information – The table below provides information as of December 31, 2014 about company stock that may be issued upon the exercise of options, warrants and rights granted to employees or members of Praxair’s Board of Directors under present and former equity compensation plans, including plans approved by shareholders and one plan which has not been approved by shareholders, the 1996 Praxair, Inc. Performance Incentive Plan ("the 1996 Plan"). The equity compensation plan not approved by shareholders was terminated in March 2001 and directors and officers of the company were not eligible to participate in that plan. Shareholder approval of that plan was not required under applicable NYSE rules. The 1996 Plan provided for granting nonqualified or incentive stock options, stock grants, performance awards and other stock related incentives for key employees. The exercise price under the 1996 Plan was equal to the closing price of Praxair’s common stock on the date of grant. Options that were granted under this plan became exercisable after one or more years after the date of grant and the option term was no more than ten years.

Table of Contents

EQUITY COMPENSATION PLANS TABLE

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)		Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by shareholders	12,121,179	(1)	$80.65	7,982,085
Equity compensation plans not approved by shareholders	—		—	—
Total	12,121,179		$80.65	7,982,085

(1) This amount includes 307,159 restricted shares and 832,860 performance shares. Up to an additional 700,345 performance shares could be issued if performance goals are achieved at the maximum specified targets. See Note 15 to the consolidated financial statements.

Certain information required by this item regarding the beneficial ownership of the Company's common stock is incorporated herein by reference to the section captioned "Share Ownership" in Praxair's Proxy Statement for the Annual Meeting of Shareholders to be held on April 28, 2015.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information required by this item is incorporated herein by reference to the sections captioned "Corporate Governance And Board Practices – Review, Approval or Ratification of Transactions with Related Persons," "Corporate Governance And Board Practices – Certain Relationships and Transactions," and "Corporate Governance And Board Practices – Director Independence" in Praxair's Proxy Statement for the Annual Meeting of Shareholders to be held on April 28, 2015.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information required by this item is incorporated herein by reference to the section captioned "The Independent Auditor" in Praxair's Proxy Statement for the Annual Meeting of Shareholders to be held on April 28, 2015.

Table of Contents

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report:

(1) The company's 2014 Consolidated Financial Statements and the Report of the Independent Registered Public Accounting Firm are included in Part II, Item 8. Financial Statements and Supplementary Data.

(2) Financial Statement Schedules – All financial statement schedules have been omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(3) Exhibits – The exhibits filed as part of this Annual Report on Form 10-K are listed in the accompanying index.

Table of Contents

SIGNATURES

Praxair, Inc. and Subsidiaries

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report on Form 10-K/A to be signed on its behalf by the undersigned thereunto duly authorized on February 27, 2015.

PRAXAIR, INC.
(Registrant)

By: /s/ ELIZABETH T. HIRSCH
Elizabeth T. Hirsch
Vice President and Controller
(On behalf of the Registrant and
as Chief Accounting Officer)

INDEX TO EXHIBITS
Praxair, Inc. and Subsidiaries

Exhibit No.	Description
3.01	Restated Certificate of Incorporation of Praxair, Inc. as filed with the Secretary of State of the State of Delaware on April 27, 2012 (Filed as Exhibit 3.01 to the Company's Current Report on Form 8-K dated April 30, 2012, Filing No. 1-11037, and incorporated herein by reference).
3.02	Amended and Restated By-Laws of Praxair, Inc. (Filed as Exhibit 3.02 to the Company's Current Report on Form 8-K dated April 30, 2012, Filing No. 1-11037, and incorporated herein by reference).
3.03	Certificate of Designations for the 7.48% Cumulative Preferred Stock, Series A (Filed on February 13, 1997 as Exhibit 3.3 to Amendment #1 to the Company's Registration Statement on Form S-3, Registration No. 333-18141).
3.04	Certificate of Designations for the 6.75% Cumulative Preferred Stock, Series B (Filed on February 13, 1997 as Exhibit 3.4 to Amendment #1 to the Company's Registration Statement on Form S-3, Registration No. 333-18141).
4.01	Common Stock Certificate (Filed as Exhibit 4.01 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
4.02	Indenture, dated as of July 15, 1992, between Praxair, Inc. and U.S. Bank National Association, as the ultimate successor trustee to Bank of America, Illinois, formerly Continental Bank, National Association (Filed as Exhibit 4 to the Company's Current Report on Form 8-K dated March 19, 2007, Filing No. 1-11037, and incorporated herein by reference).
4.03	Copies of the agreements relating to long-term debt which are not required to be filed as exhibits to this Annual Report on Form 10-K will be furnished to the Securities and Exchange Commission upon request.
4.04	Series A Preferred Stock Certificate (Filed on February 7, 1997 as Exhibit 4.3 to Amendment #1 to the Company's Registration Statement on Form S-3, Registration No. 333-18141).
4.05	Series B Preferred Stock Certificate (Filed on February 7, 1997 as Exhibit 4.4 to Amendment #1 to the Company's Registration Statement on Form S-3, Registration No. 333-18141).
*10.01	Restated 2002 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.01 to the Company's 2003 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.01a	Amendment, dated as of October 24, 2006, to the Amended and Restated 2002 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.01a to the Company's 2006 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.01b	Amendment, dated as of January 23, 2007, to the Amended and Restated 2002 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.01b to the Company's 2006 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).

*10.01c	Form of Standard Option Award under the 2002 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.01c to the Company's 2007 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.01d	Form of Transferable Option Award under the 2002 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.01d to the Company's 2007 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).

Table of Contents

Exhibit No.	Description
*10.02	Form of Executive Severance Compensation Agreement effective January 1, 2009 (Filed as Exhibit 10.02 to the Company’s 2008 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.02a	Form of Amendment, effective December 31, 2012, to Executive Severance Compensation Agreements that were effective January 1, 2009 (Filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated December 14, 2012, Filing No. 1-11037, and incorporated herein by reference.
*10.02b	Form of Executive Severance Compensation Agreement effective January 1, 2010 (Filed as Exhibit 10.02 to the Company’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, Filing No. 1-11037, and incorporated herein by reference).
*10.02c	Form of Amendment, effective December 31, 2012, to Executive Severance Compensation Agreements that were effective January 1, 2010 (Filed as Exhibit 10.02c to the Company’s 2012 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.02d	Form of Executive Severance Compensation Agreement effective January 1, 2013 (Filed as Exhibit 10.02d to the Company’s 2012 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.03	Praxair, Inc. Variable Compensation Plan amended and restated effective April 24, 2012 (Filed as Exhibit 10.01 to the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2012, Filing No. 1-11037, and incorporated herein by reference).
*10.04	Amended and Restated 1995 Stock Option Plan for Non-Employee Directors (Filed as Exhibit 10.04 to the Company’s 2003 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.04a	First Amendment, dated as of October 24, 2006, to the Amended and Restated 1995 Stock Option Plan for Non-Employee Directors (Filed as Exhibit 10.04a to the Company’s 2006 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.04b	2005 Equity Compensation Plan for Non-Employee Directors of Praxair, Inc. amended and restated effective January 26, 2010 (Filed as Exhibit 10.04b to the Company’s 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.04c	Form of Option Award under the 2005 Equity Compensation Plan for Non-Employee Directors of Praxair, Inc (Filed as Exhibit 10.04a to the Company’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, Filing No. 1-11037, and incorporated herein by reference).
*10.05a	Praxair, Inc. Supplemental Retirement Income Plan A effective January 1, 2008 (Filed as Exhibit 10.05a to the Company’s 2008 Annual Report on Form 10-K, Filing No. 1-11037,

	and incorporated herein by reference).
*10.05b	First amendment to the Praxair, Inc. Supplemental Retirement Income Plan A effective January 1, 2010 (Filed as Exhibit 10.05b to the Company’s 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.05c	Praxair, Inc. Supplemental Retirement Income Plan B amended and restated effective December 31, 2007 (Filed as Exhibit 10.05b to the Company’s 2008 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.05d	First amendment to the Praxair, Inc. Supplemental Retirement Income Plan B effective January 1, 2010 (Filed as Exhibit 10.05d to the Company’s 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.05e	Second Amendment to Praxair, Inc. Supplemental Retirement Income Plan B effective July 1, 2012 (Filed as Exhibit 10.05e to the Company’s 2012 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.05f	Praxair, Inc. Equalization Benefit Plan amended and restated effective December 31, 2007 (Filed as Exhibit 10.05c to the Company’s 2008 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).

107

Table of Contents

Exhibit No.	Description
*10.05g	First amendment to the Praxair, Inc. Equalization Benefit Plan amended and restated effective January 1, 2010 (Filed as Exhibit 10.05f to the Company's 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.06	Praxair, Inc. Director's Fees Deferral Plan amended and restated effective January 26, 2010 (Filed as Exhibit 10.06 to the Company's 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.07	Praxair, Inc. Compensation Deferral Program Amended and Restated as of July 15, 2014 (Filed as Exhibit 10.01 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, Filing No. 1-11037, and incorporated herein by reference).
10.08	Transfer Agreement dated January 1, 1989, between Union Carbide Corporation and the registrant (Filed as Exhibit 10.06 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.08a	Amendment No. 1 dated as of December 31, 1989, to the Transfer Agreement (Filed as Exhibit 10.07 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.08b	Amendment No. 2 dated as of July 2, 1990, to the Transfer Agreement (Filed as Exhibit 10.08 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.08c	Amendment No. 3 dated as of January 2, 1991, to the Transfer Agreement (Filed as Exhibit 10.09 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.09	Transfer Agreement dated January 1, 1989, between Union Carbide Corporation and Union Carbide Coatings Service Corporation (Filed as Exhibit 10.14 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.09a	Amendment No. 1 dated as of December 31, 1989, to the Transfer Agreement (Filed as Exhibit 10.15 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.09b	Amendment No. 2 dated as of July 2, 1990, to the Transfer Agreement (Filed as Exhibit 10.16 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.10	Additional Provisions Agreement dated as of June 4, 1992 (Filed as Exhibit 10.21 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.11	

	Amended and Restated Realignment Indemnification Agreement dated as of June 4, 1992 (Filed as Exhibit 10.23 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.12	Environmental Management, Services and Liabilities Allocation Agreement dated as of January 1, 1990 (Filed as Exhibit 10.13 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.12a	Amendment No. 1 to the Environmental Management, Services and Liabilities Allocation Agreement dated as of June 4, 1992 (Filed as Exhibit 10.22 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.13	Danbury Lease-Related Services Agreement dated as of June 4, 1992 (Filed as Exhibit 10.24 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.13a	First Amendment to Danbury Lease-Related Services Agreement (Filed as Exhibit 10.13a to the Company's 1994 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).

Exhibit No.	Description
10.14	Danbury Lease Agreements, as amended (Filed as Exhibit 10.26 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.14a	Second Amendment to Linde Data Center Lease (Danbury) (Filed as Exhibit 10.14a to the Company's 1993 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
10.14b	Fourth Amendment to Carbide Center Lease (Filed as Exhibit 10.14b to the Company's 1993 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
10.14c	Third Amendment to Linde Data Center Lease (Filed as Exhibit 10.14c to the Company's 1994 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
10.14d	Fifth Amendment to Carbide Center Lease (Filed as Exhibit 10.14d to the Company's 1994 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
10.14e	Sixth Amendment to Carbide Center Lease (Filed as Exhibit 10.14e to the Company's 2004 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
10.15	Employee Benefits Agreement dated as of June 4, 1992 (Filed as Exhibit 10.25 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.15a	First Amendatory Agreement to the Employee Benefits Agreement (Filed as Exhibit 10.15a to the Company's 1994 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
10.16	Tax Disaffiliation Agreement dated as of June 4, 1992 (Filed as Exhibit 10.20 to the Company's Registration Statement on Form 10, Filing No. 1-11037, and incorporated herein by reference).
10.17	Credit Agreement dated as of December 19, 2014 among Praxair, Inc. and the Eligible Subsidiaries Referred to therein, the Lenders listed therein, and Bank of America, N.A., as Administrative Agent, Citibank N.A., Deutsche Bank Securities Inc. and HSBC Securities (USA) Inc., as Syndication Agents was filed as Exhibit 10.1 to the Company's current report on Form 8-K, dated December 22, 2014, Filing No. 1-11037, and is incorporated herein by reference.
*10.18	Praxair, Inc. Plan for Determining Performance-Based Awards Under Section 162(m) (included as Appendix 3 to the Company's definitive proxy statement for its 2011 annual meeting of shareholders filed on March 16, 2011 and incorporated herein by reference).

*10.19	Service Credit Arrangement for Stephen F. Angel dated May 23, 2007 was filed as Exhibit 10.20 to the Company's Form 8-K filed on May 24, 2007 and is incorporated herein by reference.
*10.20	2009 Praxair, Inc. Long Term Incentive Plan as amended on April 27, 2010, January 25, 2011 and October 23, 2012 was filed as Exhibit 10.2 to the Company's Current Report on Form 8-K dated December 14, 2012 Filing No. 1-11037, and incorporated herein by reference.
*10.21	Form of Standard Option Award under the 2009 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.22 to the Company's 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).

109

Table of Contents

Exhibit No.	Description
*10.22	Form of Transferable Option Award under the 2009 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.23 to the Company's 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.23	Form of Restricted Stock Unit Award under the 2009 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.24 to the Company's 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.24a	Form of Performance Share Unit Award under the 2009 Praxair, Inc. Long Term Incentive Plan for grants made from 2010-2013 (Filed as Exhibit 10.25 to the Company's 2009 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.24b	Form of Performance Share Unit Award under the 2009 Praxair, Inc. Long Term Incentive Plan for grants made in 2013-2014 with Earnings Per Share performance metrics (Filed as Exhibit 10.24b to the Company's 2012 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.24c	Form of Performance Share Unit Award under the 2009 Praxair, Inc. Long Term Incentive Plan for grants made in 2013-2014 with Return on Capital performance metrics (Filed as Exhibit 10.24c to the Company's 2012 Annual Report on Form 10-K, Filing No. 1-11037, and incorporated herein by reference).
*10.25	Amended and Restated 2009 Praxair, Inc. Long Term Incentive Plan (Filed as Exhibit 10.01 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, Filing No. 1-11037, and incorporated herein by reference).
*10.26	Form of Transferable Option Award under the Amended and Restated 2009 Praxair, Inc. Long Term Incentive Plan for grants made in 2015 and thereafter is filed herewith.
*10.27	Form of Restricted Stock Unit Award under the Amended and Restated 2009 Praxair, Inc. Long Term Incentive Plan for grants made in 2015 and thereafter is filed herewith.
*10.28a	Form of Performance Share Unit Award under the Amended and Restated 2009 Praxair, Inc. Long Term Incentive Plan for grants made in 2015 and thereafter with Earnings Per Share performance metrics is filed herewith.
*10.28b	Form of Performance Share Unit Award under the Amended and Restated 2009 Praxair, Inc. Long Term Incentive Plan for grants made in 2015 and thereafter with Return on Capital performance metrics is filed herewith.
*10.29	

	Letter of Clarification of Certain Pension Benefits dated October 26, 2010 between the Company and James T. Breedlove (Filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010, Filing No. 1-11037, and incorporated herein by reference).
10.30	Form of Standard Underwriting Agreement Provisions was filed as Exhibit 1.1 to the Company's Form S-3 filed on August 8, 2012, and is incorporated herein by reference.
10.31	Terms Agreement dated February 1, 2012 among the Company, Citigroup Global Markets Inc., HSBC Securities (USA) Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, as representatives of the underwriters named therein for the issuance and sale of $600,000,000 2.450% Notes due 2022, was filed as Exhibit 1 to the Company's Current Report on Form 8-K, dated February 6, 2012, Filing No. 1-11037, and incorporated herein by reference.
10.32	Terms Agreement dated July 30, 2012 among the Company, Credit Suisse Securities (USA) LLC, J.P. Morgan Securities LLC and Wells Fargo Securities, LLC, as representatives of the underwriters named therein for the issuance and sale of $500,000,000 2.20% Notes due August 15, 2022, was filed as Exhibit 1 to the Company's Current Report on Form 8-K, dated August 2, 2012, Filing No. 1-11037, and incorporated herein by reference.
10.33	Terms Agreement dated November 2, 2012 among the Company, Citigroup Global Markets Inc., Deutsche Bank Securities Inc. and RBS Securities Inc., as representatives of the underwriters named therein for the issuance and sale of $400,000,000 1.05% Notes due 2017, and $300,000,000 3.55% Notes due 2042, was filed as Exhibit 1 to the Company's Current Report on Form 8-K, dated November 7, 2012, Filing No. 1-11037, and incorporated herein by reference.

110

Table of Contents

Exhibit No.	Description
10.34	Terms Agreement dated February 13, 2013 among the Company, HSBC Securities (USA) Inc., Merrill Lynch, Pi Incorporated and Mitsubishi UFJ Securities (USA), Inc., as representatives of the underwriters named therein for of $400,000,000 0.75% Notes due 2016, and $500,000,000 aggregate principal amount of its 2.70 % Notes due 20 Exhibit 1 to the Company's Current Report on Form 8-K, dated February 19, 2013, Filing No. 1-11037, and incor reference.
10.35	Terms Agreement dated February 27, 2013 between the Company and Citigroup Global Markets Inc., the underw for the issuance and sale of $500,000,000 1.200% Notes due 2018, was filed as Exhibit 1 to the Company's Curre 8-K, dated March 4, 2013, Filing No. 1-11037, and incorporated herein by reference.
10.36	Terms Agreement dated April 29, 2013 among the Company, Citigroup Global Markets Inc. , Credit Suisse Secu RBS Securities Inc., as representatives of the underwriters named therein for the issuance and sale of $475,000,00 2018 and $175,000,000 3.550% Notes due 2042, was filed as Exhibit 1 to the Company's Current Report on Form 2013, Filing No. 1-11037, and incorporated herein by reference.
10.37	Terms Agreement dated November 4, 2013 between the Company and Citigroup Global Markets Inc., the underw for the issuance and sale of $500,000,000 1.900% Notes due 2019, was filed as Exhibit 1 to the Company's Curre 8-K, dated November 5, 2013, Filing No 1-11037, and incorporated herein by reference.
10.38	Terms Agreement dated March 4, 2014 among the Company and Credit Suisse Securities (Europe) Limited, Deut London Branch and HSBC Bank plc, acting on behalf of the several underwriters for the issuance and sale of €60 Notes due 2020, was filed as Exhibit 1 to the Company's current report on Form 8-K dated March 5, 2014, Filing incorporated herein by reference.
10.39	Terms Agreement dated November 21, 2014 among the Company and Citigroup Global Markets Limited, Deutsc Branch, HSBC Bank plc and Merrill Lynch International, acting on behalf of the several underwriters for the issu €500,000,000 1.625% Notes due 2025, was filed as Exhibit 1 to the Company's current report on Form 8-K dated Filing No. 1-11037, and incorporated herein by reference.
12.01	Computation of Ratio of Earnings to Fixed Charges.
21.01	Subsidiaries of Praxair, Inc.
23.01	Consent of Independent Registered Public Accounting Firm.
31.01	Rule 13a-14(a) Certification
31.02	Rule 13a-14(a) Certification
32.01	Section 1350 Certification (such certifications are furnished for the information of the Commission and shall not incorporated by reference into any filing under the Securities Act or the Exchange Act).
32.02	Section 1350 Certification (such certifications are furnished for the information of the Commission and shall not incorporated by reference into any filing under the Securities Act or the Exchange Act).

101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

Exhibit No.	Description
101.DEF	XBRL Taxonomy Extension Definition Linkbase

Copies of exhibits incorporated by reference can be obtained from the SEC and are located in SEC File No. 1-11037.

* Indicates a management contract or compensatory plan or arrangement.