

PROOFPOINT INC  
Form 10-Q  
August 02, 2018  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2018

OR

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

For the Transition Period from to

Commission File Number 001-35506

PROOFPOINT, INC.

(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	51-0414846 (I.R.S. employer identification no.)
892 Ross Drive  Sunnyvale, California (Address of principal executive offices)	94089 (Zip Code)

(408) 517-4710

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company
	Emerging growth company

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

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

Shares of Proofpoint, Inc. common stock, \$0.0001 par value per share, outstanding as of July 20, 2018: 51,272,010 shares.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

Proofpoint, Inc.

Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)

(Unaudited)

	June 30, 2018	December 31, 2017
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 114,225	\$ 286,072
Short-term investments	19,832	45,526
Accounts receivable, net	140,644	107,696
Inventory	400	730
Deferred product costs	1,727	1,541
Deferred commissions	29,711	26,249
Prepaid expenses and other current assets	22,349	18,669
Total current assets	328,888	486,483
Property and equipment, net	75,941	73,617
Long-term deferred product costs	326	259
Goodwill	460,592	297,704
Intangible assets, net	158,355	95,602
Long-term deferred commissions	53,712	51,954
Other assets	6,088	12,813
Total assets	\$ 1,083,902	\$ 1,018,432
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 17,229	\$ 12,271
Accrued liabilities	62,404	65,503
Capital lease obligations	35	34
Deferred rent	799	586
Deferred revenue	426,090	364,521
Total current liabilities	506,557	442,915
Convertible senior notes	204,011	197,858
Long-term capital lease obligations	38	55
Long-term deferred rent	3,950	4,102
Other long-term liabilities	7,162	11,069
Long-term deferred revenue	65,147	63,318
Total liabilities	786,865	719,317

Commitments and contingencies (Note 6)

Stockholders' equity:

Convertible preferred stock, \$0.0001 par value; 5,000 shares

authorized; no shares issued and outstanding

— —

Common stock, \$0.0001 par value; 200,000 shares authorized; 51,189

and 50,325 shares issued and outstanding at June 30, 2018 and

December 31, 2017, respectively

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Additional paid-in capital

835,156 787,572

Accumulated other comprehensive loss

(1 ) (9 )

Accumulated deficit

(538,123 ) (488,453 )

Total stockholders' equity

297,037 299,115

Total liabilities and stockholders' equity

\$1,083,902 \$ 1,018,432

See accompanying Notes to the Condensed Consolidated Financial Statements.

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Proofpoint, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,	2017	June 30,	2017
	2018		2018	
<b>Revenue:</b>				
Subscription	\$ 169,019	\$ 118,703	\$ 327,806	\$ 231,794
Hardware and services	2,856	3,738	6,530	6,282
Total revenue	171,875	122,441	334,336	238,076
<b>Cost of revenue:<sup>(1)(2)</sup></b>				
Subscription	45,618	30,363	87,816	58,684
Hardware and services	5,154	4,130	10,013	8,185
Total cost of revenue	50,772	34,493	97,829	66,869
Gross profit	121,103	87,948	236,507	171,207
<b>Operating expense:<sup>(1)(2)</sup></b>				
Research and development	47,527	32,306	91,259	61,912
Sales and marketing	84,911	60,126	162,808	116,046
General and administrative	19,029	12,348	36,554	22,835
Total operating expense	151,467	104,780	290,621	200,793
Operating loss	(30,364 )	(16,832 )	(54,114 )	(29,586 )
Interest expense	(3,187 )	(5,848 )	(6,008 )	(11,814 )
Other (expense) income, net	(633 )	184	(290 )	55
Loss before income taxes	(34,184 )	(22,496 )	(60,412 )	(41,345 )
(Provision for) benefit from income taxes	(114 )	(999 )	13,958	(2,433 )
Net loss	\$(34,298 )	\$(23,495 )	\$(46,454 )	\$(43,778 )
Net loss per share, basic and diluted	\$(0.67 )	\$(0.54 )	\$(0.92 )	\$(1.00 )
Weighted average shares outstanding, basic and diluted	50,935	43,890	50,721	43,562

(1) Includes stock-based compensation expense as follows:

Cost of subscription revenue	\$3,448	\$2,863	\$6,899	\$5,239
Cost of hardware and services revenue	\$571	\$469	\$1,162	\$908
Research and development	\$9,986	\$7,744	\$20,021	\$14,794
Sales and marketing	\$12,382	\$8,230	\$23,884	\$16,127
General and administrative	\$7,410	\$5,198	\$12,903	\$9,810

(2) Includes intangible amortization expense as follows:

Cost of subscription revenue	\$7,244	\$3,189	\$13,020	\$6,377
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Research and development	\$15	\$15	\$30	\$30
Sales and marketing	\$3,982	\$949	\$6,397	\$1,916

See accompanying Notes to the Condensed Consolidated Financial Statements.

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Proofpoint, Inc.

Condensed Consolidated Statements of Comprehensive Loss

(In thousands)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net loss	\$(34,298)	\$(23,495)	\$(46,454)	\$(43,778)
Other comprehensive income, net of tax:				
Unrealized gain on short-term investments, net	1	—	8	4
Comprehensive loss	\$(34,297)	\$(23,495)	\$(46,446)	\$(43,774)

See accompanying Notes to the Condensed Consolidated Financial Statements.

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Proofpoint, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2018	2017
Cash flows from operating activities		
Net loss	\$(46,454 )	\$(43,778 )
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	34,878	19,147
Stock-based compensation	64,869	46,878
Change in fair value of contingent consideration	(79 )	(1,730 )
Amortization of debt issuance costs and accretion of debt discount	6,153	10,888
Amortization of deferred commissions	16,708	13,275
Deferred income taxes	(14,896 )	(1,974 )
Other	820	139
Changes in assets and liabilities:		
Accounts receivable	(23,025 )	(2,746 )
Inventory	330	101
Deferred product costs	(253 )	359
Deferred commissions	(21,929 )	(17,623 )
Prepaid expenses	(2,614 )	(1,686 )
Other current assets	1,657	260
Long-term assets	350	(3,710 )
Accounts payable	4,210	(1,374 )
Accrued liabilities	(4,498 )	4,565
Deferred rent	61	824
Deferred revenue	48,698	45,140
Net cash provided by operating activities	64,986	66,955
Cash flows from investing activities		
Proceeds from maturities of short-term investments	37,432	56,081
Proceeds from sales for short-term investments	11,931	—
Purchase of short-term investments	(23,694 )	(41,360 )
Purchase of property and equipment	(16,611 )	(22,867 )
Receipt from escrow account	555	4,620
Acquisition of business, net of cash acquired	(223,786)	—
Net cash used in investing activities	(214,173)	(3,526 )
Cash flows from financing activities		
Proceeds from issuance of common stock	13,001	13,218
Withholding taxes related to restricted stock net share settlement	(34,640 )	(25,122 )

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Repayments of equipment loans and capital lease obligations	(16 )	(16 )
Contingent consideration payment	(555 )	(4,620 )
Net cash used in financing activities	(22,210 )	(16,540 )
Effect of exchange rate changes on cash, cash equivalents and		
restricted cash	(213 )	575
Net (decrease) increase in cash, cash equivalents and restricted cash	(171,610)	47,464
Cash, cash equivalents and restricted cash		
Beginning of period	286,660	345,537
End of period	\$115,050	\$393,001
Supplemental disclosure of noncash investing and financing information		
Unpaid purchases of property and equipment and asset retirement		
obligations	\$3,850	\$6,275
Liability awards converted to equity	\$8,870	\$8,307

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	June 30, 2018	June 30, 2017
Reconciliation of cash, cash equivalents and restricted cash as shown in the consolidated statement of cash flows		
Cash and cash equivalents	\$ 114,225	\$ 392,886
Restricted cash included in prepaid expenses and other current assets	337	83
Restricted cash included in other non-current assets	488	32
Total cash, cash equivalents and restricted cash	\$ 115,050	\$ 393,001

See accompanying Notes to the Condensed Consolidated Financial Statements.

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Proofpoint, Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

(Dollars and share amounts in thousands, except per share amounts)

1. The Company and Summary of Significant Accounting Policies

The Company

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

Proofpoint, Inc. is a leading security-as-a-service provider that enables large and mid-sized organizations worldwide to defend, protect, archive and govern their most sensitive data. The Company’s security-and compliance platform is comprised of an integrated suite of threat protection, information protection, and brand protection solutions, including email protection, advanced threat protection, email authentication, data loss prevention, SaaS application protection, response orchestration and automation, digital risk, web browser isolation, email encryption, archiving, eDiscovery, supervision, secure communication, phishing simulation and security awareness computer-based training.

Basis of Presentation and Consolidation

These condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

These condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (“GAAP”), pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Certain information and note disclosures have been condensed or omitted pursuant to such rules and regulations. The accompanying Condensed Consolidated Balance Sheet as of December 31, 2017 is derived from audited financial statements as of that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The unaudited condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary for a fair statement of the periods presented. Certain prior period amounts have been adjusted due to the adoption of Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers: Topic 606 (“ASC 606”). Refer to Note 2 “Revenue, Deferred Revenue and Deferred Contract Costs” for more information. The results of operations for the three and six months ended June 30, 2018 are not necessarily indicative of the results to be expected for the year ending December 31, 2018 or for other interim periods or for future years.

These condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and accompanying notes for the year ended December 31, 2017 included in the Company’s Annual Report on Form 10-K filed with the SEC. The Company’s significant accounting policies are described in Note 1 to those audited consolidated financial statements. See Note 2 “Revenue, Deferred Revenue and Deferred Contract Costs” for the summary of the new accounting policies under ASC 606.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of expenses during the reporting period. Actual results could differ from those estimates and such difference may be material to the financial statements.

#### Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price of the acquired enterprise over the fair value of identifiable assets acquired and liabilities assumed. The Company performs an annual goodwill impairment test during the fourth quarter of a calendar year and more frequently if an event or circumstances indicates that impairment may have occurred. For the purposes of impairment testing, the Company has determined that it has one operating segment and one reporting unit. The Company performs a two-step impairment test of goodwill whereby the fair value of the reporting unit is compared to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not considered impaired and further testing is not required. If the carrying value of the net assets assigned to the

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reporting unit exceeds the fair value of the reporting unit, then the Company must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then impairment loss equal to the difference is recorded. The identification and measurement of goodwill impairment involves the estimation of the fair value of the Company. The estimate of fair value of the Company, based on the best information available as of the date of the assessment, is subjective and requires judgment, including management assumptions about expected future revenue forecasts and discount rates, changes in the overall economy, trends in the stock price and other factors. No impairment indicators were identified by the Company as of June 30, 2018.

Intangible assets consist of developed technology, customer relationships, non-compete arrangements, trademarks and patents and order backlog. The values assigned to intangibles are based on estimates and judgments regarding expectations for success and life cycle of solutions and technologies acquired.

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

	Low	High
Patents	4	5
Developed technology	3	7
Customer relationships	2	8
Order backlog	1	3
Trade names and trademarks	1	5

## Comprehensive Loss

Comprehensive loss includes all changes in equity that are not the result of transactions with stockholders. The Company's comprehensive loss consists of its net loss and changes in unrealized gains (losses) from its available-for-sale investments. The Company had no material reclassifications out of accumulated other comprehensive loss into net loss for the three and six months ended June 30, 2018 and 2017.

## Accounting Pronouncements Adopted in 2018

In May 2014, the FASB issued ASC 606 to supersede nearly all existing revenue recognition guidance under U.S. GAAP. The standard contains a comprehensive new revenue recognition model that requires revenue to be recognized in a manner to depict the transfer of services or products to a customer at an amount that reflects the consideration expected to be received in exchange for those services or products. The FASB has issued several amendments to the standard, including clarifications on disclosure of prior-period and remaining performance obligations. The Company adopted ASC 606 effective January 1, 2018 using full retrospective transition method. Refer to Note 2 "Revenue, Deferred Revenue and Deferred Contract Costs" for more information.

In October 2016, FASB issued ASU No. 2016-16, Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory ("ASU 2016-16"). ASU 2016-16 eliminates the requirement to defer the recognition of current and deferred income taxes for intra-entity asset transfer until the asset has been sold to an outside party. Therefore, an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer

occurs. ASU 2016-16 has been applied on a modified retrospective basis starting January 1, 2018. As a result of the adoption, the Company's long-term assets decreased and accumulated deficit increased by \$3,216 as of January 1, 2018, the date of adoption.

In August 2016, FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 clarifies how certain cash receipts and payments should be classified in the statement of cash flows, including the potential cash settlement of the Company's convertible senior notes. If the Company elects to cash settle its convertible senior notes (see Note 7 "Convertible Senior Notes"), repayment of the principal amounts will be bifurcated between (i) cash outflows for operating activities for the portion related to accreted interest attributable to debt discounts arising from the difference between the coupon interest rate and the effective interest rate, and (ii) financing activities for the remainder. See Note 7 "Convertible Senior Notes" regarding timing of settlement. The Company adopted ASU 2016-15 on January 1, 2018 with no impact on its consolidated financial statements.



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Recent Accounting Pronouncements Not Yet Effective

In January 2017, FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment (“ASU 2017-04”). ASU 2017-04 removes the requirement to perform a hypothetical purchase price allocation to measure goodwill impairment. A goodwill impairment charge will be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The update to the standard is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted, and should be applied prospectively. The Company does not expect ASU 2017-04 to have a material impact on its consolidated financial statements.

In June 2016, FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (“ASU 2016-13”). ASU 2016-13 changes the impairment model for most financial assets, and will require the use of an expected loss model in place of the currently used incurred loss method. Under this model, entities will be required to estimate the lifetime expected credit loss on such instruments and record an allowance to offset the amortized cost basis of the financial asset, resulting in a net presentation of the amount expected to be collected on the financial asset. The update to the standard is effective for interim and annual periods beginning after December 15, 2019. The Company is currently evaluating the impact of the adoption of ASU 2016-13 on its consolidated financial statements.

In February 2016, FASB issued ASU No. 2016-02, Leases (Topic 842) (“ASU 2016-02”), which requires lessees to put most leases on their balance sheets but recognize the expenses on their statements of operations in a manner similar to current practice. ASU 2016-02 states that a lessee would recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. The new standard is effective for interim and annual periods beginning after December 15, 2018 and early adoption is permitted. While the Company is currently assessing the impact ASU 2016-02 will have on the Company’s consolidated financial statements, the Company expects the primary impact to its consolidated financial position upon adoption will be the recognition, on a discounted basis, of the Company’s minimum commitments under non-cancelable operating leases on its consolidated balance sheets resulting in the recording of right of use assets and lease obligations.

2. Revenue, Deferred Revenue and Deferred Contract Costs

Effective January 1, 2018, the Company adopted ASC 606 using the full retrospective method. Under this method, the Company is presenting the consolidated financial statements as of December 31, 2017, and for the three and six months ended June 30, 2017, as if ASC 606 had been effective for those periods. The most significant impact of the standard related to i) the timing of revenue recognition for contracts related to certain on-premise offerings, in which the Company granted customers the right to deploy its subscription software on the customers’ own servers. For these contracts, the Company is required to recognize as revenue a significant portion of the contract price upon delivery of the software compared to the previous practice of recognizing the entire contract price ratably over a subscription period; and ii) the timing of revenue recognition in instances when all revenue recognition criteria were not met until after the start date of the subscription. Previously these amounts were recognized prospectively over the remaining contract term, while under ASC 606, the Company is required to recognize revenue on a cumulative catch-up basis for amounts earned up to the time all revenue recognition criteria have been met. In addition, iii) certain contract acquisition costs such as sales commissions are being amortized over an expected benefit period that is longer than the Company’s previous policy of amortizing the deferred amounts over the specific revenue contract term for the associated contract.

The Company applied ASC 606 using two practical expedients: 1) for the reporting periods presented before January 1, 2018, the Company won't disclose the amount of the transaction price allocated to the remaining performance obligations or an explanation of when the Company expects to recognize that amount as revenue; 2) the Company won't disclose the amount of the transaction price allocated to the remaining performance obligations for contracts with an original expected length of one year or less.

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Select condensed consolidated balance sheet line items, which reflect the adoption of the new standard, are as follows:

	December 31, 2017		
	As		
	Previously		
	Reported	Adjustments	As Adjusted
<b>Assets</b>			
Accounts receivable, net	\$ 109,325	\$ (1,629 )	\$ 107,696
Deferred commissions, current	\$ 27,144	\$ (895 )	\$ 26,249
Long-term deferred commissions	\$ 5,811	\$ 46,143	\$ 51,954
<b>Liabilities</b>			
Accrued liabilities	\$ 63,926	\$ 1,577	\$ 65,503
Deferred revenue	\$ 381,915	\$ (17,394 )	\$ 364,521
Long-term deferred revenue	\$ 69,873	\$ (6,555 )	\$ 63,318
<b>Stockholders' Equity</b>			
Accumulated deficit	\$ (554,444)	\$ 65,991	\$ (488,453)

Select unaudited condensed consolidated statements of operations line items, which reflect the adoption of the new standard, are as follows:

	Three Months Ended June 30, 2017		
	As		
	Previously		
	Reported	Adjustments	As Adjusted
<b>Revenue:</b>			
Subscription	\$ 118,928	\$ (225 )	\$ 118,703
Hardware and services	3,401	337	3,738
Total revenue	\$ 122,329	\$ 112	\$ 122,441
Gross profit	\$ 87,836	\$ 112	\$ 87,948
<b>Operating expense:</b>			
Sales and marketing	\$ 62,454	\$ (2,328 )	\$ 60,126
Operating loss	\$ (19,272 )	\$ 2,440	\$ (16,832 )
Net loss	\$ (25,935 )	\$ 2,440	\$ (23,495 )
Net loss per share, basic and diluted	\$ (0.59 )	\$ 0.05	\$ (0.54 )

	Six Months Ended June 30, 2017		
	As		
	Adjustments		
	As	As	Adjusted
	Previously		

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	Reported		
Revenue:			
Subscription	\$229,853	\$ 1,941	\$231,794
Hardware and services	5,726	556	6,282
Total revenue	\$235,579	\$ 2,497	\$238,076
Gross profit	\$168,710	\$ 2,497	\$171,207
Operating expense:			
Sales and marketing	\$121,186	\$ (5,140 )	\$116,046
Operating loss	\$(37,223 )	\$ 7,637	\$(29,586 )
Net loss	\$(51,415 )	\$ 7,637	\$(43,778 )
Net loss per share, basic and diluted	\$(1.18 )	\$ 0.18	\$(1.00 )

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Select unaudited condensed consolidated statement of cash flows line items, which reflect the adoption of the new standard are as follows:

	Six Months Ended June 30, 2017		
	As Previously		As
	Reported	Adjustments	Adjusted
Cash flows from operating activities			
Net loss	\$(51,415)	\$ 7,637	\$(43,778 )
Adjustments to reconcile net loss to net cash provided by operating activities:			
Amortization of deferred commissions	\$—	\$ 13,275	\$ 13,275
Changes in assets and liabilities:			
Accounts receivable	\$(2,725 )	\$ (21 )	\$(2,746 )
Deferred commissions	\$791	\$ (18,414 )	\$(17,623 )
Accrued liabilities	\$4,014	\$ 551	\$4,565
Deferred revenue	\$48,168	\$ (3,028 )	\$45,140
Net cash provided by operating activities	\$66,955	\$ —	\$66,955

The core principle of ASC 606 is to recognize revenue to depict the transfer of services or products to customers in an amount that reflects the consideration the Company expects to be entitled to in exchange for those services or products. The principle is achieved through the following five-step approach:

1. Identification of the contract, or contracts, with the customer - The Company considers the terms and conditions of the contract and its customary business practice in identifying its contracts under ASC 606. The Company determines it has a contract with a customer when the contract is approved, the Company can identify each party's rights regarding the services and products to be transferred, the Company can identify the payment terms for the services and products, the Company has determined the customer has the ability and intent to pay and the contract has commercial substance. At contract inception, the Company evaluates whether two or more contracts should be combined and accounted for as a single contract and whether the combined contract or single contract includes more than one performance obligation. The Company applies judgment in determining the customer's ability and intent to pay, which is based on a variety of factors, including the customer's historical payment experience or, in the case of a new customer, credit and financial information pertaining to the customer.

2. Identification of the performance obligation in the contract - Performance obligations promised in a contract are identified based on the services or products that will be transferred to the customer that are both i) capable of being distinct, whereby the customer can benefit from the service or product either on its own or together with other resources that are readily available from third parties or from the Company, and ii) distinct in the context of the contract, whereby the transfer of the services or products is separately identifiable from other promises in the contract. To the extent a contract includes multiple promised services or products, the Company applies judgment to determine whether promised services or products are capable of being distinct and distinct in the context of the contract. If these criteria are not met the promised services or products are accounted for as a combined performance obligation.

• **Determination of the transaction price** - The transaction price is determined based on the consideration to which the Company expects to be entitled in exchange for transferring services and products to the customer. Variable consideration is included in the transaction price if, in the Company's judgment, it is probable that a significant future reversal of cumulative revenue under the contract will not occur. None of the Company's contracts contain a significant financing component.

• **Allocation of the transaction price to the performance obligations in the contract** - If the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price, or SSP, basis.

• **Recognition of revenue when, or as, the Company satisfies a performance obligation** - The Company recognizes revenue when control of the services or products are transferred to the customers, in an amount that reflects the consideration the Company expects to be entitled to in exchange for those services or products. The Company records its revenue net of any value added or sales tax.

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The Company generates sales directly through its sales team and, to a growing extent, through its channel partners. Sales to channel partners are made at a discount and revenues are recorded at this discounted price once all revenue recognition criteria are met. Channel partners generally receive an order from an end-customer prior to placing an order with the Company, and these partners do not carry any inventory of the Company's products or solutions. Payment from channel partners is not contingent on the partner's success in sales to end-customers. In the event that the Company offers rebates, joint marketing funds, or other incentive programs to a partner, recorded revenues are reduced by these amounts accordingly.

Payment terms on invoiced amounts are typically 30 to 45 days.

## Disaggregation of Revenue

The Company derives its revenue primarily from: (1) subscription service revenue; (2) subscription software revenue, and (3) hardware and services, which include professional service and training revenue provided to customers related to their use of the platform.

The following table presents the Company's revenue disaggregation:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Subscription service revenue	\$165,365	\$115,811	\$317,985	\$224,137
Subscription software revenue	3,654	2,892	9,821	7,657
Hardware and services	2,856	3,738	6,530	6,282
Total revenue	\$171,875	\$122,441	\$334,336	\$238,076

## Subscription service revenue

Subscription service revenue is derived from a subscription-based enterprise licensing model with contract terms typically ranging from one to three years, and consists of (1) subscription fees from the licensing of the Company's security-as-a-service platform and its various components, (2) subscription fees for software with support and related future updates where the software updates are critical to the customers' ability to derive benefit from the software due to the fast changing nature of the technology. These function together as one performance obligation, and (3) subscription fees for the right to access the Company's customer support services for software with significant standalone functionality and support services for hardware. The hosted on-demand service arrangements do not provide customers with the right to take possession of the software supporting the hosted services. Support revenue is derived from ongoing security updates, upgrades, bug fixes, and maintenance. A time-elapsed method is used to measure progress because the Company transfers control evenly over the contractual period. Accordingly, the fixed consideration related to subscription service revenue is generally recognized on a straight-line basis over the contract term beginning on the date access is provided, as long as other revenue recognition criteria have been met. Most of the company's contracts are non-cancelable over the contract term. Customers typically have the right to terminate their contract for cause if the Company fails to perform in accordance with the contractual terms. Some of the Company's customers have the option to purchase additional subscription services at a stated price. These options are evaluated on a case-by-case basis but generally do not provide a material right as they are priced at or above the Company's SSP

and, as such, would not result in a separate performance obligation.

#### Subscription software revenue

Subscription software revenue is primarily derived from term-based software that is deployed on the customers' own servers and has significant standalone functionality, is recognized upon transfer of control to the customer. The control for subscription software is transferred at the later of delivery to the customer or the software license start date.

#### Hardware and services

Hardware revenue consists of amounts derived from the sale of the Company's on-premise hardware appliance, which is recognized upon passage of control, which occurs upon shipment of the product. Professional services revenue consists of fees associated with consulting, implementation and training services for assisting customers in implementing and expanding the use of the Company's services and products. These services are distinct from subscription, subscription software licenses and hardware. Professional services do not result in significant customization of the Company's services and products. The Company recognizes revenue related to the professional services as they are performed.



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### Contracts with multiple performance obligations

Most of the Company's contracts with customers contain multiple performance obligations that are distinct and accounted for separately. The transaction price allocated to subscription services and subscription software that does not have significant standalone functionality is determined by considering factors such as historical pricing practices, and the selling price of hardware and professional services is estimated using a cost plus model. The selling price for support of a functional subscription software license is calculated as a percentage of functional subscription software license value which is derived by analyzing internal pricing practice, customer expectations, and industry practice.

### Variable Consideration

Revenue from sales is recorded at the net sales price, which is the transaction price, and includes estimates of variable consideration. The amount of variable consideration that is included in the transaction price is constrained, and is included in the net sales price only to the extent that it is probable that a significant reversal in the amount of the cumulative revenue will not occur when the uncertainty is resolved. If the Company's services or products do not meet certain service level commitments, the Company's customers are entitled to receive service credits representing a form of variable consideration. The Company has not historically experienced any significant incidents affecting the defined levels of reliability and performance as required by the Company's subscription contracts. Accordingly, any estimated refunds related to these contracts in the condensed consolidated financial statements are not material during the periods presented.

### Unbilled accounts receivables

Unbilled accounts receivable represents amounts for which the Company has recognized revenue, pursuant to its revenue recognition policy, for software licenses already delivered and professional services already performed, but billed in arrears and for which the Company believes it has an unconditional right to payment. The unbilled accounts receivable balance, included in accounts receivable in the condensed consolidated balance sheet, was \$1,090 and \$603 as of June 30, 2018 and December 31, 2017.

### Deferred commissions

The Company capitalizes sales commissions and associated payroll taxes paid to internal sales personnel, and referral fees paid to independent third-parties, that are incremental to the acquisition of customer contracts. These costs are recorded as deferred commissions on the condensed consolidated balance sheets. The Company determines whether costs should be deferred based on its sales compensation plans, if the commissions are incremental and would not have occurred absent the customer contract. Sales commissions for renewal of a subscription contract are not considered commensurate with the commissions paid for the acquisition of the initial subscription contract given the substantive difference in commission rate between new and renewal contracts. Commissions paid upon the initial acquisition of a contract are amortized over an estimated period of benefit of five years while commissions paid related to renewal contracts are amortized over a contractual renewal period. Amortization is recognized based on the expected future revenue streams under the customer contracts. Amortization of deferred sales commissions is included in sales and marketing expense in the accompanying condensed consolidated statements of operations. The Company determines the period of benefit for commissions paid for the acquisition of the initial subscription contract by taking into consideration its initial estimated customer life and the technological life of the Company's software and related significant features. The Company classifies deferred commissions as current or long-term based on the timing of when the Company expects to recognize the expense. The Company periodically reviews these deferred commission costs to determine whether events or changes in circumstances have occurred that could impact the period of benefit

of these deferred contract acquisition costs. There were no material impairment losses recorded during the periods presented.

For the three and six months ended June 30, 2018, the Company capitalized \$12,715 and \$21,929 of commission costs, respectively, and amortized \$8,334 and \$16,708, respectively. For the three and six months ended June 30, 2017, the Company capitalized \$10,874 and \$17,623, respectively, of commission costs, respectively, and amortized \$6,666 and \$13,275, respectively.

#### Deferred product costs

Deferred product costs are the incremental costs to fulfill a contract that are directly associated with each non-cancellable customer contract and primarily consist of royalty payments made to third parties, from whom the Company has obtained licenses to integrate certain software into its products. The deferred product costs are recognized based on the contractual term, and included in cost of revenue in the accompanying condensed consolidated statements of operations. The Company classifies deferred product costs as current or long-term based on the timing of when the Company expects to recognize the expense.

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For the three and six months ended June 30, 2018, the Company capitalized \$758 and \$1,436 of deferred product costs, respectively, and amortized \$611 and \$1,183, respectively. For the three and six months ended June 30, 2017, the Company capitalized \$600 and \$1,164 of deferred product costs, respectively, and amortized \$869 and \$1,523, respectively.

### Deferred revenue

The Company records deferred revenue when cash payments are received, or invoices are issued in advance of the Company's performance, and generally recognizes revenue over the contractual term. The Company recognized \$149,817 and \$237,395 of revenue during the three and six months ended June 30, 2018, respectively, that was included in the deferred revenue balances at the beginning of the respective periods. The Company recognized \$101,114 and \$165,210 of revenue during the three and six months ended June 30, 2017, respectively, that was included in the deferred revenue balances at the beginning of the respective periods.

The Company recognized \$2,091 and \$2,584 of revenue during the three and six months ended June 30, 2018, respectively, related to the performance obligations satisfied in prior periods. The Company recognized \$1,054 and \$1,034 of revenue during the three and six months ended June 30, 2017, respectively, related to the performance obligations satisfied in prior periods.

The acquisition of Wombat Securities, Inc. (see Note 3 "Acquisitions") on February 28, 2018, increased deferred revenue by \$14,700, of which \$6,720 was recognized in the six month period ended June 30, 2018.

### Remaining performance obligations

Contracted revenue as of June 30, 2018 that has not yet been recognized ("contracted not recognized") was \$389,492, which includes deferred revenue and non-cancellable amounts that will be invoiced and recognized as revenue in future periods and excludes contracts with an original expected length of one year or less. The Company expects 62% of contracted and not recognized revenue to be recognized over the next twelve months, 37% in years two and three, with the remaining balance recognized thereafter.

### 3. Acquisitions

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

While the Company uses its best estimates and assumptions as part of the purchase price allocation process to value assets acquired and liabilities assumed at the acquisition date, these estimates and assumptions are subject to refinement. When additional information becomes available, such as finalization of negotiations of working capital adjustments and tax related matters, the Company may revise its preliminary purchase price allocation. As a result, during the preliminary purchase price allocation period, which may be up to one year from the acquisition date, the

Company may record adjustments to the assets acquired and liabilities assumed, with the corresponding offset to goodwill. Subsequent to the purchase price allocation period, adjustments to assets acquired or liabilities assumed are recognized in the operating results.

#### 2018 Acquisitions

##### Wombat Security Technologies, Inc.

On February 28, 2018 (the “Wombat Acquisition Date”), pursuant to the terms of the merger agreement, the Company acquired all shares of Wombat Security Technologies, Inc. (“Wombat”), a leader for phishing simulation and security awareness computer-based training. By collecting data from Wombat’s PhishAlarm solution, the Company has access to data on phishing campaigns as seen by non-Company customers, providing broader visibility and insight to the Proofpoint Nexus platform.

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With this acquisition, the Company's customers can leverage the industry's first solution combining the Company's advanced threat protection with Wombat's phishing simulation and computer-based security awareness training. With the combined solutions, the Company's customers can:

- Use real detected phishing attacks for simulations, assessing users based on the threats that are actually targeting them;

- Both investigate and take action on user-reporting phishing, leveraging orchestration and automation to find real attacks, quarantine emails in users' inboxes, and lock user accounts to limit risk;

- Train users in the moment immediately after they click for both simulated and real phishing attacks.

The Company also expects to achieve savings in corporate overhead costs for the combined entities. These factors, among others, contributed to a purchase price in excess of the estimated fair value of acquired net identifiable assets and, as a result, goodwill was recorded in connection with the acquisition. The Company has estimated fair values of acquired tangible assets, intangible assets and liabilities at the Wombat Acquisition Date. The amounts reported are considered provisional as the Company is completing the valuation work to determine the fair value of certain assets and liabilities acquired, largely with respect to working capital adjustments. The results of operations and the provisional fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since the Wombat Acquisition Date.

At the Wombat Acquisition Date, the consideration transferred was \$225,366, net of cash acquired of \$13,452. Of the consideration transferred, \$22,500 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Quarterly Report on Form 10-Q. The Company incurred \$719 in acquisition-related costs which were recorded within operating expenses for the six months ended June 30, 2018. The Company recorded \$10,283 in revenue from Wombat for the six months ended June 30, 2018, and due to the continued integration of the combined businesses, it was impractical to determine the earnings.

Per the terms of the merger agreement, unvested in-the-money stock options held by Wombat employees were canceled and paid off using the same amount per option as for the common share less applicable exercise price for each option. The fair value of \$1,580 of these unvested options was attributed to pre-combination service and included in consideration transferred. The fair value of unvested options of \$1,571 was allocated to post-combination services and expensed in the three months ended March 31, 2018. Also, as part of the merger agreement, 51 shares of the Company's common stock were deferred for certain key employees with the total fair value of \$5,458 (see Note 8 "Equity Award Plans"), which was not included in the purchase price. The deferred shares are subject to forfeiture if employment terminates prior to the lapse of the restrictions, and their fair value is expensed as stock-based compensation expense over the vesting period.

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

	Estimated	Estimated
	Fair	Useful Life (in years)
	Value	
Current assets	\$23,344	N/A
Fixed assets	954	N/A
Customer relationships	37,800	7

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Order backlog	6,800	2
Core/developed technology	35,200	4
Trade name	2,400	4
Deferred revenue	(14,700 )	N/A
Deferred tax liability, net	(14,725 )	N/A
Other liabilities	(1,120 )	N/A
Goodwill	162,865	Indefinite
	\$238,818	

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## 2017 Acquisitions

## Cloudmark, Inc.

On November 21, 2017 (the “Cloudmark Acquisition Date”), pursuant to the terms of the merger agreement, the Company acquired all shares of Cloudmark, Inc. (“Cloudmark”), a leader in messaging security and threat intelligence for internet service providers and mobile carriers worldwide. As part of the acquisition, Cloudmark’s Global Threat Network will be incorporated into Company’s cloud-based Nexus platform, which powers its email, social media, mobile, and SaaS security effectiveness.

The Company believes that with this acquisition, it will benefit from increased messaging threat intelligence from the analysis of billions of daily emails, malicious domain intelligence, and visibility into fraudulent and malicious SMS messages directed to mobile carriers worldwide. The Company also expects to achieve savings in corporate overhead costs for the combined entities. These factors, among others, contributed to a purchase price in excess of the estimated fair value of acquired net identifiable assets and, as a result, goodwill was recorded in connection with the acquisition.

The Company has provisionally estimated fair values of acquired tangible and intangible assets and assumed liabilities at the Cloudmark Acquisition Date. The amounts reported are considered provisional as the Company is completing the valuation work to determine the fair value of certain assets and liabilities acquired, largely with respect to working capital adjustments. The results of operations and the provisional fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since the Cloudmark Acquisition Date.

At the Cloudmark Acquisition Date, the consideration transferred was \$107,283, net of cash acquired of \$31,973. Of the consideration transferred, \$16,700 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Quarterly Report on Form 10-Q.

Per the terms of the merger agreement, unvested stock options and unvested restricted stock units held by Cloudmark employees were canceled and exchanged for the Company’s unvested stock options and unvested restricted stock units, respectively. The fair value of \$91 of these unvested awards was attributed to pre-combination services and included in consideration transferred. The fair value of \$1,180 was allocated to post-combination services. The unvested awards are subject to the recipient’s continued service with the Company, and \$1,180 will be recognized ratably as stock-based compensation expense over the required remaining service period.

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

	Estimated	Estimated
	Fair	Useful
	Value	Life (in
		years)
Current assets	\$37,390	N/A
Fixed assets	543	N/A
Non-current assets	50	N/A

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Liabilities	(4,565 )	N/A
Deferred revenue	(15,400 )	N/A
Customer relationships	15,300	8
Order backlog	1,400	1
Core/developed technology	18,500	4
Deferred tax liability, net	(7,905 )	N/A
Goodwill	93,943	Indefinite
	\$ 139,256	

WebLife Balance, Inc.

On November 30, 2017 (the “WebLife Acquisition Date”), pursuant to the terms of a merger agreement, the Company acquired all shares of WebLife Balance, Inc. (“WebLife”), a browser isolation offerings vendor, to extend its advanced threat protection capabilities into personal email, while preserving the privacy of its users.

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The Company has estimated fair values of acquired tangible assets, intangible assets and liabilities at the WebLife Acquisition Date. The amounts reported are considered provisional as the Company is completing the valuation work to determine the fair value of certain assets and liabilities acquired, largely with respect to working capital adjustments. The results of operations and the provisional fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since the WebLife Acquisition Date.

At the WebLife Acquisition Date, the consideration transferred was \$48,765, net of cash acquired of \$278. Of the consideration transferred, \$6,203 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Quarterly Report on Form 10-Q.

Per the terms of the merger agreement, unvested stock options held by WebLife employees were canceled and exchanged for the Company's unvested awards. The fair value of \$333 of these unvested options was attributed to pre-combination service and included in consideration transferred. The fair value of \$1,468 was allocated to post-combination services. The unvested awards are subject to the recipient's continued service with the Company, and \$1,468 will be recognized ratably as stock-based compensation expense over the required remaining service period. Also, as part of the merger agreement, 107 shares of the Company's common stock were deferred for certain key employees with the total fair value of \$9,652 (see Note 8 "Equity Award Plans"), which was not included in the purchase price. The deferred shares are subject to forfeiture if employment terminates prior to the lapse of the restrictions, and their fair value is expensed as stock-based compensation expense over the vesting period.

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

	Estimated Fair Value	Estimated Useful Life (in years)
Current assets	\$ 534	N/A
Fixed assets	23	N/A
Liabilities	(88 )	N/A
Deferred revenue	(700 )	N/A
Customer relationships	600	5
Core/developed technology	16,600	5
Deferred tax liability, net	(4,440 )	N/A
Goodwill	36,514	Indefinite
	\$ 49,043	

## Pro Forma Financial Information (unaudited)

The following unaudited pro forma financial information presents the combined results of operations for the three and six months ended June 30, 2018 and 2017 as though the Wombat acquisition had occurred as of January 1, 2017, with adjustments to give effect to pro forma events that are directly attributable to the acquisition such as amortization

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expense of acquired intangible assets, stock-based compensation directly attributable to the acquisition and acquisition-related transaction costs. Accordingly, these unaudited pro forma results are presented for informational purposes only and are not necessarily indicative of what the actual results of operations of the combined company would have been if the acquisition had occurred at the beginning of the period presented, nor are they indicative of future results of operations:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Total revenue	\$171,875	\$131,691	\$340,970	\$255,792
Net loss	\$(34,289)	\$(26,830)	\$(46,685)	\$(53,360)
Basic and diluted net loss per share	\$(0.67)	\$(0.61)	\$(0.92)	\$(1.22)

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## 4. Goodwill and Intangible Assets

The goodwill activity and balances are presented below:

	June 30, 2018
Beginning balance as of December 31, 2017	\$297,704
Acquisition during period	162,865
Purchase accounting adjustments	23
Closing balance	\$460,592

Intangible assets, excluding goodwill, consisted of the following:

	June 30, 2018		Net Carrying Amount	December 31, 2017		Net Carrying Amount
	Gross			Gross		
	Carrying Amount	Accumulated Amortization		Carrying Amount	Accumulated Amortization	
Developed technology	\$154,069	\$ (65,574 )	\$88,495	\$118,869	\$ (52,554 )	\$66,315
Customer relationships	71,400	(10,092 )	61,308	33,600	(5,918 )	27,682
Trade names and patents	3,330	(1,095 )	2,235	930	(825 )	105
Order backlog	9,100	(2,783 )	6,317	2,300	(800 )	1,500
	\$237,899	\$ (79,544 )	\$158,355	\$155,699	\$ (60,097 )	\$95,602

Amortization of intangible assets expense was \$11,241 and \$4,153 for the three months ended June 30, 2018 and 2017, respectively, and \$19,447 and \$8,323 for the six months ended June 30, 2018 and 2017, respectively.

Future estimated amortization of intangible assets expense as of June 30, 2018 are presented below:

Year ending December 31,	
2018, remainder	\$21,710
2019	39,650
2020	34,566
2021	31,698
2022	13,501
Thereafter	17,230
	\$158,355

## 5. Fair Value Measurements and Investments

### Fair Value Measurements

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

The fair value hierarchy prioritizes the inputs into three broad levels:

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

Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability. The Company’s Level 2 assets and liabilities generally consist of corporate debt securities, commercial papers, U.S. agency and Treasury securities and convertible senior notes.

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

In connection with the acquisition of Return Path in 2016, a liability was recognized on the Return Path Acquisition Date for the estimate of the fair value of the Company's contingent payment. The Company determined the fair value of the Acquisition-related contingent liability based on the estimated amount and timing of future contract assignments, and the probability of success. This fair value measurement is based on significant inputs not observable in the market and thus represent Level 3 measurement.

The following tables summarize, for each category of assets or liabilities carried at fair value, the respective fair value as of June 30, 2018 and December 31, 2017 and the classification by level of input within the fair value hierarchy:

	June 30, 2018			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Cash equivalents:				
Money market funds	\$71,136	\$71,136	\$—	\$ —
Commercial paper	14,967	—	14,967	—
Corporate debt securities	1,000	—	1,000	—
Short-term investments:				
Corporate debt securities	2,899	—	2,899	—&nbs