

PROOFPOINT INC  
Form 10-Q  
November 01, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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

For the Quarterly Period Ended September 30, 2016  
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 51-0414846

(State or other jurisdiction of (I.R.S. employer  
incorporation or organization) identification no.)

892 Ross Drive 94089  
Sunnyvale, California (Zip Code)  
(Address of principal executive offices)

(408) 517-4710

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(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 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>
<input checked="" type="checkbox"/>		(Do not check if a smaller reporting company)	

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

Shares of Proofpoint, Inc. common stock, \$0.0001 par value per share, outstanding as of October 21, 2016:  
42,492,332 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)

	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$374,182	\$346,205
Short-term investments	38,165	60,032
Accounts receivable, net of allowance for doubtful accounts of \$164 and \$199 as of September 30, 2016 and December 31, 2015, respectively	69,167	54,522
Inventory	430	485
Deferred product costs	1,840	2,228
Deferred commissions	18,822	19,314
Prepaid expenses and other current assets	15,512	5,695
Total current assets	518,118	488,481
Property and equipment, net	47,715	34,501
Deferred product costs	297	314
Goodwill	140,282	133,769
Intangible assets, net	43,089	41,330
Long-term deferred commissions	3,613	3,488
Other assets	5,720	3,733
Total assets	\$758,834	\$705,616
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$13,387	\$14,081
Accrued liabilities	45,315	35,053
Capital lease obligations	33	32
Deferred rent	558	496
Deferred revenue	239,103	182,195
Total current liabilities	298,396	231,857
Convertible senior notes	361,215	345,699
Long-term capital lease obligations	98	123
Long-term deferred rent	1,869	2,033
Other long-term liabilities	5,718	1,188
Long-term deferred revenue	41,436	41,531
Total liabilities	708,732	622,431
Commitments and contingencies (note 5)		
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; 42,389 and 40,840 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	4	4

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Additional paid-in capital	496,332	441,104
Accumulated other comprehensive loss	(10 )	(23 )
Accumulated deficit	(446,224 )	(357,900 )
Total stockholders' equity	50,102	83,185
Total liabilities and stockholders' equity	\$758,834	\$705,616
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		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Revenue:				
Subscription	\$97,163	\$67,223	\$261,878	\$184,857
Hardware and services	2,621	1,926	6,813	5,601
Total revenue	99,784	69,149	268,691	190,458
Cost of revenue: <sup>(1)(2)</sup>				
Subscription	23,987	18,209	68,867	51,372
Hardware and services	3,293	2,845	9,895	8,794
Total cost of revenue	27,280	21,054	78,762	60,166
Gross profit	72,504	48,095	189,929	130,292
Operating expense: <sup>(1)(2)</sup>				
Research and development	24,493	20,000	70,734	54,367
Sales and marketing	51,467	38,651	146,654	107,240
General and administrative	8,393	9,961	41,996	25,789
Total operating expense	84,353	68,612	259,384	187,396
Operating loss	(11,849 )	(20,517 )	(69,455 )	(57,104 )
Interest expense	(5,920 )	(5,903 )	(17,529 )	(12,088 )
Other expense, net	(228 )	(375 )	(528 )	(1,635 )
Loss before provision for income taxes	(17,997 )	(26,795 )	(87,512 )	(70,827 )
Provision for income taxes	(370 )	(219 )	(812 )	(493 )
Net loss	\$(18,367)	\$(27,014)	\$(88,324)	\$(71,320)
Net loss per share, basic and diluted	\$(0.44 )	\$(0.67 )	\$(2.12 )	\$(1.80 )
Weighted average shares outstanding, basic and diluted	42,109	40,072	41,604	39,536

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

Cost of subscription revenue	\$2,080	\$1,357	\$5,439	\$3,620
Cost of hardware and services revenue	\$375	\$270	\$1,120	\$774
Research and development	\$6,019	\$5,862	\$17,498	\$15,562
Sales and marketing	\$7,174	\$5,469	\$20,710	\$15,495
General and administrative	\$4,315	\$3,238	\$12,387	\$8,406

(2) Includes intangible amortization expense as follows:

Cost of subscription revenue	\$2,223	\$1,945	\$6,458	\$4,914
Research and development	\$15	\$23	\$45	\$69
Sales and marketing	\$1,429	\$1,242	\$3,938	\$3,839
General and administrative	\$—	\$—	\$—	\$12

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		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net loss	\$(18,367)	\$(27,014)	\$(88,324)	\$(71,320)
Other comprehensive (loss) income, net of tax:				
Unrealized (loss) gain on short-term investments, net	(8)	(5)	13	20
Comprehensive loss	\$(18,375)	\$(27,019)	\$(88,311)	\$(71,300)

See accompanying Notes to the Condensed Consolidated Financial Statements.

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Proofpoint, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities		
Net loss	\$(88,324 )	\$(71,320 )
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	22,713	17,940
Loss on disposal of property and equipment	305	124
Amortization of investment premiums, net of accretion of purchase discounts	52	91
Recovery of allowance for doubtful accounts	(35 )	(258 )
Stock-based compensation	57,154	43,857
Amortization of debt issuance costs and accretion of debt discount	15,516	9,911
Foreign currency transaction loss	259	1,417
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(14,834 )	3,273
Inventory	55	(339 )
Deferred product costs	404	(478 )
Deferred commissions	366	(3,759 )
Prepaid expenses	(2,469 )	(2,010 )
Other current assets	461	623
Deferred income taxes	(23 )	356
Long-term assets	48	45
Accounts payable	2,906	(2,173 )
Accrued liabilities	2,933	4,934
Deferred rent	(103 )	(329 )
Deferred revenue	55,613	36,381
Net cash provided by operating activities	52,997	38,286
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	103,062	34,459
Purchase of short-term investments	(81,233 )	(48,078 )
Purchase of property and equipment	(25,527 )	(18,127 )
Payment to escrow account	(9,645 )	—
Acquisitions of businesses, net of cash acquired	(8,351 )	(40,054 )
Net cash used in investing activities	(21,694 )	(71,800 )
Cash flows from financing activities		
Proceeds from issuance of common stock	15,146	11,881
Withholding taxes related to restricted stock net share settlement	(17,015 )	(12,456 )
Payments of debt issuance costs	—	(371 )
Repayments of equipment loans and capital lease obligations	(24 )	(699 )
Proceeds from issuance of convertible senior notes, net of discount	—	223,790
Holdback payments for prior acquisitions	(1,397 )	—
Net cash (used in) provided by financing activities	(3,290 )	222,145
Effect of exchange rate changes on cash and cash equivalents	(36 )	(797 )
Net increase in cash and cash equivalents	27,977	187,834
Cash and cash equivalents		



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Beginning of period	346,205	180,337
End of period	\$374,182	\$368,171

Supplemental disclosure of noncash investing and financing information

Unpaid purchases of property and equipment	\$5,169	\$4,958
Liability awards converted to equity	\$6,059	\$1,745

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-as-a-service platform is comprised of an integrated suite of on-demand data protection solutions, including threat protection, incident response, regulatory compliance, archiving, governance, eDiscovery, and secure communication.

#### Basis of Presentation and Consolidation

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

Starting January 1, 2016, the Company began separately presenting the effect of exchange rate changes on cash and cash equivalents in its condensed consolidated statements of cash flows due to growing operations in foreign currency environments. Amounts in the comparable prior period have been reclassified to conform to the current period presentation.

The Company acquired one business in the three months ended September 30, 2016, and completed a number of acquisitions during the year ended December 31, 2015. These acquisitions are more fully described in Note 2, "Acquisitions". The condensed consolidated financial statements include the results of operations from these business combinations from their date of acquisition.

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, 2015 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. The results of operations for the three and nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2016 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, 2015 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. Refer to "Sales Commissions" below regarding the Company's change in accounting policy for sales commissions effective January 1, 2016.

#### 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.

Table of Contents**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 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 September 30, 2016.

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	7
Non-compete agreements	2	4
Order backlog	1	3
Trade names and trademarks	1	5

**Revenue Recognition**

The Company derives its revenue primarily from two sources: (1) subscription revenue for rights related to the use of the security-as-a-service platform and (2) hardware, training and professional services revenue provided to customers related to their use of the platform. The Company records its revenues net of any value added or sales tax.

Subscription revenue is derived from a subscription based enterprise licensing model with contract terms typically ranging from one to three years, and consists of (i) subscription fees from the licensing of the security-as-a-service platform, (ii) subscription fees for access to the on-demand elements of the platform and (iii) subscription fees for the right to access the Company's customer support services.

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

• Persuasive evidence of an arrangement exists;

• Delivery has occurred or services have been rendered;

• Sales price is fixed or determinable; and

Collectability is reasonably assured.

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,

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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.

From time to time, certain third parties that the Company has an arrangement with provide the Company with referrals for which the Company pays a referral fee. The referral fee paid could vary depending on the level of effort. These fees are recorded in sales and marketing expense in proportion to the related revenue streams consistent with the sales commissions accounting. The Company did not incur any material referral fee expenses during the three and nine months ended September 30, 2016 and 2015.

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

The Company's revenue arrangements typically include subscription services to its security-as-a-service platform. These hosted on demand service arrangements do not provide customers with the right to take possession of the software supporting the hosted services. Certain arrangements also include the sale of hardware appliances. Revenue from hardware appliances containing software components and hardware components that function together to deliver the hardware appliance's essential functionality is excluded from the scope of the industry specific revenue recognition guidance. The Company recognizes revenue from its hosted on demand services in accordance with general revenue recognition accounting guidance. Only revenue derived from the licensing of the software is recognized in accordance with the industry specific revenue guidance.

When a sales arrangement contains multiple elements, such as hardware appliances, subscription services, customer support services, and/or professional services, the Company allocates revenue to each unit of accounting or element based on a selling price hierarchy. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company's control. When applying the relative selling price method, the Company determines the selling price for each deliverable using vendor-specific objective evidence ("VSOE") of selling price. If VSOE does not exist, the Company uses third-party evidence ("TPE") of selling price. If neither VSOE nor TPE of selling price exist for a deliverable, the Company uses its best estimate of selling price ("BESP") for that deliverable. Revenue allocated to each element is then recognized when the basic revenue recognition criteria are met for each element. The Company determines BESP for an individual element within a multiple element revenue arrangement using the same methods utilized to determine the selling price of an element sold on a standalone basis. The Company estimates the selling price for its subscription solutions by considering internal factors such as historical pricing practices and it estimates the selling price of hardware and other services using a cost plus model.

Hardware appliance revenue is recognized upon shipment. Subscription and support revenue are recognized over the contract period commencing on the start date of the contract. Professional services and training, when sold with hardware appliances or subscription and support services, are accounted for separately when those services have standalone value. In determining whether professional services and training services can be accounted for separately from subscription and support services, the Company considers the following factors: availability of the services from

other vendors, the nature of the services, and the dependence of the subscription services on the customer's decision to buy the professional services. If professional services and training do not qualify for separate accounting, the Company recognizes the professional services and training ratably over the contract term of the subscription services.

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

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The Company assesses collectability based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. Through September 30, 2016, the Company has not experienced significant credit losses.

**Deferred Revenue**

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

**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 nine months ended September 30, 2016 and 2015.

**Sales Commissions**

Effective January 1, 2016, the Company changed its accounting policy for sales commissions that are incremental and directly related to its customer sales contracts in which revenue is deferred. These commission costs are accrued and capitalized upon execution of a non-cancelable customer contract, and subsequently expensed over the term of such contract in proportion to the related future revenue streams. For commission costs where revenue is recognized, the related commission costs are recorded in the period of revenue recognition. Prior to this change in accounting policy, commission costs were expensed in the period in which they were incurred. The adoption of this accounting policy change has been applied retrospectively to all periods presented in this Quarterly Report on Form 10-Q, in which the cumulative effect of the change has been reflected as of the beginning of the first period presented. Deferred commissions as of September 30, 2016 and December 31, 2015 were \$22,435 and \$22,802, respectively. During the three and nine months ended September 30, 2016, the Company deferred \$8,857 and \$23,895 of commission costs and amortized \$8,602 and \$24,262 within sales and marketing expense, respectively. During the three and nine months ended September 30, 2015, the Company deferred \$7,243 and \$19,134 of commission costs and amortized \$5,824 and \$15,375 within sales and marketing expense, respectively.

The Company believes this change in accounting policy is preferable as the direct and incremental commission costs are closely related to the revenue, and therefore they should be recorded as an asset and recognized as an expense over the same period that the related revenue is recognized.

The cumulative effect of the change on accumulated deficit was \$15,060 as of December 31, 2014. The following tables present the changes to the financial statement lines as a result of the accounting change for the periods presented in the accompanying unaudited Condensed Consolidated Financial Statements:

**Condensed Consolidated Balance Sheet**

	As of December 31, 2015		
	As reported	Adjustment	As adjusted
Short-term deferred commissions	\$—	\$ 19,314	\$19,314
Long-term deferred commissions	\$—	\$ 3,488	\$3,488
Accumulated deficit	\$(380,702)	\$ 22,802	\$(357,900)

**Condensed Consolidated Statements of Operations**





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	Three months ended September 30, 2015			Nine months ended September 30, 2015		
	As reported	Adjustment	As adjusted	As reported	Adjustment	As adjusted
Operating expenses: Sales and marketing	\$40,070	\$ (1,419 )	\$38,651	\$110,999	\$ (3,759 )	\$107,240
Net loss	\$(28,433)	\$ 1,419	\$(27,014)	\$(75,079 )	\$ 3,759	\$(71,320 )
Net loss per share, basic and diluted	\$(0.71 )	\$ 0.04	\$(0.67 )	\$(1.90 )	\$ 0.10	\$(1.80 )
Weighted average shares outstanding, basic and diluted	40,072	—	40,072	39,536	—	39,536

## Condensed Consolidated Statements of Comprehensive Loss

	Three months ended September 30, 2015			Nine months ended September 30, 2015		
	As reported	Adjustment	As adjusted	As reported	Adjustment	As adjusted
Net loss	\$(28,433)	\$ 1,419	\$(27,014)	\$(75,079)	\$ 3,759	\$(71,320)
Unrealized gains on short-term investments, net	\$(5 )	\$ —	\$(5 )	\$20	\$ —	\$20
Comprehensive loss	\$(28,438)	\$ 1,419	\$(27,019)	\$(75,059)	\$ 3,759	\$(71,300)

There have been no changes, other than as discussed above, in the Company's significant accounting policies for the nine months ended September 30, 2016, as compared to the significant accounting policies described in the Company's Annual Form 10-K for the year ended December 31, 2015.

## Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (ASU 2016-15). ASU 2016-15 makes eight targeted changes how cash receipts and cash payments are presented and classified in the statement of cash flows. The update to the standard is effective for interim and annual periods beginning after December 15, 2017, and requires adoption on a retrospective transition method unless it is impracticable to apply. The Company is currently evaluating the impact of the adoption of ASU 2016-15 on its consolidated financial statements.

In June 2016, FASB issued an Accounting Standards Update 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 March 2016, FASB issued Accounting Standards Update No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (ASU 2016-09). ASU 2016-09 changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The update to the standard is effective for interim and annual periods beginning after December 15, 2016. The Company is currently evaluating the impact of the adoption of ASU 2016-09 on its consolidated financial statements.

In February 2016, FASB issued Accounting Standards Update 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

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for interim and annual periods beginning after December 15, 2018 and early adoption is permitted. The Company is currently evaluating the impact of the adoption of ASU 2016-02 on its consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers: Topic 606 (ASU 2014-09), to supersede nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing U.S. GAAP including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Originally, ASU 2014-09 would be effective for the Company starting January 1, 2017 using either of two methods: (i) retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or (ii) retrospective with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined per ASU 2014-09. In July 2015, the FASB voted to amend ASU 2014-09 by approving a one-year deferral of the effective date as well as providing the option to early adopt the standard on the original effective date. The FASB has issued several updates to the standard which i) clarify the application of the principal versus agent guidance (ASU 2016-08); ii) clarify the guidance on inconsequential and perfunctory promises and licensing (ASU 2016-10) and iii) narrow-scope improvements and practical expedients (ASU 2016-12). The Company is currently evaluating the timing, transition method and impact of the adoption of the standard on its consolidated financial statements.

## 2. 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, except for one of the acquisitions made in the fourth quarter of 2015, is 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.

## Return Path

On August 24, 2016 (the "Return Path Acquisition Date"), pursuant to the terms of an asset purchase agreement, the Company acquired Return Path, Inc.'s ("Return Path") Email Fraud Protection ("EFP") business unit. Return Path's EFP business, which provides standards-based DMARC authentication and proprietary sender-analysis capabilities, will be integrated into the Company's suite of email protection solutions to further enhance its business email

compromise capabilities.

The Company has provisionally estimated fair values of acquired tangible assets, intangible assets and liabilities at the Return Path 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. 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 Return Path Acquisition Date. Revenue from Return Path was not material for the three and nine months ended September 30, 2016, and due to the continued integration of the combined businesses, it was impractical to determine the earnings. Pro forma results of operations have not been presented because the acquisition was not material to the Company's results of operations.

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The total purchase price was \$17,513, of which \$9,162 was classified and recorded as contingent consideration on the balance sheet as of the Return Path Acquisition Date. The Company expects to pay the contingent consideration within two years depending on the timing of contract assignments following the Return Path acquisition date and the maximum potential payment amount could be up to \$9,644. The Company incurred \$406 in acquisition related costs which were recorded within operating expenses for the nine months ended September 30, 2016.

The fair value of the contingent consideration liability was determined as of the acquisition date using unobservable inputs. These inputs include the estimated amount and timing of future contract assignments, the probability of success and a risk-adjusted discount rate to adjust the probability-weighted cash flows to present value.

## Fair value of acquired assets

The following table summarizes the estimated fair values of acquired assets and liabilities:

	Estimated Fair Value	Estimated Useful Life (in years)
Customer relationships	\$7,600	6
Developed technology	3,900	4
Order backlog	700	1
Deferred revenue assumed	(1,200)	N/A
Goodwill	6,513	Indefinite
	\$17,513	

## 2015 Acquisitions

In the fourth quarter of the year ended December 31, 2015, the Company made two acquisitions that were accounted for as business combinations. The Company has provisionally estimated fair values of acquired tangible and intangible assets at the respective date of each acquisition. The amounts reported are considered provisional as the Company is completing the valuation work to determine the fair value of certain assets acquired. 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 from the respective date of each acquisition.

The aggregate purchase price was \$11,568. The following table summarizes the fair values of acquired tangible and intangible assets, liabilities and goodwill:

	Estimated Fair Value	Estimated Useful Life (in years)
Current assets acquired	\$414	N/A
Fixed assets acquired	73	N/A
Liabilities assumed	(234)	N/A
Deferred revenue assumed	(1,400)	N/A
Deferred tax liability, net	(45)	N/A
Customer relationships	2,800	7
Order backlog	900	3
Developed technology	3,000	4
Goodwill	6,060	Indefinite
	\$11,568	

Marble Security, Inc.

On July 22, 2015 (the "Marble Acquisition Date"), pursuant to the terms of an asset purchase agreement, the Company acquired certain assets of Marble Security, Inc. ("Marble"). The Marble mobile security technology proactively removes malicious mobile applications by leveraging its tight integration with the leading enterprise mobility management platforms,

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including MobileIron and AirWatch by VMware. The acquisition extends the Company's threat intelligence and advanced threat protection for email and social media security into the realm of mobile devices.

The results of operations and the fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since the Marble Acquisition Date.

The total purchase price was \$8,500. Of the cash consideration paid, \$1,700 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.

### Fair value of acquired assets

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

	Fair Value	Estimated Useful Life (in years)
Fixed assets acquired	\$25	N/A
Developed technology	7,300	4
Goodwill	1,175	Indefinite
	\$8,500	

### Emerging Threats Pro, LLC

On March 6, 2015 (the "Emerging Threats Acquisition Date"), pursuant to the terms of a purchase agreement, the Company acquired 100% of membership interests in Emerging Threats Pro, LLC ("Emerging Threats"). Based in Indianapolis, Indiana, Emerging Threats provides threat intelligence solutions to help protect networks from known or potentially malicious threats. With this acquisition, the Company integrated Emerging Threat's advanced threat intelligence solutions with its existing Targeted Attack Protection and Threat Response security solutions to advance threat detection and response across the completed attack chain. The combined technology provides customers with deeper insight into cyberthreats, enabling them to react faster to inbound cyberattacks, and to identify, block, and disable previously undetected malware already embedded in their organizations.

The results of operations and the fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since the Emerging Threat Acquisition Date.

The total purchase price was \$31,803, net of cash acquired of \$52, of which \$3,662 was paid in the second quarter of 2015. Of the cash consideration paid, \$6,000 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.

### Fair value of acquired assets and liabilities assumed

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



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	Fair Value	Estimated Useful Life (in years)
Current assets acquired	\$1,275	N/A
Fixed assets acquired	174	N/A
Liabilities assumed	(448)	N/A
Deferred revenue assumed	(700)	N/A
Holdback liability to the sellers	(3,662)	N/A
Trade names	200	2
Customer relationships	4,200	7
Order backlog	200	1
Developed technology	7,900	7
Goodwill	19,054	Indefinite
	\$28,193	

## 3. Goodwill and Intangible Assets

The goodwill activity and balances are presented below:

Balance at December 31, 2015	\$133,769
Add: Goodwill from acquisition	6,513
Less: Other purchase price allocation adjustments to Goodwill	—
Balance at September 30, 2016	\$140,282

## Intangible Assets

Intangible assets, excluding goodwill, consisted of the following:

	September 30, 2016			December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	\$61,168	\$ (35,076 )	\$ 26,092	\$57,268	\$ (28,618 )	\$ 28,650
Customer relationships	17,943	(2,531 )	15,412	23,382	(12,291 )	11,091
Non-compete agreements	—	—	—	804	(691 )	113
Trade names and patents	930	(607 )	323	1,006	(502 )	504
Order backlog	1,600	(338 )	1,262	1,300	(328 )	972
	\$81,641	\$ (38,552 )	\$ 43,089	\$83,760	\$ (42,430 )	\$ 41,330

Amortization of intangible assets expense was \$3,667 and \$3,210 for the three months ended September 30, 2016 and 2015, respectively, and \$10,441 and \$8,834 for the nine months ended September 30, 2016 and 2015, respectively.

Future estimated amortization of intangible assets expense as of September 30, 2016 are presented below:

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Year ending December 31,	
2016, remainder	\$3,128
2017	11,867
2018	10,771
2019	7,406
2020	4,701
Thereafter	5,216
	\$43,089

## 4. 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.

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, a liability was recognized on 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 September 30, 2016 and December 31, 2015 and the classification by level of input within the fair value hierarchy:

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	Balance as of September 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets				
Cash equivalents:				
Money market funds	\$ 318,074	\$318,074	\$ —	\$ —
Corporate debt securities	1,500	—	1,500	—
Commercial paper	17,737	—	17,737	—
Short-term investments:				
Corporate debt securities	22,416	—	22,416	—
Commercial papers	15,749	—	15,749	—
Total financial assets	\$ 375,476	\$318,074	\$ 57,402	\$ —