PROOFPOINT INC
Form 10-Q
November 06, 2014
Table of Contents

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2014
OR

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

Indicate by check mark whether the registrant 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 þ NO o

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 o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ Shares of Proofpoint, Inc. common stock, $0.0001 par value per share, outstanding as of October 31, 2014:

38,134,381 shares.

PROOFPOINT, INC.
FORM 10-Q

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

Proofpoint, Inc.
Condensed Consolidated Balance Sheets
(In thousands, except per share amounts)
(Unaudited)

	September 30, 2014	December 31, 2013
Assets		
Current assets		
Cash and cash equivalents	$194,617	$243,786
Short-term investments	38,175	8,015
Accounts receivable, net of allowance for doubtful accounts of $345 and $276 at September 30, 2014 and December 31, 2013, respectively	32,770	26,221
Inventory	1,298	860
Deferred product costs, current	1,793	1,004
Prepaid expenses and other current assets	10,118	7,963
Total current assets	278,771	287,849
Property and equipment, net	18,369	11,221
Deferred product costs, noncurrent	342	357
Goodwill	81,832	63,764
Intangible assets, net	22,257	22,976
Other noncurrent assets	4,157	4,392
Total assets	$405,728	$390,559
Liabilities and Stockholders’ Equity		
Current liabilities		
Accounts payable	$8,270	$7,281
Accrued liabilities	23,242	19,260
Notes payable and lease obligations, current	1,110	1,655
Deferred rent, current	366	297
Deferred revenue, current	109,304	89,450
Total current liabilities	142,292	117,943
Convertible senior notes	159,409	152,928
Notes payable and lease obligations, noncurrent	—	695
Deferred rent, noncurrent	1,667	56
Other long term liabilities	7,008	7,244
Deferred revenue, noncurrent	34,080	34,533
Total liabilities	344,456	313,399
Stockholders’ Equity		
Common stock, $0.0001 par value; 200,000 shares authorized at September 30, 2014 and December 31, 2013, respectively; 37,869 and 36,140 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively	4	4
Additional paid-in capital	318,178	287,165
Accumulated other comprehensive loss	(36)	—

Accumulated deficit	(256,874)	(210,009)
Total stockholders' equity	61,272	77,160
Total liabilities and stockholders' equity	$405,728	$390,559

See accompanying Notes to the Condensed Consolidated Financial Statements.

Table of Contents

Proofpoint, Inc.
Condensed Consolidated Statements of Operations
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30, 2014	2013	Nine Months Ended September 30, 2014	2013
Revenue:				
Subscription	$48,506	$33,464	$134,757	$92,732
Hardware and services	1,805	1,039	4,656	4,362
Total revenue	50,311	34,503	139,413	97,094
Cost of revenue:(1)(2)				
Subscription	14,300	8,937	38,295	25,042
Hardware and services	2,964	1,409	7,941	3,851
Total cost of revenue	17,264	10,346	46,236	28,893
Gross profit	33,047	24,157	93,177	68,201
Operating expense:(1)(2)				
Research and development	13,454	8,307	37,700	23,460
Sales and marketing	25,662	17,415	72,660	49,782
General and administrative	7,133	5,758	19,485	13,437
Total operating expense	46,249	31,480	129,845	86,679
Operating loss	(13,202)	(7,323)	(36,668)	(18,478)
Interest expense, net	(2,814)	(11)	(8,385)	(4)
Other income (expense), net	(1,180)	352	(1,372)	(163)
Loss before (provision for) benefit from income taxes	(17,196)	(6,982)	(46,425)	(18,645)
(Provision for) benefit from income taxes	(149)	(207)	(440)	2,998
Net loss	$(17,345)	$(7,189)	$(46,865)	$(15,647)
Net loss per share, basic and diluted	$(0.46)	$(0.20)	$(1.26)	$(0.45)
Weighted average shares outstanding, basic and diluted	37,554	35,436	37,082	34,502
(1) Includes stock based compensation expense as follows:				
Cost of subscription revenue	$715	$203	$1,638	$631
Cost of hardware and services revenue	158	45	431	120
Research and development	2,999	502	7,483	1,566
Sales and marketing	2,658	881	7,163	2,502
General and administrative	1,966	748	5,082	1,783
(2) Includes intangible amortization expense as follows:				
Cost of subscription revenue	$1,110	$568	$2,913	$1,307
Research and development	23	8	70	24
Sales and marketing	1,105	321	3,302	619
General and administrative	12	12	34	23

See accompanying Notes to the Condensed Consolidated Financial Statements.

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net loss	$(17,345)	$(7,189)	$(46,865)	$(15,647)
Other comprehensive loss, net of tax:				
Unrealized gains (losses) on short-term investments, net	(36)	9	(36)	(4)
Comprehensive loss	$(17,381)	$(7,180)	$(46,901)	$(15,651)

See accompanying Notes to the Condensed Consolidated Financial Statements.

Table of Contents

Proofpoint, Inc.
Condensed Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2014	2013
Cash flows from operating activities		
Net loss	$(46,865)	$(15,647)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	12,839	6,123
Accretion of discounts on investments	130	490
Provision for allowance for doubtful accounts	91	26
Stock based compensation	21,797	6,602
Deferred income taxes	4	(2,444)
Change in fair value of contingent earn-outs	5	6
Amortization of debt issuance costs and accretion of debt discount	6,519	—
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(6,660)	(2,902)
Inventory	(470)	138
Deferred products costs	(774)	310
Prepaid expenses	(1,356)	(148)
Other current assets	(1,355)	34
Noncurrent assets	(38)	(216)
Accounts payable	(1,227)	897
Accrued liabilities	2,116	(187)
Earn-out payment	(13)	—
Deferred rent	1,680	(257)
Deferred revenue	19,401	14,469
Net cash provided by operating activities	5,824	7,294
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	8,000	47,386
Purchase of short-term investments	(37,805)	(20,376)
Purchase of property and equipment	(10,395)	(4,502)
Acquisitions of businesses, net of cash acquired	(22,035)	(28,509)
Net cash used in investing activities	(62,235)	(6,001)
Cash flows from financing activities		
Proceeds from issuance of common stock	11,740	12,954
Withholding taxes related to restricted stock net share settlement	(1,839)	—
Payments of debt issuance costs	(191)	—
Repayments of notes payable and loans	(1,240)	(1,673)
Earn-out payment	(487)	—
Holdback payments for prior acquisitions	(741)	—
Net cash provided by financing activities	7,242	11,281
Net (decrease) increase in cash and cash equivalents	(49,169)	12,574
Cash and cash equivalents		
Beginning of period	243,786	39,254

End of period	$194,617	$51,828
Supplemental disclosure of noncash investing and financing information		
Unpaid purchases of property and equipment	$4,321	$1,838

See accompanying Notes to the Condensed Consolidated Financial Statements.

Table of Contents

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 is a pioneering security-as-a-service ("SaaS") vendor that enables large and mid-sized organizations throughout the world to defend, protect, archive and govern their most sensitive data. The Company’s SaaS platform is comprised of a number of data protection solutions, including threat protection, regulatory compliance, archiving, governance, and secure communication.

Basis of Presentation and Consolidation

The accompanying unaudited Condensed Consolidated Financial Statements and condensed footnotes have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary (consisting only of normal recurring adjustments) for a fair statement of results for the interim periods presented have been included. The results of operations for the three months ended September 30, 2014 are not necessarily indicative of the results to be expected for the year ended December 31, 2014 or for other interim periods or for future years.

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accompanying Condensed Consolidated Balance Sheet as of December 31, 2013 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. These accompanying Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's 2013 Annual Report on Form 10-K.

There have been no material changes to the Company's significant accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, including those described below.

Use of Estimates

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

Goodwill and Intangible Assets

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

Table of Contents

unit is compared to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not considered impaired and further testing is not required. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then the Company must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then an impairment loss equal to the difference is recorded. The identification and measurement of goodwill impairment involves the estimation of the fair value of the Company. The estimate of fair value of the Company, based on the best information available as of the date of the assessment, is subjective and requires judgment, including management assumptions about expected future revenue forecasts and discount rates, changes in the overall economy, trends in the stock price and other factors. No impairment indicators were identified by the Company as of September 30, 2014.

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

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

	Low	High
Patents	4	5
Developed technology	3	7
Customer relationships	2	5
Non-compete agreements	2	4
Tradenames 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. Subscription revenue is derived from a subscription based enterprise licensing model with contract terms typically ranging from one to three years, and consists of (i) subscription fees from the licensing of the security-as-a-service platform, (ii) subscription fees for access to the on-demand elements of the platform and (iii) subscription fees for the right to access the Company's customer support services.

The Company applies the provision of ASC 985-605, "Software Revenue Recognition" and related interpretations, to all transactions involving the licensing of software, as well as related support, training, and other professional services. ASC 985-605 requires revenue earned on software arrangements involving multiple elements such as software license, support, training and other professional services to be allocated to each element based on the relative fair values of these elements. The fair value of an element must be based on vendor specific objective evidence ("VSOE") of fair value. VSOE of fair value of each element is based on the price charged when the element is sold separately. Revenue is recognized when all of the following criteria are met as set forth in ASC 985-605:

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

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

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

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

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

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

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

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

For all arrangements within the scope of these new accounting pronouncements, including the Company’s hosted on-demand services, the Company evaluates each element in a multiple element arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company’s control. Revenue derived from the licensing of the security-as-a-service platform continues to be accounted for in accordance with the industry specific revenue recognition guidance.

Hardware appliance revenue is recognized upon shipment. Subscription and support revenue are recognized over the contract period commencing on the start date of the contract. Professional services and training, when sold with hardware appliances or subscription and support services, are accounted for separately when those services have standalone value and are recognized when delivered. 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

Table of Contents

professional services. If professional services and training do not qualify for separate accounting, the Company recognizes the professional services and training ratably over the contract term of the subscription services.
Delivery generally occurs when the hardware appliance is delivered to a common carrier freight on board shipping point by the Company or the hosted service has been activated and communicated to the customer accordingly. The Company's fees are typically considered to be fixed or determinable at the inception of an arrangement and are negotiated at the outset of an arrangement, generally based on specific products and quantities to be delivered. In the event payment terms are provided that differ significantly from the Company's standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized as the fees become paid.
The Company assesses collectability based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. Through September 30, 2014, 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. Total comprehensive loss has been presented in the accompanying Condensed Consolidated Statements of Comprehensive Loss. The Company had no significant reclassifications out of accumulated other comprehensive loss into net loss for the nine months ended September 30, 2014 and 2013.

Recent Accounting Policies

In August 2014, the FASB issued ASU 2014-15, "Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern", a new accounting standard update that requires management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The new guidance will become effective for the Company on January 1, 2016. Early adoption is permitted. The adoption of this guidance is not expected to have material impact on the Company's consolidated financial position, result of operations or cash flows.

In June 2014, the FASB issued ASU 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period", a new accounting standard update that clarifies the accounting for share-based payments when the terms of an award allow for a performance target to be achieved after an employee completes the requisite period. The amendments require that a performance target that affects vesting and that could be achieved after the requisite period be treated as a performance condition. A company should apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting to account for such awards. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attribute to the period(s) for which the requisite service has already been rendered. The new guidance will become effective for the Company on January 1, 2016 with early adoption is permitted. The adoption of this guidance is not expected to have material impact on the Company's consolidated financial position or results of operations.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers", a new accounting standard update jointly issued with the IASB on revenue recognition. The new guidance provides a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within industries, across industries and across capital markets. Companies are required by the standard to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in an exchange for those goods and services. The new guidance will become effective for the Company on January 1, 2017. Early adoption is not permitted and the Company is currently assessing the impact on its consolidated financial position or results of operations.

Table of Contents

In July 2013, the FASB issued ASU 2013-11, "Income Taxes", a new accounting standard update on the financial statement presentation of unrecognized tax benefits. The new guidance provides that a liability related to an unrecognized tax benefit would be presented as a reduction of a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. The new guidance became effective for the Company on January 1, 2014 and had no material impact to the Company's consolidated financial position or results of operations.

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 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.

In 2014 and 2013, the Company acquired a total of six companies (collectively, the "Acquisitions") which are further described below.

NetCitadel, Inc.

On May 13, 2014 (the "NetCitadel Acquisition Date"), pursuant to the terms of an Agreement and Plan of Merger, a wholly-owned subsidiary of the Company merged with and into NetCitadel, Inc. ("NetCitadel"), with NetCitadel surviving as a wholly-owned subsidiary of the Company. Formerly based in Mountain View, California, NetCitadel is a pioneer in the field of automated security incident response. The acquisition extends the reach and capabilities of the Company's existing advanced threat solutions, adding additional threat verification and containment capabilities via an open platform that unifies products from the Company and other vendors.

The Company has provisionally estimated fair values for the acquired tangible and identifiable intangible assets and liabilities assumed at the NetCitadel Acquisition Date. The amounts reported were considered provisional as the Company was completing the valuation work to determine the fair value of assets acquired and liabilities assumed.

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 NetCitadel Acquisition Date. Revenue from NetCitadel was immaterial for the nine months ended September 30, 2014.

At the NetCitadel Acquisition Date, the Company paid $22,754 in cash consideration, net of cash acquired. Of the cash consideration paid, $3,369 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 $345 in acquisition-related costs which were recorded in operating expenses for the nine months ended September 30, 2014.

Fair value of acquired assets and liabilities assumed

The determination of the fair values of the assets acquired and liabilities assumed has been prepared on a provisional basis and changes to that determination may occur as additional information becomes available. The following table summarizes the fair values of tangible assets acquired, liabilities assumed, intangible assets and goodwill:

Table of Contents

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	$ 14	N/A
Liabilities assumed	(1,270)	N/A
Customer relationships	100	5
Core/developed technology	5,500	5
Goodwill	18,387	Indefinite
	$ 22,731	

Sendmail, Inc.

On October 1, 2013, the Company acquired Sendmail, Inc. ("Sendmail"), a leading provider of messaging infrastructure solutions to enterprises whose solutions ensure global email connectivity, routing and message delivery between people, systems and applications located on-premise, in-cloud or on mobile devices. The Company paid $12,463 in cash consideration, net of cash acquired and debts paid. Of the cash consideration paid, $3,422 was held in escrow to secure indemnification obligations, of which $719 was recovered from indemnification claim as of September 30, 2014. As part of the acquisition, the Company assumed and paid off $7,933 in long-term debt on the Sendmail Acquisition Date.

Armorize Technologies, Inc.

On September 5, 2013, the Company acquired Armorize Technologies, Inc. ("Armorize"), a Taiwan-based developer and retailer of leading cloud-based SaaS anti-malware products. The Company paid $24,215 in cash consideration, net of cash acquired. Of the cash consideration paid, $3,750 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Quarterly Report on Form 10-Q.

Abaca Technology Corporation

On July 19, 2013, the Company acquired Abaca Technology Corporation ("Abaca"), who specializes in email filtering and protection algorithms and their cloud-based, in-memory threat scoring technologies. The Company paid $23 in cash consideration, net of cash acquired. The purchase consideration included an additional holdback amount of $1,520 to secure indemnification obligations and has not been released as of the filing date of this Quarterly Report on Form 10-Q.

eDynamics, LLC

On July 10, 2013, the Company purchased substantially all of the business intellectual property and assumed certain liabilities of eDynamics, LLC ("eDynamics"), a social media archiving company, for $500 in cash consideration. The Company also agreed to pay earn-out consideration of up to $600 through April 2014, such liability being contingent upon the achievement of specified product development milestones. The purchase consideration also included an additional holdback amount of $100 to secure indemnification obligations. As of September 30, 2014, the Company has paid both of these amounts in full.

Mail Distiller Limited

On April 5, 2013, the Company acquired Mail Distiller Limited, a Northern Ireland Company ("Mail Distiller"), a European-based provider of SaaS email security solutions. The Company paid $3,771 in cash consideration, net of cash acquired. The purchase consideration included an additional holdback amount of $669 to secure indemnification obligations. The Company has released the holdback amount in full as of September 30, 2014.

Pro Forma Financial Information

The following unaudited pro forma financial information presents the combined results of operations for the three and nine months ended September 30, 2014 and 2013 for NetCitadel, which was acquired during the second quarter of 2014, and Mail Distiller, eDynamics, Abaca and Armorize, all of which were acquired during the nine months ended September 30, 2013. Adjustments were made to give effect to pro forma events that are directly attributable to these acquisitions, such as amortization expense from acquired intangible assets, acquisition-related transaction costs and, if any, related tax effects. The unaudited pro forma results do not reflect any operating efficiencies or potential cost savings which may result from the consolidation of the operations of the Company and the two acquisitions. Accordingly, these unaudited pro forma results are

Table of Contents

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 NetCitadel had occurred on January 1, 2013 and Mail Distiller, eDynamics, Abaca and Armorize had occurred on January 1, 2012, nor are they indicative of future results of operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Total revenue	$50,311	$35,093	$139,487	$100,181
Net loss	(17,345)	(8,479)	(48,457)	(23,822)
Basic and diluted loss per share	$(0.46)	$(0.24)	$(1.31)	$(0.69)

The unaudited pro forma financial information includes non-recurring acquisition-related transaction cost of $345 for the nine months ended September 30, 2013.

3. Goodwill and Intangible Assets

The goodwill activity and balances are presented below:

Balance at December 31, 2013	$63,764
Add: Goodwill from acquisitions	18,387
Less: Other adjustments to Goodwill	(319)
Balance at September 30, 2014	$81,832

The goodwill balance as of September 30, 2014 was the result of the acquisitions of Fortiva, Inc., Secure Data in Motion, Inc., Everyone.net, Inc., Spam and Open Relay Blocking System from GFI Software Ltd., NextPage, Inc., Mail Distiller, eDynamics, Abaca, Armorize, Sendmail and NetCitadel.

Intangible Assets

Intangible assets, excluding goodwill, consisted of the following:

	September 30, 2014			December 31, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	$34,968	$(20,295)	$14,673	$29,468	$(17,383)	$12,085
Customer relationships	13,382	(6,794)	6,588	13,282	(3,726)	9,556
Non-compete agreements	804	(389)	415	804	(170)	634
Trademark and patents	806	(225)	581	806	(105)	701
	$49,960	$(27,703)	$22,257	$44,360	$(21,384)	$22,976

Amortization expense of intangible assets totaled $2,250 and $909, respectively, for the three months ended September 30, 2014 and 2013, and $6,319 and $1,973, respectively, for the nine months ended September 30, 2014 and 2013.

Future estimated amortization costs of intangible assets as of September 30, 2014 are presented below:

Year ending December 31,	
2014, remainder	$2,244
2015	8,220
2016	5,887
2017	2,742
2018	2,295
Thereafter	869
	$22,257

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 bonds and agency debt securities, commercial paper, and certificates of deposit.

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

In connection with the acquisition of eDynamics in 2013, a liability was recognized on the eDynamics Acquisition Date for the estimate of the fair value of the Company's contingent earn-out payments related to eDynamics. The Company determined the fair value of the Acquisition-related contingent earn-out liability based on the probability-based attainment of product development milestones. The fair value measurements were based on significant inputs not observable in the market and thus represent Level 3 measurements, which reflected the Company's own assumptions concerning achievement of the product development milestones of eDynamics, in measuring the fair value of the contingent earn-out liability related to the acquisition of eDynamics. As of September 30, 2014, this contingent earn-out liability was extinguished.

The following tables summarize, for each category of assets or liabilities carried at fair value, the respective fair value as of September 30, 2014 and December 31, 2013 and the classification by level of input within the fair value hierarchy:

	Balance as of September 30, 2014	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	$164,731	$164,731	$—	$—
Short-term investments:				
Corporate debt securities	33,679	—	33,679	—
Commercial paper	4,496	—	4,496	—
Total financial assets	$202,906	$164,731	$38,175	$—

	Balance as of December 31, 2013	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	$215,094	$215,094	$—	$—
Short-term investments:				
Corporate debt securities	6,015	—	6,015	—
Certificates of deposit	2,000	—	2,000	—
Total financial assets	$223,109	$215,094	$8,015	$—
Liabilities				
Acquisition-related contingent earn-out liability	$495	$—	$—	$495

Based on quoted market prices as of September 30, 2014, the fair value of the 1.25% Convertible Senior Notes was approximately $239,428, determined using Level 2 inputs as they are not actively traded in markets.

The following table represents a reconciliation of the acquisition-related contingent earn-out liability measured at fair value on a recurring basis, using significant unobservable inputs (Level 3) for the nine months ended September 30, 2014:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
Balance at December 31, 2013	$495
Payments during the period	(500)
Adjustments to fair value during the period recorded in General and administrative expenses	5
Balance at September 30, 2014	$—

Table of Contents

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

Investments

The cost and fair value of the Company’s cash and cash equivalents and available-for-sale investments as of September 30, 2014 and December 31, 2013 were as follows:

	September 30, 2014			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and cash equivalents:				
Cash	$29,886	$—	$—	$29,886
Money market funds	164,731	—	—	164,731
Total	$194,617	$—	$—	$194,617
Short-term investments:				
Corporate debt securities	33,715	1	(37)	33,679
Commercial paper	4,496	—	—	4,496
Total	$38,211	$1	$(37)	$38,175

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

As of September 30, 2014 and December 31, 2013, all investments mature in less than one year. Estimated fair values for marketable securities are based on quoted market prices for the same or similar instruments.

5. Commitments and Contingencies

Operating Leases

In March 2014, the Company entered into an amendment to extend the lease agreement of its corporate offices located in Sunnyvale, California through December 31, 2019, which included an expansion of office space. Overall, the Company has noncancellable operating leases with various expiration dates through December 2019.

Rent expense was $987 and $442, respectively, for the three months ended September 30, 2014 and 2013, and $2,385 and $1,245, respectively, for the nine months ended September 30, 2014 and 2013.

Capital Leases

Table of Contents

In July 2012, the Company entered into two lease agreements to lease certain office equipment with expiration dates in July and October 2015. These leases bear an annual interest rate of 4.5% and are secured by fixed assets used in the Company's office locations.

At September 30, 2014, future annual minimum lease payments under noncancellable operating and capital leases were as follows:

	Capital Leases	Operating Leases
Year ending December 31,		
2014, remainder	$5	$1,041
2015	11	5,236
2016	—	3,956
2017	—	2,979
2018	—	2,727
Thereafter	—	2,638
Total minimum lease payments	16	$18,577
Less: Amount representing interest	(1)	
Present value of capital lease obligations	15	
Less: current portion	(15)	
Long-term portion of capital lease obligations	$—	

Contingencies

Under the indemnification provisions of the Company's customer agreements, the Company agrees to indemnify and defend and hold harmless its customers against, among other things, infringement of any patent, trademark or copyright under any country's laws or the misappropriation of any trade secret arising from the customers' legal use of the Company's solutions. The exposure to the Company under these indemnification provisions is generally limited to the total amount paid by the customers under the applicable customer agreement. However, certain indemnification provisions potentially expose the Company to losses in excess of the aggregate amount paid to the Company by the customer under the applicable customer agreement. To date, there have been no claims against the Company or its customers pursuant to these indemnification provisions.

Legal Contingencies

From time to time, the Company may be involved in legal proceedings and subject to claims in the ordinary course of business. On December 16, 2013, Finjan, Inc. sued the Company and its wholly-owned subsidiary, Armorize Technologies, Inc., in the United States District Court, Northern District of California for alleged patent infringement of a variety of its patents, demanding preliminary and permanent injunctive relief, and unspecified damages. The Company and Armorize filed an answer to the complaint on February 10, 2014. On April 15, 2014, Finjan’s initial disclosures in the lawsuit alleged approximately $13,500 in damages, but provide no basis or facts in support of this sum. On June 12, 2014, at the mandatory case management conference, the court ordered that the claims construction hearing be held in May 2015 and trial be set for January 2016, subject to later adjustment or delay. Based on the early stage of the claims and evaluation of the facts available at this time, the amount or range of reasonable possible losses to which the Company or Armorize is exposed cannot be estimated and the ultimate resolution of this matter and the associated financial impact, if any, remains uncertain at this time. The Company and Armorize intend to vigorously defend the lawsuit. Intellectual property litigation is subject to inherent uncertainties, and there can be no assurance that the expenses associated with defending any litigation or the resolution of this dispute would not have a material adverse impact on the Company's results of operations or cash flows. Regardless of the outcome, such proceedings and claims can have an adverse impact on the Company because of defense and settlement costs, diversion of resources and other factors, and there can be no assurances that favorable outcomes will be obtained.

6. Convertible Senior Notes

On December 11, 2013, the Company issued $175,000 principal amount of 1.25% Convertible Senior Notes (the "Notes") due 2018 in a private offering to qualified institutional buyers ("Holders") pursuant to Rule 144A under the Securities

Table of Contents

Act of 1944 (the "Exchange Act"), as amended. The initial Holders of the Notes also had an option to purchase an additional $26,250 in principal amount which was exercised in full. The net proceeds after the agent's discount and issuance costs of $5,803 from the Notes offering were approximately $195,446. The Company intends to use the net proceeds for working capital and general corporate purposes, which may include funding the Company's operations, capital expenditures, potential acquisitions of businesses, products or technologies believed to be of strategic importance. The Notes bear interest at 1.25% per year, payable semi-annually in arrears every June 15 and December 15, beginning on June 15, 2014.

The Notes are unsecured and rank senior in right of payment to any indebtedness expressly subordinated in right of payment to the Notes. They rank equally with the Company's other existing and future unsecured indebtedness that is not subordinated and are structurally subordinated to any current or future secured indebtedness to the extent of the value of the assets securing the indebtedness and other liabilities of the Company's subsidiaries.

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

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

Prior to June 15, 2018, the Notes will be convertible at the option of the Holders only upon the satisfaction of certain conditions and during certain periods if any of the following events occur:

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

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

Holders of the Notes also have the right to require the Company to repurchase all or a portion of the Notes at 100% of the principal amount, plus accrued and unpaid special interest, if any, upon the occurrence of certain fundamental changes to the Company.

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

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

Table of Contents

At September 30, 2014, the net carrying amount of the liability component of the Notes consists of:

Liability component:	
Principal	$201,250
Less: debt discount, net of amortization	(41,841)
Net carrying amount	$159,409
Equity component (1)	$43,293

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

For the three and nine months ended September 30, 2014, the Company incurred the following interest expense related to the Notes:

	Three Months Ended	Nine Months Ended
	September 30, 2014	
1.25% coupon	$629	$1,882
Amortization of debt discount	2,190	6,481
Amortization of debt issuance costs	13	38
	$2,832	$8,401

7. Debt

Equipment Financing Loans

The Company entered into an equipment loan agreement with Silicon Valley Bank in April 2011 for an aggregate loan principal amount of $6,000. Interest on the advances is equal to prime rate plus 0.5%. As of September 30, 2014, the interest rate on the outstanding advances was 4.5%. The Company had the ability to draw down on this equipment line through April 19, 2012. Each drawn amount is due 48 months after funding. Borrowings outstanding under the equipment loan at September 30, 2014 were $1,094. Equipment financed under this loan arrangement is collateralized by the respective assets underlying the loan. The terms of the loan restrict the Company’s ability to pay dividends. The loan includes a covenant that requires the Company to maintain cash and cash equivalents plus net accounts receivable of at least two times the amount of all outstanding indebtedness, excluding the impact from the Notes. As of September 30, 2014, the Company was in compliance with the financial covenant.

Interest expense was $19 and $33, respectively, for the three months ended September 30, 2014 and 2013, and $69 and $113, respectively, for the nine months ended September 30, 2014 and 2013.

At September 30, 2014, the remaining repayment commitments related to the equipment loans are as follows:

Year ending December 31,	
2014, remainder	$410
2015	684
	$1,094

8. Common Stock

Table of Contents

As of September 30, 2014, the Company is authorized to issue two classes of stock totaling 205,000 shares, of which 5,000 are designated as preferred stock and 200,000 are designated common stock, each with a par value of $0.0001 per share. The Company had 37,869 and 36,140 shares, respectively, issued and outstanding at September 30, 2014 and December 31, 2013.

Number of shares of common stock reserved for future issuance was as follows:

	As of September 30, 2014	As of December 31, 2013
Shares available for future grant under the stock plans	5,155	4,584
Options outstanding under stock plans	5,848	7,223
Shares available for future issuance under ESPP	1,026	759
Common stock issuable upon exercise of warrant and settlement of outstanding restricted stock units	2,192	1,216
Common stock issuable upon conversion of the convertible senior notes	5,158	5,158
Total shares reserved	19,379	18,940

9. Stock Equity Plans

Stock-Based Compensation Plans

On March 30, 2012, the Board of Directors and the Company’s stockholders approved the 2012 Equity Incentive Plan (the "2012 Plan"), which became effective in April 2012. The Company has two equity incentive plans: the Company’s 2002 stock option plan (the “2002 Plan”) and the 2012 Plan. Upon the initial public offering, all shares that were reserved under the 2002 Plan but not issued, and shares issued but subsequently returned to the plan through forfeitures, cancellations and repurchases became part of the 2012 Plan and no further shares will be granted pursuant to the 2002 Plan. All outstanding stock awards under the 2002 and 2012 Plans will continue to be governed by their existing terms. Under the 2012 Plan, the Company has the ability to issue incentive stock options (“ISOs”), nonstatutory stock options (“NSOs”), restricted stock awards, stock bonus awards, stock appreciation rights ("SARs"), restricted stock units (“RSUs”), and performance shares. The 2012 Plan also allows direct issuance of common stock to employees, outside directors and consultants at prices equal to the fair market value at the date of grant of options or issuance of common stock. Additionally, the 2012 Plan provides for the grant of performance cash awards to employees, directors and consultants. The Company has the right to repurchase any unvested shares (at the option exercise price) of common stock issued directly or under option exercises. The right of repurchase generally expires over the vesting period.

Under the 2002 and 2012 Plans, the term of an option grant shall not exceed 10 years from the date of its grant and options generally vest over a three to four-year period, with vesting on a monthly or annual interval. Under the 2012 Plan, 20,316 shares of common stock are reserved for issuance to eligible participants. Restricted stock awards generally vest over a four-year period. The number of shares available for grant and issuance under the 2012 Plan will be increased automatically on each January 1 of 2013 through 2016 by an amount equal to 5% of the Company's shares outstanding on the immediately preceding December 31, but not to exceed 3,724 shares, unless the Board of Directors, in its discretion, determines to make a smaller increase. As of September 30, 2014, 5,155 shares were available for future grant.

Stock Options

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

Table of Contents

The weighted average fair value of stock options granted to employees was $21.62 and $16.60, respectively, during the three months ended September 30, 2014 and 2013, and $20.01 and $8.31, respectively, during the nine months ended September 30, 2014 and 2013. The fair values were estimated on the grant dates using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Expected life (in years)	6.08	6.08	5.31-6.08	5.31-6.08
Volatility	56 %	61 %	54% - 58%	57% - 61%
Risk-free interest rate	1.9 %	1.8 %	1.8% - 1.9%	0.9% - 1.8%
Dividend yield	— %	— %	— %	— %

The estimate for expected life of options granted reflects the midpoint of the vesting term and the contractual life computed utilizing the simplified method as allowed by the SEC staff. The Company does not have significant historical share option exercise experience and hence considers the expected term assumption calculated using the simplified method to be reasonable. Since the Company's stock has been publicly traded for a limited time, the stock volatility assumptions represent an estimate of the historical volatilities of the common stock of a group of publicly-traded peer companies that operate in a similar industry. The estimate was determined based on the average historical volatilities of these peer companies. The risk-free interest rate used was the Federal Reserve Bank's constant maturities interest rate commensurate with the expected life of the options in effect at the time of the grant. The expected dividend yield was zero, as the Company does not anticipate paying a dividend within the relevant time frame. Expected forfeitures are estimated based on the Company's historical experience.

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

Stock option activity under the Plan is as follows:

	Shares subject to Options Outstanding			
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Balance at December 31, 2013	7,223	$8.17	6.82	$180,543
Options granted	540	36.36		
Options exercised	(1,465)	6.50		
Options forfeited and canceled	(450)	14.36		
Balance at September 30, 2014	5,848	$10.72	6.44	$154,661

The total intrinsic value of options exercised was $45,942 and $39,434, respectively, for the nine months ended September 30, 2014 and 2013. Total cash proceeds from such option exercises were $9,515 and $11,786, respectively, for the nine months ended September 30, 2014 and 2013.

The fair value of option grants that vested was $2,362 and $1,410, respectively, during the three months ended September 30, 2014 and 2013, and $8,231 and $5,178, respectively, during the nine months ended September 30, 2014 and 2013.

As of September 30, 2014, the Company had unamortized stock-based compensation expense of $16,641 related to stock options, that will be recognized net of forfeitures over the average remaining vesting term of the options of 2.20 years.

Restricted Stock Units

Table of Contents

A summary of the status of RSUs awarded and unvested under the stock option plans as of September 30, 2014 is presented below:

	RSUs Outstanding	
	Number of Shares	Granted Fair Value Per Unit
Awarded and unvested at December 31, 2013	1,214	$29.57
Awards granted	1,357	34.77
Awards vested	(217)	37.75
Awards forfeited	(162)	29.81
Awarded and unvested at September 30, 2014	2,192	$32.49

As of September 30, 2014, there was $46,834 of unamortized stock-based compensation expense related to unvested RSUs, which are expected to be recognized over a weighted average period of 3.23 years.

Employee Stock Purchase Plan

On March 30, 2012, the Board of Directors and the Company’s stockholders approved the 2012 Employee Stock Purchase Plan (the "ESPP"), which became effective in April 2012. A total of 745 shares of the Company's common stock was initially reserved for future issuance under the ESPP. The number of shares reserved for issuance under the ESPP will increase automatically on January 1 of each of the first eight years commencing with 2013 by the number of shares equal to 1% of the Company's shares outstanding on the immediately preceding December 31, but not to exceed 1,490 shares, unless the Board of Directors, in its discretion, determines to make a smaller increase. As of September 30, 2014, there were 1,026 shares of the Company's common stock available for future issuance under the ESPP.

There were no stock purchase rights granted under the ESPP during the three months ended September 30, 2014 and 2013.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Expected life (in years)	n/a	n/a	0.50	0.50
Volatility	n/a	n/a	52%	40%
Risk-free interest rate	n/a	n/a	0.05%	0.08%
Dividend yield	n/a	n/a	—%	—%

As of September 30, 2014, the Company expects to recognize $223 of the total unamortized compensation cost related to employee purchases under the ESPP over a weighted average period of 0.13 years.

10. Net Loss per Share

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

19

Table of Contents

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

	As of September 30,	
	2014	2013
Stock options to purchase common stock	5,848	7,379
Employee stock purchase plan	106	102
Common stock subject to repurchase	—	2
Restricted stock units	2,192	153
Convertible senior notes	5,158	—
Total	13,304	7,636

11. Segment Reporting

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Total revenue by solution:				
Privacy, Protection and Security	$38,881	$25,382	$107,033	$69,757
Archiving and Governance	11,430	9,121	32,380	27,337
Total revenue	$50,311	$34,503	$139,413	$97,094

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Total revenue:				
United States	$40,681	$28,241	$113,909	$80,038
Rest of world	9,630	6,262	25,504	17,056
Total revenue	$50,311	$34,503	$139,413	$97,094

Long-lived assets by geographic area are presented below:

Table of Contents

	As of September 30, 2014	As of December 31, 2013
Long-lived assets:		
United States	$15,284	$9,425
Rest of world	3,085	1,796
Total long lived assets	$18,369	$11,221

12. Income Taxes

The Company’s quarterly provision for income taxes is based on an estimated effective annual income tax rate. The Company’s quarterly provision for income taxes also includes the tax impact of certain unusual or infrequently occurring items, if any, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur.

Income tax expense for the three and nine months ended September 30, 2014 was $149 and $440 on pre-tax losses of $17,196 and $46,425, respectively. The Company recognized an income tax expense of $207 during the three months ended September 30, 2013 and an income tax benefit of $2,998 during the nine months ended September 30, 2013. These were based on three months and nine months pre-tax losses of $6,982 and $18,645, respectively. The income tax rate for the three and nine months ended September 30, 2014 varies from the United States statutory income tax rate primarily due to valuation allowances in the United States whereby pre-tax losses and gains do not result in the recognition of corresponding income tax benefits and expenses. The income tax rate for the three and nine months ended September 30, 2013 also varied from the United States statutory rate due to the recognition of a $3,364 deferred income tax benefit related to the release of a valuation allowance in a certain foreign jurisdiction which occurred during the period.

The Company's effective tax rate for the nine months ended September 30, 2014 decreased to negative 1.0% from 16.1% for the same prior year period. The prior period's effective tax rate was impacted by the recognition of a $3,364 deferred income tax benefit related to the release of a valuation allowance in a foreign jurisdiction.

The Company reviews the likelihood that it will realize the benefit of its deferred tax assets and, therefore, the need for valuation allowances, on a quarterly basis. There is no corresponding income tax benefit recognized with respect to losses incurred and no corresponding income tax expense recognized with respect to earnings generated in jurisdictions with a valuation allowance. This causes variability in the Company’s effective tax rate. The Company intends to maintain the valuation allowances until it is more likely than not that the net deferred tax assets will be realized.

As of September 30, 2014, the Company's gross uncertain tax benefits totaled $3,976, excluding related accrued interest and penalties of $243. As of September 30, 2014, $1,481 of the Company's uncertain tax benefits, including related accrued interest and penalties, would affect the effective tax rate if recognized. During the three months ended September 30, 2014, the Company's gross uncertain tax benefits increased $34. The increase is comprised of a $75 increase for tax positions taken in the current period offset by a $40 decrease for tax positions taken in prior periods.

The Company is not currently under audit by the IRS or any similar taxing authority in any other material jurisdiction. The Company believes it has recorded all appropriate provisions for all jurisdictions and open years. However, the Company can give no assurance that taxing authorities will not propose adjustments that would increase its tax liabilities.

Table of Contents

13. Subsequent Events
On October 31, 2014, the Company completed the acquisition of privately-held Nexgate, Inc. ("Nexgate") for $35,000. The results of Nexgate's operations will be included in the Consolidated Financial Statements following the acquisition date. The Company is currently evaluating the purchase price allocation following the consummation of the transaction. It is not possible to disclose the preliminary purchase price allocation or pro forma combined financial information given the short period of time between acquisition date and the filing of this report.

In October 2014, the Company entered into an amendment to extend the Taiwan office lease agreement for additional three years with the new expiration date of September 30, 2019.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.
The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the (1) unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q, and (2) the audited consolidated financial statements and notes thereto and management's discussion and analysis of financial condition and results of operations for the fiscal year ended December 31, 2013 included in our Annual Report on Form 10-K for fiscal year 2013, or 2013 Annual Report on Form 10-K. This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These statements are often identified by the use of words such as "may," "will," "expect," "believe," "anticipate," "intend," "could," "estimate," or "conti similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified herein, and those discussed in the section titled "Risk Factors", set forth in Part II, Item 1A of this Form 10-Q and in our other SEC filings, including our 2013 Annual Report on Form 10-K. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.
Overview
Proofpoint is a pioneering security-as-a-service ("SaaS") vendor that enables large and mid-sized organizations through out the world to defend, protect, archive and govern their most sensitive data. Our SaaS platform is comprised of an integrated suite of on-demand data protection solutions, including threat management, regulatory compliance, data governance, and secure communication.

We were founded in 2002 to provide a unified solution to help enterprises address their growing data security requirements. Our first solution was commercially released in 2003 to combat the burgeoning problem of spam and viruses and their impact on corporate email systems. As the threat environment has continued to evolve, we have dedicated significant resources to meet the ongoing challenges that this highly dynamic environment creates for our customers such as investing significantly to expand the breadth of our data protection platform as these expenditures are primarily in connection with the replacement and upgrade of equipment to lower the cost of deployment as well as to improve the efficiency for our cloud-based architecture.

Our business is based on a recurring revenue model. Our customers pay a subscription fee to license the various components of our SaaS platform for a contract term that is typically one to three years. At the end of the license term, customers may renew their subscription and in each year since the launch of our first solution in 2003, we have retained over 90% of our customers. We derive this retention rate by calculating the total annually recurring subscription revenue from customers currently using our SaaS platform and dividing it by the total annually recurring subscription revenue from both these current customers as well as all business lost through non-renewal. A growing number of our customers increase their annual subscription fees after their initial purchase by broadening their use of our platform or by adding more users, and these sales have consistently represented 15% or more of our billings each year since 2008. As our business has grown, our subscription revenue has increased as a percentage of our total revenue, from 90% of total revenue in 2011 to 96% in the three months ended September 30, 2014.

We market and sell our solutions to large and mid-sized organizations both directly through our field and inside sales teams and indirectly through a hybrid model where our sales organization actively assists our network of distributors and

Table of Contents

resellers. We also derive a lesser portion of our total revenue from the license of our solutions to strategic partners who offer our solutions in conjunction with one or more of their own products or services.

Our solutions are designed to be implemented, configured and operated without the need for any training or professional services. For those customers that seek to develop deeper expertise in the use of our solutions or would like assistance with complex configurations or the importing of data, we offer various training and professional services. In some cases, we provide a hardware appliance to those customers that elect to host elements of our solution behind their firewall. Increasing adoption of virtualization in the data center has led to a decline in the sales of our hardware appliances and a shift towards our software-based virtual appliances, which are delivered as a download via the Internet. Our hardware and services offerings carry lower margins and are provided as a courtesy to our customers. We expect the overall proportion of revenue derived from the hardware and services offerings to generally remain below 10% of our total revenue.

Historically, the majority of our revenue is derived from our customers in the United States. We believe the markets outside of the United States offer an opportunity for growth and we intend to make additional investments in sales and marketing to expand in these markets. Revenue from customers outside of the United States grew 54% for the three months ended September 30, 2014 as compared to the prior year period. As of September 30, 2014, we had approximately 3,200 customers around the world, including 41 of the Fortune 100. In terms of customer concentration, one partner accounted for 12% of our total revenue for the three months ended September 30, 2014, although the partner sold to a number of end-user customers, none which accounted for more than 10% of our total revenue. Other than the aforementioned partner above, there were no other single partners or customers that accounted for more than 10% of our total revenue in the three months ended September 30, 2014.

We have not been profitable to date and will need to grow revenue at a rate faster than our investments in cost of revenue and operating expenses in order to achieve profitability, as discussed in more detail below.

We completed six acquisitions between January 1, 2013 and through September 30, 2014 to complement our solutions offerings which are more fully described in Note 2 to our accompanying Condensed Consolidated Financial Statements included in this report.

Key Opportunities and Challenges
The majority of costs associated with generating customer agreements are incurred up front. These upfront costs include direct incremental sales commissions, which are recognized upon the billing of the contract. The costs associated with the teams tasked with closing business with new customers and additional business with our existing customers have represented more than 90% of our total sales and marketing costs since 2008. Although we expect customers to be profitable over the duration of the customer relationship, these upfront costs typically exceed related revenue during the earlier periods of a contract. As a result, while our practice of invoicing our customers for the entire amount of the contract at the start of the term provides us with a relatively immediate contribution to cash flow, the revenue is recognized ratably over the term of the contract, and hence contributions toward operating income are limited in the period where these sales and marketing costs are incurred. Accordingly, an increase in the mix of new customers as a percentage of total customers would likely negatively impact our near-term operating results. On the other hand, we expect that an increase in the mix of existing customers as a percentage of total customers would positively impact our operating results over time. As we accumulate customers that continue to renew their contracts, we anticipate that our mix of existing customers will increase, contributing to a decrease in our sales and marketing costs as a percentage of total revenue and a commensurate improvement in our operating income.

As part of maintaining our SaaS platform, we provide ongoing updates and enhancements to the platform services both in terms of the software as well as the underlying hardware and data center infrastructure. These updates and enhancements are provided to our customers at no additional charge as part of the subscription fees paid for the use of our platform. While more traditional products eventually become obsolete and require replacement, we are constantly updating and maintaining our cloud-based services and as such they operate with a continuous product life cycle. Much of this work is designed to both maintain and enhance the customers' experiences over time while also lowering our costs to deliver the service, as evidenced by our improvements in gross profit over the past three years. Our SaaS platform is a shared infrastructure that is used by all of our customers. Accordingly, the costs of the platform are spread in a relatively uniform manner across the entire customer base and no specific infrastructure elements are directly attached to any particular customer. As such, in the event that a customer chooses to not renew its subscription, the underlying resources are reallocated either to new customers or to accommodate the expanding needs of our existing customers and, as a result, we do not believe that the loss of any particular customer has a meaningful impact on our gross profit as long as we continue to grow our customer base.

Table of Contents

To date, our customers have primarily used our solutions in conjunction with email messaging content. We have developed solutions to address the new and evolving messaging solutions such as social media and file sharing applications, but these solutions are relatively nascent. If customers increase their use of these new messaging solutions in the future, we anticipate that our growth in revenue associated with older email messaging solutions may slow over time. Although revenue associated with our social media and file sharing applications has not been material to date, we believe that our ability to provide security, archiving, governance and discovery for these new solutions will be viewed as valuable by our existing customers, enabling us to derive revenue from these new forms of messaging and communication.

While the majority of our current and prospective customers run their email systems on premise, we believe that there is a trend for large and mid-sized enterprises to migrate these systems to the cloud. While our current revenue derived from customers using cloud-based email systems continues to grow as a percentage of our total revenue, many of these cloud-based email solutions offer some form of threat protection and governance services, potentially mitigating the need for customers to buy these capabilities from third parties such as ourselves. We believe that we can continue to provide security, archiving, governance, and discovery solutions that are differentiated from the services offered by cloud-based email providers, and as such our platform will continue to be viewed as valuable to enterprises once they have migrated their email services to the cloud, enabling us to continue to derive revenue from this new trend toward cloud-based email deployment models.

With the majority of our business, we invoice our customers for the entire contract amount at the start of the term and these amounts are recorded as deferred revenue on our balance sheet, with the dollar weighted average duration of these contracts for any given period over the past three years typically ranging from 17 to 22 months. As a result, while our practice of invoicing customers for the entire amount of the contract at the start of the term provides us with a relatively immediate contribution to cash flow, the revenue is recognized ratably over the term of the contract, and hence contributions toward operating income are realized over an extended period. As such, our efforts to improve our profitability require us to invest far less in operating expenses than the cash flow generated by our business might otherwise allow. As we strive to invest in an effort to continue to increase the size and scale of our business, we expect that the level of investment afforded by our growth in revenue should be sufficient to fund the investments needed to drive revenue growth and broaden our product line.

Considering all of these factors, we do not expect to be profitable on a GAAP basis in the near term and in order to achieve profitability we will need to grow revenue at a rate faster than our investments in operating expenses and cost of revenue.

We intend to grow our revenue through acquiring new customers by investing in our sales and marketing activities. We believe that an increase in new customers in the near term will result in a larger base of renewal customers, which, over time, we expect to be more profitable for us.

Sales and marketing is our greatest expense and hence a significant contributing factor to our operating losses. Given that our costs to acquire new revenue sources, either in the form of new customers or the sale of additional solutions to existing customers, often exceed the actual revenue recognized in the initial periods, we believe that our opportunity to improve our return on investment on sales and marketing costs relies primarily on our ongoing ability to cost-effectively renew our business with existing customers, thereby lowering our overall sales and marketing costs as a percentage of revenue as the mix of revenue derived from this more profitable renewal activity increases over time. Therefore, we anticipate that our initial significant investments in sales and marketing activities will, over time, generate a larger base of more profitable customers. Cost of subscription revenue is also a significant expense for us, and we expect to continue to build on the improvements over the past three years, such as in replacing third-party technology with our proprietary technology and improving the utilization of our fixed investments in equipment and infrastructure, in order to provide the opportunity for improved subscription gross margins over time. Although we plan to continue enhancing our solutions, we intend to lower our rate of investment in research and development as a percentage of revenue over time by deriving additional revenue from our existing platform of solutions rather than by adding entirely new categories of solutions. In addition, as personnel costs are one of the primary drivers of the increases in our operating expenses, we plan to reduce our historical rate of headcount growth over time.

Key Metrics

We regularly review a number of metrics, including the following key metrics presented in the table below, to evaluate our business, measure our performance, identify trends in our business, prepare financial projections and make strategic decisions. Many of these key metrics, such as adjusted subscription gross profit, billings and adjusted EBITDA, are non-GAAP measures. This non-GAAP information is not necessarily comparable to non-GAAP information of other companies. Non-GAAP information should not be viewed as a substitute for, or superior to, net loss prepared in accordance with GAAP as a

Table of Contents

measure of our profitability or liquidity. Users of this financial information should consider the types of events and transactions for which adjustments have been made.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(in thousands)		(in thousands)	
Total revenue	$50,311	$34,503	$139,413	$97,094
Growth	46 %	27 %	44 %	25 %
Subscription revenue	$48,506	$33,464	$134,757	$92,732
Growth	45 %	29 %	45 %	25 %
Adjusted subscription gross profit	$36,031	$25,298	$101,013	$69,628
% of subscription revenue	74 %	76 %	75 %	75 %
Billings	$62,132	$41,357	$158,814	$111,563
Growth	50 %	38 %	42 %	39 %
Adjusted EBITDA	$260	$(935)	$(990)	$(3,965)

Subscription revenue

Subscription revenue represents the recurring subscription fees paid by our customers and recognized as revenue during the period for the use of our security-as-a-service platform, typically licensed for one to three years at a time. We consider subscription revenue to be a key business metric because it reflects the recurring aspect of our business model and is the primary driver of growth for our business over time. The consistent growth in subscription revenue over the past several years has resulted from our ongoing investment in sales and marketing personnel, our efforts to expand our customer base, and our efforts to broaden the use of our platform with existing customers.

Adjusted subscription gross profit

We have included adjusted subscription gross profit, a non GAAP financial measure, in this report because it is a key measure used by our management and board of directors to understand and evaluate our operating results, core operating performance, and trends to prepare and approve our annual budget and to develop short and long-term operational plans. We define adjusted subscription gross profit as subscription gross profit, the most directly comparable GAAP financial measure, less stock-based compensation expense and the amortization of intangible assets associated with acquisitions which we have provided a reconciliation below. We believe that adjusted subscription gross profit provides useful information to investors and others in understanding and evaluating our operating results in the same manner as our management and board of directors.

Our use of adjusted subscription gross profit has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results as reported under GAAP. Because of these limitations, you should consider adjusted subscription gross profit alongside other financial performance measures, including subscription gross profit and our other GAAP results.

The following table presents the reconciliation of subscription gross profit to adjusted subscription gross profit for the three and nine months ended September 30, 2014 and 2013:

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(in thousands)		(in thousands)	
Subscription revenue	$48,506	$33,464	$134,757	$92,732
Cost of subscription revenue	14,300	8,937	38,295	25,042
Subscription gross profit	34,206	24,527	96,462	67,690
Stock based compensation	715	203	1,638	631
Amortization of intangible assets	1,110	568	2,913	1,307
Adjusted subscription gross profit	$36,031	$25,298	$101,013	$69,628

Billings

We have included billings, a non GAAP financial measure, in this report because it is a key measure used by our management and board of directors to manage our business and monitor our near term cash flows. We have provided a reconciliation between total revenue, the most directly comparable GAAP financial measure, and billings. Accordingly, we believe that billings provides useful information to investors and others in understanding and evaluating our operating results in the same manner as our management and board of directors.

Our use of billings as a non-GAAP measure has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for revenue or an analysis of our results as reported under GAAP. Some of these limitations are:

- Billings is not a substitute for revenue, as trends in billings are not necessarily directly correlated to trends in revenue;
- Billings is affected by a combination of factors including the timing of renewals, the sales of our solutions to both new and existing customers, the relative duration of contracts sold, and the relative amount of business derived from strategic partners. As each of these elements has unique characteristics in the relationship between billings and revenue, our billings activity is not necessarily closely correlated to revenue; and
- Other companies, including companies in our industry, may not use billings, may calculate billings differently, or may use other financial measures to evaluate their performance all of which reduce the usefulness of billings as a comparative measure.

The following table presents the reconciliation of total revenue to billings for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(in thousands)		(in thousands)	
Total revenue	$50,311	$34,503	$139,413	$97,094
Deferred revenue				
Ending	143,384	101,328	143,384	101,328
Beginning	131,563	94,474	123,983	86,859
Net change	11,821	6,854	19,401	14,469
Billings	$62,132	$41,357	$158,814	$111,563

Adjusted EBITDA

Table of Contents

We define adjusted EBITDA as net loss, adjusted to exclude: depreciation, amortization of intangibles, interest (income) expense, net, provision for (benefit from) income taxes, stock based compensation, acquisition- and litigation-related expenses, other income, and other expense. We believe that adjusted EBITDA is useful to investors and other users of our financial statements in evaluating our operating performance because it provides them with an additional tool to compare business performance across companies and across periods. We believe that:

- Adjusted EBITDA provides investors and other users of our financial information consistency and comparability with our past financial performance, facilitates period-to-period comparisons of operations and facilitates comparisons with our peer companies, many of which use similar non-GAAP financial measures to supplement their GAAP results; and
- It is useful to exclude certain non-cash charges, such as depreciation, amortization of intangible assets and stock based compensation and non-core operational charges, such as acquisition- and litigation-related expenses, from adjusted EBITDA because the amount of such expenses in any specific period may not be directly correlated to the underlying performance of our business operations and these expenses can vary significantly between periods as a result of new acquisitions, full amortization of previously acquired tangible and intangible assets or the timing of new stock based awards, as the case may be.

We use adjusted EBITDA in conjunction with traditional GAAP operating performance measures as part of our overall assessment of our performance, for planning purposes, including the preparation of our annual operating budget, to evaluate the effectiveness of our business strategies and to communicate with our board of directors concerning our financial performance.

We do not place undue reliance on adjusted EBITDA as our only measure of operating performance. Adjusted EBITDA should not be considered as a substitute for other measures of financial performance reported in accordance with GAAP. There are limitations to using non-GAAP financial measures, including that other companies may calculate these measures differently than we do, that they do not reflect our capital expenditures or future requirements for capital expenditures and that they do not reflect changes in, or cash requirements for, our working capital.

The following table presents the reconciliation of net loss to adjusted EBITDA for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(in thousands)		(in thousands)	
Net loss	$(17,345)	$(7,189)	$(46,865)	$(15,647)
Depreciation	2,486	1,513	6,522	4,150
Amortization of intangible assets	2,250	909	6,319	1,973
Interest expense, net	2,814	11	8,385	4
Provision for (benefit from) income taxes	149	207	440	(2,998)
EBITDA	(9,646)	(4,549)	(25,199)	(12,518)
Stock-based compensation expense	8,496	2,379	21,797	6,602
Acquisition-related expense	21	1,587	379	1,788
Litigation-related expense	209	—	661	—
Other income	(29)	(24)	(43)	(28)
Other expense (income), net	1,209	(328)	1,415	191
Adjusted EBITDA	$260	$(935)	$(990)	$(3,965)

Critical Accounting Policies and Estimates

Table of Contents

The discussion and analysis of our financial condition and results of operations is based upon our accompanying Condensed Consolidated Financial Statements, which have been prepared in accordance with U.S. GAAP. The preparation of these financial statements requires us to make estimates, assumptions and judgments that can have significant impact on the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. We base our estimates, assumptions and judgments on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. On a regular basis we evaluate our estimates, assumptions and judgments and make changes accordingly.

We believe that the estimates, assumptions and judgments involved in business combinations, revenue recognition, deferred revenue, stock-based compensation and accounting for income taxes have the greatest potential impact on our accompanying Condensed Consolidated Financial Statements, and consider these to be our critical accounting policies. Historically, our estimates, assumptions and judgments relative to our critical accounting policies have not differed materially from actual results. The critical accounting estimates associated with these policies are described in our 2013 Annual Report on Form 10-K, under "Management's Discussion and Analysis of Financial Condition and Results of Operations." There have been no material changes to our significant accounting policies as compared to the significant accounting policies described in our 2013 Annual Report on Form 10-K for the year ended December 31, 2013.

Components of Our Results of Operations

Business Combinations

In each of our acquisitions, we used the purchase method of accounting which requires us to allocate the fair value of the total consideration transferred to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values on the date of the acquisition, with the difference between the net assets acquired and the total consideration transferred recorded as goodwill. The fair values assigned, defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between willing market participants, are based on significant estimates and assumptions determined by management. These estimates and assumptions are inherently uncertain and subject to refinement, as a result, during the adjustment period, which may be up to one year from the acquisition date, we may record adjustments to the assets acquired or liabilities assumed with any corresponding offset to goodwill. Upon conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded to our accompanying Condensed Consolidated Statements of Operations.

We used either the discounted cash flow method or the replacement cost method to assign fair values to acquired identifiable intangible assets. This method requires significant management judgment to forecast future operating results and establish residual growth rates and discount factors. These models are based on reasonable estimates and assumptions given available facts and circumstances, including industry estimates and averages, as of the acquisition dates and are consistent with the plans and estimates that we use to manage our business. If the subsequent actual results and updated projections of the underlying business activity change compared with the estimates and assumptions used to develop these values, we could experience impairment charges. In addition, we have estimated the economic lives of certain acquired assets and these lives are used to calculate depreciation and amortization expense. If our estimates of the economic lives change, depreciation or amortization expenses could be accelerated or slowed.

Revenue

We derive our revenue primarily through the license of various solutions and services on our security-as-a-service platform on a subscription basis, supplemented by the sales of training, professional services and hardware depending upon our customers' requirements.

Subscription. We license our platform and its associated solutions and services on a subscription basis. The fees are charged on a per user, per year basis. Subscriptions are typically one to three years in duration. We invoice our customers upon signing for the entire term of the contract. The invoiced amounts billed in advance are treated as deferred revenue on the balance sheet and are recognized ratably, in accordance with the appropriate revenue recognition guidelines, over the term of the contract (as more fully described above. We also derive a portion of our subscription revenue from the license of our solutions to strategic partners. We bill these strategic partners monthly. We expect our subscription revenue will continue to grow and remain above 90% of our total revenue.

Table of Contents

Hardware and services. We provide hardware appliances as a convenience to our customers and as such it represents a small part of our business. Our solutions are designed to be implemented, configured and operated without the need for any training or professional services. For those customers that seek to develop deeper expertise in the use of our solutions or would like assistance with complex configurations or the importing of data, we offer various training and professional services. We typically invoice the customer for hardware at the time of shipment. We typically invoice customers for services at the time the order is placed and recognize this revenue ratably over the term of the contract. On occasion, customers may retain us for special projects such as archiving import and export services; these types of services are recognized upon completion of the project. We expect the overall proportion of revenue derived from hardware and service offerings to generally remain below 10% of our total revenue.

Total Cost of Revenue

Our cost of revenues consists of cost of subscription revenue and cost of hardware and services revenue. Personnel costs, which consist of salaries, benefits, bonuses, and stock based compensation, data center costs and hardware costs are the most significant components of our cost of revenues. We expect personnel costs to continue to increase in absolute dollars as we hire new employees to continue to grow our business.

Cost of Subscription Revenue. Cost of subscription revenue primarily includes personnel costs, consisting of salaries, benefits, bonuses, and stock based compensation, for employees who provide support services to our customers and operate our data centers. Other costs include fees paid to contractors who supplement our support and data center personnel; expenses related to the use of third party data centers in both the United States and internationally; depreciation of data center equipment; amortization of licensing fees and royalties paid for the use of third party technology; amortization of capitalized research and development costs; and the amortization of intangible assets related to prior acquisitions. Growth in subscription revenue generally consumes production resources, requiring us to gradually increase our cost of subscription revenue in absolute dollars as we expand our investment in data center equipment, the third-party data center space required to house this equipment, and the personnel needed to manage this higher level of activity. However, we have reduced our cost of subscription revenue as we have replaced third party licensed technology with our proprietary technology, and we expect the benefit of these initiatives to continue in future periods.

Cost of Hardware and Services Revenue. Cost of hardware and services revenue includes personnel costs for employees who provide training and professional services to our customers as well as the cost of server hardware shipped to our customers that we procure from third parties and configure with our software solutions. We expect that cost of hardware and services revenue may gradually increase as a percentage of hardware and services revenue in future periods, as the remaining deferred costs are amortized over remaining contract terms.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, and general and administrative expenses. Personnel costs, which consist of salaries, benefits, bonuses, and stock based compensation, are the most significant component of our operating expenses. We expect personnel costs to continue to increase in absolute dollars as we hire new employees to continue to grow our business. Our headcount has increased 51% from December 31, 2012 to December 31, 2013. As a result of this growth in headcount, operating expenses have increased significantly over these periods. We expect personnel costs to continue to increase in absolute dollars as we hire new employees to continue to grow our business.

Research and Development. Research and development expenses include personnel costs, consulting services and depreciation. We believe that these investments have played an important role in broadening the capabilities of our platform over the course of our operating history, enhancing the relevance of our solutions in the market in general and helping us to retain our customers over time. We expect to continue to devote substantial resources to research and development in an effort to continuously improve our existing solutions as well as to develop new offerings. We believe that these investments are necessary to maintain and improve our competitive position, however, over the longer term, we intend to monitor these costs so as to decrease this spending as a percentage of total revenue. Our research efforts include both software developed for our internal use on behalf of our customers as well as software elements to be used by our customers in their own facilities. To date, our capitalized costs on software developed for internal use on behalf of our customers were not material. For the software developed for use on our customers' premises, the costs associated with the development work between technological feasibility and the general availability has not been material and as such we have not capitalized any of these development costs to date.

Sales and Marketing. Sales and marketing expenses include personnel costs, sales commissions, and other costs including travel and entertainment, marketing and promotional events, public relations and marketing activities. All of these costs are expensed

Table of Contents

as incurred, including sales commissions. These costs also include amortization of intangible assets as a result of our past acquisitions. Due to our continued investment in growing our sales and marketing operations, both domestically and internationally, headcount increases were reflected in higher compensation expense consistent with our revenue growth. Our sales personnel are typically not immediately productive, and therefore the increase in sales and marketing expenses we incur when we add new sales representatives is not immediately offset by increased revenue and may not result in increased revenue over the long-term if these new sales people fail to become productive. The timing of our hiring of new sales personnel and the rate at which they generate incremental revenue will affect our future financial performance. We expect that sales and marketing expenses will continue to increase in absolute dollars and be among the most significant components of our operating expenses.

General and Administrative.   General and administrative expenses consist of personnel costs, consulting services, audit fees, tax services, legal expenses and other general corporate items. As a result of our operational growth, we expect our general and administrative expenses to increase in absolute dollars in future periods as we continue to expand our operations and hire additional personnel.

Total Other Income (Expense), Net

Total other income (expense), net, consists of interest income (expense), net and other income (expense), net. Interest income (expense), net, consists primarily of interest income earned on our cash, cash equivalents and short-term investments offset by the interest expense related to our convertible senior notes, our capital lease payments and borrowings under our equipment loans. Other income (expense), net, consists primarily of the net effect of foreign currency transaction gains or losses.

(Provision for) Benefit from Income Taxes

The (provision for) benefit from income taxes is related to certain state and foreign income taxes. As we have incurred operating losses in all periods to date and recorded a full valuation allowance against our deferred tax assets, we have not historically recorded a provision for federal income taxes. Realization of any of our deferred tax assets depends upon future earnings, the timing and amount of which are uncertain. Utilization of our net operating losses may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Analyses have been conducted to determine whether an ownership change had occurred since inception. The analyses have indicated that although an ownership change occurred in a prior year, the net operating losses and research and development credits would not expire before utilization as a result of the ownership change. In the event we have subsequent changes in ownership, net operating losses and research and development credit carryovers could be limited and may expire unutilized as a result of the subsequent ownership change.

Results of Operations

The following table is a summary of our consolidated statements of operations and results of operations as a percentage of our total revenue for those periods.

Table of Contents

	Three Months Ended September 30, 2014		2013		Nine Months Ended September 30, 2014		2013	
	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue	Amount	% of revenue
	($ in thousands)				($ in thousands)			
Revenue:								
Subscription	$48,506	96 %	$33,464	97 %	$134,757	97 %	$92,732	96 %
Hardware and services	1,805	4	1,039	3	4,656	3	4,362	4
Total revenue	50,311	100	34,503	100	139,413	100	97,094	100
Cost of revenue:								
Subscription	14,300	28	8,937	26	38,295	27	25,042	26
Hardware and services	2,964	6	1,409	4	7,941	6	3,851	4
Total cost of revenue	17,264	34	10,346	30	46,236	33	28,893	30
Gross profit	33,047	66	24,157	70	93,177	67	68,201	70
Operating expense:								
Research and development	13,454	27	8,307	24	37,700	27	23,460	24
Sales and marketing	25,662	51	17,415	50	72,660	52	49,782	51
General and administrative	7,133	14	5,758	17	19,485	14	13,437	14
Total operating expense	46,249	92	31,480	91	129,845	93	86,679	89
Operating loss	(13,202)	(26)	(7,323)	(21)	(36,668)	(26)	(18,478)	(19)
Interest expense, net	(2,814)	(6)	(11)	—	(8,385)	(6)	(4)	—
Other income (expense), net	(1,180)	(2)	352	1	(1,372)	(1)	(163)	—
Loss before (provision for) benefit from income taxes	(17,196)	(34)	(6,982)	(20)	(46,425)	(33)	(18,645)	(19)
(Provision for) benefit from income taxes	(149)	—	(207)	(1)	(440)	(1)	2,998	3
Net loss	$(17,345)	(34)%	$(7,189)	(21)%	$(46,865)	(34)%	$(15,647)	(16)%

Comparison of the three and nine months ended September 30, 2014 and 2013:

Revenue

	Three Months Ended September 30, 2014	2013	% Change	Nine Months Ended September 30, 2014	2013	% Change
	(in thousands)			(in thousands)		
Revenue						
Subscription	$48,506	$33,464	45 %	$134,757	$92,732	45 %
Hardware and services	1,805	1,039	74	4,656	4,362	7
Total revenue	$50,311	$34,503	46 %	$139,413	$97,094	44 %

Subscription revenue for the three and nine months ended September 30, 2014 increased $15.0 million, or 45%, and $42.0 million, or 45%, as compared to the corresponding periods last year. These increases were primarily due to a $12.0 million and $34.4 million, respectively, increase in subscription revenue contributed from the United States, including $1.5 million and $5.7 million, respectively, released from deferred revenue related to an acquisition in the fourth quarter of 2013. To a lesser extent, for the same period, there was an increase of $3.0 million and $7.6 million, respectively, from our international operations. These increases were due to our ongoing investment in sales and marketing resources, including net

31