

PROOFPOINT INC  
Form 10-Q  
November 01, 2018  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2018

OR

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

For the Transition Period from \_\_\_\_ to \_\_\_\_

Commission File Number 001-35506

PROOFPOINT, INC.

(Exact name of Registrant as specified in its charter)

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

(408) 517-4710

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

Edgar Filing: PROOFPOINT INC - Form 10-Q

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

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

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

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

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

Shares of Proofpoint, Inc. common stock, \$0.0001 par value per share, outstanding as of October 19, 2018:  
54,647,922 shares.

Table of Contents

TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
<u>ITEM 1. FINANCIAL STATEMENTS (UNAUDITED):</u>	3
<u>Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2018 and 2017</u>	4
<u>Condensed Consolidated Statements of Comprehensive Loss for the Three and Nine Months Ended September 30, 2018 and 2017</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	8
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	29
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	43
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	44
<u>PART II. OTHER INFORMATION</u>	
<u>ITEM 1. LEGAL PROCEEDINGS</u>	45
<u>ITEM 1A. RISK FACTORS</u>	45
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	60
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	60
<u>ITEM 4. MINE SAFETY DISCLOSURES</u>	60
<u>ITEM 5. OTHER INFORMATION</u>	60
<u>ITEM 6. EXHIBITS</u>	61
<u>SIGNATURES</u>	62



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, 2018	December 31, 2017
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 160,561	\$ 286,072
Short-term investments	29,829	45,526
Accounts receivable, net	143,859	107,696
Inventory	372	730
Deferred product costs	1,789	1,541
Deferred commissions	32,840	26,249
Prepaid expenses and other current assets	19,274	18,669
<b>Total current assets</b>	<b>388,524</b>	<b>486,483</b>
Property and equipment, net	73,518	73,617
Long-term deferred product costs	316	259
Goodwill	460,596	297,704
Intangible assets, net	147,237	95,602
Long-term deferred commissions	60,459	51,954
Other assets	7,064	12,813
<b>Total assets</b>	<b>\$ 1,137,714</b>	<b>\$ 1,018,432</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 14,931	\$ 12,271
Accrued liabilities	81,578	65,503
Capital lease obligations	31	34
Deferred rent	799	586
Deferred revenue	444,051	364,521
<b>Total current liabilities</b>	<b>541,390</b>	<b>442,915</b>
Convertible senior notes	—	197,858
Long-term capital lease obligations	30	55
Long-term deferred rent	3,918	4,102
Other long-term liabilities	7,241	11,069
Long-term deferred revenue	81,287	63,318
<b>Total liabilities</b>	<b>633,866</b>	<b>719,317</b>

## Commitments and contingencies (Note 6)

## Stockholders' equity:

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

authorized; no shares issued and outstanding	—	—
Common stock, \$0.0001 par value; 200,000 shares authorized; 54,483 and 50,325 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	5	5
Additional paid-in capital	1,078,028	787,572
Accumulated other comprehensive loss	(2 )	(9 )
Accumulated deficit	(574,183 )	(488,453 )
Total stockholders' equity	503,848	299,115
Total liabilities and stockholders' equity	\$ 1,137,714	\$ 1,018,432

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,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>Revenue:</b>				
Subscription	\$ 181,505	\$ 130,534	\$ 509,311	\$ 362,328
Hardware and services	2,674	4,152	9,204	10,434
Total revenue	184,179	134,686	518,515	372,762
<b>Cost of revenue:<sup>(1)(2)</sup></b>				
Subscription	45,679	31,211	133,495	89,895
Hardware and services	5,258	4,800	15,271	12,985
Total cost of revenue	50,937	36,011	148,766	102,880
Gross profit	133,242	98,675	369,749	269,882
<b>Operating expense:<sup>(1)(2)</sup></b>				
Research and development	45,917	32,477	137,176	94,389
Sales and marketing	90,006	66,406	252,814	182,452
General and administrative	23,877	13,388	60,431	36,223
Total operating expense	159,800	112,271	450,421	313,064
Operating loss	(26,558 )	(13,596 )	(80,672 )	(43,182 )
Interest expense	(9,097 )	(5,733 )	(15,105 )	(17,547 )
Other (expense) income, net	(425 )	829	(715 )	884
Loss before income taxes	(36,080 )	(18,500 )	(96,492 )	(59,845 )
Benefit from (provision for) income taxes	20	(977 )	13,978	(3,410 )
Net loss	\$(36,060 )	\$(19,477 )	\$(82,514 )	\$(63,255 )
Net loss per share, basic and diluted	\$(0.69 )	\$(0.44 )	\$(1.61 )	\$(1.44 )
Weighted average shares outstanding, basic and diluted	52,184	44,418	51,214	43,850

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

Cost of subscription revenue	\$3,503	\$2,876	\$10,402	\$8,115
Cost of hardware and services revenue	\$474	\$493	\$1,636	\$1,401
Research and development	\$9,678	\$7,803	\$29,699	\$22,597
Sales and marketing	\$13,191	\$8,943	\$37,075	\$25,070
General and administrative	\$11,250	\$5,222	\$24,153	\$15,032

(2) Includes intangible amortization expense as follows:

Cost of subscription revenue	\$7,121	\$3,190	\$20,141	\$9,567
------------------------------	---------	---------	----------	---------

Edgar Filing: PROOFPOINT INC - Form 10-Q

Research and development	\$15	\$15	\$45	\$45
Sales and marketing	\$3,982	\$875	\$10,379	\$2,791

See accompanying Notes to the Condensed Consolidated Financial Statements.

4

---



Table of Contents

Proofpoint, Inc.

Condensed Consolidated Statements of Comprehensive Loss

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net loss	\$ (36,060)	\$ (19,477)	\$ (82,514)	\$ (63,255)
Other comprehensive income, net of tax:				
Unrealized (loss) gain on short-term investments, net	(1 )	3	7	7
Comprehensive loss	\$ (36,061)	\$ (19,474)	\$ (82,507)	\$ (63,248)

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,	
	2018	2017
Cash flows from operating activities		
Net loss	\$(82,514 )	\$(63,255 )
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	54,315	29,286
Stock-based compensation	102,965	72,215
Change in fair value of contingent consideration	(79 )	(1,797 )
Amortization of debt issuance costs and accretion of debt discount	8,383	16,491
Amortization of deferred commissions	26,121	20,720
Loss on conversion of convertible notes	7,207	—
Deferred income taxes	(15,269 )	(1,831 )
Other	1,147	(466 )
Changes in assets and liabilities:		
Accounts receivable	(26,501 )	(18,452 )
Inventory	359	141
Deferred product costs	(304 )	190
Deferred commissions	(41,218 )	(29,242 )
Prepaid expenses	(2,344 )	(1,849 )
Other current assets	1,212	312
Long-term assets	248	(3,438 )
Accounts payable	2,655	(1,914 )
Accrued liabilities	10,479	15,469
Deferred rent	29	1,184
Deferred revenue	82,799	77,406
Net cash provided by operating activities	129,690	111,170
Cash flows from investing activities		
Proceeds from maturities of short-term investments	51,237	78,803
Proceeds from sales of short-term investments	11,931	—
Purchase of short-term investments	(47,457 )	(71,096 )
Purchase of property and equipment	(23,108 )	(34,756 )
Receipt from escrow account	3,321	5,116
Acquisition of business, net of cash acquired	(223,786)	—
Net cash used in investing activities	(227,862)	(21,933 )
Cash flows from financing activities		
Proceeds from issuance of common stock	15,898	16,928

Edgar Filing: PROOFPOINT INC - Form 10-Q

Withholding taxes related to restricted stock net share settlement	(41,967 )	(31,239 )
Repayments of equipment loans and capital lease obligations	(29 )	(25 )
Repayments of convertible notes	(142 )	—
Contingent consideration payment	(555 )	(5,116 )
Net cash used in financing activities	(26,795 )	(19,452 )
Effect of exchange rate changes on cash, cash equivalents and		
restricted cash	(352 )	1,035
Net (decrease) increase in cash, cash equivalents and restricted cash	(125,319)	70,820
Cash, cash equivalents and restricted cash		
Beginning of period	286,660	345,537
End of period	\$161,341	\$416,357
Supplemental disclosure of noncash investing and financing information		
Unpaid purchases of property and equipment and asset retirement		
obligations	\$3,253	\$2,310
Liability awards converted to equity	\$8,870	\$8,307
Convertible senior notes converted to equity	\$213,306	\$1,828

6

Table of Contents

	September 30, 2018	September 30, 2017
Reconciliation of cash, cash equivalents and restricted cash as shown in the consolidated statement of cash flows		
Cash and cash equivalents	\$ 160,561	\$ 416,006
Restricted cash included in prepaid expenses and other current assets	289	83
Restricted cash included in other non-current assets	491	268
Total cash, cash equivalents and restricted cash	\$ 161,341	\$ 416,357

See accompanying Notes to the Condensed Consolidated Financial Statements.

7

---

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

Basis of Presentation and Consolidation

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

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

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

Use of Estimates

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

#### Goodwill and Intangible Assets

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

Table of Contents

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

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

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

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

## Comprehensive Loss

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

## Accounting Pronouncements Adopted in 2018

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

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

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

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 clarifies how certain cash receipts and payments should be classified in the statement of cash flows. The Company adopted ASU 2016-15 on January 1, 2018 with no impact on its consolidated financial statements.



## Table of Contents

### Recent Accounting Pronouncements Not Yet Effective

In August 2018, the FASB issued ASU No. 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract ("ASU 2018-15"). ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The update to the standard is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted. Entities can choose to adopt the ASU 2018-15 prospectively or retrospectively. The Company is currently assessing the impact ASU 2018-15 will have on its consolidated financial statements.

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

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

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

### 2. Revenue, Deferred Revenue and Deferred Contract Costs

Effective January 1, 2018, the Company adopted ASC 606 using the full retrospective method. Under this method, the Company is presenting the consolidated financial statements as of December 31, 2017, and for the three and nine months ended September 30, 2017, as if ASC 606 had been effective for those periods. The most significant impact of the standard related to i) the timing of revenue recognition for contracts related to certain on-premise offerings, in which the Company granted customers the right to deploy its subscription software on the customers' own servers. For these contracts, the Company is required to recognize as revenue a significant portion of the contract price upon delivery of the software compared to the previous practice of recognizing the entire contract price ratably over a

subscription period; and ii) the timing of revenue recognition in instances when all revenue recognition criteria were not met until after the start date of the subscription. Previously these amounts were recognized prospectively over the remaining contract term, while under ASC 606, the Company is required to recognize revenue on a cumulative catch-up basis for amounts earned up to the time all revenue recognition criteria have been met. In addition, iii) certain contract acquisition costs such as sales commissions are being amortized over an expected benefit period that is longer than the Company's previous policy of amortizing the deferred amounts over the specific revenue contract term for the associated contract.

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

Table of Contents

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

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

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

	Three Months Ended September 30, 2017		
	As		
	Previously		
	Reported	Adjustments	As Adjusted
<b>Revenue:</b>			
Subscription	\$ 131,038	\$ (504 )	\$ 130,534
Hardware and services	3,274	878	4,152
Total revenue	\$ 134,312	\$ 374	\$ 134,686
Gross profit	\$ 98,301	\$ 374	\$ 98,675
<b>Operating expense:</b>			
Sales and marketing	\$ 68,518	\$ (2,112 )	\$ 66,406
Operating loss	\$ (16,082 )	\$ 2,486	\$ (13,596 )
Net loss	\$ (21,963 )	\$ 2,486	\$ (19,477 )
Net loss per share, basic and diluted	\$ (0.49 )	\$ 0.05	\$ (0.44 )

Nine Months Ended September 30, 2017

Adjustments

Edgar Filing: PROOFPOINT INC - Form 10-Q

	As Previously Reported		As Adjusted
<b>Revenue:</b>			
Subscription	\$360,891	\$ 1,437	\$362,328
Hardware and services	9,000	1,434	10,434
Total revenue	\$369,891	\$ 2,871	\$372,762
Gross profit	\$267,011	\$ 2,871	\$269,882
<b>Operating expense:</b>			
Sales and marketing	\$189,704	\$ (7,252 )	\$182,452
Operating loss	\$(53,305 )	\$ 10,123	\$(43,182 )
Net loss	\$(73,378 )	\$ 10,123	\$(63,255 )
Net loss per share, basic and diluted	\$(1.67 )	\$ 0.23	\$(1.44 )

Table of Contents

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

	Nine Months Ended September 30, 2017		
	As Previously		
	Reported	Adjustments	As Adjusted
Cash flows from operating activities			
Net loss	\$(73,378 )	\$ 10,123	\$(63,255 )
Adjustments to reconcile net loss to net cash provided by			
operating activities:			
Amortization of deferred commissions	\$—	\$ 20,720	\$20,720
Changes in assets and liabilities:			
Accounts receivable	\$(18,575 )	\$ 123	\$(18,452 )
Deferred commissions	\$(1,271 )	\$(27,971 )	\$(29,242 )
Accrued liabilities	\$15,544	\$(75 )	\$15,469
Deferred revenue	\$80,326	\$(2,920 )	\$77,406
Net cash provided by operating activities	\$111,170	\$ —	\$111,170

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

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

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

obligation.

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

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

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

12

---

Table of Contents

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

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

## Disaggregation of Revenue

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

The following table presents the Company's revenue disaggregation:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Subscription service revenue	\$174,082	\$126,419	\$492,068	\$350,556
Subscription software revenue	7,423	4,115	17,243	11,772
Hardware and services	2,674	4,152	9,204	10,434
Total revenue	\$184,179	\$134,686	\$518,515	\$372,762

## Subscription service revenue

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

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

#### Subscription software revenue

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

#### Hardware and services

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



## Table of Contents

### Contracts with multiple performance obligations

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

### Variable Consideration

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

### Unbilled accounts receivables

Unbilled accounts receivable represents amounts for which the Company has recognized revenue, pursuant to its revenue recognition policy, for software licenses already delivered and professional services already performed, but billed in arrears and for which the Company believes it has an unconditional right to payment. The unbilled accounts receivable balance, included in accounts receivable in the condensed consolidated balance sheet, was \$1,886 and \$603 as of September 30, 2018 and December 31, 2017.

### Deferred commissions

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

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

For the three and nine months ended September 30, 2018, the Company capitalized \$19,289 and \$41,218 of commission costs, respectively, and amortized \$9,413 and \$26,121, respectively. For the three and nine months ended September 30, 2017, the Company capitalized \$11,619 and \$29,242, respectively, of commission costs, respectively, and amortized \$7,445 and \$20,720, respectively.

#### Deferred product costs

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

## Table of Contents

For the three and nine months ended September 30, 2018, the Company capitalized \$691 and \$2,127 of deferred product costs, respectively, and amortized \$641 and \$1,824, respectively. For the three and nine months ended September 30, 2017, the Company capitalized \$825 and \$1,989 of deferred product costs, respectively, and amortized \$656 and \$2,179, respectively.

### Deferred revenue

The Company records deferred revenue when cash payments are received, or invoices are issued in advance of the Company's performance, and generally recognizes revenue over the contractual term. The Company recognized \$156,741 and \$314,849 of revenue during the three and nine months ended September 30, 2018, respectively, that was included in the deferred revenue balances at the beginning of the respective periods. The Company recognized \$110,044 and \$216,512 of revenue during the three and nine months ended September 30, 2017, respectively, that was included in the deferred revenue balances at the beginning of the respective periods.

The Company recognized \$2,039 and \$2,869 of revenue during the three and nine months ended September 30, 2018, respectively, related to the performance obligations satisfied in prior periods. The Company recognized \$494 and \$1,037 of revenue during the three and nine months ended September 30, 2017, respectively, related to the performance obligations satisfied in prior periods.

The acquisition of Wombat Securities, Inc. (see Note 3 "Acquisitions") on February 28, 2018, increased deferred revenue by \$14,700, of which \$10,071 was recognized in the nine month period ended September 30, 2018.

### Remaining performance obligations

Contracted revenue as of September 30, 2018 that has not yet been recognized ("contracted not recognized") was \$421,003, which includes deferred revenue and non-cancellable amounts that will be invoiced and recognized as revenue in future periods and excludes contracts with an original expected length of one year or less. The Company expects 62% of contracted and not recognized revenue to be recognized over the next twelve months, 37% in years two and three, with the remaining balance recognized thereafter.

### 3. Acquisitions

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

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

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

#### 2018 Acquisitions

##### Wombat Security Technologies, Inc.

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

Table of Contents

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

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

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

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

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

At the Wombat Acquisition Date, the consideration transferred was \$225,366, net of cash acquired of \$13,452. Of the consideration transferred, \$22,500 was held in escrow to secure indemnification obligations, which has not been released as of the filing date of this Quarterly Report on Form 10-Q. The Company incurred \$719 in acquisition-related costs which were recorded within operating expenses for the nine months ended September 30, 2018. The Company recorded \$21,183 in revenue from Wombat for the nine months ended September 30, 2018, and due to the continued integration of the combined businesses, it was impractical to determine the earnings.

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

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

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

Edgar Filing: PROOFPOINT INC - Form 10-Q

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

Table of Contents

## 2017 Acquisitions

## Cloudmark, Inc.

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

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

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

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

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

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

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

Edgar Filing: PROOFPOINT INC - Form 10-Q

Liabilities	(4,569 )	N/A
Deferred revenue	(15,400 )	N/A
Customer relationships	15,300	8
Order backlog	1,400	1
Core/developed technology	18,500	4
Deferred tax liability, net	(7,905 )	N/A
Goodwill	93,947	Indefinite
	\$ 139,256	

WebLife Balance, Inc.

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



Table of Contents

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

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

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

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

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

## Pro Forma Financial Information (unaudited)

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

Edgar Filing: PROOFPOINT INC - Form 10-Q

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Total revenue	\$184,179	\$145,026	\$525,149	\$400,819
Net loss	\$(36,060)	\$(22,357)	\$(82,745)	\$(75,717)
Basic and diluted net loss per share	\$(0.69)	\$(0.50)	\$(1.62)	\$(1.73)

Table of Contents

## 4. Goodwill and Intangible Assets

The goodwill activity and balances are presented below:

Beginning balance as of December 31, 2017	\$297,704
Acquisition during period	162,865
Purchase accounting adjustments	27
Closing balance as of September 30, 2018	\$460,596

Intangible assets, excluding goodwill, consisted of the following:

	September 30, 2018		December 31, 2017			
	Gross	Net	Gross	Net		
	Carrying	Accumulated	Carrying	Carrying	Accumulated	
	Amount	Amortization	Amount	Amount	Amortization	
					Amount	
Developed technology	\$154,069	\$ (72,695 )	\$81,374	\$118,869	\$ (52,554 )	\$66,315
Customer relationships	71,400	(12,629 )	58,771	33,600	(5,918 )	27,682
Trade names and patents	3,330	(1,280 )	2,050	930	(825 )	105
Order backlog	9,100	(4,058 )	5,042	2,300	(800 )	1,500
	\$237,899	\$ (90,662 )	\$147,237	\$155,699	\$ (60,097 )	\$95,602

Amortization of intangible assets expense was \$11,118 and \$4,080 for the three months ended September 30, 2018 and 2017, respectively, and \$30,565 and \$12,403 for the nine months ended September 30, 2018 and 2017, respectively.

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

Year ending December 31,	
2018, remainder	\$ 10,592
2019	39,650
2020	34,566
2021	31,698
2022	13,501
Thereafter	17,230
	\$ 147,237

## 5. Fair Value Measurements and Investments

### Fair Value Measurements

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

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

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

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

19

---

Table of Contents

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

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

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

	September 30, 2018			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Cash equivalents:				
Money market funds	\$ 118,776	\$ 118,776	\$—	\$ —
Corporate debt securities	3,548	—	3,548	—
Commercial paper	1,996	—	1,996	—
U.S agency securities	1,997	—	1,997	—
Short-term investments:				
Commercial paper	22,894	—	22,894	—
Corporate debt securities	4,947	—	4,947	—
U.S. Treasury securities	1,988	—	1,988	—
<b>Total financial assets</b>	<b>\$ 154,158</b>	<b>\$ 118,776</b>	<b>\$ 35,382</b>	<b>\$ —</b>

	December 31, 2017			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Cash equivalents:				
Money market funds	\$231,828	\$231,828	\$—	\$—
Commercial paper	7,995	—	7,995	—
U.S agency securities	1,996	—	1,996	—
Short-term investments:				
Corporate debt securities	11,600	—	11,600	—
Commercial paper	27,939	—	27,939	—
U.S. agency securities	3,991	—	3,991	—
U.S. Treasury securities	1,996	—	1,996	—
<b>Total financial assets</b>	<b>\$287,345</b>	<b>\$231,828</b>	<b>\$55,517</b>	<b>\$—</b>

**Liabilities**

Acquisition-related contingent consideration liability	\$634	\$—	\$—	\$634
--	-------	-----	-----	-------

The following table represents a reconciliation of the Acquisition-related contingent consideration liability measured at fair value on a recurring basis, using significant unobservable inputs (Level 3):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
Beginning balance	\$ —	\$ 1,883	\$ 634	\$ 8,233
Payments during the period	—	(496 )	(555)	(5,116)
Adjustments to fair value during the period recorded				
in general and administrative expenses	—	(67 )	(79 )	(1,797)
Ending balance	\$ —	\$ 1,320	\$ —	\$ 1,320

Table of Contents

The carrying amounts of the Company's cash equivalents, accounts receivable and accounts payable approximate their fair values due to their short maturities.

## Investments

The cost and fair value of the Company's cash and cash equivalents and available-for-sale investments as of September 30, 2018 and December 31, 2017 were as follows:

	September 30, 2018				Fair
	Amortized Cost	Unrealized Gains	Unrealized Losses		Value
<b>Cash and cash equivalents:</b>					
Cash	\$34,244	\$ —	\$ —		\$34,244
Money market funds	118,776	—	—		118,776
Corporate debt securities	3,549	—	(1)	)	3,548
Commercial paper	1,996	—	—		1,996
U.S. agency securities	1,997	—	—		1,997
<b>Total</b>	<b>\$160,562</b>	<b>\$ —</b>	<b>\$ (1)</b>	<b>)</b>	<b>\$160,561</b>

<b>Short-term investments:</b>					
Commercial paper	\$22,894	\$ —	\$ —		\$22,894
Corporate debt securities	4,948	—	(1)	)	4,947
U.S. Treasury securities	1,989	—	(1)	)	1,988
<b>Total</b>	<b>\$29,831</b>	<b>\$ —</b>	<b>\$ (2)</b>	<b>)</b>	<b>\$29,829</b>

	December 31, 2017				Fair
	Amortized Cost	Unrealized Gains	Unrealized Losses		Value
<b>Cash and cash equivalents:</b>					
Cash	\$44,253	\$ —	\$ —		\$44,253
Money market funds	231,828	—	—		231,828
Commercial paper	7,995	—	—		7,995
U.S. agency securities	1,996	—	—		1,996
<b>Total</b>	<b>\$286,072</b>	<b>\$ —</b>	<b>\$ —</b>		<b>\$286,072</b>

<b>Short-term investments:</b>					
Corporate debt securities	\$11,607	\$ —	\$ (7)	)	\$11,600
Commercial paper	27,939	—	—		27,939
U.S. agency securities	3,992	—	(1)	)	3,991
U.S. Treasury securities	1,997	—	(1)	)	1,996
<b>Total</b>	<b>\$45,535</b>	<b>\$ —</b>	<b>\$ (9)</b>	<b>)</b>	<b>\$45,526</b>

As of September 30, 2018 and December 31, 2017, 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.

The Company reviews its investments on a quarterly basis to identify and evaluate investments that have an indication of possible impairment and has determined that no other-than-temporary impairments were required to be recognized during the three and nine months ended September 30, 2018.

## 6. Commitments and Contingencies

### Operating Leases

The Company leases certain of its facilities under non-cancellable operating leases with various expiration dates through 2027.

Premises rent expense was \$2,817 and \$2,087 for the three months ended September 30, 2018 and 2017, respectively, and \$8,192 and \$5,758 for the nine months ended September 30, 2018 and 2017, respectively.



Table of Contents

## Capital Lease

In July 2015, the Company entered into a lease agreement (the “July 2015 Lease”) to lease certain office equipment with expiration in August 2020. The July 2015 Lease bears an annual interest rate of 6.5%. The lease is secured by fixed assets used in the Company’s office locations.

At September 30, 2018, future annual minimum lease payments under non-cancellable operating and capital leases were as follows:

	Capital	Operating
	Leases	Leases
Year ending December 31,		
2018, remainder	\$ 7	\$ 6,460
2019	37	25,108
2020	21	16,853
2021	—	9,657
2022	—	7,021
Thereafter	—	11,382
Total minimum lease payments	65	\$ 76,481
Less: Amount representing interest	(4 )	
Present value of capital lease obligations	61	
Less: current portion	(31 )	
Long-term portion of capital lease obligations	\$ 30	

## 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. For lawsuits where the Company is the defendant, the Company is in the process of defending these litigation matters, and while there can be no assurances and the outcomes of these matters are currently not determinable, the Company currently believes that there are no existing claims or proceedings that are likely to have a material adverse effect on the Company’s financial position, results of operations or cash flows.

## 7. Convertible Senior Notes

### 0.75% Convertible Senior Notes due June 2020

On June 17, 2015, the Company issued \$200,000 principal amount of 0.75% Convertible Senior Notes (the “0.75% Notes”) due 2020 in a private offering to qualified institutional buyers (“Holders”) pursuant to Rule 144A under the Securities Act of 1934, as amended (the “Securities Act”). The initial Holders of the 0.75% Notes also had an option to purchase an additional \$30,000 in principal amount which was exercised in full. The net proceeds after the agent’s discount and issuance costs of \$6,581 from the 0.75% Notes offering were approximately \$223,419. The Company used the net proceeds for working capital and general corporate purposes, which included funding the Company’s operations, capital expenditures, and acquisitions of businesses, products or technologies. The 0.75% Notes bore interest at 0.75% per year, payable semi-annually in arrears every June 15 and December 15, beginning on December 15, 2015.

In accordance with the authoritative accounting guidance, the Company allocated the total amount of the 0.75% 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 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

Table of Contents

the 0.75% 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 was being accreted using the effective interest rate method over the period from the issuance date through the conversion date as a non-cash charge to interest expense. Upon issuance of the 0.75% Notes, the Company recorded \$174,359 as debt and \$55,641 as additional paid in capital within stockholders' equity.

Additionally, the debt discount and issuance costs were allocated based on the total amount incurred to the liability and equity components using the same proportions as the proceeds from the 0.75% Notes. The equity issuance costs of \$1,592 were recorded as a decrease to additional paid-in capital at the issuance date.

During the quarter ended September 30, 2018, \$229,869 of the principal amount of the 0.75% Notes was converted into 2,928 shares of common stock, with the remaining \$142 repaid in cash. The shares of common stock had a fair value of \$336,994 at the time of the conversion. This transaction resulted in a \$7,207 loss on extinguishment that is included in interest expense in the Consolidated Statement of Operations. The loss on extinguishment was calculated as the difference between the fair value amount allocated to the liability component on the date of conversion and net carrying amount of the liability component.

The following table presents the carrying values of the 0.75% Notes as of September 30, 2018 and December 31, 2017:

	September 30, 2018	December 31, 2017
Liability component:		
Principal	\$ —	\$ 230,000
Less: debt discount and issuance costs, net of amortization	—	(32,142 )
Net carrying amount	\$ —	\$ 197,858
Equity component (1)	\$ —	\$ 54,049

(1) Recorded on the condensed consolidated balance sheet as additional paid-in capital, net of the issuance costs in equity

#### 1.25% Convertible Senior Notes due December 2018

On December 11, 2013, the Company issued \$175,000 principal amount of 1.25% Convertible Senior Notes (the "1.25% Notes") due 2018 in a private offering to Holders pursuant to Rule 144A under the Securities Act. The initial Holders of the 1.25% 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 1.25% Notes offering were approximately \$195,446. The Company used the net proceeds for working capital and general corporate purposes, which included funding the Company's operations, capital expenditures, and acquisitions of businesses, products or technologies believed to be of strategic importance. The 1.25% Notes bore interest at 1.25% per year, payable semi-annually in arrears every June 15 and December 15, beginning on June 15, 2014.

During the year ended December 31, 2017, the entire \$201,250 of the principal amount of the 1.25% Notes was converted into 5,159 shares of common stock, with the remaining \$14 paid in cash.

Edgar Filing: PROOFPOINT INC - Form 10-Q

For the three and nine months ended September 30, 2018 and 2017, the Company incurred the following expenses related to the convertible senior notes:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Interest expense related to contractual interest coupon	\$309	\$1,053	\$1,172	\$3,173
Amortization of debt discount and issuance costs	2,230	5,603	8,383	16,491
Loss on conversion	7,207	—	7,207	—
	\$9,746	\$6,656	\$16,762	\$19,664

## Table of Contents

### 8. Equity Award 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 six equity incentive plans: the Company's 2002 stock option plan (the "2002 Plan"), the 2012 Plan and four plans assumed by the Company upon various business acquisitions. The assumed plans are the Cloudmark plan, the WebLife plan, and two FireLayers plans. Upon the Company's 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. No further shares will be granted pursuant to the assumed plans. All outstanding stock awards under the 2002 Plan, the assumed plans and 2012 Plan 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 stock units ("PSUs"). 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.

Stock bonus and other liability awards are accounted for as liability-classified awards, because the obligations are based predominantly on fixed monetary amounts that are generally known at the inception of the obligation, to be settled with a variable number of shares of the Company's common stock.

Under the equity incentive plans, the term of an option grant shall not exceed ten 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. As of September 30, 2018, 4,483 shares were available for future grant. Restricted stock awards generally vest over a four-year period.

The Company net-share settles equity awards held by employees by withholding shares upon vesting to satisfy tax withholding obligations. The shares withheld to satisfy employee tax withholding obligations are returned to the Company's 2012 Plan and will be available for future issuance. Payments for employee's tax obligations to the tax authorities are recognized as a reduction to additional paid-in capital and reflected as financing activities in the Company's consolidated statements of cash flows.

#### Stock Options

There were no options granted during the three and nine months ended September 30, 2018 and 2017.

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:

Edgar Filing: PROOFPOINT INC - Form 10-Q

	Shares subject to Options Outstanding		Weighted	
			Average	
			Remaining	
	Weighted		Contractual	Aggregate
	Number	Average	Term	Intrinsic
	of	Exercise	(in years)	Value
	Shares	Price		
Balance at December 31, 2017	2,040	\$ 22.88	5.17	\$ 134,511
Options exercised	(548 )	13.08		
Options forfeited and expired	(18 )			