

PROOFPOINT INC  
Form 10-Q  
November 12, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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

For the Quarterly Period Ended September 30, 2013  
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

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(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller  
reporting company)

Smaller reporting  
company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No  Shares of Proofpoint, Inc. common stock, \$0.0001 par value per share, outstanding as of October 31, 2013:

35,906,978 shares.

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PROOFPOINT, INC.  
FORM 10-Q

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

Proofpoint, Inc.

Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)

(Unaudited)

	September 30, 2013	December 31, 2012
Assets		
Current assets		
Cash and cash equivalents	\$51,828	\$39,254
Short-term investments	19,760	47,263
Accounts receivable, net of allowance for doubtful accounts of \$249 and \$187 at September 30, 2013 and December 31, 2012, respectively	21,881	18,115
Inventory	429	567
Deferred product costs, current	928	1,184
Prepaid expenses and other current assets	3,838	3,491
Total current assets	98,664	109,874
Property and equipment, net	10,545	8,560
Deferred product costs, noncurrent	272	326
Goodwill	39,206	18,557
Intangible assets, net	13,348	2,913
Other noncurrent assets	3,848	211
Total assets	\$165,883	\$140,441
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$4,468	\$2,496
Accrued liabilities	15,960	12,078
Notes payable and lease obligations, current	1,667	1,658
Deferred rent	445	462
Deferred revenue, current	75,053	62,642
Total current liabilities	97,593	79,336
Notes payable and lease obligations, noncurrent	1,110	2,354
Other long term liabilities, noncurrent	3,062	726
Deferred revenue, noncurrent	26,275	24,217
Total liabilities	128,040	106,633
Stockholders' Equity		
Common stock, \$0.0001 par value; 200,000 shares authorized at September 30, 2013 and December 31, 2012, respectively; 35,786 and 33,044 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	4	3
Additional paid-in capital	235,965	216,280
Accumulated other comprehensive (loss) income	(1	) 3
Accumulated deficit	(198,125	) (182,478

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Total stockholders' equity	37,843	33,808
Total liabilities and stockholders' equity	\$165,883	\$140,441
See accompanying Notes to the Condensed Consolidated Financial Statements.		

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue:				
Subscription	\$33,464	\$25,991	\$92,732	\$74,010
Hardware and services	1,039	1,093	4,362	3,636
Total revenue	34,503	27,084	97,094	77,646
Cost of revenue: <sup>(1)(2)</sup>				
Subscription	8,937	6,967	25,042	21,414
Hardware and services	1,409	1,163	3,851	3,466
Total cost of revenue	10,346	8,130	28,893	24,880
Gross profit	24,157	18,954	68,201	52,766
Operating expense: <sup>(1)(2)</sup>				
Research and development	8,307	6,262	23,460	18,367
Sales and marketing	17,415	14,126	49,782	39,751
General and administrative	5,758	3,141	13,437	8,871
Total operating expense	31,480	23,529	86,679	66,989
Operating loss	(7,323 )	(4,575 )	(18,478 )	(14,223 )
Interest expense, net	(11 )	(7 )	(4 )	(110 )
Other income (expense), net	352	109	(163 )	(100 )
Loss before (provision for) benefit from income taxes	(6,982 )	(4,473 )	(18,645 )	(14,433 )
(Provision for) benefit from income taxes	(207 )	(119 )	2,998	(430 )
Net loss	\$(7,189 )	\$(4,592 )	\$(15,647 )	\$(14,863 )
Net loss per share, basic and diluted	\$(0.20 )	\$(0.14 )	\$(0.45 )	\$(0.70 )
Weighted average shares outstanding, basic and diluted	35,436	31,844	34,502	21,258
(1) Includes stock based compensation expense as follows:				
Cost of subscription revenue	\$203	\$205	\$631	\$443
Cost of hardware and services revenue	45	20	120	46
Research and development	502	502	1,566	1,409
Sales and marketing	881	830	2,502	2,301
General and administrative	748	390	1,783	1,184
(2) Includes intangible amortization expense as follows:				
Cost of subscription revenue	\$568	\$333	\$1,307	\$2,452
Research and development	8	8	24	23
Sales and marketing	321	72	619	389
General and administrative	12	—	23	—

See accompanying Notes to the Condensed Consolidated Financial Statements.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Net loss	\$ (7,189	) \$ (4,592	) \$ (15,647	) \$ (14,863
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on short-term investments, net	9	22	(4	) 13
Comprehensive loss	\$ (7,180	) \$ (4,570	) \$ (15,651	) \$ (14,850

See accompanying Notes to the Condensed Consolidated Financial Statements.

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

	Nine Months Ended September 30,	
	2013	2012
Cash flows from operating activities		
Net loss	\$(15,647	) \$(14,863
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	6,123	6,037
Accretion of investments	490	—
Provision for allowance for doubtful accounts	26	—
Stock based compensation	6,602	5,383
Change in fair value of contingent earn-out liability	6	—
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(2,902	) (1,292
Inventory	138	(169
Deferred products costs	310	1,121
Prepaid expenses and other current assets	(114	) (1,133
Noncurrent assets	(3,580	) 54
Accounts payable	897	1,099
Accrued liabilities	733	2,778
Deferred rent	(257	) 321
Deferred revenue	14,469	2,596
Net cash provided by operating activities	7,294	1,932
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	47,386	3,151
Purchase of short-term investments	(20,376	) (49,316
Purchase of property and equipment	(4,502	) (3,884
Acquisitions of businesses, net of cash acquired	(28,509	) —
Net cash used in investing activities	(6,001	) (50,049
Cash flows from financing activities		
Proceeds from issuance of common stock, net of repurchases	12,954	2,106
Proceeds from initial public offering, net of offering costs	—	68,329
Repayments of equipment financing loans	(1,673	) (557
Net cash provided by financing activities	11,281	69,878
Net increase in cash and cash equivalents	12,574	21,761
Cash and cash equivalents		
Beginning of period	39,254	9,767
End of period	\$51,828	\$31,528
Supplemental disclosure of noncash investing and financing information		
Unpaid initial public offering costs	\$—	\$34
Unpaid purchase of property and equipment	\$1,838	\$439

See accompanying Notes to the Condensed Consolidated Financial Statements.





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Proofpoint, Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

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

1. The Company and Summary of Significant Accounting Policies

The Company

Proofpoint, Inc. (the "Company") was incorporated in Delaware in June 2002 and is headquartered in California. Proofpoint is a pioneering security-as-a-service ("SaaS") vendor that enables large and mid-sized organizations worldwide 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 and 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 and nine months ended September 30, 2013 and 2012 are not necessarily indicative of the results to be expected for the year ended December 31, 2013 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 on consolidation. The accompanying Condensed Consolidated Balance Sheet as of December 31, 2012 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 2012 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, 2012 except as otherwise 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.

Business Combinations

The accompanying Condensed Consolidated Financial Statements include the operations of each acquired businesses after the completion of the acquisitions. The Company accounts for acquired businesses using the acquisition method of accounting which requires, among other things, that assets acquired and liabilities assumed be recognized at their estimated fair values as of the acquisition date, while transaction costs are expensed as incurred. The measurement of fair value of assets and

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liabilities assumed requires significant judgment. Any excess of the purchase price over the fair value of the net assets acquired is recorded as goodwill.

**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 Accounting Standards Codification ("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. A two-step impairment test of goodwill is required pursuant to ASC 350-20-35. In the first step, the Company conducts an assessment of qualitative factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If the Company determines that it is more likely than not that the fair value of its reporting unit is less than its carrying amount, it then conducts the second step, a two-part test for impairment of goodwill. The Company first compares the fair value of its reporting unit to its carrying value. If the fair value exceeds the carrying value of the net assets, goodwill is not considered impaired and no further analysis is required. If the carrying value of the net assets exceeds the fair values of the reporting unit, then the second part of the impairment test must be performed in order to determine the implied fair value of the goodwill. The implied fair value of goodwill is calculated by deducting the fair value of all tangible and intangible net assets of the reporting unit, excluding goodwill, from the fair value of the reporting unit as determined in the first step. If the carrying value of the goodwill exceeds the implied fair value, then an impairment loss equal to the difference would be 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. No impairment to the carrying value of goodwill was identified to date by the Company during the nine months ended September 30, 2013.

Intangible assets consist of developed technology, customer relationships, vendor relationships, non-compete arrangements and trademarks and patents. 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, typically ranging from one to seven years.

**Revenue Recognition**

The Company derives its revenue primarily from two sources: (1) subscription revenue for rights related to the use of the SaaS 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 consist of (i) subscription fees from the licensing of the SaaS 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

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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 Statement 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 services. 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.

The Company elected to adopt this new guidance in the first quarter of fiscal 2011 for new and materially modified revenue arrangements originating after January 1, 2011.

Prior to the adoption of ASU 2009-14, revenue derived from hardware appliance sales were recognized based on the software revenue recognition guidance. The Company could not establish VSOE of fair value for the undelivered elements in the arrangement, and therefore the entire fee from the arrangement was recognized ratably over the contractual term of the

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agreement. In addition, the Company was unable to establish VSOE of fair value of its hosted on-demand service agreements, and therefore the entire fee for the agreement was recognized ratably over the contractual term of the agreement.

As a result of the adoption of this accounting guidance, revenue derived from subscription services and hardware appliance sales are no longer subject to industry specific software revenue recognition guidance. 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 SaaS 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. In determining whether professional services and training services can be accounted for separately from subscription and support services, the Company considers the following factors: availability of the services from other vendors, the nature of the services, and the dependence of the subscription services on the customer's decision to buy the professional services. If professional services and training do not qualify for separate accounting, the Company recognizes the professional services and training ratably over the contract term of the subscription services. Delivery generally occurs when the hardware appliance is delivered to a common carrier freight on board shipping point by the Company or the hosted service has been activated and communicated to the customer accordingly. The Company's fees are typically considered to be fixed or determinable at the inception of an arrangement and are negotiated at the outset of an arrangement, generally based on specific products and quantities to be delivered. In the event payment terms are provided that differ significantly from the Company's standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized as the fees become paid.

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, 2013, the Company experienced no 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, which typically ranges from 12 to 36 months.

### Fair Value of Financial Instruments

The carrying amounts of certain 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 note payable approximates its fair value and is a Level 2 measurement within the fair value hierarchy. The Company has an Acquisition-related contingent earn-out liability that requires Level 3 classification because there are no active markets or observable inputs.

### 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.

During the nine months ended September 30, 2013, the Company adopted Accounting Standards Update ("ASU") 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income", which requires

filers to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net loss. The Company had no significant reclassifications out of accumulated other comprehensive loss into net loss for the three and nine months ended September 30, 2013 and 2012.

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Recent Accounting Pronouncements

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 becomes effective for the Company on January 1, 2014 and it should be applied prospectively to unrecognized tax benefits that exist at the effective date with retrospective application permitted. The Company is currently assessing the impact of this new guidance.

2. Acquisitions

In 2013, the Company entered into agreements to acquire several companies (collectively, the "Acquisitions"). Each acquisition was accounted for under the acquisition method of accounting in which the tangible and identifiable intangible assets and liabilities of each acquired company was 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 expects the combined entities to 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.

Armorize Technologies, Inc.

On September 5, 2013 (the "Armorize Acquisition Date"), pursuant to the terms of an Agreement and Plan of Merger, a wholly-owned subsidiary of the Company merged with and into Armorize Technologies, Inc. ("Armorize"), with Armorize surviving as a wholly-owned subsidiary of the Company. Based in Taiwan, Armorize develops and markets leading cloud-based SaaS anti-malware products and will add real-time dynamic detection of next generation threats and malware to the Company's existing capabilities.

At September 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the Armorize Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the accompanying Condensed Consolidated Financial Statements since the Armorize Acquisition Date. The Company recorded \$183 in revenue from Armorize for the nine months ended September 30, 2013.

At the Armorize Acquisition Date, the Company paid \$24,215 in cash consideration, net of cash acquired of \$1,746. 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. The Company incurred \$775 in acquisition-related costs which were recorded in operating expenses for the three and nine months ended September 30, 2013.

Fair value of acquired assets and liabilities assumed

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

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	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	\$2,754	N/A
Liabilities assumed	(1,256	)N/A
Customer relationships	1,300	2
Non-compete agreements	500	3
Core/developed technology	3,850	5
Goodwill	18,813	Indefinite
	\$25,961	

## Abaca Technology Corporation

On July 19, 2013 (the "Abaca Technology Acquisition Date"), pursuant to the terms of an Agreement and Plan of Merger, a wholly-owned subsidiary of the Company merged with and into Abaca Technology Corporation ("Abaca Technology"), with Abaca Technology surviving as a wholly-owned subsidiary of the Company. Abaca Technology specializes in email filtering and protection algorithms and their cloud-based, in-memory threat scoring technologies are expected to complement the Company's continued investment in anti-spam and threat detection capabilities.

At September 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities at the Abaca Technology Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the accompanying Condensed Consolidated Financial Statements since the Abaca Technology Acquisition Date. The Company recorded \$121 in revenue from Abaca Technology for the nine months ended September 30, 2013.

At the Abaca Technology Acquisition Date, the Company paid \$23 in cash consideration, net of cash acquired of \$3. The purchase consideration included an additional amount of \$1,520 which was held back to secure contingent liabilities related to indemnification obligations. The initial fair values of the contingent liabilities of \$1,397 were recorded in Other long term liabilities in the accompanying Condensed Consolidated Balance Sheets. The indemnification obligations have not been released as of the filing date of this Quarterly Report on Form 10-Q. The Company incurred \$254 in acquisition-related costs which were recorded in operating expenses for the three and nine months ended September 30, 2013.

## Fair value of acquired assets and liabilities assumed

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

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	\$311	N/A
Liabilities assumed	(975	)N/A
Customer relationships	40	3
Core/developed technology	1,770	5
Goodwill	277	Indefinite
	\$1,423	

## eDynamics, LLC



On July 10, 2013 (the "eDynamics Acquisition Date"), pursuant to the terms of an Asset Purchase Agreement, the Company purchased substantially all of the business intellectual property and assumed certain liabilities of eDynamics, LLC ("eDynamics"). eDynamics is a social media archiving company and is expected to be an integral part of the Company's broader effort in rolling out a comprehensive social media archiving platform for customers.

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At September 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the eDynamics Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the accompanying Condensed Consolidated Financial Statements since the eDynamics Acquisition Date. Revenue from eDynamics was immaterial for the nine months ended September 30, 2013.

At the eDynamics Acquisition Date, the Company paid \$500 in cash consideration. The Company also agreed to pay earn-out consideration ("Acquisition-related contingent earn-out liability") of up to \$600 through April 2014, such liability being contingent upon the achievement of specified product development milestones. The initial fair value of the contingent earn-out liability of \$586 was recorded as part of the purchase consideration. The purchase consideration also included an additional amount of \$100, which was held back to secure any claims that may arise in the 12-month period after the eDynamics Acquisition Date. The initial fair value of such amount withheld of \$72 as well as the contingent earn-out liability were recorded in Accrued liabilities on the accompanying Condensed Consolidated Balance Sheets. The Company incurred \$7 in acquisition-related costs which were recorded in operating expenses for the three and nine months ended September 30, 2013.

## Fair value of acquired assets and liabilities assumed

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

	Estimated Fair Value in USD	Estimated Useful Life (in years)
Customer relationships	\$243	3.5
Non-compete agreements	75	2
Core/developed technology	733	3.5
Goodwill	107	Indefinite
	\$1,158	

## Mail Distiller Limited

On April 5, 2013 (the "Mail Distiller Acquisition Date"), pursuant to the terms of a share transfer agreement, the Company purchased all of the outstanding share capital of Mail Distiller Limited, a Northern Ireland Company ("Mail Distiller"). Mail Distiller is a European-based provider of the SaaS email security solutions. Mail Distiller allowed the Company to create the Proofpoint Essentials product line, a suite of SaaS security and compliance solutions specifically designed for distribution across managed service providers and dedicated security resellers.

At June 30, 2013, the Company completed the valuation of the estimated fair values of the acquired tangible and identifiable intangible assets and liabilities assumed at the Mail Distiller Acquisition Date, and the results of operations and the fair values of the acquired assets and liabilities assumed have been included in the accompanying Condensed Consolidated Financial Statements since the Mail Distiller Acquisition Date. The Company recognized \$38 in revenue from Mail Distiller for the nine months ended September 30, 2013.

At the Mail Distiller Acquisition Date, the Company paid \$3,771 in cash consideration, net of cash acquired of \$60. The purchase consideration included an additional amount of \$669 held back to secure indemnification obligations, which was recorded in Accrued liabilities on the accompanying Condensed Consolidated Balance Sheets. The indemnification obligations have not been released as of the filing date of this Quarterly Report on Form 10-Q. The Company incurred \$129 and \$256 in acquisition-related costs which were recorded in operating expenses for the three

and nine months ended September 30, 2013.

Fair value of acquired assets and liabilities assumed

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

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	Estimated Fair Value in USD	Estimated Useful Life (in years)
Tangible assets acquired	\$204	N/A
Liabilities assumed	(1,052	) N/A
Trade name	7	1
Customer relationships	1,291	2
Non-compete agreements	123	2
Core/developed technology	2,475	7
Goodwill	1,452	Indefinite
	\$4,500	

## 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, 2013 and 2012 as if all the Acquisitions entered into during 2013 had been completed on January 1, 2012, with adjustments to give effect to pro forma events that are directly attributable to the Acquisitions such as amortization expense from acquired intangible assets and acquisition-related transaction costs. 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 Acquisitions. Accordingly, these unaudited pro formas 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 Acquisitions had occurred at the beginning of the period presented, nor are they indicative of future results of operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Total revenue	\$35,089	\$28,560	\$100,169	\$81,429
Net loss	(7,183	) (5,985	) (18,947	) (21,565
Basic and diluted loss per share	\$(0.20	) \$(0.19	) \$(0.55	) \$(1.01

The unaudited pro forma financial information includes non-recurring acquisition-related transaction cost of \$1,292 for the nine months ended September 30, 2012.

## 3. Goodwill and Intangible Assets

The goodwill activity and balances are presented below:

Balance at December 31, 2012	\$18,557
Add: Goodwill from acquisitions	20,649
Balance at September 30, 2013	\$39,206

The goodwill balance as of September 30, 2013 was the result of the acquisitions of Fortiva, Inc., Secure Data in Motion, Inc. ("Sigaba"), Everyone.net, Inc. ("EDN"), GFI Software Ltd., Spam and Open Relay Blocking System ("SORBS"), NextPage, Inc. and the Acquisitions during the nine months ended September 30, 2013.

## Intangible Assets

Intangible assets excluding goodwill, consisted of the following:

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	September 30, 2013			December 31, 2012		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	\$26,469	\$(16,469 )	\$10,000	\$17,641	\$(15,163 )	\$2,478
Customer relationships	5,282	(2,684 )	2,598	2,408	(2,109 )	299
Non-compete agreements	804	(97)	707	106	(27 )	79
Trademark and patents	105	(62)	43	98	(41 )	57
	\$32,660	\$(19,312 )	\$13,348	\$20,253	\$(17,340 )	\$2,913

Amortization expense of intangibles totaled \$909 and \$413, respectively, for the three months ended September 30, 2013 and 2012 and \$1,973 and \$2,864, respectively, for the nine months ended September 30, 2013 and 2012.

Future estimated amortization expense of intangible assets as of September 30, 2013 is presented below:

2013, remainder	\$1,093
2014	4,071
2015	3,297
2016	1,877
2017	1,482
Thereafter	1,528
	\$13,348

#### 4. Fair Value Measurements and Financial Instruments

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

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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 during the three months ended September 30, 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. Any changes to the variables and assumptions could significantly impact the estimated fair values recorded for the liability, resulting in significant charges to the accompanying Condensed Consolidated Statements of Operations. The fair value measurements are based on significant inputs not observable in the market and thus represent Level 3 measurements, which reflect the Company's own assumptions concerning achievement of the product development milestones of eDynamics, in measuring the fair value of the Acquisition-related contingent earn-out liability.

The following tables summarize, for each category of assets or liabilities, the respective fair value as of September 30, 2013 and December 31, 2012 and the classification by level of input within the fair value hierarchy.

	Balance as of September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Cash equivalents				
Money market funds	\$ 6,828	\$ 6,828	\$—	\$—
Short-term investments:				
Corporate debt securities	15,760	—	15,760	—
Commercial paper	2,000	—	2,000	—
Certificates of deposit	2,000	—	2,000	—
Total financial assets	\$ 26,588	\$ 6,828	\$ 19,760	\$—
<b>Liabilities</b>				
Acquisition-related contingent earn-out liability	\$ 592	\$—	\$—	\$ 592
	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets</b>				
Cash equivalents:				
Money market funds	\$ 26,485	\$ 26,485	\$ 26,485	\$—
Commercial paper	1,020	1,020	1,020	—
Short-term investments:				
Corporate debt securities	29,267	—	—	29,267
Commercial paper	15,988	—	—	15,988
Certificates of deposit	2,008	—	—	2,008
Total financial assets	\$ 74,768	\$ 27,505	\$ 27,505	\$ 47,263



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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, 2013:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)
Balance at December 31, 2012	\$—
Additions during the period	586
Adjustments to fair value during the period recorded in General and Administrative expenses	6
Balance at September 30, 2013	\$ 592

## Financial Instruments

The cost and fair value of the Company's available-for-sale investments as of September 30, 2013 and December 31, 2012 were as follows:

	September 30, 2013			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and cash equivalents:				
Cash	\$45,000	\$—	\$—	\$45,000
Money market funds	6,828	—	—	6,828
Total	\$51,828	\$—	\$—	\$51,828
Short term investments:				
Corporate debt securities	\$15,761	\$2	\$(3)	\$15,760
Commercial paper	2,000	—	—	2,000
Certificates of deposit	2,000	—	—	2,000
Total	\$19,761	\$2	\$(3)	\$19,760
	December 31, 2012			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and cash equivalents:				
Cash	\$11,749	\$—	\$—	\$11,749
Money market funds	26,485	—	—	26,485
Commercial paper	1,020	—	—	1,020
Total	\$39,254	\$—	\$—	\$39,254
Short term investments:				
Corporate debt securities	\$29,266	\$4	\$(3)	\$29,267
Commercial paper	15,987	1	—	15,988
Certificates of deposit	2,007	1	—	2,008
Total	\$47,260	\$6	\$(3)	\$47,263



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As of September 30, 2013 and December 31, 2012, 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

The Company has noncancellable operating leases with various expiration dates through May 2017.

Rent expense was \$442 and \$393, respectively, for the three months ended September 30, 2013 and 2012 and \$1,245 and \$1,165, respectively, for the nine months ended September 30, 2013 and 2012.

## Capital Leases

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, 2013, future annual minimum lease payments under noncancellable operating and capital leases were as follows:

	Capital Leases	Operating Leases
2013, remainder	\$5	\$1,544
2014	18	3,948
2015	11	767
2016	—	306
2017	—	130
Total minimum lease payments	34	\$6,695
Less: Amount representing interest	(1	)
Present value of capital lease obligations	33	
Less: Current portion	(17	)
Long-term portion of capital lease obligations	\$16	

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## 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 material claims against the Company pursuant to these indemnification provisions.

## Legal Contingencies

From time to time, the Company is involved in claims and legal proceedings that arise in the ordinary course of business. Based on currently available information, management does not believe that the ultimate outcome of these unresolved matters, individually and in the aggregate, is likely to have a material adverse effect on the Company's financial position, results of operations or cash flows. However, litigation is subject to inherent uncertainties and the Company's view of these matters may change in the future. Were an unfavorable outcome to occur, there exists the possibility of a material adverse impact on the Company's financial position, results of operations or cash flows for the period in which the unfavorable outcome occurs, and potentially in future periods.

## 6. Debt

## Equipment Financing Loans

The Company entered into a new 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, 2013, 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, 2013 were \$2,736. 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. As of September 30, 2013, the Company was in compliance with the financial covenant.

Interest expense was \$33 and \$53, respectively, for the three months ended September 30, 2013 and 2012, and \$113 and \$162, respectively, for the nine months ended September 30, 2013 and 2012.

At September 30, 2013, the remaining repayment commitments related to the equipment loans are as follows:

2013, remainder	\$410
2014	1,642
2015	684
	\$2,736

## Third-Party Financing

As part of the acquisitions of Mail Distiller and Abaca Technology, the Company assumed third-party financing held by each respective company. The third-party financing held by Abaca Technology was paid off in full during the three months ended September 30, 2013. As of September 30, 2013, Mail Distiller had an the outstanding balance of \$8.

## 7. Stockholders' Equity

## Initial Public Offering

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In April 2012, the Company completed its initial public offering of its common stock to the public ("IPO") whereby 5,859 shares of common stock sold by the Company (inclusive of 729 shares of common stock from the partial exercise of the overallotment option granted to the underwriters) and 1,370 shares of common stock sold by the selling shareholders (inclusive of 171 shares of common stock from the partial exercise of the overallotment option granted to the underwriters). The public offering price of the shares sold in the offering was \$13.00 per share. The Company did not receive any proceeds from the sales of shares by the selling stockholders. The total gross proceeds from the offering to the Company were \$76,200. After deducting underwriters' discounts and commissions and offering expenses, the aggregate net proceeds received by the Company totaled approximately \$68,300. Immediately prior to the closing of the IPO, all shares of the Company's outstanding redeemable convertible preferred stock automatically converted into 19,567 shares of common stock. As a result, following the IPO, the Company has two classes of authorized stock: Common stock and Preferred stock.

As of September 30, 2013, 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 35,786 and 33,044 shares, respectively, issued and outstanding at September 30, 2013 and December 31, 2012.

On March 30, 2012, the Company's Board of Directors approved a 1-for-2 reverse stock split of the Company's common stock. The reverse stock split became effective on April 2, 2012. All of the share numbers, share prices, and exercise prices have been retrospectively adjusted to reflect the reverse stock split.

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

	As of September 30, 2013	As of December 31, 2012
Options available for future grant under the stock plans	5,741	4,611
Options outstanding under stock option plans	7,379	9,636
Shares available for future issuance under ESPP	860	646
Common stock issuable upon settlement of outstanding restricted stock units	153	1
Total shares reserved	14,133	14,894

#### Stock Option Plan

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 IPO, 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 (collectively, the "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 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 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. 20,316 shares of common stock were initially reserved for issuance to eligible participants, under the 2012 Plan. As of September 30, 2013, 5,741 shares were available for future grant. Restricted stock awards generally vest over a four-year period with 25% vesting at the end of one year and the remaining vest monthly thereafter. 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

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discretion, determines to make a smaller increase. On January 1, 2013, the number of shares of the Company's common stock available for grant and issuance under the 2012 Plan increased by 1,652 shares.

Stock option activity under the Plan was as follows:

	Shares subject to		Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
	Options Outstanding			
	Number of Shares	Weighted Average Exercise Price per share		
Balance at December 31, 2012	9,636	\$5.63	7.33	\$64,719
Options granted	1,380	15.40		
Options exercised	(2,626)	) 4.49		
Options forfeited and canceled	(1,011)	) 8.35		
Balance at September 30, 2013	7,379	\$7.49	7.15	\$181,727

The total intrinsic value of options exercised was \$39,434 and \$10,725, respectively, for the nine months ended September 30, 2013 and 2012. Total cash proceeds from such option exercises were \$11,786 and \$2,125, respectively, for the nine months ended September 30, 2013 and 2012.

**Restricted Stock Units**

The fair value of each unit is based on the fair value of the Company's common stock on the date of assumption. A summary of the status of RSUs awarded and unvested under the stock option plans as of September 30, 2013 is presented below:

	RSUs	
	Outstanding Number of Shares	Granted Fair Value Per Unit
Awarded and unvested at December 31, 2012	1	\$7.98
Awards granted	166	26.09
Awards released	(1)	) 7.98
Awards forfeited	(13)	) 21.44
Awarded and unvested at September 30, 2013	153	\$26.49

**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 were 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, 2013, there were 860 shares of the Company's common stock available for future issuance under the ESPP. On January 1, 2013, the number of shares of the Company's common stock reserved and available for issuance under the ESPP increased by 330 shares.

**8. Stock Based Compensation**

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The Company recognized stock-based compensation expense under the Plan in the accompanying Condensed Consolidated Statements of Operations as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Cost of subscription revenue	\$203	\$205	\$631	\$443
Cost of hardware and services revenue	45	20	120	46
Research and development	502	502	1,566	1,409
Sales and marketing	881	830	2,502	2,301
General and administrative	748	390	1,783	1,184
Total stock-based compensation expense	\$2,379	\$1,947	\$6,602	\$5,383

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.

Prior to the Company's IPO, the Board of Directors, in good faith, determined the fair market values of the Company's common stock, based on the best information available to the Board and the Company's management at the time of grant. The Company performed its analysis in accordance with applicable elements of the practice aid issued by the American Institute of Certified Public Accountants entitled Valuation of Privately Held Company Equity Securities Issued as Compensation. The procedures performed to determine the fair value of the Company's common stock were based on a probability-weighted expected return method to estimate the aggregate equity value of the Company. The weighted average fair value of stock options granted to employees was \$16.60 and \$7.51, respectively, during the three months ended September 30, 2013 and 2012 and \$8.31 and \$5.39, respectively, for the nine months ended September 30, 2013 and 2012. 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		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Expected life (in years)	6.08	6.08	5.31-6.08	5.50-6.08
Volatility	61%	59%	57-61%	59-60%
Risk-free interest rate	1.8%	1.0%	0.9-1.8%	1.0-1.2%
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. 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

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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 deferred tax asset valuation allowances.

As of September 30, 2013, the Company had unamortized stock based compensation expense of \$15,441 related to stock options, that will be recognized net of forfeitures over the average remaining vesting term of the options of 2.46 years. The Company had \$3,058 of unamortized stock based compensation expense related to unvested RSUs, which are expected to be recognized over a weighted average period of 3.73 years.

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		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Expected life (in years)	n/a	n/a	0.50	0.53
Volatility	n/a	n/a	40%	51%
Risk-free interest rate	n/a	n/a	0.1%	0.1%
Dividend yield	n/a	n/a	—%	—%

No ESPP shares were issued during the three months ended September 30, 2013. As of September 30, 2013, the Company had \$82 of unamortized compensation costs related to the current ESPP offering period, which are expected to be recognized over a weighted average period of 0.08 years.

#### 9. 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.

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:

	Nine Months Ended	
	September 30,	
	2013	2012
Stock options to purchase common stock	7,379	10,205
Common stock subject to repurchase	2	5
Restricted stock units	153	23
Total	7,534	10,233

#### 10. Segment Reporting

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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 sets forth total revenue and long-lived assets by geographic area. Revenue by geography is based upon the billing address of the customer:

	Three Months Ended		Nine Months Ended	
	September 30, 2013	2012	September 30, 2013	2012
Total revenue:				
United States	\$28,241	\$21,966	\$80,038	\$63,272
Rest of World	6,262	5,118	17,056	14,374
Total revenue	\$34,503	\$27,084	\$97,094	\$77,646

	As of September 30, 2013	As of December 31, 2012
Long-lived assets:		
United States	\$8,728	\$6,857
Rest of World	1,817	1,703
Total long lived assets	\$10,545	\$8,560

## 11. 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.

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 pre-tax losses of \$6,982 and \$18,645, respectively. Income tax expense for the three and nine months ended September 30, 2012 was \$119 and \$430 on pre-tax losses of \$4,473 and \$14,433, respectively. The income tax rate for the three and nine months ended September 30, 2013 varies from the United States statutory income tax rate primarily due to valuation allowances in the United States and certain foreign jurisdictions whereby pre-tax losses and gains in these jurisdictions do not result in the recognition of corresponding income tax benefits and expenses. The income tax rate for the nine months ended September 30, 2013 also varies 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 Canada which occurred during the period.

The Company's effective tax rate for the nine months ended September 30, 2013 increased to 16.1% from (3.0)% for the same prior year period. The current 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 Canada.

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.

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In Canada, the Company has historically had cumulative losses in recent years. However, that position changed to a three year cumulative income position during the second quarter of 2013. This position, along with management's analysis of all other available evidence, resulted in the conclusion that the net deferred tax asset in this jurisdiction are more likely than not to be utilized. As such, the valuation allowance previously recorded against the net deferred tax assets has been reversed during the second quarter of 2013.

As of September 30, 2013, the Company's gross uncertain tax benefits totaled \$3,373, excluding related accrued interest and penalties of \$214. As of September 30, 2013, \$1,238 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, 2013, the Company's gross uncertain tax benefits increased \$301. The increase is comprised of a \$137 increase for tax positions taken in the current period and a \$164 increase for tax positions taken in prior period. Of the \$164 increase for tax positions taken in a prior period, \$154 relate to tax positions for entities which were acquired during the current quarter.

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.

## 12. Subsequent Events

On October 1, 2013, the Company completed the acquisition of privately-held Sendmail, Inc. ("Sendmail") for \$23,000. The results of Sendmail's operations will be included in the accompanying 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 2013, the Company entered into an operating lease agreement to rent office space in Taiwan. The lease has a 36-month term and will expire on September 30, 2016.

## 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, 2012 included in our Annual Report on Form 10-K for fiscal year 2012, or 2012 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 "contingent." 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 2012 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 worldwide 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 protection, regulatory compliance, archiving and governance, and secure communication.

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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. In addition, we have invested significantly to expand the breadth of our data protection platform:

In 2004, we launched our Regulatory Compliance and Digital Asset Security solutions, designed to prevent the loss of critical data. These Data Loss Prevention, or DLP, solutions apply our proprietary machine learning and deep content inspection technologies to screen outbound email to prevent the theft or inadvertent loss of sensitive or confidential information.

In 2005, we launched Proofpoint Secure Messaging, our first email encryption solution.

In 2006, we combined our email encryption and DLP technologies to develop a new solution for policy based encryption, enabling each outgoing message to be inspected for confidential content and automatically encrypted accordingly.

In 2007, we began selling our software based virtual appliance, enabling our customers to deploy our solutions in a private cloud configuration. We also invested in international expansion by establishing a team in the United Kingdom as a precursor to the build out of our data center infrastructure, and launching operations in Germany and the Netherlands to support our customers outside of the United States.

In 2008, we introduced Proofpoint Enterprise Archive, a cloud based email archiving solution that enables businesses to securely archive both their email and instant message conversations while enabling real-time access to the entire repository for quick and easy electronic discovery, or eDiscovery.

In 2009, we launched Proofpoint Encryption, a proprietary email encryption solution that improved the level of integration across our data protection suite and allowed us to phase out technology licensed from a third party. We also introduced a cloud based email messaging service.

In 2010, we evolved our solutions to address new forms of messaging and information sharing in the enterprise such as social media and Internet based collaboration and file sharing applications.

In 2011, we achieved FISMA certification for our cloud based archiving and governance solution, enabling us to serve the rigorous security requirements of U.S. Federal agencies. We also introduced an integrated security offering in conjunction with VMware for its Zimbra Collaboration Server.

In 2012, we introduced Proofpoint Enterprise Governance, an information governance solution that provides organizations the ability to monitor and apply governance policies to unstructured information across the enterprise. We also introduced Proofpoint Targeted Attack Protection along with Proofpoint Secure Share. Proofpoint Targeted Attack Protection is a solution that uses big data analysis techniques to identify and apply additional security controls to suspicious messages. Proofpoint Secure Share allows enterprises to securely exchange large files with ease in a cloud-based environment.

In 2013, we launched Proofpoint Essentials, a suite of SaaS security and compliance capabilities designed to meet the needs of managed service providers and dedicated security resellers, enabling these partners to offer their customers this full suite of cloud-based solutions. We also introduced Proofpoint's Social Platform for Archiving, which provides our customers a quick path to regulatory compliance regarding their social media usage, enabling them to leverage a wide range of social media platforms such as Yammer, Chatter, and Facebook while adhering to strict compliance standards.

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

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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 nonrenewal. 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 89% of total revenue in 2010, to 96% during the nine months of 2013.

We market and sell our solutions to large and mid-sized customers 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 resellers. We also derive a lesser portion of our 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 sales and marketing operation consists of sales people and associated marketing resources, each of whom are assigned to a specific geographic territory. Their mission is to grow additional revenue within their respective territory in whatever manner is most efficient, either by obtaining new customers or by working with existing customers to expand their use of our solutions. Our sales teams are compensated equally for sales to new customers or sales of additional solutions to existing customers, and we do not allocate sales and marketing resources between activities related to the acquisition of new customers and activities associated with the sale of additional solutions to existing customers.

We invoice our customers for the entire contract amount at the start of the term. The majority of these invoiced amounts is treated as deferred revenue on our consolidated balance sheets and is recognized ratably over the term of the contract. We invoice our strategic partners on a monthly basis, and the associated fees vary based upon the level of usage during the month by their customers. These amounts are recognized as revenue at the time of invoice.

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.

The substantial 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 22% and 19% for the three and nine months ended September 30, 2013 as compared to the prior year periods. As of September 30, 2013, we had more than 2,700 customers around the world, including 30 of the Fortune 100. In terms of customer concentration, there was one partner that accounted for 14% of our total revenue in the three months ended September 30, 2013, although the partner sold to a number of end user customers, none of 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, 2012.

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.

Additionally, during 2013, we have completed a number of acquisitions to complement our solutions offerings. These acquisitions are described in Note 2 to our Condensed Consolidated Financial Statements included in this report. We expect Sendmail to contribute approximately \$5 million in total revenue in 2014, with approximately equal amounts from the legacy renewals associated with maintenance contracts and the remainder from new sales of Proofpoint solutions to these existing customers. With respect to adjusted EBITDA for the fourth quarter and for 2014, we currently expect that the Amorize and Sendmail acquisitions will negatively reduce adjusted EBITDA by approximately \$2.5 million and \$5.0 million, respectively.

Key Opportunities and Challenges

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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' experience 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 more than 2,700 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.

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 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.

We are currently in the midst of a significant investment cycle in which we have taken steps designed to drive future revenue growth and profitability. For example, we plan to build out our infrastructure, develop our technology, offer additional SaaS solutions, and expand our sales and marketing personnel both in the United States and internationally. Accordingly, we expect that our total cost of revenue and operating expenses will continue to increase in absolute dollars, limiting our ability to achieve and maintain positive operating cash flow and profitability in the near term.

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 16 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



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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 unaudited 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 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		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
	(in thousands)			
Total revenue	\$34,503	\$27,084	\$97,094	\$77,646
Growth	27	% 32	% 25	% 31
Subscription revenue	\$33,464	\$25,991	\$92,732	\$74,010
Growth	29	% 38	% 25	% 41
Adjusted subscription gross profit	\$25,298	\$19,562	\$69,628	\$55,491
% of subscription revenue	76	% 75	% 75	% 75
Billings	\$41,357	\$30,014	\$111,563	\$80,242
Growth	38	% 39	% 39	% 29
Adjusted EBITDA	\$(935)	\$(1,090)	\$(3,965)	\$(2,800)
Subscription revenue				

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Subscription revenue represents the recurring subscription fees paid by our customers and recognized as revenue during the period for the use of our SaaS 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 have provided a reconciliation between subscription gross profit, the most directly comparable GAAP financial measure, and adjusted subscription gross profit. 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 unaudited table presents the reconciliation of subscription gross profit to adjusted subscription gross profit for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
	(in thousands)			
Subscription revenue	\$33,464	\$25,991	\$92,732	\$74,010
Cost of subscription revenue	8,937	6,967	25,042	21,414
Subscription gross profit	24,527	19,024	67,690	52,596
Stock based compensation	203	205	631	443
Amortization of intangible assets	568	333	1,307	2,452
Adjusted subscription gross profit	\$25,298	\$19,562	\$69,628	\$55,491

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 directly correlated to trends in revenue except when measured over longer periods of time;

- 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

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from strategic partners. As each of these elements has unique characteristics in the relationship between billings and revenue, our billings activity is not closely correlated to revenue except over longer periods of time; 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 unaudited table presents the reconciliation of total revenue to billings for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	2012	2012	2012	2012
	(in thousands)			
Total revenue	\$34,503	\$27,084	\$97,094	\$77,646
Deferred revenue				
Ending	101,328	78,836	101,328	78,836
Beginning	94,474	75,906	86,859	76,240
Net change	6,854	2,930	14,469	2,596
Billings	\$41,357	\$30,014	\$111,563	\$80,242

**Adjusted EBITDA**

We have included adjusted EBITDA, a non GAAP financial measure, in this report because it is a key metric used by our management and board of directors to measure operating performance and trends and to prepare and approve our annual budget. 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-related expense, 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 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 measures 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.

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The following unaudited table presents the reconciliation of net loss to adjusted EBITDA for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands)			
Net loss	\$(7,189	) \$(4,592	) \$(15,647	) \$(14,863
Depreciation	1,513	1,125	4,150	3,173
Amortization of intangible assets	909	413	1,973	2,864
Interest expense (income), net	11	7	4	110
Provision (benefit) for income taxes	207	119	(2,998	) 430
EBITDA	(4,549	) (2,928	) (12,518	) (8,286
Stock based compensation expense	2,379	1,947	6,602	5,383
Acquisition related expense	1,587	—	1,788	3
Other income	(24	) (1	) (28	) (12
Other expense	(328	) (108	) 191	112
Adjusted EBITDA	\$(935	) \$(1,090	) \$(3,965	) \$(2,800

#### Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our 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 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 2012 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 2012 Annual Report on Form 10-K for the year ended December 31, 2012.

#### Components of Our Results of Operations

##### Business Combinations

In each of our acquisitions, we used the acquisition 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 Condensed Consolidated Statements of Operations.



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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 SaaS 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 in our 2012 Annual Report on Form 10-K under "Management's Discussion and Analysis of Financial Condition and Results of Operations"). 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.

**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, our cost of subscription revenue has declined in recent periods as a percentage of its associated 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.

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**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. Our cost of hardware and services as a percentage of its associated revenue has been relatively consistent from period to period in the past. With the adoption of our new accounting guidance 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.

**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, for software developed for internal use on behalf of our customers, we have capitalized costs of approximately \$0.4 million, all of which was incurred during 2011, and is being amortized as cost of subscription revenue over a two year period. 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 as incurred, including sales commissions. These costs also include amortization of intangible assets as a result of our past acquisitions. Reflecting our continued investment in growing our sales and marketing operations, both domestically and internationally, headcount increases were reflected in higher compensation expense consistently 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 as a recently public company, 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 for 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





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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 and research and development credits 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 has occurred since inception. The analyses have indicated that although an ownership change occurred in a prior year, the net operating losses 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.

	Three Months Ended September 30, 2013				Nine Months Ended September 30, 2013				2012			
	Amount (\$ in thousands)	% of revenue		% of revenue	Amount (\$ in thousands)	% of revenue		% of revenue	Amount	% of revenue		% of revenue
Revenue:												
Subscription	\$33,464	97	%	\$25,991	96	%	\$92,732	96	%	\$74,010	95	%
Hardware and services	1,039	3		1,093	4		4,362	4		3,636	5	
Total revenue	34,503	100		27,084	100		97,094	100		77,646	100	
Cost of revenue:												
Subscription	8,937	26		6,967	26		25,042	26		21,414	28	
Hardware and services	1,409	4		1,163	4		3,851	4		3,466	4	
Total cost of revenue	10,346	30		8,130	30		28,893	30		24,880	32	
Gross profit	24,157	70		18,954	70		68,201	70		52,766	68	
Operating expense:												
Research and development	8,307	24		6,262	23		23,460	24		18,367	24	
Sales and marketing	17,415	50		14,126	52		49,782	51		39,751	51	
General and administrative	5,758	17		3,141	12		13,437	14		8,871	11	
Total operating expense	31,480	91		23,529	87		86,679	89		66,989	86	
Operating loss	(7,323 )	(21 )	)	(4,575 )	(17 )	)	(18,478 )	(19 )	)	(14,223 )	(18 )	)
Interest expense, net	(11 )	—		(7 )	—		(4 )	—		(110 )	—	
Other income (expense), net	352	1		109	—		(163 )	—		(100 )	—	
Loss before (provision for) benefit from income taxes	(6,982 )	(20 )	)	(4,473 )	(17 )	)	(18,645 )	(19 )	)	(14,433 )	(18 )	)
(Provision for) benefit from income taxes	(207 )	(1 )	)	(119 )	—		2,998	3		(430 )	(1 )	)
Net loss	\$(7,189 )	(21 )%	)	\$(4,592 )	(17 )%	)	\$(15,647 )	(16 )%	)	\$(14,863 )	(19 )%	)

Comparison of the three and nine months ended September 30, 2013 and 2012:

Revenue

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	Three Months Ended September 30,			Nine Months Ended September 30,				
	2013 (in thousands)	2012	% Change	2013 (in thousands)	2012	% Change		
Revenue								
Subscription	\$33,464	\$25,991	29 %	\$92,732	\$74,010	25 %		
Hardware and services	1,039	1,093	(5 )	4,362	3,636	20		
Total revenue	\$34,503	\$27,084	27 %	\$97,094	\$77,646	25 %		

Subscription revenue for the three and nine months ended September 30, 2013 increased \$7.5 million, or 29%, and \$18.7 million, or 25%, respectively as compared to the corresponding periods last year. This increase was primarily due to growth in revenue in the United States of \$6.3 million and \$16.8 million, respectively, during the three and nine months ended September 30, 2013 as compared to the same periods in 2012. Our international revenue also grew \$1.1 million and \$2.7 million, respectively, during the three and nine months ended September 30, 2013 as compared to the same periods in 2012. The increases were due to our ongoing investment in sales and marketing resources, including net headcount increase in sales and marketing personnel, coupled with an ongoing improvement in economic conditions in the United States, resulting in improved demand for our platform worldwide. We believe that the shift in the overall threat landscape, the growth of business-to-business collaboration as well as the consumerization of IT led to the increase in demand for data protection and governance solutions.

During the three months ended September 30, 2013, hardware and services revenue declined 5% from the three months ended September 30, 2012 due primarily to lower hardware appliances revenue as a result our continuing transition to a SaaS business model which led to decreased sales of appliances. Additionally, we adopted new revenue recognition guidance (as more fully described in Critical Accounting Policies in our 2012 Annual Report on Form 10-K) effective January 1, 2011 under which revenue from sales of hardware appliances is recognized when sold. For the nine months ended September 30, 2013, hardware and services revenue increased \$0.7 million, or 20% compared to the corresponding period last year, primarily attributable to the timing of services revenue recognition of \$1.3 million in professional services revenue upon completion of the services during the nine months ended September 30, 2013. This increase was partially offset by a decrease of \$0.5 million from hardware appliances revenue during the nine months ended September 30, 2013 due to the reasons discussed above.

## Cost of Revenue

	Three Months Ended September 30,			Nine Months Ended September 30,				
	2013 (in thousands)	2012	% Change	2013 (in thousands)	2012	% Change		
Cost of revenue								
Subscription	\$8,937	\$6,967	28 %	\$25,042	\$21,414	17 %		
Hardware and services	1,409	1,163	21	3,851	3,466	11		
Total cost of revenue	\$10,346	\$8,130	27 %	\$28,893	\$24,880	16 %		

Cost of subscription revenue for the three and nine months ended September 30, 2013 increased \$2.0 million, or 28%, and \$3.6 million, or 17%, respectively, compared to the corresponding periods last year. Customer support-related services used to support our ongoing growth contributed \$0.6 million and \$2.1 million, respectively, of the overall increase during the three and nine months ended September 30, 2013 as compared to the same periods in 2012. Data center costs increased \$0.4 million and \$0.3 million, respectively, as compared to the prior periods primarily due to our growth and need for additional resources. Operations-related expenses increased \$1.1 million and \$1.2 million, respectively, during the same periods primarily due to increased costs related to our growth, partially offset by a net reduction in intangible assets amortization for developed technology from past acquisitions offset by the amortization from current year acquisitions. Other increases were attributable to



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increased licensing fees and professional service costs in association with our growth. These increases were partially offset by lower royalty expense which decreased \$0.2 million and \$0.4 million, respectively, for the three and nine months ended September 30, 2013 due to replacement of third-party licensed technology, as well as improved economic terms associated with other ongoing license agreements.

Cost of hardware and service revenue for the three and nine months ended September 30, 2013 increased \$0.2 million, or 21%, and \$0.4 million, or 11%, for the three and nine months ended September 30, 2013 as compared to the corresponding periods last year. These increases were primarily due to the increases in cost of professional services personnel-related expense of \$0.4 million and \$1.1 million, respectively, related to the corresponding increase in professional services revenue, offset by a decrease in appliance costs of \$0.1 million and \$0.7 million, respectively.

**Operating Expenses**

	Three Months Ended September 30,			Nine Months Ended September 30,			% Change
	2013	2012	% Change	2013	2012	% Change	
	(in thousands)			(in thousands)			
Research and development	\$8,307	\$6,262	33	% \$23,460	\$18,367	28	%
Percent of total revenue	24	% 23	%	24	% 24	%	

For the three and nine months ended September 30, 2013, research and development expense increased \$2.0 million, or 33%, and \$5.1 million, or 28%, respectively, as compared to the previous year periods, primarily due to increased personnel costs as a result of increased headcount.

	Three Months Ended September 30,			Nine Months Ended September 30,			% Change
	2013	2012	% Change	2013	2012	% Change	
	(in thousands)			(in thousands)			
Sales and marketing	\$17,415	\$14,126	23	% \$49,782	\$39,751	25	%
Percent of total revenue	50	% 52	%	51	% 51	%	

Sales and marketing expense increased \$3.3 million, or 23%, and \$10.0 million, or 25%, respectively, for the three and nine months ended September 30, 2013, as compared to the corresponding periods last year. These increases were primarily due to higher salaries, commissions and benefits of \$2.3 million and \$7.1 million, respectively, related to increased headcount on a worldwide basis and more sales since 2012. Other increases included facilities and corporate expenses of \$0.9 million and \$1.9 million, respectively, marketing costs and travel expenses of \$0.1 million and \$1.0 million, respectively, as we continued to expand operations, seek out new leads and support existing customers during 2013.

	Three Months Ended September 30,			Nine Months Ended September 30,			% Change
	2013	2012	% Change	2013	2012	% Change	
	(in thousands)			(in thousands)			
General and administrative	\$5,758	\$3,141	83	% \$13,437	\$8,871	51	%
Percent of total revenue	17	% 12	%	14	% 11	%	

For the three and nine months ended September 30, 2013, general and administrative expense increased \$2.6 million, or 83%, and \$4.6 million, or 51%, respectively, primarily due to an increase in net personnel-related expenses of \$1.0 million

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and \$2.1 million, respectively, from higher headcount, and outside services of \$0.4 million and \$1.3 million, respectively, as we continued to fill more roles in our growth as a recently public company. Additionally, facilities and corporate expenses increased a net \$1.2 million for both the three and nine months ended September 30, 2013 as compared to 2012 as a result of costs incurred in 2013 and the overall growth of the Company.

Other Income (Expense), Net

	Three Months Ended			Nine Months Ended		
	September 30, 2013	2012	% Change	September 30, 2013	2012	% Change
Other income (expense), net	\$352	\$109	223 %	\$(163)	\$(100)	63 %

Other income (expense), net increased \$0.2 million for the three months ended September 30, 2013, as compared to the corresponding period last year, primarily due to foreign currency transactions due to a stronger dollar against the Taiwan dollar.

For the nine months ended September 30, 2013, other income (expense), net decreased \$0.1 million, primarily due to foreign currency transactions as a result of a weaker dollar against the British pound and Euro. This was partially offset by the increase in foreign currency transactions due to a stronger dollar against the Taiwan dollar.

(Provision For) Benefit From Income Taxes

	Three Months Ended			Nine Months Ended		
	September 30, 2013	2012	% Change	September 30, 2013	2012	% Change
(Provision for) benefit from income taxes	\$(207)	\$(119)	(74) %	\$2,998	\$(430)	797 %

For the nine months ended September 30, 2013, we recognized a net income tax benefit of \$3.0 million primarily due to a discrete charge in the current period for the release of a deferred tax valuation allowance on Canadian deferred tax assets of \$3.4 million in 2013.

### Liquidity and Capital Resources

Since our inception, we have relied principally on sales of our capital stock to fund our operating activities. To date, we have raised \$92.8 million from the sale of preferred stock. Additionally, in April and May 2012, we raised net proceeds of \$68.3 million in our initial public offering. Finally, we have generated cash from operating activities of \$7.3 million in the nine months ended September 30, 2013 and utilized equipment lines to fund capital purchases. As of September 30, 2013, we had cash and cash equivalents of \$51.8 million and short-term investments of \$19.8 million.

In April 2011, we entered into a new equipment loan agreement with Silicon Valley Bank for an aggregate loan principal amount of \$6.0 million. Interest on the advances is equal to the prime rate plus 0.50%. As of September 30, 2013, the interest rate on the outstanding advances was 4.50%. Each drawn amount is due 48 months after funding. Borrowings outstanding under the equipment loan at September 30, 2013 were \$2.7 million. Equipment financed under this loan arrangement is collateralized by the respective assets underlying the loan. The terms of the loan restrict our ability to pay dividends. The loan includes a covenant that requires us to maintain cash and cash equivalents plus net accounts receivable of at least two times the amount of all outstanding indebtedness. As of September 30, 2013, we were in compliance with this financial covenant.

We plan to grow our customer base by continuing to emphasize investments in sales and marketing to add new customers, expand our customers' use of our platform, and maintain high renewal rates. We also expect to incur additional cost of subscription revenue in accordance with the resulting growth in our customer base. We believe that the combination of our ongoing improvements in gross margins, the benefits of lower sales and marketing costs associated with our renewal activity, and the fact that our contracts are structured to bill our customers in advance should enable us to improve our cash flow from operations as we grow. Based on our current level of operations and anticipated growth, both of which are expected to be consistent with recent quarters, we believe that our existing

sources of liquidity will be sufficient to fund our operations for at least the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities, and the timing and extent of spending to support product development efforts and expansion into new territories, and the timing of introductions of new features and enhancements to our solutions.

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To the extent that existing cash and cash equivalents and cash from operations are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. We have invested and plan to continue investing in acquiring complementary business, applications and technologies and may continue to make such investments in the future, any of which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

**Cash Flows**

The following table sets forth a summary of our consolidated cash flows for the periods indicated:

	Nine Months Ended	
	September 30,	
	2013	2012
	(in thousands)	
Net cash provided by operating activities	\$7,294	\$1,932
Net cash used in investing activities	(6,001	) (50,049
Net cash provided by financing activities	11,281	69,878
<b>Net Cash Flows Provided by Operating Activities</b>		

Our net loss and cash flows from operating activities are significantly influenced by our investments in headcount and data center operations to support anticipated growth. Our cash flows are also influenced by cash payments from customers. We invoice customers for the entire contract amount at the start of the term, and as such our cash flow from operations is also affected by the length of a customer contract.

We generated \$7.3 million of cash from operating activities in the nine months ended September 30, 2013. This generation of cash was the result of a net loss of \$15.6 million, offset by non-cash expenditures of \$13.2 million, which included depreciation, amortization, accretion of investments and stock based compensation expense. These non-cash expenditures increased due to capital expenditures and headcount growth, primarily related to continued investment in our business. Cash generated from operations further benefited from an increase in deferred revenue of \$14.5 million related to timing of revenue recognition. Additional contributions were due to the net change in certain working capital items, most notably a decrease in accounts payable of \$0.9 million related to timing of accrued payables paid during the period. These increases were partially offset by a decrease in accounts receivable of \$2.9 million and an increase in other non-current assets of \$3.6 million due to the recognition of deferred tax benefit related to the release of valuation allowance in Canada.

We generated \$1.9 million of cash from operating activities in the nine months ended September 30, 2012. This generation of cash was the result of a net loss of \$14.9 million, offset by non-cash expenditures of \$11.4 million, which included depreciation, amortization and stock based compensation expense. These non-cash expenditures increased due to capital expenditure and headcount growth, primarily related to continued investment in our business. Cash generated from operations was further due to an increase in deferred rent of \$0.3 million due to lease improvement incentives, an increase in deferred revenue of \$2.6 million related to timing of revenue recognition. Additional fund contributions were due to the net change in certain working capital items, most notably an increase in accounts receivable of \$1.3 million, an increase in inventory of \$0.2 million, and a decrease in deferred product costs of \$1.1 million as a result of increased sales activity, an increase in accrued liabilities of \$2.8 million related to timing of accrued payables, an increase of \$1.1 million in prepaid expenses and other assets, and an increase in accounts payable of \$1.1 million related to timing of accrued payables paid during the period.

**Net Cash Flows Used in Investing Activities**

Our primary investing activities have consisted of the purchase and sale of short-term investments and capital expenditures in support of expanding our infrastructure and workforce. As our business grows, we expect our capital expenditures and our investment activity to continue to increase.



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Cash from investing activities used \$6.0 million of cash during the nine months ended September 30, 2013 primarily due to purchases of short term investments of \$20.4 million and the four acquisitions completed in 2013 for net cash payments totaling \$28.5 million. In addition, we used \$4.5 million to purchase equipment for infrastructure expansion. These expenditures were primarily for replacement and upgrade of equipment to lower the cost of deployment as well as to improve the efficiency for our cloud based architecture. These uses were partially offset by proceeds of \$47.4 million from sales and maturities of the short-term investments.

We used \$50.0 million of cash in investing activities during the nine months ended September 30, 2012. This was primarily due to purchases of short term investments of \$49.3 million with proceeds generated from our initial public offering, offset by net proceeds of \$3.2 million from sales and maturities of short-term investments. In addition, we used \$3.9 million to purchase equipment for infrastructure expansion. These expenditures were primarily for replacement and upgrade of equipment to lower the cost of deployment as well as to improve the efficiency for our cloud based architecture.

### Net Cash Flows Provided by Financing Activities

Cash provided by financing activities in the nine months ended September 30, 2013 was \$11.3 million. This was primarily related to \$13.0 million of proceeds from the exercise of stock options and purchases made under the employee stock purchase plan, partially offset by \$1.7 million in repayments under our equipment financing loans. Cash provided by financing activities in the nine months ended September 30, 2012 was \$70.0 million. This was primarily related to proceeds from our initial public offering, net of offering costs, of \$68.3 million. Contributions also included \$2.1 million of proceeds from the exercise of stock options partially offset by \$0.6 million in repayments under our equipment financing loans.

### Off-Balance Sheet Arrangements

During the periods presented, we did not have, nor do we currently have, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. We are therefore not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in those types of relationships.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We have operations both within the United States and internationally, and we are exposed to market risks in the ordinary course of our business. These risks primarily include interest rate, foreign exchange and inflation risks, as well as risks relating to changes in the general economic conditions in the countries where we conduct business. To reduce certain of these risks, we monitor the financial condition of our large clients and limit credit exposure by collecting in advance and setting credit limits as we deem appropriate. In addition, our investment strategy has been to invest in financial instruments that are highly liquid and readily convertible into cash with maturity dates within three months from the date of purchase. To date, we have not used derivative instruments to mitigate the impact of our market risk exposures. We have also not used, nor do we intend to use, derivatives for trading or speculative purposes.

#### Interest Rate Risk

We are exposed to market risk related to changes in interest rates. Our investments are considered cash equivalents and short term investments primarily consist of money market funds, commercial paper, corporate debt securities. As of September 30, 2013, we had cash, cash equivalents, and short term investments of \$71.6 million. The carrying amount of our cash, cash equivalents and short-term investments reasonably approximates fair value, due to the short maturities of these investments. The primary objectives of our investment activities are the preservation of capital, the fulfillment of liquidity needs and the fiduciary control of cash and investments. We do not enter into investments for trading or speculative purposes. Our investments are exposed to market risk due to a fluctuation in interest rates, which may affect our interest income and the fair market value of our investments. Due to the short-term nature of our investment portfolio, we believe only dramatic fluctuations in interest rates would have a material effect on our

investments. As such we do not expect our operating results or cash flows to be materially affected by a sudden change in market interest rates.

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As of September 30, 2013 we had borrowings outstanding with principal amounts of \$2.7 million. Our outstanding long-term borrowings consist of fixed and variable interest rate financial instruments. The interest rate of our fixed-rate borrowings as of September 30, 2013 was 4.5%. A hypothetical 10% increase or decrease in interest rates relative to our current interest rates would not have a material impact on the fair values of all of our outstanding fixed-rate borrowings. Changes in interest rates could, however, affect operating results and cash flows, because of the variable rate nature of our borrowings. A hypothetical 10% increase or decrease in interest rates relative to interest rates at September 30, 2013 would have resulted in an insignificant impact to interest expense for 2013.

### Foreign Currency Risk

Our sales to international customers are generally U.S. dollar denominated. As a result, there are no significant foreign currency gains or losses related to these transactions. The functional currency for our wholly owned foreign subsidiaries is the U.S. dollar. Accordingly, the subsidiaries remeasure monetary assets and liabilities at period-end exchange rates, while nonmonetary items are remeasured at historical rates. Income and expense accounts are remeasured at the average exchange rates in effect during the year. Remeasurement adjustments are recognized in the Condensed Consolidated Statements of Operations as foreign currency transaction gains or losses in the year of occurrence. Aggregate foreign currency transaction loss included in determining net loss was \$0.1 million for both the nine months ended September 30, 2013 and 2012. Transaction gains and losses are included in other income (expense), net.

As our international operations grow, our risks associated with fluctuation in currency rates will become greater, and we will continue to reassess our approach to managing this risk. In addition, currency fluctuations or a weakening U.S. dollar can increase the costs of our international expansion. To date, we have not entered into any foreign currency hedging contracts, since exchange rate fluctuations have not had a material impact on our operating results and cash flows. Based on our current international structure, we do not plan on engaging in hedging activities in the near future.

### Inflation Risk

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. Nonetheless, if our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

## ITEM 4. CONTROLS AND PROCEDURES.

### Evaluation of Disclosure Controls and Procedures

Regulations under the Securities Exchange Act of 1934, or the Exchange Act, require public companies, including us, to maintain “disclosure controls and procedures,” which are defined in Rule 13a-15(e) and Rule 15d-15(e) to mean a company’s controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including our principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required or necessary disclosures. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Our chief executive officer and chief financial officer have concluded, based on the evaluation of the effectiveness of the disclosure controls and procedures by our management as of the end of the fiscal quarter covered by this Quarterly Report, that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

Regulations under the Exchange Act require public companies, including our company, to evaluate any change in our “internal control over financial reporting” as such term is defined in Rule 13a-15(f) and Rule 15d-15(f) of the Exchange Act. As

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of the end of the period covered by this Quarterly Report, our Chief Executive Officer and Chief Financial Officer did not identify any change in our internal control over financial reporting during the fiscal quarter covered by this Quarterly Report that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

From time to time, we are involved in various legal proceedings arising from the normal course of business activities. We are not presently a party to any litigation the outcome of which, we believe, if determined adversely to us, would individually or in the aggregate have a material adverse effect on our business, operating results, cash flows or financial condition.

ITEM 1A. RISK FACTORS.

Our operations and financial results are subject to various risks and uncertainties, including those described below, which could adversely affect our business, results of operations, cash flows, financial condition, and the trading price of our common stock.

Risks Related to Our Business and Industry

We have a history of losses, and we are unable to predict the extent of any future losses or when, if ever, we will achieve profitability in the future.

We have incurred net losses in every year since our inception, including net losses of approximately \$15.6 million and \$14.9 million, respectively, for the nine months ended September 30, 2013 and 2012. As a result, we had an accumulated deficit of \$198.1 million as of September 30, 2013. Achieving profitability will require us to increase revenue, manage our cost structure, and avoid unanticipated liabilities. We do not expect to be profitable in the near term. Revenue growth may slow or revenue may decline for a number of possible reasons, including slowing demand for our solutions, increasing competition, a decrease in the growth of our overall market, or if we fail for any reason to continue to capitalize on growth opportunities. Any failure by us to obtain and sustain profitability, or to continue our revenue growth, could cause the price of our common stock to decline significantly.

Our quarterly operating results are likely to vary significantly and be unpredictable, which could cause the trading price of our stock to decline.

Our operating results have historically varied from period to period, and we expect that they will continue to do so as a result of a number of factors, many of which are outside of our control and may be difficult to predict, including:

- the level of demand for our solutions and the level of perceived urgency regarding security threats and compliance requirements;
- the timing of new subscriptions and renewals of existing subscriptions;
- the mix of solutions sold;
- the extent to which customers subscribe for additional solutions or increase the number of users;
- customer budgeting cycles and seasonal buying patterns;
- the extent to which we bring on new distributors;
- any changes in the competitive landscape of our industry, including consolidation among our competitors, customers, partners or resellers;
- timing of costs and expenses during a quarter;
- deferral of orders in anticipation of new solutions or enhancements announced by us;

- price competition;

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- changes in renewal rates and terms in any quarter;
- any disruption in our sales channels or termination of our relationship with important channel partners;
- general economic conditions, both domestically and in our foreign markets;
- insolvency or credit difficulties confronting our customers, affecting their ability to purchase or pay for our solutions; or
- future accounting pronouncements or changes in our accounting policies.

Any one of the factors above or the cumulative effect of some of the factors referred to above may result in significant fluctuations in our quarterly financial and other operating results, including fluctuations in our key metrics. This variability and unpredictability could result in our failing to meet the expectations of securities analysts or investors for any period. If we fail to meet or exceed such expectations for these or any other reasons, the market price of our shares could fall substantially and we could face costly lawsuits, including securities class action suits. In addition, a significant percentage of our operating expenses are fixed in nature and based on forecasted revenue and cash flow trends. Accordingly, in the event of revenue shortfalls, we are generally unable to mitigate the negative impact on margins or other operating results in the short term.

We may fail to meet or exceed the expectations of securities analysts and investors, and the market price for our common stock could decline. If one or more of the securities analysts who cover us change their recommendation regarding our stock adversely, the market price for our common stock could decline. Additionally, our stock price may be based on expectations, estimates or forecasts of our future performance that may be unrealistic or may not be achieved. Further our stock price may be affected by financial media, including press reports and blogs.

If we are unable to maintain high subscription renewal rates, our future revenue and operating results will be harmed. Our customers have no obligation to renew their subscriptions for our solutions after the expiration of their initial subscription period, which typically ranges from one to three years. In addition, our customers may renew for fewer subscription services or users, renew for shorter contract lengths or renew at lower prices due to competitive or other pressures. We cannot accurately predict renewal rates and our renewal rates may decline or fluctuate as a result of a number of factors, including competition, customers' IT budgeting and spending priorities, and deteriorating general economic conditions. If our customers do not renew their subscriptions for our solutions, our revenue would decline and our business would suffer.

If we are unable to sell additional solutions to our customers, our future revenue and operating results will be harmed. Our future success depends on our ability to sell additional solutions to our customers. This may require increasingly sophisticated and costly sales efforts and may not result in additional sales. In addition, the rate at which our customers purchase additional solutions depends on a number of factors, including the perceived need for additional solutions, growth in the number of end-users, and general economic conditions. If our efforts to sell additional solutions to our customers are not successful, our business may suffer.

If our solutions fail to protect our customers from security breaches, our brand and reputation could be harmed, which could have a material adverse effect on our business and results of operations.

The threats facing our customers are constantly evolving and the techniques used by attackers to access or sabotage data change frequently. As a result, we must constantly update our solutions to respond to these threats. If we fail to update our solutions in a timely or effective manner to respond to these threats, our customers could experience security breaches. Many state and foreign governments have enacted laws requiring companies to notify individuals of data security breaches involving their personal data. These mandatory disclosures regarding a security breach often lead to widespread negative publicity, and any association of us with such publicity may cause our customers to lose



confidence in the effectiveness of our data security measures. Any security breach at one of our customers would harm our reputation as a secure and trusted company and could cause the loss of customers. Similarly, if a well-publicized breach of data security at a customer of any other cloud based data protection or archiving service provider or other major enterprise cloud services provider were to occur, there could be a loss of confidence in the cloud based storage of sensitive data and information generally.

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In addition, our solutions work in conjunction with a variety of other elements in customers' IT and security infrastructure, and we may receive blame and negative publicity for a security breach that may have been the result of the failure of one of the other elements not provided by us. The occurrence of a breach, whether or not caused by our solutions, could delay or reduce market acceptance of our solutions and have an adverse effect on our business and financial performance. In addition, any revisions to our solutions that we believe may be necessary or appropriate in connection with any such breach may cause us to incur significant expenses. Any of these events could have material adverse effects on our brand and reputation, which could harm our business, financial condition, and operating results. If our customers experience data losses, our brand, reputation and business could be harmed.

Our customers rely on our archive solutions to store their corporate data, which may include financial records, credit card information, business information, health information, other personally identifiable information or other sensitive personal information. A breach of our network security and systems or other events that cause the loss or public disclosure of, or access by third parties to, our customers' stored files or data could have serious negative consequences for our business, including possible fines, penalties and damages, reduced demand for our solutions, an unwillingness of our customers to use our solutions, harm to our brand and reputation, and time-consuming and expensive litigation. The techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently, often are not recognized until launched against a target, and may originate from less regulated or remote areas around the world. As a result, we may be unable to proactively prevent these techniques, implement adequate preventative or reactionary measures, or enforce the laws and regulations that govern such activities. In addition, because of the large amount of data that we collect and manage, it is possible that hardware failures, human errors or errors in our systems could result in data loss or corruption, or cause the information that we collect to be incomplete or contain inaccuracies that our customers regard as significant. If our customers experience any data loss, or any data corruption or inaccuracies, whether caused by security breaches or otherwise, our brand, reputation and business would be harmed.

Our errors and omissions insurance may be inadequate or may not be available in the future on acceptable terms, or at all. In addition, our policy may not cover any claim against us for loss of data or other indirect or consequential damages. Defending a suit based on any data loss or system disruption, regardless of its merit, could be costly and divert management's attention.

Defects or vulnerabilities in our solutions could harm our reputation, reduce the sales of our solutions and expose us to liability for losses.

Because our solutions are complex, undetected errors, failures or bugs may occur, especially when solutions are first introduced or when new versions or updates are released despite our efforts to test those solutions and enhancements prior to release. We may not be able to correct defects, errors, vulnerabilities or failures promptly, or at all.

Any defects, errors, vulnerabilities or failures in our solutions could result in:

- expenditure of significant financial and development resources in efforts to analyze, correct, eliminate or work around errors or defects or to address and eliminate vulnerabilities;
- loss of existing or potential partners or customers;
- loss or disclosure of our customers' confidential information, or the inability to access such information;
- loss of our proprietary technology;
- our solutions being susceptible to hacking or electronic break-ins or otherwise failing to secure data;
- delayed or lost revenue;
- delay or failure to attain market acceptance;
- lost market share;
- negative publicity, which could harm our reputation; or

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litigation, regulatory inquiries or investigations that would be costly and harm our reputation.

Limitation of liability provisions in our standard terms and conditions may not adequately or effectively protect us from any claims related to defects, errors, vulnerabilities or failures in our solutions, including as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries.

Because we provide security solutions, our software, website and internal systems may be subject to intentional disruption that could adversely impact our reputation and future sales.

We could be a target of attacks specifically designed to impede the performance of our solutions and harm our reputation. Similarly, experienced computer hackers may attempt to penetrate our network security or the security of our website and misappropriate proprietary information and/or cause interruptions of our services. Because the techniques used by such computer hackers to access or sabotage networks change frequently and may not be recognized until launched against a target, we may be unable to anticipate these techniques. If an actual or perceived breach of network security occurs, it could adversely affect the market perception of our solutions, and may expose us to the loss of information, litigation and possible liability. In addition, such a security breach could impair our ability to operate our business, including our ability to provide support services to our customers.

We believe that there is a trend for large and mid sized enterprises to migrate their on premise email systems to cloud based offerings. If we fail to successfully develop, market, broaden or enhance our solutions to continue to be attractive to existing customers currently using cloud based email systems or by new prospects, our ability to grow or maintain our revenue could be harmed, and our business could suffer.

We derive a substantial portion of our revenue from our solutions that protect and archive data in our customers' on-premise email systems and expect to continue to do so for the foreseeable future. We currently derive a portion of our revenue from customers using cloud-based email systems such as Google's Google Apps and Microsoft's Office 365, both of which include varying degrees of threat protection and governance services as part of their offering. A significant market shift from on premise email systems toward such cloud based email systems could decrease demand for our solutions because customers who move to cloud based email systems may no longer value our threat and governance solutions and may choose to instead use competing or low cost alternatives from companies such as Google or Microsoft that may offer competing solutions in connection with their cloud-based email systems. If our current or prospective customers who utilize cloud based systems fail to find value in our solutions or migrate to these other threat or governance offerings, our business could be adversely affected.

Historically, our solutions have been used primarily for email, and any decrease in the use of email systems by large and mid sized enterprises over time, or the failure of our newly developed solutions for emerging methods of communication and collaboration to gain acceptance could harm our business.

Historically, our customers have primarily used our solutions to protect and archive data in their corporate email systems. If the use of email decreases, demand for our solutions would decrease and we may fail to diversify our revenue base by increasing demand for our other technology solutions.

In addition, messaging and collaboration technologies are evolving rapidly. For instance, the widespread adoption and use of mobile devices, unmanaged Internet based collaboration and file sharing applications and social networking sites have caused valuable and sensitive data to proliferate well beyond traditional corporate email systems, resulting in new and increasing security risks. We are devoting resources to continue developing and marketing our solutions for these emerging methods of communication and collaboration. However, our customers may not perceive the need to deploy our solutions intended to address these emerging areas. If we are unable to successfully develop, market, broaden or enhance our solutions to address the wider range of threats caused by the proliferation of new technologies and methods of communication, demand for our existing solutions would decrease, and our business would be harmed.

If functionality similar to that offered by our solutions is incorporated into our competitors' networking products, potential or existing customers may decide against adding our solutions to their network, which would have an adverse effect on our business.

Some large, well-established providers of networking equipment, such as Cisco and Juniper Networks, Inc. currently offer, and may continue to introduce, network security features that compete with our solutions, either in stand alone security



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products or as additional features in their network infrastructure products. The inclusion of, or the announcement of an intent to include, functionality perceived to be similar to that offered by our solutions in networking products that are already generally accepted as necessary components of customers' network architecture may have an adverse effect on our ability to market and sell our solutions. Furthermore, even if the functionality offered by network infrastructure providers is more limited than that offered by our solutions, a significant number of our customers may elect to accept such limited functionality in lieu of adding appliances or software from an additional vendor such as us. Many organizations have invested substantial personnel and financial resources to design and operate their networks and have established deep relationships with other providers of networking products, which may make them reluctant to add new third party components to their networks.

Our solutions collect, filter and archive customer data which may contain personal information, which raises privacy concerns and could result in us having liability or inhibit sales of our solutions.

Many federal, state and foreign government bodies and agencies have adopted or are considering adopting laws and regulations regarding the collection, use, and disclosure of personal information. Because many of the features of our solutions use, store, and report on customer data which may contain personal information from our customers, any inability to adequately address privacy concerns, or comply with applicable privacy laws, regulations and policies could, even if unfounded, result in liability to us, damage to our reputation, loss of sales, and harm to our business. Furthermore, the costs of compliance with, and other burdens imposed by, such laws, regulations and policies that are applicable to the businesses of our customers may limit the use and adoption of our solutions and reduce overall demand for them. Privacy concerns, whether or not valid, may inhibit market adoption of our solutions. For example, in the United States regulations such as the Gramm Leach Bliley Act (GLBA), which protects and restricts the use of consumer credit and financial information, and the Health Insurance Portability and Accountability Act of 1996 (HIPAA), which regulates the use and disclosure of personal health information, impose significant security and data protection requirements and obligations on businesses that may affect the use and adoption of our solutions. The European Union has also adopted a data privacy directive that requires member states to impose restrictions on the collection and use of personal data that, in some respects, are more stringent, and impose more significant burdens on subject businesses, than current privacy standards in the United States.

Any failure or perceived failure to comply with laws and regulations may result in proceedings or actions against us by government entities or others, or could cause us to lose users and customers, which could potentially have an adverse effect on our business.

We operate in a highly competitive environment with large, established competitors, and our competitors may gain market share in the markets for our solutions that could adversely affect our business and cause our revenue to decline.

Our traditional competitors include security focused software vendors, such as Symantec Corporation and McAfee, Inc., an Intel Corporation subsidiary, which offer software products that directly compete with our solutions. In addition to competing with these vendors directly for sales to customers, we compete with them for the opportunity to have our solutions bundled with the product offerings of our strategic partners. Our competitors could gain market share from us if any of these partners replace our solutions with the products of our competitors or if these partners more actively promote our competitors' products over our solutions. In addition, software vendors who have bundled our solutions with theirs may choose to bundle their software with their own or other vendors' software, or may limit our access to standard product interfaces and inhibit our ability to develop solutions for their platform.

We also face competition from large technology companies, such as Cisco Systems, Inc., EMC Corporation, Google Inc., Hewlett Packard Company, Intel and Microsoft. These companies are increasingly developing and incorporating into their products data protection and storage software that compete on various levels with our solutions. Our competitive position could be adversely affected to the extent that our customers perceive that the functionality incorporated into these products would replace the need for our solutions or that buying from one vendor would provide them with increased leverage and purchasing power and a better customer experience. We also face competition from many smaller companies that specialize in particular segments of the markets in which we compete.

Many of our competitors have greater financial, technical, sales, marketing or other resources than we do and consequently may have the ability to influence our customers to purchase their products instead of ours. Further consolidation within our industry or other changes in the competitive environment could also result in larger competitors that compete with us on several levels. In addition, acquisitions of smaller companies that specialize in particular segments of the markets in which we compete by large technology companies would result in increased competition from these large technology companies. For example, Cisco's acquisition of IronPort, an email and web security service, resulted in Cisco becoming one of our competitors.

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If we are unsuccessful in responding to our competitors or to changing technological and customer demands, our competitive position and financial results could be adversely affected.

If we do not effectively expand and train our sales force, we may be unable to add new customers or increase sales to our existing customers and our business will be harmed.

We continue to be substantially dependent on our sales force to obtain new customers and to sell additional solutions to our existing customers. We believe that there is significant competition for sales personnel with the skills and technical knowledge that we require. Our ability to achieve significant revenue growth will depend, in large part, on our success in recruiting, training and retaining sufficient numbers of sales personnel to support our growth. New hires require significant training and may take significant time before they achieve full productivity. Our recent hires and planned hires may not become as productive as we expect, and we may be unable to hire or retain sufficient numbers of qualified individuals in the markets where we do business or plan to do business. If we are unable to hire and train sufficient numbers of effective sales personnel, or the sales personnel are not successful in obtaining new customers or increasing sales to our existing customer base, our business will be harmed.

Our sales cycle is long and unpredictable, and our sales efforts require considerable time and expense. As a result, our results are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

We sell our security and compliance offerings primarily to enterprise IT departments that are managing a growing set of user and compliance demands, which has increased the complexity of customer requirements to be met and confirmed in the sales cycle. Additionally, we have found that increasingly security, legal and compliance departments are involved in testing, evaluating and finally approving purchases, which has also made the sales cycle longer and less predictable. We may not be able to accurately predict or forecast the timing of sales, which makes our future revenue difficult to predict and could cause our results to vary significantly. In addition, we might devote substantial time and effort to a particular unsuccessful sales effort, and as a result we could lose other sales opportunities or incur expenses that are not offset by an increase in revenue, which could harm our business.

Because our long-term success depends, in part, on our ability to expand the sales of our platform to our customers located outside of the United States, our business will be increasingly susceptible to risks associated with international operations.

One key element of our growth strategy is to develop a worldwide customer base and expand our operations worldwide. We have added employees, offices and customers internationally, particularly in Europe and Asia. Operating in international markets requires significant resources and management attention and will subject us to regulatory, economic, political and competitive risks and competition that are different from those in the United States. Because of our limited experience with international operations, we cannot assure you that our international expansion efforts will be successful or that expected returns on such investments will be achieved in the future. In addition, our international operations may fail to succeed due to other risks inherent in operating businesses internationally, including:

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