QUALYS, INC.
Form 10-Q
November 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended September 30, 2012

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission file number 001-35662

QUALYS, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	77-0534145 (I.R.S. Employer Identification Number)

1600 Bridge Parkway, Redwood City, California 94065
(Address of principal executive offices, including zip code)

(650) 801-6100
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 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 x

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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. (Check one):

Large accelerated filer	o	Accelerated filer	o	Non-accelerated filer	x	Smaller reporting company	o

(Do not check if a
smaller reporting
company)

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

The number of shares of the Registrant's common stock outstanding as of October 31, 2012 was 31,409,793.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
Qualys, Inc.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(in thousands, except share and per share data)

	September 30, 2012	December 31, 2011 (restated)
Assets		
Current assets:		
Cash	$25,804	$24,548
Accounts receivable, net of allowance of $355 and $230 at September 30, 2012 and December 31, 2011, respectively	23,452	20,750
Prepaid expenses and other current assets	6,502	3,774
Total current assets	55,758	49,072
Restricted cash	112	112
Property and equipment, net	16,896	13,861
Intangible assets, net	2,869	3,175
Goodwill	317	317
Other noncurrent assets	1,884	2,252
Total assets	$77,836	$68,789
Liabilities, Convertible Preferred Stock and Stockholders' Equity (Deficit)		
Current Liabilities :		
Accounts payable	$1,715	$2,254
Accrued liabilities	9,085	8,468
Deferred revenues, current	51,693	46,717
Capital lease obligations, current	1,556	1,987
Total current liabilities	64,049	59,426
Deferred revenues, noncurrent	6,152	4,713
Income taxes payable, noncurrent	504	661
Other noncurrent liabilities	1,189	2,134
Capital lease obligations, noncurrent	1,074	2,406
Total liabilities	72,968	69,340
Commitments and contingencies (Note 6)		
Convertible preferred stock:		
Series A convertible preferred stock: $0.001 par value; 48,079,860 shares authorized; 4,766,543 shares issued and outstanding at September 30, 2012 and December 31, 2011; aggregate liquidation preference—$28,774	28,603	28,603
Series B convertible preferred stock: $0.001 par value; 110,314,114 shares authorized; 11,031,387 shares issued and outstanding at September 30, 2012 and December 31, 2011; aggregate liquidation preference—$28,862	28,568	28,568
Series C convertible preferred stock: $0.001 par value; 18,006,026 shares authorized; 1,799,328 shares issued and outstanding at September 30, 2012 and December 31, 2011; aggregate liquidation preference— $6,631	6,702	6,702
Total convertible preferred stock	63,873	63,873
Stockholders' equity (deficit):		
Common stock, $0.001 par value; 299,900,000 shares authorized; — 5,964,621 and 5,300,288 shares issued and outstanding at September 30, 2012 and December 31,	6	5

2011, respectively		
Additional paid-in capital	17,257	12,927
Accumulated other comprehensive loss	(1,001)	(984)
Accumulated deficit	(75,267)	(76,372)
Total stockholders’ equity (deficit)	(59,005)	(64,424)
Total liabilities, convertible preferred stock and stockholders’ equity (deficit)	$77,836	$68,789

See accompanying Notes to Condensed Consolidated Financial Statements

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Qualys, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues	$23,382	$19,375	$66,763	$55,560
Cost of revenues	4,634	3,225	13,423	9,124
Gross profit	18,748	16,150	53,340	46,436
Operating expenses:				
Research and development	5,076	4,922	15,325	14,680
Sales and marketing	8,797	7,985	27,827	22,297
General and administrative	3,154	2,249	8,811	6,510
Total operating expenses	17,027	15,156	51,963	43,487
Income from operations	1,721	994	1,377	2,949
Other income (expense), net:				
Interest expense	(38)	(47)	(153)	(164)
Interest income	1	4	2	10
Other income (expense), net	60	(418)	(44)	101
Total other income (expense), net	23	(461)	(195)	(53)
Income before provision for income taxes	1,744	533	1,182	2,896
Provision for income taxes	77	81	77	291
Net income	$1,667	$452	$1,105	$2,605
Net income attributable to common stockholders	$415	$102	$264	$576
Net income per share attributable to common stockholders:				
Basic	$0.07	$0.02	$0.05	$0.12
Diluted	$0.06	$0.02	$0.04	$0.11
Weighted average shares used in computing net income per share attributable to common stockholders:				
Basic	5,843	5,137	5,540	5,002
Diluted	26,545	24,402	25,972	24,208

See accompanying Notes to Condensed Consolidated Financial Statements

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Qualys, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$1,667	$452	$1,105	$2,605
Foreign currency translation gain (loss), net of zero tax	41	(106)	(17)	(138)
Other comprehensive income (loss), net	41	(106)	(17)	(138)
Comprehensive income	$1,708	$346	$1,088	$2,467

See accompanying Notes to Condensed Consolidated Financial Statements

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Qualys, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	$1,105	$2,605
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	5,397	3,781
Bad debt expense	182	171
Loss on disposal of property and equipment	3	—
Stock-based compensation	2,583	1,512
Non-cash interest expense	24	27
Changes in operating assets and liabilities:		
Accounts receivable	(2,884)	(1,973)
Prepaid expenses and other assets	146	(1,283)
Accounts payable	(542)	676
Accrued liabilities	(1,509)	752
Deferred revenues	6,415	4,724
Income taxes payable	(189)	311
Other noncurrent liabilities	(62)	(16)
Net cash provided by operating activities	10,669	11,287
Cash flows from investing activities:		
Purchases of property and equipment	(8,104)	(4,250)
Net cash used in investing activities	(8,104)	(4,250)
Cash flows from financing activities:		
Principal payments under capital lease obligations	(1,763)	(1,153)
Payment of consideration related to acquisition	(1,000)	—
Proceeds from exercise of stock options	1,998	971
Payments for offering costs in connection with initial public offering	(560)	—
Proceeds from issuance of Series C Preferred Stock	—	128
Net cash used in financing activities	(1,325)	(54)
Effect of exchange rate changes on cash	16	(128)
Net increase in cash	1,256	6,855
Cash at beginning of period	24,548	15,010
Cash at end of period	$25,804	$21,865
Non-cash investing and financing activities:		
Deferred offering costs not yet paid	$1,973	$—
Issuance of common stock for acquisition of license	$51	$—

See accompanying Notes to Condensed Consolidated Financial Statements

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. The Company and Summary of Significant Accounting Policies

Description of Business
Qualys, Inc. (the “Company”) was incorporated in the state of Delaware on December 30, 1999. The Company is headquartered in Redwood City, California and has majority-owned subsidiaries throughout the world. The Company is a pioneer and leading provider of cloud security and compliance solutions that enable organizations to identify security risks to their IT infrastructures, help protect their IT systems and applications from ever-evolving cyber attacks and achieve compliance with internal policies and external regulations. The Company’s cloud solutions address the growing security and compliance complexities and risks that are amplified by the dissolving boundaries between internal and external IT infrastructures and web environments, the rapid adoption of cloud computing and the proliferation of geographically dispersed IT assets. Organizations can use the Company’s integrated suite of solutions delivered on its QualysGuard Cloud Platform to cost-effectively obtain a unified view of their security and compliance posture across globally-distributed IT infrastructures.

Basis of Presentation
The accompanying unaudited condensed consolidated financial statements and condensed footnotes have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") for interim financial information as well as the instructions to Form 10-Q and the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in the financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated balance sheet as of December 31, 2011, included herein, was derived from the audited financial statements as of that date but does not include all disclosures, including notes required by U.S. GAAP. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, which include only normal recurring adjustments, necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results of operations expected for the entire year ending December 31, 2012 or for any other future annual or interim period. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company’s Prospectus dated September 27, 2012, filed with the SEC pursuant to Rule 424(b)(4) under the Securities Act of 1933.

Certain prior year amounts have been reclassified to conform to the current year presentation. These reclassifications did not change previously reported total assets, liabilities, convertible preferred stock, stockholders' equity (deficit), income from operations or net income.

Principles of Consolidation
The accompanying condensed consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries, which are located in Brazil, Canada, France, Germany, Hong Kong, India, Japan, Mexico, Singapore, the United Arab Emirates and the United Kingdom. All significant intercompany transactions and balances have been eliminated upon consolidation.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Use of Estimates

The preparation of the condensed consolidated financial statements in conformity with U.S. GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported results of operations during the reporting period. The Company’s management regularly assesses these estimates, which primarily affect revenue recognition, the valuation of accounts receivable, goodwill and intangible assets, common stock, stock-based compensation and the valuation allowances associated with deferred tax assets. Actual results could differ from those estimates and such differences may be material to the accompanying condensed consolidated financial statements.

Convertible Preferred Stock
A sale of all or substantially all of the Company’s assets or merger or consolidation of the Company with another entity is treated as a liquidation unless, following such transaction, the Company’s stockholders directly or indirectly own, in the aggregate, more than 50% of the total voting power of the surviving or acquiring entity. These liquidation provisions and the extent of preferred stock holdings resulted in the preferred stock having redemption features that were not solely in the control of the Company. Because a potential purchaser could have acquired a majority of the outstanding voting stock, triggering a redemption that was outside of the Company’s control, all shares of convertible preferred stock were presented outside of permanent equity in the accompanying condensed consolidated balance sheets as of September 30, 2012 and December 31, 2011.

On October 3, 2012, immediately prior to the closing of the Company’s initial public offering ("IPO"), all outstanding shares of convertible preferred stock converted into an equivalent number of shares of common stock. The related carrying value of the convertible preferred stock of $63.9 million was reclassified to common stock and additional paid-in capital at the time of the conversion. See Note 13 for additional information regarding the Company's IPO.

Concentration of Credit Risk
The Company deposits its cash balances with major financial institutions. Cash balances with any one institution at times may be in excess of federally insured limits. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk.

Credit risk with respect to accounts receivable is dispersed due to the large number of customers. In addition, the Company’s credit risk is mitigated by the relatively short collection period. Collateral is not required for accounts receivable. The Company maintains an allowance for potential credit losses based upon the expected collectability of accounts receivable. The Company writes off its receivables when collectability is deemed to be doubtful. As of September 30, 2012, no customer or channel partner accounted for more than 10% of the Company's accounts receivable balance. One channel partner accounted for 13% of the Company’s accounts receivable balance as of December 31, 2011.

Cash
Cash includes highly liquid investments with original maturities of three months or less when acquired. These investments are stated at cost, which approximates fair market value. The Company’s balance of $25,804,000 and $24,548,000 at September 30, 2012 and December 31, 2011, respectively, consists entirely of cash held in banks.

Accounts Receivable

Accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts represents the Company’s best estimate of the amount of probable credit losses and is determined based on a review of existing accounts receivable by aging category to identify significant customers or invoices with collectability issues. For those invoices not specifically reviewed, the reserve is calculated based on the age of the receivable.

Any change in the assumptions used in analyzing a specific account receivable may result in an additional provision for doubtful accounts being recognized in the period in which the change occurs. When the Company ultimately concludes that a receivable is uncollectible, the balance is written off against the allowance for doubtful accounts. Payments subsequently received on such receivables are credited back to the allowance for doubtful accounts.

Deferred Offering Costs

Deferred offering costs relating to the Company’s IPO are capitalized in prepaid expenses and other current assets on the condensed consolidated balance sheet and consist primarily of legal, accounting, printing and filing fees. The deferred offering costs will be offset against the proceeds from the IPO, which closed on October 3, 2012. As of September 30, 2012, the Company had capitalized $2,533,000 of deferred offering costs.

Restricted Cash

Restricted cash includes amounts maintained with banks as security deposits for certain leased facilities and, accordingly, is classified as a non-current asset.

Property and Equipment, net

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which range from three to five years. Leasehold improvements are amortized on a straight-line basis over the lesser of the estimated useful life of the asset or the lease term. Property under capital lease is amortized over the term of the respective lease or the estimated useful life of the asset, whichever is shorter.

The Company purchases physical scanner appliances and other computer equipment that are provided on a subscription basis. This equipment is recorded within property and equipment on the accompanying condensed consolidated balance sheet, and the depreciation is recorded to cost of revenues over an estimated useful life of three years.

Upon retirement or disposal, the cost of assets and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in the consolidated statements of operations. Repairs and maintenance that do not extend the life of an asset are expensed as incurred and major improvements are capitalized as property and equipment.

Impairment of Long-Lived Assets

The Company evaluates its long-lived assets, which consist of property and equipment, and intangible assets subject to amortization, for indicators of possible impairment when events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Impairment exists if the carrying amounts of such assets exceed the estimates of future undiscounted cash flows expected to be generated by such assets. Should an impairment exist, the impairment loss would be measured based on the excess carrying value of the asset over the asset’s estimated fair value. As of September 30, 2012 and December 31, 2011, the Company has not written down any of its long-lived assets as a result of impairment.

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(Unaudited)

Goodwill and Intangible Assets
Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination and is not subject to amortization. Goodwill and other intangible assets with indefinite lives are not amortized, but tested for impairment annually or if certain circumstances indicate a possible impairment may exist. These tests are performed at the reporting unit level. The Company’s operations are organized as one reporting unit.

In testing for a potential impairment of goodwill, the Company first performs a qualitative assessment of its reporting units to determine if it is more likely than not (a more than 50% likelihood) that the fair value of the reporting unit is less than its carrying amount. If the fair value is not considered to be less than the carrying amount, no further evaluation is necessary. The Company performed the annual qualitative assessment for the year ended December 31, 2011 and concluded there was no impairment of goodwill.

If the qualitative assessment indicates there is more than a 50% likelihood that the fair value is less than the carrying amount, the Company would perform a two-step test. In the first step, the carrying value of the reporting unit is compared to its estimated fair value. If the estimated fair value is less than the carrying value, then potential impairment exists. In the second step, the Company calculates the amount of any impairment by determining the implied fair value of goodwill using a hypothetical purchase price allocation, similar to that which would be applied if it were an acquisition and the purchase price was equivalent to fair value as calculated in the first step. Impairment is equivalent to any excess of goodwill carrying value over its implied fair value.

Certain other intangible assets acquired are amortized over their estimated useful lives and tested for impairment if certain circumstances indicate an impairment may exist. The Company’s intangible assets are comprised primarily of existing technology, patent license, and non-competition agreements and are amortized over periods ranging from three to fourteen years on a straight-line basis.

Software Development Costs
The Company capitalizes qualifying software costs developed or obtained for internal use. These costs generally include internal costs, such as payroll and benefits of those employees directly associated with the development of the software. Total capitalized development costs are $251,000 at September 30, 2012 and December 31, 2011. The capitalized development costs are recorded within other noncurrent assets and were fully amortized at September 30, 2012 and December 31, 2011.

Derivative Financial Instruments
Derivative financial instruments are utilized by the Company to reduce foreign currency exchange risks. The Company uses foreign currency forward contracts to mitigate the impact of foreign currency fluctuations of certain non-U.S. dollar denominated asset positions, primarily cash and accounts receivable. These contracts are recorded within prepaid expenses and other current assets in the condensed consolidated balance sheets. Gains and losses resulting from currency exchange rate movements on these forward contracts are recognized in other income (expense) in the accompanying condensed consolidated statements of operations in the period in which the exchange rates change and offset the foreign currency gains and losses on the underlying exposure being hedged. The Company does not enter into financial instruments for trading or speculative purposes.

At September 30, 2012, the Company had one outstanding forward contract with a notional amount of 7,600,000 Euros, which expired on October 31, 2012. At December 31, 2011, the Company had one outstanding forward contract with a notional amount of 3,680,000 Euros, which expired on January 31, 2012. These contracts were entered into at the end of each period, and thus the fair value of the contracts was $0 at September 30, 2012 and December 31, 2011. The Company began to use these forward contracts in December 2011. The Company recorded a loss of $362,000 and $91,000 from these contracts, which partially offset the foreign currency transaction gains of $415,000 and $49,000 during the three and nine months ended September 30, 2012, respectively. There were no gains or losses from forward contracts in the three and nine months ended September 30, 2011. These derivatives were not designated as hedges.

Stock-Based Compensation

The Company recognizes stock-based compensation expense for its employee stock options over the requisite service period for awards of equity instruments based on the grant-date fair value of those awards expected to vest. Forfeitures are estimated on the date of grant and revised if actual or expected forfeiture activity differs materially from original estimates.

Option grants to non-employees are accounted for at the fair value of the equity instrument issued, as calculated using the Black-Scholes model. The stock-based compensation expense for non-employees is subject to periodic adjustments as the options vest, and the expense is recognized over the period in which services are received.

Revenue Recognition

The Company derives revenues from subscriptions that require customers to pay a fee in order to access the Company’s cloud solutions. Customers generally enter into one year renewable subscriptions. The subscription fee entitles the customer to an unlimited number of scans for a specified number of networked devices or web applications and, if requested by a customer as part of their subscription, a specified number of physical or virtual scanner appliances. The Company’s physical and virtual scanner appliances are requested by certain customers as part of their subscriptions in order to scan IT infrastructures within their firewalls and do not function without, and are not sold separately from, subscriptions for the Company’s solutions. Customers are required to return physical scanner appliances if they do not renew their subscriptions.

The Company recognizes revenues when all of the following conditions are met:

- There is persuasive evidence of an arrangement.

- The service has been provided to the customer.

- The collection of the fees is reasonably assured.

- The amount of fees to be paid by the customer is fixed or determinable.

Subscriptions are recognized ratably over the subscription period. The Company recognizes revenues from subscriptions that include physical scanner appliances and other computer equipment ratably over the period of the subscription. Because the customer’s access to the Company’s cloud solutions are delivered at the same time as or within close proximity to the delivery of physical scanner appliances and the terms are commensurate for these services and equipment, the Company considers these elements as a single unit of accounting recognized ratably over the subscription period.

Beginning on January 1, 2011, the Company adopted authoritative accounting guidance on multiple-element arrangements, using the prospective method for all arrangements entered into or materially modified from the date of adoption. As a result of implementing this authoritative guidance, the Company's revenues for the three and nine months ended September 30, 2012 and 2011 were not materially different from what would have been recognized under the previous guidance for multiple-element arrangements. The Company does not expect that the adoption of this standard will have a significant impact on its revenue recognition in the future.

Deferred revenues consist of revenues billed or received that will be recognized in the future under subscriptions existing at the balance sheet date. The current portion of deferred revenues represents amounts that are expected to be recognized within one year of the balance sheet date.

Costs of shipping and handling charges incurred by the Company associated with physical scanner appliances and other computer equipment are included in cost of revenues.

Sales taxes and other taxes collected from customers to be remitted to government authorities are excluded from revenues.

Advertising Expenses

Advertising costs are expensed as incurred and include costs of advertising, trade show costs and promotional materials. For the three months ended September 30, 2012 and 2011, the Company incurred advertising costs of $830,000 and $1,021,000, respectively, and for the nine months ended September 30, 2012 and 2011, such costs were $2,983,000 and $2,933,000, respectively.

Income Taxes

The Company uses the asset and liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities. Deferred tax assets and liabilities are measured using statutory tax rates and laws that will be in effect when the differences are expected to reverse. A valuation allowance is established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company operates in various tax jurisdictions and is subject to audit by various tax authorities. Tax positions are based upon their technical merits, relevant tax law and the specific facts and circumstances as of each reporting period. Changes in facts and circumstances could result in material changes to the amounts recorded for such tax positions. A tax position is only recognized in the financial statements if it is "more likely than not" to be sustained based solely on its technical merits as of the reporting date. The Company considers many factors when evaluating and estimating its tax positions and tax benefits, which may require periodic adjustments that could result in recognition of additional tax benefits or additional charges to the tax provision and may not accurately reflect the actual outcomes. The Company's policy is to recognize interest and penalties relating to unrecognized tax benefits as a component of the provision for income taxes.

Other Comprehensive Income (Loss)

Other comprehensive income (loss) consists of foreign currency translation adjustments, which are reflected net of tax, that are not included in the Company's net income. Total comprehensive income includes net income and other comprehensive income (loss) and is included in the condensed consolidated statements of comprehensive income.

Qualys, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Foreign Currency Translation and Transactions
The Company's operations are conducted in various countries around the world and the financial statements of its foreign subsidiaries are reported in the applicable local foreign currencies (functional currencies). Financial information is translated from the applicable functional currency to the U.S. dollar, the reporting currency, for inclusion in the Company's condensed consolidated financial statements. Accordingly, the assets and liabilities of the Company's foreign subsidiaries are translated using exchange rates in effect as of the balance sheet date, and income and expenses are translated at average exchange rates during the period. Resulting translation adjustments are included as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit).

Foreign currency transaction gains or losses are recognized in other income (expense). The Company recorded foreign currency transaction gains (losses) of $53,000 and $(418,000) during the three months ended September 30, 2012 and 2011, respectively, and $(42,000) and $97,000 during the nine months ended September 30, 2012 and 2011, respectively.

Fair Value Measurement
Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. For certain of the Company's financial instruments, including cash, accounts receivable, accounts payable, and other current liabilities, the carrying amounts approximate their fair value due to the relatively short maturity of these balances.

The Company has an asset that is valued in accordance with the provisions of the authoritative accounting guidance that addresses fair value measurements. This guidance establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1—Valuations based on quoted prices in active markets for identical assets or liabilities.

Level 2—Valuations based on other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3—Valuations based on inputs that are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability.

At September 30, 2012 and December 31, 2011, a derivative financial instrument, consisting of a foreign currency forward contract, was valued at $0 as the contract was entered into on the last day of the period. This instrument was valued using Level 2 inputs.

Net Income Per Share Attributable to Common Stockholders
The Company computes net income attributable to common stockholders using the two-class method required for participating securities. Convertible preferred stock and common stock subject to repurchase resulting from the early exercise of stock options are considered to be participating securities since they contain non-forfeitable rights to dividends or dividend equivalents in the event the Company declares a dividend for common stock. In accordance with the two-class method, earnings allocated to these participating securities are subtracted from net income after

deducting preferred stock dividends, if any, to determine total undistributed earnings to be allocated to common stockholders. The holders of our convertible preferred stock do not have a contractual obligation to share in our net losses and such shares are excluded from the computation of basic earnings per share in periods of net loss.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Basic net income per share attributable to common stockholders is computed by dividing net income attributable to common stockholders by the weighted-average number of common shares outstanding during the period. All participating securities are excluded from basic weighted average common shares outstanding. In computing diluted net income attributable to common stockholders, undistributed earnings are reallocated to reflect the potential impact of dilutive securities. Diluted net income per share is computed by dividing net income attributable to common stockholders by the weighted-average number of shares of common stock outstanding during the period, adjusted for the effects of potentially dilutive common shares, which comprise outstanding stock options, warrants, convertible preferred stock and contingently issuable shares related to an acquisition. The dilutive potential common shares are computed using the treasury stock method or the as-if converted method, as applicable. The effects of outstanding stock options, warrants, convertible preferred stock and contingently issuable shares related to an acquisition are excluded from the computation of diluted net income per common share in periods in which the effect would be antidilutive.

Recent Accounting Pronouncements
Under the Jumpstart Our Business Startups Act (the "JOBS Act"), the Company meets the definition of an “emerging growth company.” The Company has irrevocably elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b) of the JOBS Act. As a result, the Company will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required from non-emerging growth companies.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement, which generally represents clarifications of ASC Topic 820, Fair Value Measurement, but also includes some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. ASU 2011-04 results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 should be applied prospectively and is effective for annual periods beginning after December 15, 2011. Early adoption is not permitted. The Company does not expect the adoption of ASU 2011-04 to have a material impact on its consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. This newly issued accounting standard requires an entity to disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions executed under a master netting or similar arrangement and was issued to enable users of financial statements to understand the effects or potential effects of those arrangements on its financial position. This ASU is required to be applied retrospectively and is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. As this accounting standard only requires enhanced disclosure, the adoption of this standard is not expected to have an impact the Company’s financial position or results of operations.

In July 2012, the FASB issued ASU 2012-02, Intangibles—Goodwill and Other (Topic 350)—Testing Indefinite-Lived Intangible Assets for Impairment. This standard allows entities to use a qualitative approach to test indefinite-lived intangible assets for impairment. ASU 2012-02 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not (a more than 50% likelihood) that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If the fair value is not considered to be less than the carrying amount, no further evaluation is necessary. If there is more than 50% likelihood the fair value is less than the carrying amount, it is necessary to perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 and earlier adoption is permitted. The Company does not expect the adoption of this standard to have a material impact on its consolidated financial statements.

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Reverse Stock Split
In September 2012, the Company's board of directors and stockholders approved an amendment to the Company's amended and restated certificate of incorporation effecting a one-for-ten reverse stock split of the Company's issued and outstanding shares of common and convertible preferred stock. The par value of the common and convertible preferred stock was not adjusted as a result of the reverse stock split. All issued and outstanding common stock, convertible preferred stock, warrants for convertible preferred stock, options for common stock, contingently issuable shares of common stock and per share amounts contained in the Company's condensed consolidated financial statements have been retroactively adjusted to reflect this reverse stock split for all periods presented.

NOTE 2. Restatement of Previously Issued Financial Statements

The Company has restated its condensed consolidated balance sheet as of December 31, 2011 to reflect the correction of an error in the 2010 provision for income taxes. The restatement relates to the tax benefit resulting from a reduction of the liability for uncertain tax positions upon the lapse of the statute of limitations for the 2007 tax year of its French subsidiary. The Company did not release the liability at December 31, 2010 due to an error in the determination of when the statute of limitations would expire.

The following table presents the impact of the restatement adjustment on the Company's condensed consolidated balance sheet as of December 31, 2011:

	Balance as of December 31, 2011		
	As Previously Reported (in thousands)	Effect of Restatement	As Restated
Income taxes payable, noncurrent	$1,101	$(440)	$661
Accumulated deficit - beginning of year	(78,766)	440	(78,326)
Accumulated deficit - end of year	(76,812)	440	(76,372)

This restatement did not have a net impact on the cash provided by (used in) the Company's operating, investing or financing activities for the nine months ended September 30, 2011.

The accompanying notes to condensed consolidated financial statements have been updated, as necessary, to reflect the impact of the restatement adjustment.

NOTE 3. Property and Equipment, Net

Property and equipment, which includes assets under capital lease, consists of the following:

	September 30, 2012 (in thousands)	December 31, 2011
Computer equipment	$17,144	$12,483
Computer software	5,913	5,720
Furniture, fixtures and equipment	1,438	1,330
Scanner appliances	15,894	13,394

Leasehold improvements	1,623	1,418
Total property and equipment	42,012	34,345
Less: accumulated depreciation and amortization	(25,116)	(20,484)
Property and equipment, net	$16,896	$13,861

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Assets held under capital lease included in computer equipment and software at September 30, 2012 and December 31, 2011 totaled approximately $8,053,000. The related accumulated depreciation at September 30, 2012 and December 31, 2011 totaled $4,558,000 and $3,313,000, respectively. The capital lease obligations are secured by the related equipment and software.

Physical scanner appliances and other computer equipment that are or will be subject to subscriptions by customers have a net carrying value of $4,905,000 and $3,436,000 at September 30, 2012 and December 31, 2011, respectively, including assets that have not been placed in service of $1,170,000 and $210,000, respectively. Other fixed assets not placed in service at September 30, 2012 and December 31, 2011, included in computer equipment and leasehold improvements, relate to new information technology systems and tenant improvements of approximately $1,315,000 and $500,000 respectively. Depreciation and amortization expense relating to property and equipment, including capitalized leases, was $1,739,000 and $1,121,000 for the three months ended September 30, 2012 and 2011, respectively, and $5,066,000 and $3,466,000 for the nine months ended September 30, 2012 and 2011, respectively.

NOTE 4. Business Combination

On August 31, 2010, the Company acquired Nemean Networks, LLC (“Nemean”), a company developing network security solutions for detection and awareness of external intrusions to computer networks. The Company acquired Nemean to provide additional solutions on its cloud platform. The consideration for this acquisition consisted of $3.7 million in cash and common stock, including a non-contingent payment of $1.0 million in cash and 6,250 shares of common stock, both of which occurred in September 2012. The non-contingent cash payment amount was recorded in current liabilities at December 31, 2011 at its net present value. The Company accounted for this transaction as a business combination.

In addition, the Company acquired an exclusive license to certain patents in connection with the Nemean acquisition and elected to make an annual payment of $25,000 in September 2012 to a third party in order to maintain the exclusivity of the license. This payment was recorded within prepaid expenses and other current assets and is being amortized over a one-year period. The Company has the option to make such annual payments for nine additional years.

NOTE 5. Goodwill and Intangible Assets, Net

Intangible assets consist primarily of existing technology, patent license and non-competition agreements acquired in business combinations. Acquired intangibles are amortized on a straight-line basis over the respective estimated useful lives of the assets.

The carrying values of intangible assets are as follows (in thousands):

			September 30, 2012		December 31, 2011	
	Estimated Lives	Cost	Accumulated Amortization	Net Book Value	Accumulated Amortization	Net Book Value
Existing technology	7 years	$1,910	$(568)	$1,342	$(364)	$1,546
Patent license	14 years	1,339	(199)	1,140	(127)	1,212
Non-competition agreements and other	3 years	171	(79)	92	(49)	122

Total intangibles subject to amortization	$3,420	$(846)	2,574	$(540)	2,880
Intangible assets not subject to amortization			295		295
Total intangible assets, net			$2,869		$3,175

Intangibles amortization expense was