QUALYS, INC.
Form 10-Q
May 03, 2019

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 March 31, 2019
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	77-0534145
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

919 E. Hillsdale Boulevard, 4th Floor, Foster City, California 94404
(Address of principal executive offices, including zip code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of exchange on which registered
Common stock, $0.001 par value per share	QLYS	NASDAQ Stock Market

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 x No ¨

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

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

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

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

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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 April 30, 2019 was 39,158,096.

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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)

	March 31, 2019	December 31, 2018
Assets		
Current assets:		
Cash and cash equivalents	$93,127	$41,026
Short-term marketable securities	205,009	248,140
Accounts receivable, net of allowance of $653 and $683 as of March 31, 2019 and December 31, 2018, respectively	67,863	75,825
Prepaid expenses and other current assets	16,538	13,974
Total current assets	382,537	378,965
Long-term marketable securities	96,322	76,710
Property and equipment, net	60,486	61,442
Operating leases - right of use asset	29,604	—
Deferred tax assets, net	24,653	26,387
Intangible assets, net	21,356	21,976
Goodwill	7,325	7,225
Restricted cash	1,200	1,200
Other noncurrent assets	12,658	11,775
Total assets	$636,141	$585,680
Liabilities and Stockholders' Equity		
Current liabilities :		
Accounts payable	$566	$5,588
Accrued liabilities	32,017	25,130
Deferred revenues, current	174,452	164,624
Finance lease, current	1,153	1,565
Total current liabilities	208,188	196,907
Deferred revenues, noncurrent	20,450	20,423
Operating lease liability, noncurrent	33,589	—
Other noncurrent liabilities	511	10,361
Total liabilities	262,738	227,691
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 20,000,000 shares authorized, no shares issued and outstanding at March 31, 2019 and December 31, 2018	—	—
Common stock, $0.001 par value; 1,000,000,000 shares authorized; 39,133,832 and 39,015,034 shares issued and outstanding at March 31, 2019 and December 31, 2018, respectively	39	39
Additional paid-in capital	338,566	330,572
Accumulated other comprehensive income (loss)	310	(586)
Retained earnings	34,488	27,964
Total stockholders' equity	373,403	357,989
Total liabilities and stockholders' equity	$636,141	$585,680

The accompanying notes are an integral part of these 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 March 31,	
	2019	2018
Revenues	$75,343	$64,878
Cost of revenues	17,709	15,901
Gross profit	57,634	48,977
Operating expenses:		
Research and development	15,837	12,553
Sales and marketing	17,315	16,233
General and administrative	10,431	11,785
Total operating expenses	43,583	40,571
Income from operations	14,051	8,406
Other income (expense), net:		
Interest expense	(42)	(38)
Interest income	2,051	1,090
Other income (expense), net	(223)	193
Total other income, net	1,786	1,245
Income before income taxes	15,837	9,651
Provision for income taxes	2,571	509
Net income	$13,266	$9,142
Net income per share:		
Basic	$0.34	$0.24
Diluted	$0.32	$0.22
Weighted average shares used in computing net income per share:		
Basic	39,109	38,789
Diluted	41,546	41,934

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2019	2018
Net income	$13,266	$9,142
Other comprehensive income (loss):		
Available-for-sale marketable securities:		
Change in net unrealized gain (loss) on marketable securities, net of tax	655	(407)
Reclassification adjustment for net realized gain included in net income, net of tax	28	16
Total change in unrealized gain (loss) on marketable securities, net of tax	683	(391)
Cash flow hedges:		
Change in net unrealized gain, net of tax	213	—
Other comprehensive income (loss), net of tax	896	(391)
Comprehensive income	$14,162	$8,751

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2019	2018
Cash flows from operating activities:		
Net income	$13,266	$9,142
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	7,935	7,043
Loss on disposal of property and equipment	105	7
Stock-based compensation	8,445	8,891
Amortization of premiums and accretion of discounts on marketable securities	(580)	36
Deferred income taxes	1,643	140
Changes in operating assets and liabilities:		
Accounts receivable	7,962	14,538
Prepaid expenses and other assets	(3,194)	(2,341)
Accounts payable	(1,374)	(302)
Accrued liabilities	316	4,577
Deferred revenues	9,855	2,330
Other non-current liabilities	(32)	(1,072)
Net cash provided by operating activities	44,347	42,989
Cash flows from investing activities:		
Purchases of marketable securities	(66,224)	(72,176)
Sales and maturities of marketable securities	91,046	40,080
Purchases of property and equipment	(8,608)	(5,985)
Business combinations	(850)	—
Net cash provided by (used in) investing activities	15,364	(38,081)
Cash flows from financing activities:		
Repurchase of common stock	(7,871)	(1,481)
Proceeds from exercise of stock options	4,047	7,933
Payments for taxes related to net share settlement of equity awards	(3,367)	(4,030)
Principal payments under finance lease obligations	(419)	(747)
Net cash (used in) provided by financing activities	(7,610)	1,675
Net increase in cash, cash equivalents and restricted cash	52,101	6,583
Cash, cash equivalents and restricted cash at beginning of period	42,226	87,791
Cash, cash equivalents and restricted cash at end of period	$94,327	$94,374

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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Qualys, Inc.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Unaudited)
(in thousands, except share data)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (deficit)	Total Stockholders' Equity
	Shares	Amount				
Balances at December 31, 2017	38,598,117	$ 39	$ 304,155	$ (574)	$ 39,924	$ 343,544
Adoption of revenue recognition standard	—	—	—	—	2,711	2,711
Net income	—	—	—	—	9,142	9,142
Other comprehensive loss, net of tax	—	—	—	(391)	—	(391)
Issuance of common stock upon exercise of stock options	285,997	—	7,933	—	—	7,933
Repurchase of common stock	(21,288)	—	(255)	—	(1,226)	(1,481)
Issuance of common stock upon vesting of restricted stock units	94,866	—	—	—	—	—
Taxes related to net share settlement of equity awards	—	—	(4,030)	—	—	(4,030)
Stock-based compensation	—	—	8,891	—	—	8,891
Balances at March 31, 2018	38,957,692	39	316,694	(965)	50,551	366,319

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (deficit)	Total Stockholders' Equity
	Shares	Amount				
Balances at December 31, 2018	39,015,034	$ 39	$ 330,572	$ (586)	$ 27,964	$ 357,989
Net income	—	—	—	—	13,266	13,266
Other comprehensive income, net of tax	—	—	—	896	—	896
Issuance of common stock upon exercise of stock options	152,164	—	4,047	—	—	4,047
Repurchase of common stock	(94,090)	—	(1,129)	—	(6,742)	(7,871)
Issuance of common stock upon vesting of restricted stock units	99,601	—	—	—	—	—
Taxes related to net share settlement of equity awards	(38,877)	—	(3,367)	—	—	(3,367)
Stock-based compensation	—	—	8,443	—	—	8,443
Balances at March 31, 2019	39,133,832	39	338,566	310	34,488	373,403

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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

NOTE 1. The Company and Summary of Significant Accounting Policies

Description of Business

Qualys, Inc. (the “Company”, "we", "us", "our") was incorporated in the state of Delaware on December 30, 1999. The Company is headquartered in Foster City, California and has wholly-owned subsidiaries throughout the world. The Company is a pioneer and leading provider of cloud-based 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 Qualys 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 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, 2018, 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 month period ended March 31, 2019 are not necessarily indicative of the results of operations expected for the entire year ending December 31, 2019 or for any other future annual or interim periods. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018, filed with the SEC on February 27, 2019.

Use of Estimates
The preparation of the unaudited 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 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, capitalization of internally developed software, stock-based compensation and the provision for income taxes. Actual results could differ from those estimates and such differences may be material to the accompanying unaudited condensed consolidated financial statements.

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, to date primarily cash and accounts receivable (non-designated), as well as to manage foreign currency fluctuation risk related to forecasted transactions (designated). The Company accounts for these instruments as either non-designated or cash flow hedges, respectively. Open contracts are recorded within prepaid expenses and other current assets or accrued liabilities in the consolidated balance sheets. Gains and losses resulting from currency exchange rate movements on non-designated forward contracts are recognized in other income (expense). Any gains or losses from derivatives designated as cash flow hedges are first accumulated in other comprehensive income (AOCI) and then reclassified to revenue when the hedged item impacts the consolidated financial statements.

The cash flow effects of the Company's derivative contracts for the three months ended March 31, 2019 were included within net cash provided by operating activities on its condensed consolidated statements of cash flows. The Company had notional amounts on foreign currency exchange contracts designated as cash flow hedges outstanding of €17.7 million and £8.0 million as of March 31, 2019. The unrealized foreign exchange losses on these contracts were recorded in AOCI and are insignificant. The Company has no hedges designated as cash flow hedges in the prior year's quarter ending March 31, 2018.

Stock-Based Compensation

The Company recognizes the fair value of its employee stock options and restricted stock units (RSUs) over the requisite service period for those awards ultimately expected to vest. The fair value of each option is estimated on date of grant using the Black-Scholes-Merton option pricing model and the fair value of each restricted stock unit is based on the fair value of the Company's stock on the date of grant. 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-Merton option-pricing model and the expense is recognized over the vesting periods of the options. The value of options granted to non-employees is re-measured as they vest over a performance period.

The Company has performance-based awards and accounts for these awards as share-based compensation with multiple performance conditions. The Company assesses these conditions on a quarterly basis and for the three months ended March 31, 2019, the Company recorded approximately $0.3 million of stock-based compensation cost for these awards.

For performance-based vesting RSUs, the Company records compensation expense for only the performance milestones that are probable of being achieved, with such expense recorded on a straight-line basis over the expected vesting period. The Company reassesses performance-based estimates each reporting period and, if the estimated service period changes, the Company recognizes all remaining compensation expense over the remaining service period and, if the probability of achievement changes to or from “probable,” the Company recognizes the cumulative effect.

Internally Developed Software Costs

The Company capitalizes certain costs incurred to develop new internal-use software. Capitalized costs include salaries, benefits, and stock-based compensation charges for employees that are directly involved in developing its cloud security platform during the application development stage. These capitalized costs are included in other noncurrent assets on the accompanying condensed consolidated balance sheets. Such costs are amortized on a straight-line basis over its estimated useful life of three years. Amortization of internally developed software is recorded to cost of revenues. Capitalization of internally developed software cost was $0.2 million for the three months ended March 31, 2019. Unamortized cost for capitalized internally developed software was $1.4 million at March 31, 2019 and $1.2 million at December 31, 2018. Amortization expense for capitalized internally developed software was insignificant for the three months ended March 31, 2019. Management evaluates the useful lives of these assets on an annual basis and tests for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets.

Cost Method Investments

In the second quarter of fiscal 2018, the Company invested $2.5 million in a privately-held company. The Company used the cost method of accounting to account for the investment because the Company does not hold a controlling interest in this entity and does not have the ability to exercise significant influence over the entity's operating and financial policies. The investment is included in long term assets on the accompanying condensed consolidated balance sheets. The Company's cost method investment is assessed for impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. The Company has not recorded any dividends or other-than-temporary impairment charges related to its cost method investment. The fair value of the investment is not readily available, and there are no quoted market prices for the investment.

Recently Adopted Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires lessees to recognize all leases, including operating leases, on the balance sheet as a lease asset and lease liability, unless the lease is a short-term lease. ASU 2016-02 also requires additional disclosures regarding leasing arrangements. ASU 2016-02 is effective for the Company beginning in the first quarter of fiscal 2019 and early adoption is permitted. In July 2018, the FASB issued ASU 2018-11, Targeted Improvements - Leases (Topic 842). This update provides an optional transition method that allows entities to elect to apply the standard prospectively at its effective date, versus recasting the prior periods presented. If elected, an entity would recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Pursuant to the leasing criteria, most of the Company's leased space and equipment leases will be required to be accounted for as right-of-use assets on the balance sheet with offsetting financing obligations. In the statement of operations, what was formerly rent expense for operating leases will be lease expense; and finance leases will be bifurcated into amortization of right-of-use assets and interest on lease liabilities. The Company adopted the ASU utilizing the current period adjustment method on January 1, 2019, and recognized an ROU asset of $30.8 million and a lease liability of $41.6 million on its condensed consolidated financial statements. As of December 31, 2018, $3.9 million of deferred rent and $6.9 million related to tenant improvement allowance was removed upon adoption. As part of this adoption, the Company elected the package of transitional practical expedients to not reassess (1) whether any contracts that existed prior to adoption have or contain leases, (2) the classification of existing leases or (3) initial direct costs for existing leases.
In February 2018, the FASB issued ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (AOCI). This ASU eliminates the stranded tax effects in other comprehensive income resulting from the Tax Cuts and Jobs Act (the "2017 Tax Act”). Because the amendments only relate to the reclassification of the income tax effects of the 2017 Tax Act, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. The Company adopted ASU 2018-02 in the fourth quarter of 2018. The adoption of this ASU did not have an impact on the Company's condensed consolidated financial statements.
In June 2018, the FASB issued ASU 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. This ASU expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The Company adopted this guidance during the three months ended March 31, 2019. The adoption of this ASU did not have a material impact on the Company's condensed consolidated financial statements.
In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment (Topic 350). This standard eliminates Step 2 from the goodwill impairment test, instead requiring an entity to recognize a goodwill impairment charge for the amount by which the goodwill carrying amount exceeds the reporting unit’s fair value. This ASU is effective for interim and annual goodwill impairment tests in fiscal years beginning after December 15, 2019 with early adoption permitted. This ASU must be applied on a prospective basis. The Company has adopted this ASU during the three months ended March 31, 2019 and the adoption did not have a material impact on the Company's condensed consolidated financial statements.
Recently Issued Accounting Pronouncements Not Yet Adopted

In August 2018, the FASB issued ASU 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a

Service Contract. This ASU aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs related to internal-use software. ASU 2018-15 is effective for the Company beginning in the first quarter of fiscal 2020 and early adoption is permitted. The Company is currently evaluating the impact of this ASU on its condensed consolidated financial statements.

NOTE 2. Fair Value of Financial Instruments

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 certain cash equivalents, accounts receivable, accounts payable, and other current liabilities, the carrying amounts approximate their fair values due to the relatively short maturity of these balances.

The Company measures and reports certain cash equivalents, marketable securities, derivative foreign currency forward contracts and commitments associated with prior business combinations at fair value 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.

The Company's financial instruments consist of assets and liabilities measured using Level 1 and 2 inputs. Level 1 assets include a highly liquid money market fund, which is valued using unadjusted quoted prices that are available in an active market for an identical asset. Level 2 assets include fixed-income U.S. government agency securities, commercial paper, corporate bonds, asset-backed securities and derivative financial instruments consisting of foreign currency forward contracts. The securities, bonds and commercial paper are valued using prices from independent pricing services based on quoted prices in active markets for similar instruments or on industry models using data inputs such as interest rates and prices that can be directly observed or corroborated in active markets. The foreign currency forward contracts are valued using observable inputs, such as quotations on forward foreign exchange points and foreign interest rates. The estimated fair value of commitments from prior acquisitions are determined based on management’s estimate of fair value using a Monte Carlo simulation model, which uses Level 3 inputs for fair value measurements. During the quarter ended March 31, 2019, management estimated the fair value of such commitments to be zero.

The Company's cash and cash equivalents, and marketable securities consist of the following:

	March 31, 2019			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$93,070	$ —	$ —	$93,070
Money market funds	57	—	—	57
Total	93,127	—	—	93,127
Short-term marketable securities:				
Corporate bonds	38,990	—	(77)	38,913
Asset-backed securities	9,868	—	—	9,868
U.S. government agencies	156,216	39	(27)	156,228
Total	205,074	39	(104)	205,009
Long-term marketable securities:				
Asset-backed securities	37,588	79	(4)	37,663
U.S. government agencies	31,212	139	(19)	31,332
Corporate bonds	27,279	86	(38)	27,327
Total	96,079	304	(61)	96,322
Total	$394,280	$ 343	$ (165)	$394,458

	December 31, 2018			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$40,913	$ —	$ —	$40,913
Money market funds	113	—	—	113
Total	41,026	—	—	41,026
Short-term marketable securities:				
Commercial paper	3,237	—	—	3,237
Corporate bonds	30,906	—	(84)	30,822
Asset-backed securities	10,447	—	(15)	10,432
U.S. government agencies	203,734	9	(94)	203,649
Total	248,324	9	(193)	248,140
Long-term marketable securities:				
Asset-backed securities	22,945	10	(28)	22,927
U.S. government agencies	18,804	—	(53)	18,751
Corporate bonds	35,322	3	(293)	35,032
Total	77,071	13	(374)	76,710
Total	$366,421	$ 22	$ (567)	$365,876

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

The following table shows the changes to accumulated other comprehensive loss for the three months ended March 31, 2019 (in thousands):

	Unrealized (Loss) Gain, net
Balance at December 31, 2018	$ (545)
Change in net unrealized loss on available-for-sale marketable securities, net of tax	655
Amounts reclassified for net realized gain included in net income, net of tax	28
Other comprehensive income, net of tax	683
Balance at March 31, 2019	$ 138

The following table sets forth by level within the fair value hierarchy the fair value of the Company's available-for-sale marketable securities measured on a recurring basis, excluding cash and money market funds:

	March 31, 2019			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
U.S. government agencies	—	187,560	—	187,560
Corporate bonds	—	66,240	—	66,240
Asset-backed securities	—	47,531	—	47,531
Total	$—	$301,331	$ —	$301,331

	December 31, 2018			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$—	$3,237	$ —	$3,237
U.S. government agencies	—	222,400	—	222,400
Corporate bonds	—	65,854	—	65,854
Asset-backed securities	—	33,359	—	33,359
Total	$—	$324,850	$ —	$324,850

There were no transfers between Level 1, Level 2 or Level 3 of the fair value hierarchy, as determined at the end of each reporting period.

The following summarizes the fair value of marketable securities classified as available-for-sale by contractual, or effective, maturity:

March 31, 2019			
Mature within One Year	Mature after One Year	Mature over Two Years	Fair Value

		through Two Years		
	(in thousands)			
U.S. government agencies	156,228	16,736	14,596	187,560
Corporate bonds	38,913	24,825	2,502	66,240
Asset-backed securities	29,336	8,439	9,756	47,531
Total	$224,477	$50,000	$26,854	$301,331

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, to date primarily cash and accounts receivable (non-designated), as well as to manage foreign currency fluctuation risk related to forecasted transactions (designated).

At March 31, 2019, the Company had eight outstanding forward contracts with notional amounts of €13.0 million and £5.4 million, respectively. These contracts did not meet the criteria to be designated as cash flow hedges and were valued using Level 2 inputs.

At March 31, 2019, the Company had 24 open contracts with notional amounts that were designated as cash flow hedges of €17.7 million and £8.0 million, respectively. The unrealized FX gains on these contracts were recorded in AOCI for $0.2 million, net of tax.

At December 31, 2018, the Company had two outstanding non-designated forward contracts with notional amounts of €16.0 million and £6.3 million, respectively, both with the expiry date of January 31, 2019.

At December 31, 2018, the Company had two outstanding forward contracts with notional amounts of €12.9 million and £4.1 million, respectively. These derivatives met the criteria to be designated as cash flow hedges and were valued using Level 2 inputs. The unrealized foreign currency losses on these contracts were recorded in AOCI and were insignificant.

The following summarizes the gains (losses) recognized in other income (expense), net on the condensed consolidated statement of operations, from forward contracts and other foreign currency transactions:

	Three Months Ended March 31,	
	2019	2018
	(in thousands)	
Net loss from forward contracts	$(331)	$(578)
Other foreign currency transactions gain	171	810
Total foreign exchange loss, net	$(160)	$232

NOTE 3. Property and Equipment, Net

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

	March 31,	December 31,
	2019	2018
	(in thousands)	
Computer equipment	$98,537	$ 93,530
Computer software	26,041	26,030
Furniture, fixtures and equipment	5,907	5,814
Finance leases - right of use asset	3,503	3,503
Scanner appliances	15,665	15,356

Leasehold improvements	16,469	16,439
Total property and equipment	166,122	160,672
Less: accumulated depreciation and amortization	(105,636)	(99,230)
Property and equipment, net	$60,486	$ 61,442

Physical scanner appliances and other computer equipment have a net carrying value of $7.5 million and $7.9 million at March 31, 2019 and December 31, 2018, respectively, including assets that have not been placed in service

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of $1.2 million and $1.8 million, respectively. Depreciation and amortization expense relating to property and equipment, including capitalized leases, was $6.4 million and $6.4 million for the three months ended March 31, 2019 and 2018, respectively. Accumulated depreciation under finance leases was $1.3 million at March 31, 2019.

NOTE 4. Revenue from Contracts with Customers

The Company's performance obligation is typically satisfied ratably over the subscription term as its cloud-based offerings are delivered to customers electronically and over time. In addition, the Company recognizes revenues for certain limited scan arrangements on an as-used basis. The Company recognizes revenue related to the professional services based on time and materials or completion of milestones stated in the contracts.

As the vast majority of the Company’s offerings are subscription based, the Company rarely needs to allocate the transaction price to all separate performance obligations. For contracts that include scanners and PCPs, the Company recognizes revenue in proportion to the standalone selling prices ("SSP") of the underlying services at contract inception. If an SSP is not directly observable, the Company determines the SSP using information that may include market conditions and other observable inputs. The Company's transaction prices typically do not include variable consideration and are a fixed amount for a specific period of time, and the majority of contracts are twelve months with certain customers signing longer term deals. In general, the Company does not offer rights of return, performance bonuses, customer loyalty programs, payments via non-cash methods, refunds, volume rebates, incentive payments, penalties, price concessions or payments or discounts contingent on future events and the Company does not grant its customers any material rights.

Costs of shipping and handling charges 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.

Incremental direct costs of obtaining a contract, which consist of sales commissions primarily for new business and upsells, are deferred and amortized over the estimated life of the customer relationship if renewals are expected and the renewal commission is not commensurate with the initial commission. The Company amortizes the capitalized commission cost as a selling expense on a straight-line basis over a period of five years. The Company classifies deferred commissions as current or noncurrent based on the timing of when it expects to recognize the expense. The current and noncurrent portions of deferred commissions are included in prepaid expenses and other current assets and other noncurrent assets, respectively, in its condensed consolidated balance sheets.

Commission asset balances are as follows (in thousands):

	March 31, 2019	December 31, 2018
Commission asset, current	$ 1,691	$ 1,480
Commission asset, noncurrent	$ 5,087	$ 4,692

For the three months ended March 31, 2019 and 2018, the Company recognized $0.4 million and $0.2 million, respectively, of commission expense from amortization of its commission assets. During the same periods, there was no impairment loss related to capitalized costs.
The Company records deferred revenue when cash payments are received or due in advance of its performance offset by revenue recognized in the period. $64.2 million and $55.6 million of revenue was recognized during the three months ended March 31, 2019 and 2018, respectively, which amounts were included in the unearned revenue balances as of December 31, 2018 and 2017, respectively.

Accounts receivable, net, consists of the following (in thousands):

	March 31, 2019	December 31, 2018
Accounts receivable	$ 68,516	$ 76,508
Less: allowance for doubtful accounts	(653)	(683)
Total accounts receivable, net	$ 67,863	$ 75,825

The Company's payment terms vary by the type and location of its customer and the products or services offered. The term between invoicing and when payment is due is not significant. For certain products or services and customer types, the Company requires payment before the products or services are delivered to the customer.

The following table sets forth the expected revenue from all remaining performance obligations as of March 31, 2019 (in thousands):

	Total Expected Revenue
2019 (nine months remaining)	$46,413
2020	35,226
2021	15,727
2022	2,098
2023	902
2024 and thereafter	123
Total	$100,489

Revenues allocated to remaining performance obligations represents contracted revenues that have not yet been recognized, which include deferred revenue from open contracts and the amounts that will be invoiced and recognized as revenues in future periods. Remaining performance obligations represent the transaction price of noncancelable orders for which service has not been performed and excludes unexercised renewals. The Company applied the short-term contract exemption to exclude the remaining performance obligations that are part of a contract that has an original expected duration of one year or less.

From time to time, the Company enters into contracts with customers that extend beyond one year, with certain of its customers electing to pay for more than one year of services upon contract execution. For any discounts associated with these multiple year contracts, the Company concluded that its contracts did not contain a financing component.

Revenues by sales channel are as follows (in thousands):

	Three Months Ended March 31,	
	2019	2018
Direct	$43,039	$38,710
Partner	32,304	26,168
Total	$75,343	$64,878

The Company utilizes partners to enable and accelerate the adoption of its cloud platform by increasing its distribution capabilities and market awareness of its cloud platform as well as by targeting geographic regions outside the reach of its direct sales force. The Company's channel partners maintain relationships with their customers throughout the territories in which they operate and provide their customers with services and third-party solutions to help meet those customers’ evolving security and compliance requirements. As such, these partners may offer the Company's IT security and compliance solutions in conjunction with one or more of their own products or services and act as a conduit through which the Company can connect with these prospective customers to offer its solutions. For sales involving a channel partner, the channel partner engages with the prospective customer directly and involves the Company's sales team as needed to assist in developing and closing an order. When a channel partner secures a sale, the Company sells the associated subscription to the channel partner who in turn resells the subscription to the customer. Sales to channel partners are made at a discount and revenues are recorded at this discounted price over the subscription terms. The Company does not have any influence or specific knowledge of its partners' selling terms with their customers. See Note 12, "Segment Information and Information about Geographic Area" for disaggregation of revenue by geographic area.

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NOTE 5. Business Combination

On January 10, 2019, the Company acquired the assets of Adya, Inc. ("Adya"), an India-based company. The acquisition included a cloud application management platform, which enables security and compliance audits of SaaS applications.

Total purchase consideration was $1.0 million, including $0.2 million of deferred consideration due eighteen months from the closing date of the acquisition, subject to potential adjustment from possible indemnity claims. Pro forma financial information for this acquisition has not been presented because it is not material to the Company's condensed consolidated financial statements.

The Company accounted for this transaction as a business combination and allocated $0.9 million of the purchase price to technology-based intangible assets and $0.1 million to goodwill. The acquired intangible assets relating to Adya's developed technology are being amortized over the estimated useful lives of approximately four years. Goodwill arising from the Adya acquisition is deductible for tax purposes over 15 years.

NOTE 6. Goodwill and Intangible Assets, Net

Intangible assets consist primarily of developed technology and patent licenses from 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, except for years):

				March 31, 2019	
	Weighted Average Life (Years)	Weighted Average Remaining Life (Years)	Cost	Accumulated Amortization	Net Book Value
Developed technology	5 years	3.5	$26,356	$(5,580)	$20,776
Patent licenses	14 years	5.4	1,387	(847)	540
Total intangibles subject to amortization			$27,743	$(6,427)	21,316
Intangible assets not subject to amortization					40
Total intangible assets, net					$21,356

				December 31, 2018	
	Weighted Average Life (Years)	Weighted Average Remaining Life (Years)	Cost	Accumulated Amortization	Net Book Value
Developed technology	5 years	3.8	$25,456	$(4,085)	$21,371
Patent Licenses	14 years	5.9	1,387	(822)	565
Total intangibles subject to amortization			$26,843	$(4,907)	21,936
					40

Intangible assets not subject to amortization	
Total intangible assets, net	$21,976

Intangible asset amortization expense was $1.5 million and $0.6 million for the three months ended March 31, 2019 and 2018, respectively.

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As of March 31, 2019, the Company expects amortization expense in future periods to be as follows (in thousands):

2019 (remaining nine months)	$	4,561
2020	6,081	
2021	6,081	
2022	4,427	
2023	100	
2024 and thereafter	66	
Total expected future amortization expense	$	21,316

Goodwill, which is not subject to amortization, totaled $7.3 million and $7.2 million as of March 31, 2019 and December 31, 2018, respectively.

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NOTE 7. Leases

On January 1, 2019, the Company adopted ASU No. 2016-02, “Leases (Topic 842),” which requires leases with durations greater than twelve months to be recognized on the balance sheet. We adopted the standard using the current period adjustment method with an effective date of January 1, 2019. Prior year financial statements were not restated under the new standard and, therefore, those amounts are not presented below. For both operating and finance leases, we recognize a right-of-use asset, which represents our right to use the underlying asset for the lease term, and a lease liability, which represents the present value of our obligation to make payments arising over the lease term. The present value of the lease payments is calculated using the incremental borrowing rate for operating and finance leases. The incremental borrowing rate is determined using a portfolio approach based on the rate of interest that the Company would have to pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term.

Where the Company is the lessee, we have elected to account for non-lease components associated with our leases (e.g., common area maintenance costs) and lease components separately for substantially all of our asset classes. In arrangements where we are the lessor, we have customer premise equipment for which we apply the lease and non-lease component practical expedient and account for non-lease component practical expedient and account for non-lease components (e.g., service revenue) and lease components as combined components under the revenue recognition guidance in ASU 2014-09, "Revenue from Contracts with Customers" (Topic 606) as the service revenues are the predominant components in the arrangements.

We lease property and equipment under finance and operating leases. For leases with terms greater than 12 months, we record the related asset and obligation at the present value of lease payments over the term. Many of our leases include rental escalation clauses, renewal options and/or termination options that are factored into our determination of lease payments when appropriate.

When available, we use the rate implicit in the lease to discount lease payments to present value; however, most of our leases do not provide a readily determinable implicit rate. Therefore, we must estimate our incremental borrowing rate to discount the lease payments based on information available at lease commencement.

The table below presents the lease-related assets and liabilities recorded on the balance sheet.

(in thousands)	Classification on the Balance Sheet	March 31, 2019
Assets		
Operating lease assets	Operating lease - right of use asset	$29,604
Finance lease assets	Property and equipment, net	2,175
Total lease assets		$31,779
Liabilities		
Current		
Operating	Accrued liabilities	$6,760
Finance	Finance lease, current	1,153
Noncurrent		
Operating	Operating lease liability, noncurrent	33,589

Finance	Other noncurrent liabilities	148
Total lease liabilities		$41,650

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The Company leases certain computer equipment and its corporate office and data center facilities under non-cancelable operating leases for varying periods through 2028. In January 2018, the Company entered into a $3.5 million financing arrangement for data center storage equipment, accounted for as a finance lease, with an implied interest rate of 5%.

The following are the minimum annual lease payments due under these leases at March 31, 2019 (in thousands):

	Operating Leases	Finance Leases
	(in thousands)	
2019 (remaining nine months)	$6,601	$1,328
2020	7,819	130
2021	6,124	54
2022	4,542	—
2023	4,298	—
2024 and thereafter	19,299	—
Total minimum lease payments	48,683	1,512
Less: amount representing interest	(8,334)	(211)
Present value of minimum payments	40,349	1,301
Less: current portion	(6,760)	(1,153)
Lease obligations, noncurrent	$33,589	$148

Lease expense was $1.6 million and $2.2 million for the three months ended March 31, 2019 and 2018, respectively. The weighted average remaining lease term and the weighted average discount rate of our leases were as follows:

	March 31, 2019
Weighted average remaining lease term (years)	
Operating leases	8
Finance leases	2
Weighted average discount rates	
Operating leases	4.5 %
Finance leases	5.0 %

NOTE 8. Commitments and Contingencies

Indemnifications

The Company from time to time enters into certain types of contracts that contingently require it to indemnify various parties against claims from third parties. These contracts primarily relate to (i) the Company's by-laws, under which it must indemnify directors and executive officers, and may indemnify other officers and employees, for liabilities arising out of their relationship, (ii) contracts under which the Company must indemnify directors and certain officers for liabilities arising out of their relationship, and (iii) contracts under which the Company may be required to indemnify customers or resellers from certain liabilities arising from potential infringement of intellectual property rights, as well as potential damages caused by limited product defects. To date, the Company has not incurred and has not recorded any liability in connection with such indemnifications.

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The Company maintains director and officer insurance, which may cover certain liabilities arising from its obligation to indemnify its directors.

NOTE 9. Stock-based Compensation

Equity Incentive Plans
2012 Equity Incentive Plan

Under the 2012 Equity Incentive Plan (the "2012 Plan"), the Company is authorized to grant to eligible participants incentive stock options (“ISOs”), non-statutory stock options (“NSOs”), stock appreciation rights ("SARs"), restricted stock awards ("RSAs"), restricted stock units ("RSUs"), performance units and performance shares equivalent to up to 11,791,179 shares of common stock as of March 31, 2019. Options may be granted with an exercise price that is at least equal to the fair market value of the Company's stock at the date of grant and are exercisable when vested. As of March 31, 2019, 3,827,360 shares were available for grant under the 2012 Plan.

2000 Equity Incentive Plan

Under the 2000 Equity Incentive Plan (the "2000 Plan"), the Company was authorized to grant to eligible participants either ISOs or NSOs. The 2000 Plan was terminated in connection with the closing of the Company's initial public offering, and accordingly, no shares are currently available for grant under the 2000 Plan. The 2000 Plan continues to govern outstanding awards granted thereunder.

Stock-based Compensation

The following table shows a summary of the stock-based compensation expense included in the condensed consolidated statements of operations for the three months ended March 31, 2019 and 2018:

	Three Months Ended March 31,	
	2019	2018
	(in thousands)	
Cost of revenues	$545	$654
Research and development	2,340	1,841
Sales and marketing	1,068	1,401
General and administrative	4,492	4,995
Total stock-based compensation	$8,445	$8,891

As of March 31, 2019, the Company had $13.9 million of total unrecognized stock-based compensation cost related to unvested options that it expects to recognize over a weighted-average period of 2.1 years, and $52.6 million of unrecognized stock-based compensation cost related to unvested awards that it expects to recognize over a weighted-average period of 2.6 years. Compensation cost is recognized on a straight-line basis over the service period. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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Stock Option Plan Activity

A summary of the Company's stock option activity is as follows:

	Outstanding Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
Balance as of December 31, 2018	3,429,309	$ 31.79	6.4	$ 149,935
Granted	103,275	$ 94.45		
Exercised	(152,164)	$ 26.59		
Canceled	(33,355)	$ 50.49		
Balance as of March 31, 2019	3,347,065	$ 33.77	6.3	$ 166,381
Vested and expected to vest - March 31, 2019	3,160,808	$ 31.89	6.1	$ 162,480
Exercisable - March 31, 2019	2,446,532	$ 25.76	5.6	$ 139,401

Restricted Stock

A summary of the Company's RSU activity is as follows:

	Outstanding RSUs	Weighted Average Grant Date Fair Value Per Share
Balance as of December 31, 2018	1,226,883	$ 55.71
Granted	124,857	$ 79.69
Vested	(99,601)	$ 47.71
Canceled	(53,272)	$ 56.56
Balance as of March 31, 2019	1,198,867	$ 58.83
Outstanding and expected to vest - March 31, 2019	883,174	$ 57.74

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NOTE 10. Net Income Per Share

The computations for basic and diluted net income per share are as follows:

	Three Months Ended March 31,	
	2019	2018
	(in thousands, except per share data)	
Numerator:		
Net income	$13,266	$9,142
Denominator:		
Weighted-average shares used in computing net income per share:		
Basic	39,109	38,789
Effect of potentially dilutive securities:		
Common stock options	1,970	2,503
Restricted stock units	467	642
Diluted	41,546	41,934
Net income per share:		
Basic	$0.34	$0.24
Diluted	$0.32	$0.22

Potentially dilutive securities not included in the calculation of diluted net income per share because doing so would be antidilutive are as follows:

	Three Months Ended March 31,	
	2019	2018
	(in thousands)	
Common stock options	343	109
Restricted stock units	38	—
	381	109

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NOTE 11. Stockholder's Equity

Share Repurchase Program

On February 5, 2018, the Company's board of directors authorized a $100.0 million share repurchase program, which was announced on February 12, 2018. On October 30, 2018, the Company announced that the board of directors had authorized an increase of $100.0 million to the original share repurchase program authorization. Share repurchases may be effected from time to time through open market purchases or pursuant to a Rule 10b5-1 plan until October 30, 2020. Repurchased shares are retired and reclassified as authorized and unissued shares of common stock. On retirement of the repurchased shares, common stock is reduced by an amount equal to the number of shares being retired multiplied by the par value. The excess of the cost of treasury stock that is retired over its par value is first allocated as a reduction to additional paid-in capital based on the initial public offering price of the stock, with the remaining excess to retained earnings.

During the three months ended March 31, 2019, the Company repurchased 94,090 shares of its common stock for approximately $7.9 million. During the three months ended March 31, 2018, the Company repurchased 21,288 shares of its common stock for approximately $1.5 million. All share repurchases were made using cash resources. As of March 31, 2019, approximately $107.1 million remained available for share repurchases pursuant to the share repurchase program.

NOTE 12. Income Taxes

The Company's provision for income taxes for interim periods is determined using an estimate of its annual effective tax rate, adjusted for discrete items, if any, that arise during the period. Each quarter, the Company updates its estimate of the annual effective tax rate, and if the estimated annual effective tax rate changes, the Company makes a cumulative adjustment in such period.

The Company's quarterly tax provision, and estimate of its annual effective tax rate, is subject to variation due to several factors, including variability in pre-tax income (or loss), the mix of jurisdictions to which such income relates, changes in how the Company does business, and tax law developments. The Company's estimated effective tax rate for the year differs from the U.S. statutory rate of 21% primarily due to non-deductible stock-based compensation expense, state taxes, foreign income subject to different tax rates than the U.S., and the benefit of U.S. federal income tax credits.

The Company recorded an income tax provision of $2.6 million and income tax provision of $0.5 million for the three months ended March 31, 2019 and 2018, respectively, resulting in an effective tax rate of 16.2% and 5.3%, respectively. The tax provision for the three months ended March 31, 2019 as compared to the tax provision for the three months ended March 31, 2018 changed primarily due to an increase in pre-tax income and decrease in the tax benefit of excess stock-based compensation deductions.

As of March 31, 2019, the Company had unrecognized tax benefits of $6.9 million, of which $3.8 million, if recognized, would favorably impact the Company's effective tax rate. As of December 31, 2018, the Company had unrecognized tax benefits of $6.4 million, of which $3.5 million, if recognized, would favorably impact the Company's effective tax rate. The Company does not anticipate a material change in its unrecognized tax benefits in the next 12 months.

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NOTE 13. Segment Information and Information about Geographic Area

The Company operates in one segment. The Company determines its reportable operating segments in accordance with the provisions in the FASB guidance on segment reporting, which establishes standards for, and requires disclosure of, certain financial information related to reportable operating segments and geographic regions. The Company's chief operating decision maker is the Chairman, President and Chief Executive Officer, who makes operating decisions, assesses performance and allocates resources on a consolidated basis. All of the Company's principal operations and decision-making functions are located in the United States.

Revenues by geographic area, based on the location of the customer, are as follows (in thousands):

	Three Month Ended March 31,	
	2019	2018
United States	$48,621	$44,314
Foreign	26,722	20,564
Total	$75,343	$64,878

Property and equipment, net, by geographic area, are as follows:

	March 31, 2019	December 31, 2018
	(in thousands)	
United States	$57,810	$ 59,222
Foreign	2,676	2,220
Total property and equipment, net	$60,486	