QUALYS, INC.
Form 10-Q
August 03, 2017
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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 June 30, 2017
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)

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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, 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	(Do not check if a smaller reporting company)	
		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

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 July 31, 2017 was 37,521,887.

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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)

	June 30, 2017	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$130,572	$86,737
Short-term investments	148,290	157,119
Accounts receivable, net of allowance of $687 and $702 as of June 30, 2017 and December 31, 2016, respectively	46,359	47,024
Prepaid expenses and other current assets	19,055	9,808
Total current assets	344,276	300,688
Long-term investments	45,003	45,725
Property and equipment, net	42,768	39,401
Deferred tax assets, net	35,622	16,590
Intangible assets, net	801	987
Goodwill	317	317
Restricted cash	1,200	1,200
Other noncurrent assets	1,959	2,096
Total assets	$471,946	$407,004
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$1,924	$2,051
Accrued liabilities	13,836	13,317
Deferred revenues, current	124,738	114,964
Total current liabilities	140,498	130,332
Deferred revenues, noncurrent	16,701	15,528
Other noncurrent liabilities	8,685	2,731
Total liabilities	165,884	148,591
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 20,000,000 shares authorized, no shares issued and outstanding at June 30, 2017 and December 31, 2016	—	—
Common stock, $0.001 par value; 1,000,000,000 shares authorized; 37,501,697 and 35,841,001 shares issued and outstanding at June 30, 2017 and December 31, 2016	38	36
Additional paid-in capital	277,020	266,794
Accumulated other comprehensive loss	(235)	(156)
Retained Earnings (Accumulated deficit)	29,239	(8,261)
Total stockholders' equity	306,062	258,413
Total liabilities and stockholders' equity	$471,946	$407,004

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		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Revenues	$55,302	$48,466	$108,423	$94,714
Cost of revenues	12,153	10,260	24,447	19,811
Gross profit	43,149	38,206	83,976	74,903
Operating expenses:				
Research and development	10,525	9,488	20,348	17,597
Sales and marketing	15,383	14,728	31,397	28,895
General and administrative	8,232	8,278	15,566	15,102
Total operating expenses	34,140	32,494	67,311	61,594
Income from operations	9,009	5,712	16,665	13,309
Other income (expense), net:				
Interest expense	(1)	(1)	(3)	(14)
Interest income	541	290	1,022	540
Other expense, net	(180)	(249)	(206)	(318)
Total other income (expense), net	360	40	813	208
Income before income taxes	9,369	5,752	17,478	13,517
(Benefit from) provision for income taxes	2,167	2,214	(11,654)	5,196
Net income	$7,202	$3,538	$29,132	$8,321
Net income per share:				
Basic	$0.19	$0.10	$0.79	$0.24
Diluted	$0.18	$0.09	$0.74	$0.22
Weighted average shares used in computing net income per share:				
Basic	37,277	35,120	36,887	34,869
Diluted	39,535	38,143	39,207	37,988

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 June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income	$7,202	$3,538	$29,132	$8,321
Change in foreign currency translation loss, net of zero tax	—	—	—	—
Available-for-sale investments:				
Change in net unrealized gain (loss) on investments, net of tax	(29)	80	(80)	273
Less: reclassification adjustment for net realized gain included in net income	20	2	2	50
Net change, net of tax	(9)	82	(78)	323
Other comprehensive income (loss), net	(9)	82	(78)	323
Comprehensive income	$7,193	$3,620	$29,054	$8,644

See accompanying Notes to Condensed Consolidated Financial Statements

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

	Six Months Ended June 30, 2017	2016
Cash flows from operating activities:		
Net income	$29,132	$8,321
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	9,783	7,828
Bad debt expense	296	106
Loss on disposal of property and equipment	2	39
Stock-based compensation	10,779	10,019
Amortization of premiums and accretion of discounts on investments	850	390
Excess tax benefits from stock-based compensation	—	(3,713)
Deferred income taxes	(20,897)	(85)
Excess tax benefits included in deferred tax assets	8,368	—
Changes in operating assets and liabilities:		
Accounts receivable	369	1,833
Prepaid expenses and other assets	(1,067)	(83)
Accounts payable	(206)	(2)
Accrued liabilities	109	4,886
Deferred revenues	10,947	4,237
Other non-current liabilities	477	685
Net cash provided by operating activities	48,942	34,461
Cash flows from investing activities:		
Purchases of investments	(102,665)	(87,364)
Sales and maturities of investments	111,288	75,156
Purchases of property and equipment	(13,179)	(8,966)
Net cash used in investing activities	(4,556)	(21,174)
Cash flows from financing activities:		
Proceeds from exercise of stock options	14,603	9,496
Excess tax benefits from stock-based compensation	—	3,713
Payments for taxes related to net share settlement of equity awards	(15,154)	—
Net cash (used in) provided by financing activities	(551)	13,209
Net increase in cash and cash equivalents	43,835	26,496
Cash and cash equivalents at beginning of period	86,737	91,698
Cash and cash equivalents at end of period	$130,572	$118,194
Supplemental cash flow disclosures:		
Purchases of property and equipment recorded in accounts payable and accrued liabilities	$1,193	$7,379
Cash paid for income taxes	$540	$631
Not yet received tenant allowance recorded in other assets, accrued liabilities and other non-current liabilities	$8,076	$—

See accompanying Notes to 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") 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-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 by the Company 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, 2016, 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 six month periods ended June 30, 2017 are not necessarily indicative of the results of operations expected for the entire year ending December 31, 2017 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 Annual Report on Form 10-K for the year ended December 31, 2016, filed with the SEC on February 24, 2017.

Reclassification

The Company reclassified certain information technology expenses across the functions that benefit from their support. For the three months ended June 30, 2016, the Company reclassified $0.8 million out of general and administrative expenses. Of this amount the Company reclassified $0.2 million to cost of revenues, $0.3 million to research and development and $0.3 million to sales and marketing. For the six months ended June 30, 2016, the Company reclassified $1.4 million out of general and administrative expenses. Of this amount the Company reclassified $0.3 million to cost of revenues, $0.6 million to research and development and $0.5 million to sales and marketing.

Recently adopted Accounting Pronouncements

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, (ASU 2016-09) intended to simplify and improve various aspects related to how employee-share based payment transactions are accounted for and presented in the financial statements. The ASU addresses income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows and forfeiture rate calculations. This guidance is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The Company adopted this guidance in its first quarter of 2017 and elected to apply this adoption prospectively. Prior periods have not been adjusted. The Company has made the accounting policy election to continue to estimate forfeitures expected to occur to determine the amount of stock-based compensation expense to record each period. See Note 8 for information regarding the impact on the Company's financial statements.

Recent Accounting Pronouncements
Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (ASU 2014-09), as amended, which will supersede nearly all existing revenue recognition guidance. Under ASU 2014-09, an entity is required to recognize revenue upon transfer of promised goods or services to customers in an amount that reflects the expected consideration received in exchange for those goods or services. ASU 2014-09 defines a five-step process in order to achieve this core principle, which may require the use of judgment and estimates, and also requires expanded qualitative and quantitative disclosures relating to the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, including significant judgments and estimates used.

The FASB has recently issued several amendments to the new standard, including clarification on accounting for licenses of intellectual property and identifying performance obligations. The amendments include ASU 2016-08, Revenue from Contracts with Customers (Topic 606)-Principal versus Agent Considerations, which was issued in March 2016, and clarifies the implementation guidance for principal versus agent considerations in ASU 2014-09, and ASU 2016-10, Revenue from Contracts with Customers (Topic 606)-Identifying Performance Obligations and Licensing, which was issued in April 2016, and amends the guidance in ASU 2014-09 related to identifying performance obligations and accounting for licenses of intellectual property. The new standard permits adoption either by using (i) a full retrospective approach for all periods presented in the period of adoption or (ii) a modified retrospective approach with the cumulative effect of initially applying the new standard recognized at the date of initial application and providing certain additional disclosures. The new standard is effective for annual reporting periods beginning after December 15, 2017, with early adoption permitted for annual reporting periods beginning after December 15, 2016. The Company will adopt the new standard effective January 1, 2018.

The Company is continuing to assess the impact of adopting ASU 2014-09 on its financial position, results of operations, cash flows and related disclosures and has not yet determined whether the effect will be material. Additionally, as the Company continues to assess the new standard along with industry trends and additional interpretive guidance, the Company may adjust its implementation plan accordingly. The Company currently believes the new standard will have the most significant impacts relating to the potential deferral of sales commissions and contract costs and the accounting for financing components of certain long term contracts.

The Company currently plans to adopt using the modified retrospective approach.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, which will impact certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The guidance will impact the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. This guidance is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires, among other things, lease assets and lease liabilities arising from leases, including operating leases, to be recognized on the balance sheet. In addition, this ASU requires disclosing key information about leasing arrangements. This guidance supersedes existing lease guidance and is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Pursuant to the leasing criteria, most of our leased space and equipment leases will be capitalized assets on the balance sheet with an offsetting financing obligation.   In the statement of operations, what was formerly rent expense will be bifurcated into depreciation and interest expense. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force), to provide guidance on the presentation of certain cash receipts and cash payments in the statement of cash flows in order to reduce diversity in existing practice. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company is currently evaluating the impact of the adoption of this update on its consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires the statement of cash flows to explain the change during the period in the total of cash, cash equivalents and restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. This guidance is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, which revises the definition of a business and provides new guidance in evaluating when a set of transferred assets and activities is a business. This guidance will be effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 on a prospective basis. Early adoption is permitted. The Company does not expect the standard to have a material impact on our 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 guidance is effective for interim and annual goodwill impairment tests in fiscal years beginning after December 15, 2019 with early adoption permitted. This guidance must be applied on a prospective basis. The Company does not expect the adoption of this guidance to have a material impact on its 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, investments and derivative foreign currency forward contracts 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 Company's cash and cash equivalents, short-term investments, and long-term investments consist of the following:

	June 30, 2017			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$105,943	$ —	$ —	$105,943
Money market funds	20,233	—	—	20,233
U.S. government agencies	4,396	—	—	4,396
Total	130,572	—	—	130,572
Short-term investments:				
Commercial paper	3,245	—	—	3,245
Corporate bonds	25,997	4	(23)	25,978
U.S. government agencies	119,242	—	(175)	119,067
Total	148,484	4	(198)	148,290
Long-term investments:				
Asset-backed securities	3,472	—	(1)	3,471
U.S. government agencies	14,274	—	(30)	14,244
Corporate bonds	27,298	20	(30)	27,288
Total	45,044	20	(61)	45,003
Total	$324,100	$ 24	$ (259)	$323,865

	December 31, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$72,673	$ —	$ —	$72,673
Money market funds	473	—	—	473
Commercial paper	13,591	—	—	13,591
Total	86,737	—	—	86,737
Short-term investments:				
Commercial paper	14,782	5	—	14,787
Corporate bonds	13,490	—	(11)	13,479
Asset-backed securities	1,235			1,235

U.S. government agencies	127,660		(42)	127,618
Total	157,167	5	(53)	157,119
Long-term investments:				
Asset-backed securities	5,091	2	—	5,093
U.S. government agencies	29,501	—	(71)	29,430
Corporate bonds	11,243	—	(41)	11,202
Total	45,835	2	(112)	45,725
Total	$289,739	$ 7	$ (165)	$289,581

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

The following table shows the changes to accumulated other comprehensive income (loss) for the six months ended June 30, 2017 (in thousands):

	Unrealized Gain (Loss), net on Investments
Balance at December 31, 2016	$ (156)
Change in net realized gain (loss) on investments	(80)
Amounts reclassified for net realized gain (loss) included in net income	2
Other comprehensive income (loss), net	(78)
Balance at June 30, 2017	$ (234)

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

	June 30, 2017			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$ —	$ 3,245	$ —	$ 3,245
U.S. government agencies	—	137,709	—	137,709
Corporate bonds	—	53,264	—	53,264
Asset-backed securities	—	3,471	—	3,471
Total	$ —	$ 197,689	$ —	$ 197,689

	December 31, 2016			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$ —	$ 28,378	$ —	$ 28,378
U.S. government agencies	—	157,048	—	157,048
Corporate bonds	—	24,681	—	24,681
Asset-backed securities	—	6,328	—	6,328
Total	$ —	$ 216,435	$ —	$ 216,435

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.

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

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

	June 30, 2017			
	Mature within One Year	After One Year through Two Years	Over Two Years	Fair Value
	(in thousands)			
Commercial paper	$3,245	$—	$—	$3,245
U.S. government agencies	118,057	15,256	—	133,313
Corporate bonds	25,978	15,169	12,117	53,264
Asset-backed securities	2,622	850	—	3,472
Total	$149,902	$31,275	$12,117	$193,294

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 or accrued liabilities 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 derivative financial instruments for trading or speculative purposes.

At June 30, 2017, the Company had two outstanding forward contracts with notional amounts of 7 million Euros and 4.8 million British Pounds, which expire on July 31, 2017. At December 31, 2016, the Company had two outstanding forward contracts with notional amounts of 7.6 million Euros and 4.6 million British Pounds, which expired on February 2, 2017. These forward contracts were entered into at the end of each month, and thus the fair value of these contracts was $0 at June 30, 2017 and December 31, 2016. These derivatives did not meet the criteria to be designated as hedges. These instruments were valued using Level 2 inputs.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Net loss from forward contracts	$(865)	$552	$(1,122)	$74
Other foreign currency transactions gain	733	(721)	993	(274)
Total foreign exchange gain (loss), net	$(132)	$(169)	$(129)	$(200)

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

NOTE 3. Property and Equipment, Net

Property and equipment consists of the following:

	June 30, 2017	December 31, 2016
	(in thousands)	
Computer equipment	$65,579	$ 57,295
Computer software	20,107	19,716
Furniture, fixtures and equipment	3,966	3,425
Scanner appliances	14,434	14,776
Leasehold improvements	7,298	3,694
Total property and equipment	111,384	98,906
Less: accumulated depreciation and amortization	(68,616)	(59,505)
Property and equipment, net	$42,768	$ 39,401

Physical scanner appliances and other computer equipment that are or will be subject to subscriptions by customers had a net carrying value of $7.8 million and $8.3 million at June 30, 2017 and December 31, 2016, respectively, including assets that have not been placed in service of $0.6 million and $1.3 million, respectively. Depreciation and amortization expense relating to property and equipment was $4.9 million and $3.9 million for the three months ended June 30, 2017 and 2016, respectively, and $9.6 million and $7.6 million for the six months ended June 30, 2017 and 2016 respectively.

NOTE 4. Goodwill and Intangible Assets, Net

Intangible assets consist primarily of existing technology and a patent license 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):

			June 30, 2017		December 31, 2016	
	Estimated Lives	Cost	Accumulated Amortization	Net Book Value	Accumulated Amortization	Net Book Value
Existing technology	7 years	$1,910	$(1,865)	$ 45	$(1,728)	$ 182
Patent license	14 years	1,388	(672)	716	(623)	765
Total intangibles subject to amortization		$3,298	$(2,537)	761	$(2,351)	947
Intangible assets not subject to amortization				40		40
Total intangible assets, net				$ 801		$ 987

Intangibles amortization expense was $0.1 million for each of the three months ended June 30, 2017 and 2016 and $0.2 million for each of the six months ended June 30, 2017 and 2016.

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

As of June 30, 2017, the Company expects amortization expense in future periods to be as follows (in thousands):

Remainder of 2017	$	96
2018	100	
2019	100	
2020	100	
2021	100	
2022 and thereafter	265	
Total expected future amortization expense	$	761

Goodwill, which is not subject to amortization, totaled $0.3 million as of June 30, 2017 and December 31, 2016.

NOTE 5. Commitments and Contingencies

Leases

The Company leases certain computer equipment and its corporate office and data center facilities under non-cancelable operating leases for varying periods through 2028.

The following are the minimum annual lease payments due under operating leases at June 30, 2017 (in thousands):

Remainder of 2017	$2,410
2018	5,902
2019	5,199
2020	4,874
2021	4,646
2022 and thereafter	26,133
Total minimum lease payments	$49,164

Rent expense was $2.4 million and $1.8 million for the three months ended June 30, 2017 and 2016, respectively, and $4.3 million and $3.5 million for the six months ended June 30, 2017 and 2016, respectively. Although certain of the operating lease agreements provide for rent free periods or escalating rent payments over the terms of the leases, rent expense under these agreements is recognized on a straight-line basis over the term of the lease, starting when the Company takes possession of the property from the landlord. We record the difference between the recognized rent expense and the amounts payable under the lease as a short-term or long-term deferred rent liability. When we receive tenant allowances upon entering into certain leases, we record the allowances as short-term or long-term tenant allowance liability and amortize them using the straight-line method as a reduction to rent expense over the term of the lease.
As of June 30, 2017 and December 31, 2016, the Company had accrued $8.1 million and $0.4 million, respectively, of deferred rent related to these agreements, which is reflected in accrued liabilities and other non-current liabilities in the accompanying condensed consolidated balance sheets.

On October 14, 2016, the Company entered into a lease agreement (included in the table above) for its new headquarter office facility. The lease payments commence on May 1, 2018 and has a ten-year term through April 30, 2028. The total commitment of $38.6 million is payable monthly with escalating rental payments throughout the lease term. The Company took possession of the facility on May 1, 2017 and began construction of certain leasehold improvements. The Company recorded a tenant improvement allowance of $8.1 million.

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.

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

Contingencies
From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues a liability for such matters when it is probable a loss has been incurred and such loss can be reasonably estimated. At June 30, 2017, the Company has not recorded any material liabilities in accordance with accounting for contingencies.

NOTE 6. 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 9,861,234 shares of common stock. 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 June 30, 2017, 2,459,834 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 initial public offering ("IPO"), 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 and six months ended June 30, 2017 and 2016.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Cost of revenues	$536	$423	$1,037	$802
Research and development	1,505	1,493	2,726	2,788
Sales and marketing	1,129	1,389	2,213	2,638
General and administrative	3,277	2,017	4,803	3,791
Total stock-based compensation	$6,447	$5,322	$10,779	$10,019

As of June 30, 2017, the Company had $20.1 million of total unrecognized compensation cost related to unvested option awards that it expects to recognize over a weighted-average period of 2.6 years , and $33.8 million of unrecognized compensation cost related to unvested RSUs that it expects to recognize over a weighted-average period of 2.8 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.

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)
December 31, 2016	7,527,680	$ 19.25	6.0	$ 101,717
Granted	249,950	$ 37.78		
Exercised	(2,036,841)	$ 8.04		
Canceled	(219,681)	$ 34.53		
June 30, 2017	5,521,108	$ 23.61	6.8	$ 96,133
	5,160,376	$ 23.06	6.6	$ 92,715

Vested and expected to vest - June 30, 2017				
Exercisable - June 30, 2017	3,599,569	$ 19.65	5.8	$ 75,806

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(Unaudited)

Restricted Stock

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

	Outstanding RSUs and RSAs	Weighted Average Grant Date Fair Value Per Share
December 31, 2016	587,333	$ 28.85
Granted	828,958	$ 38.32
Released	(112,065)	$ 28.24
Canceled	(73,411)	$ 31.27
June 30, 2017	1,230,815	$ 36.14
Outstanding and expected to vest - June 30, 2017	1,058,449	$ 35.18

NOTE 7. Other Income (Expense), Net

Other income (expense), net consists of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Foreign exchange gain (loss)	$(132)	$(169)	$(129)	$(200)
Other income (expense)	(48)	(80)	(77)	(118)
Other expense, net	$(180)	$(249)	$(206)	$(318)

NOTE 8. Income Taxes

The Company recorded a tax provision of $2.2 million for each of the three months ended June 30, 2017 and 2016. The Company's effective income tax rate was approximately 23.1% and 38.5% for the three months ended June 30, 2017 and 2016, respectively.

The Company recorded a tax benefit of $(11.7) million and a tax provision of $5.2 million for the six months ended June 30, 2017 and 2016, respectively. The Company's effective income tax rate was approximately (66.7) % and 38.4 % for the six months ended June 30, 2017 and 2016, respectively.

The tax provision for the three months ended June 30, 2017 compared to the three months ended June 30, 2016 was relatively flat. While the Company had higher taxable income in the three months ended June 30, 2017 we also had a greater amount of excess tax benefits related to stock based compensation to offset our tax provision expense. The impact of the higher taxable income offset by excess tax benefits was a lowered effective tax rate for the three months ended June 30, 2017 compared to the three months ended June 30, 2016.

The decrease in the tax provision for the six months ended June 30, 2017 compared to the six months ended June 30, 2016 and the decrease in the effective tax rate recorded for the three and six months ended June 30, 2017 was primarily due to the discrete event of recognizing the excess tax benefits related to stock based compensation as required by ASU 2016-09.

The Company adopted ASU 2016-09 as required on January 1, 2017. In following ASU 2016-09 the Company recognized a discrete tax benefit from excess tax benefits related to stock based compensation of $16.8 million for the three months ended March 31, 2017 and $18.2 million for the six months ended June 30, 2017. The standard will result in increased volatility in the Company's effective tax rate. In the first quarter ended March 31, 2017, the Company recorded a cumulative effect adjustment to increase retained earnings by $8.4 million with corresponding increase to deferred tax assets for the Federal and state net operating losses attributable to excess tax benefits from stock based compensation which had not been previously recognized as of January 1, 2017.

As of June 30, 2017, the Company had unrecognized tax benefits of $4.5 million, of which $2.6 million, if recognized, would favorably impact the Company's effective tax rate. As of December 31, 2016, the Company had unrecognized tax benefits of $4.1 million, of which $2.4 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.

NOTE 9. Segment Information and Information about Geographic Area

The Company operates in one segment. 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:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
	(in thousands)			
United States	$39,038	$34,190	$76,499	$66,879
Foreign	16,264	14,276	31,924	27,835
Total revenues	$55,302	$48,466	$108,423	$94,714

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

	June 30,	December 31,
	2017	2016
	(in thousands)	
United States	$34,774	$ 30,733
Foreign	7,994	8,668
Total property and equipment, net	$42,768	$ 39,401

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

NOTE 10. Net Income Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands, except per share data)			
Numerator:				
Net income	$7,202	$3,538	$29,132	$8,321
Denominator:				
Weighted-average shares used in computing net income per share:				
Basic	37,277	35,120	36,887	34,869
Effect of potentially dilutive securities:				
Common stock options	2,003	2,989	2,110	3,107
Restricted stock units	255	34	210	12
Diluted	39,535	38,143	39,207	37,988
Net income per share:				
Basic	$0.19	$0.10	$0.79	$0.24
Diluted	$0.18	$0.09	$0.74	$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 June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Common stock options	1,261	3,892	1,307	3,540
Restricted stock units	9	10	6	20
	1,270	3,902	1,313	3,560

Note 11. Subsequent Event

On August 1, 2017 the Company announced the acquisition of Pune-based Nevis Networks, expanding the Company's domain expertise in passive scanning and deep packet inspection as well as accelerating its entrance into the mitigation and response segment, natively from the Qualys Cloud Platform. We expect the acquisition to close in our quarter ending September 30, 2017.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q, including this Management’s Discussion and Analysis of Financial Condition and Results of Operations, should be read in conjunction with (1) our condensed consolidated financial statements (unaudited) and the related notes included elsewhere in this report, and (2) the audited consolidated financial statements and the related notes and management’s discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, filed with the Securities and Exchange Commission, or SEC, on February 24, 2017.

In addition to historical information, this Quarterly Report on Form 10-Q contains “forward-looking” statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Forward-looking statements generally relate to future events or our future financial or operating performance. In some cases, it is possible to identify forward-looking statements because they contain words such as “anticipates,” “believes,” “contemplates,” “continue,” “could,” “estimates,” “expects,” “future,” “intends,” “likely,” “may,” “plans,” “potential,” “predic “should,” “target,” or “will,” or the negative of these words or other similar terms or expressions that concern our expectations, strategy, plans or intentions. Forward-looking statements contained in this Quarterly Report on Form 10-Q include, but are not limited to, statements about:

- our financial performance, including our revenues, costs, expenditures, growth rates, operating expenses and ability to generate positive cash flow to fund our operations and sustain profitability;
- anticipated technology trends, such as the use of cloud solutions;
- our ability to adapt to changing market conditions;
- economic and financial conditions, including volatility in foreign exchange rates;
- our ability to diversify our sources of revenues, including selling additional solutions to our existing customers and our ability to pursue new customers;
- the effects of increased competition in our market;
- our ability to innovate and enhance our cloud solutions and platform and introduce new solutions;
- our ability to effectively manage our growth;
- our anticipated investments in sales and marketing, our infrastructure, new solutions, and research and development, and acquisitions;
- maintaining and expanding our relationships with channel partners;
- our ability to maintain, protect and enhance our brand and intellectual property;
- costs associated with defending intellectual property infringement and other claims;
- our ability to attract and retain qualified employees and key personnel, including sales and marketing personnel;
- our ability to successfully enter new markets and manage our international expansion;
- our expectations, assumptions and conclusions related to our provision for income taxes, our deferred tax assets and our effective tax rate; and
- other factors discussed in this Quarterly Report on Form 10-Q in the sections titled “Risk Factors” and “Management's Discussion and Analysis of Financial Condition and Results of Operations.”

We have based the forward-looking statements contained in this Quarterly Report on Form 10-Q primarily on our current expectations and projections about future events and trends that we believe may affect our business, financial condition, results of operations and prospects. The results, events and circumstances reflected in these forward-looking statements are subject to risks, uncertainties, assumptions, and other factors including those described in Part II, Item 1A (Risk Factors) of this Quarterly Report and those discussed in other documents we file with the SEC. Moreover, we operate in a very competitive and rapidly changing environment. New risks and uncertainties emerge from time to time, and it is not possible for us to predict all risks and uncertainties that could have an impact on the forward-looking statements used herein. We cannot provide assurance that the results, events, and circumstances reflected in the forward-looking statements will be achieved or occur, and actual results, events or circumstances could differ materially from those described in the forward-looking statements.

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Overview

We are 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. Our 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. Our integrated suite of security and compliance solutions delivered on our Qualys Cloud Platform enables our customers to identify their IT assets, collect and analyze large amounts of IT security data, discover and prioritize vulnerabilities, recommend remediation actions and verify the implementation of such actions. Organizations use our integrated suite of solutions delivered on our Qualys Cloud Platform to cost-effectively obtain a unified view of their security and compliance posture across globally-distributed IT infrastructures.

IT infrastructures are more complex and more globally-distributed today than ever before, as organizations of all sizes increasingly rely upon a myriad of interconnected information systems and related IT assets, such as servers, databases, web applications, routers, switches, desktops, laptops, other physical and virtual infrastructure, and numerous external networks and cloud services. In this environment, new and evolving technologies intended to improve organizations' operations can also increase vulnerability to cyber attacks, which can expose sensitive data, damage IT and physical infrastructures, and result in serious financial or reputational consequences. In addition, the rapidly increasing amount of data and devices in IT environments makes it more difficult to identify and remediate vulnerabilities in a timely manner. The predominant approach to IT security has been to implement multiple disparate security products that can be costly and difficult to deploy, integrate and manage and may not adequately protect organizations. As a result, we believe there is a large and growing opportunity for comprehensive cloud-based security and compliance solutions.

We designed our Qualys Cloud Platform to transform the way organizations secure and protect their IT infrastructures and applications. Our cloud platform offers an integrated suite of solutions that automates the lifecycle of asset discovery, security assessments, and compliance management for an organization's IT infrastructure and assets, whether they reside inside the organization, on their network perimeter, on endpoints or in the cloud. Our solutions are designed to be delivered through the cloud and to be easily and rapidly deployed on a global scale across a broad range of industries, enabling faster implementation and lower total cost of ownership than traditional on-premise enterprise software products. Our customers, ranging from some of the largest global organizations to small businesses, are served from our globally-distributed cloud platform, enabling us to rapidly deliver new solutions, enhancements and security updates.

We were founded and incorporated in December 1999 with a vision of transforming the way organizations secure and protect their IT infrastructure and applications and initially launched our first cloud solution, Qualys Vulnerability Management (VM), in 2000. Our VM Solutions have provided a substantial majority of our revenues to date, representing 75% for the six months ended June 30, 2017.

We provide our solutions through a software-as-a-service model, primarily with renewable annual subscriptions. These subscriptions require customers to pay a fee in order to access our cloud solutions. We invoice our customers for the entire subscription amount at the start of the subscription term, and the invoiced amounts are treated as deferred revenues and are recognized ratably over the term of each subscription. We continue to experience significant revenue growth from existing customers as they renew and purchase additional subscriptions.

Our revenues increased to $108.4 million in the six months ended June 30, 2017 from $94.7 million for the comparable period in 2016, representing an increase of $13.7 million or 14%.

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Key Metrics

In addition to measures of financial performance presented in our condensed consolidated financial statements, we monitor the key metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands, except percentages)			
Adjusted EBITDA	$20,419	$15,744	$37,227	$31,872
Percentage of revenues	37 %	32 %	34 %	34 %

	Six Months Ended June 30,	
	2017	2016
	(in thousands)	
Free cash flow	$35,763	$25,495

Adjusted EBITDA

We monitor Adjusted EBITDA, a non-GAAP financial measure, to analyze our financial results and believe that it is useful to investors, as a supplement to U.S. GAAP measures, in evaluating our ongoing operational performance and enhancing an overall understanding of our past financial performance. We believe that Adjusted EBITDA helps illustrate underlying trends in our business that could otherwise be masked by the effect of the income or expenses that we exclude in Adjusted EBITDA. Furthermore, we use this measure to establish budgets and operational goals for managing our business and evaluating our performance. We also believe that Adjusted EBITDA provides an additional tool for investors to use in comparing our recurring core business operating results over multiple periods with other companies in our industry.

Adjusted EBITDA should not be considered in isolation from, or as a substitute for, financial information prepared in accordance with U.S. GAAP. We calculate Adjusted EBITDA as net income before (1) other (income) expense, net, which includes interest income, interest expense and other income and expense, (2) provision for income taxes, (3) depreciation and amortization of property and equipment, (4) amortization of intangible assets, (5) stock-based compensation and (6) other non-recurring adjustments.

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The following unaudited table presents the reconciliation of net income to Adjusted EBITDA for the three and six months ended June 30, 2017 and 2016:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Net income	$7,202	$3,538	$29,132	$8,321
Other (income) expense, net	(360)	(40)	(813)	(208)
(Benefit) provision for income taxes	2,167	2,214	(11,654)	5,196
Depreciation and amortization of property and equipment	4,854	3,885	9,564	7,609
Amortization of intangible assets	109	109	219	219
Stock-based compensation	6,447	5,322	10,779	10,019
One-time tax related expense	$—	$716	$—	$716
Adjusted EBITDA (1)	$20,419	$15,744	$37,227	$31,872

(1) Adjusted EBITDA for the three and six months ended June 30, 2016 excludes approximately $0.7 million of a non-recurring expense related to the remittance of payroll taxes from fiscal year 2013 through May 2016. During this same period, we have not excluded any amounts related to other non-recurring items from Adjusted EBITDA because we have considered such amounts to be immaterial in any given quarter during such period.

Free Cash Flow

We define free cash flow, a non-GAAP measure, as net cash provided by operating activities less purchases of property and equipment and capitalization of software development costs. We monitor free cash flow as a liquidity measure because we believe it provides useful information to management and investors about the amount of cash we generated, that, after the acquisition of property and equipment and capitalized software development costs, can be used for strategic opportunities, including investing in our business, making strategic acquisitions and strengthening the balance sheet. We also believe free cash flow provides an additional tool for investors to use in comparing our recurring core business operating results over multiple periods.

A limitation of using free cash flow as a means for evaluating liquidity is that free cash flow does not represent the total increase or decrease in cash and cash equivalents for the period because it excludes cash provided by or used in other investing and financing activities. In addition, it is important to note that other companies, including companies in our industry, may not use free cash flow, may calculate free cash flow in a different manner than we do, or may use other financial measures to evaluate their performance, all of which could reduce the usefulness of free cash flow as a comparative measure. A reconciliation of free cash flow to net cash provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

	Six Months Ended June 30,	
	2017	2016
	(in thousands)	
Net cash provided by operating activities	$48,942	$34,461
Less:		
Purchases of property and equipment	(13,179)	(8,966)
Free cash flow	$35,763	$25,495

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Limitations of Adjusted EBITDA and Free Cash Flow

Adjusted EBITDA and free cash flow, non-GAAP financial measures, have limitations as analytical tools, and should not be considered in isolation from or as a substitute for the measures presented in accordance with U.S. GAAP. Some of these limitations are:

- Adjusted EBITDA does not reflect certain cash and non-cash charges that are recurring;
- Adjusted EBITDA does not reflect income tax payments that reduce cash available to us;
- Adjusted EBITDA excludes depreciation and amortization of property and equipment and, although these are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future;
- Free cash flow does not represent the total increase or decrease in the cash and cash equivalents for the period; and
- Other companies, including companies in our industry, may calculate Adjusted EBITDA and free cash flow differently or not at all, which reduces their usefulness as a comparative measure.

Because of these limitations, Adjusted EBITDA and free cash flow should be considered alongside other financial performance measures, including revenues, net income, cash flows from operating activities and our financial results presented in accordance with U.S. GAAP.

Key Components of Results of Operations

Revenues

We derive revenues from the sale of subscriptions to our security and compliance solutions, which are delivered on our cloud platform. Subscriptions to our solutions allow customers to access our cloud-based security and compliance solutions through a unified, web-based interface. 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 devices or web applications and, if requested by a customer as part of their subscription, a specified number of physical or virtual scanner appliances. Our 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 our solutions. In some limited cases, we also provide certain computer equipment used to extend our Qualys Cloud Platform into our customers' private cloud environment. Customers are required to return physical scanner appliances and computer equipment if they do not renew their subscriptions.

We typically invoice our customers for the entire subscription amount at the start of the subscription term. Invoiced amounts are reflected on our condensed consolidated balance sheets as accounts receivable or as cash when collected, and as deferred revenues until earned and recognized ratably over the subscription period. Accordingly, deferred revenues represent the amount billed to customers that has not yet been earned or recognized as revenues, pursuant to subscriptions entered into in current and prior periods.

Cost of Revenues

Cost of revenues consists primarily of personnel expenses, comprised of salaries, benefits, performance-based compensation and stock-based compensation, for employees who operate our data centers and provide support services to our customers. Other expenses include depreciation of data center equipment and physical scanner appliances and computer hardware provided to certain customers as part of their subscriptions, expenses related to the use of third-party data centers, amortization of third-party technology licensing fees and related maintenance support, fees paid to contractors who supplement or support our operations center personnel and allocation of overhead costs. We expect to continue to make capital investments to expand and support our data center operations, which will increase the cost of revenues in absolute dollars.

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Operating Expenses

Research and Development

Research and development expenses consist primarily of personnel expenses, comprised of salaries, benefits, performance-based compensation and stock-based compensation, for our research and development teams. Other expenses include third-party contractor fees, amortization of intangibles related to prior acquisitions and allocation of overhead costs. All research and development costs are expensed as incurred. We expect to continue to devote substantial resources to research and development in an effort to continuously improve our existing solutions as well as develop new solutions and capabilities, which will increase research and development expenses in absolute dollars.

Sales and Marketing

Sales and marketing expenses consist primarily of personnel expenses, comprised of salaries, benefits, sales commissions, performance-based compensation and stock-based compensation for our worldwide sales and marketing teams. Other expenses include marketing and promotional events, lead-generation marketing programs, public relations, travel, software license and maintenance costs for sales-related software, and allocation of overhead costs. All costs are expensed as incurred, including sales commissions. Sales commissions are expensed in the quarter in which the related order is received and are paid in the month subsequent to the end of that quarter, which results in increased expenses prior to the recognition of related revenues. Our new sales personnel are typically not immediately productive, and the resulting increase in sales and marketing expenses we incur when we add new personnel may not result in increased revenues if these new sales personnel fail to become productive. The timing of our hiring of sales personnel, or the participation in new marketing events or programs, and the rate at which these generate incremental revenues may affect our future operating results. We expect to continue to significantly invest in additional sales personnel worldwide and also in more marketing programs to support new solutions on our platform, which will increase sales and marketing expenses in absolute dollars.

General and Administrative

General and administrative expenses consist primarily of personnel expenses, comprised of salaries, benefits, performance-based compensation and stock-based compensation, for our executive, finance and accounting, legal and human resources support teams, as well as professional services, insurance, fees, and allocation of overhead costs. We expect that general and administrative expenses will increase in absolute dollars, as we continue to add personnel and incur professional services to support our growth and compliance with legal requirements.

Other Income (Expense), Net

Our other income (expense), net consists primarily of interest and investment income from our short-term and long-term investments; foreign exchange gains and losses, the majority of which result from fluctuations between the U.S. dollar and the Euro, British Pound and Indian Rupee; and losses on disposal of property and equipment.

Provision for Income Taxes

We are subject to federal, state and foreign income taxes for jurisdictions in which we operate, and we use estimates in determining our provision for these income taxes and deferred tax assets. Earnings from our non-U.S. activities are subject to income taxes in the local country which are generally lower than U.S. tax rates, and may be subject to U.S. income taxes. Our effective rates differ from the U.S. statutory rate primarily due to foreign income subject to different tax rates than the U.S., research and development tax credits, deductible and non-deductible stock-based compensation expense and other adjustments.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the tax impact of timing differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry-forwards. Deferred tax assets and liabilities are measured using statutory tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and

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liabilities of a change in tax rates is recognized in income in the period when the statutory rate change is enacted into law.

We assess the likelihood that deferred tax assets will be realized, and we recognize a valuation allowance if it is more likely than not that some portion of the deferred tax assets will not be recognized. This assessment requires judgment as to the likelihood and amounts of future taxable income.

Sales Taxes

We present our revenues net of sales tax in our condensed consolidated statements of operations.

Results of Operations

The following tables set forth selected condensed consolidated statements of operations data for each of the periods presented.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Condensed Consolidated Statements of Operations data:				
Revenues	$55,302	$48,466	$108,423	$94,714
Cost of revenues [(1), (2)]	12,153	10,260	24,447	19,811
Gross profit	43,149	38,206	83,976	74,903
Operating expenses:				
Research and development [(1), (2)]	10,525	9,488	20,348	17,597
Sales and marketing [(1), (2)]	15,383	14,728	31,397	28,895
General and administrative [(1), (2)]	8,232	8,278	15,566	15,102
Total operating expenses	34,140	32,494	67,311	61,594
Income from operations	9,009	5,712	16,665	13,309
Other income (expense), net	360	40	813	208
Income before income taxes	9,369	5,752	17,478	13,517
(Benefit from) provision for income taxes	2,167	2,214	(11,654)	5,196
Net income	$7,202	$3,538	$29,132	$8,321

(1) Includes stock-based compensation as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Cost of revenues	$536	$423	$1,037	$802
Research and development	1,505	1,493	2,726	2,788
Sales and marketing	1,129	1,389	2,213	2,638
General and administrative	3,277	2,017	4,803	3,791
Total stock-based compensation	$6,447	$5,322	$10,779	$10,019

(2) We reclassified certain information technology expenses across the functions that benefit from their support. For the three months ended June 30, 2016, we reclassified $0.8 million out of general and administrative expenses. Of this amount we reclassified $0.2 million to cost of revenues, $0.3 million to research and development and $0.3 million to sales and marketing. For the six months ended June 30, 2016, we reclassified $1.4 million out of general and administrative expenses. Of this amount we reclassified $0.3 million to cost of revenues, $0.6 million to research and development and $0.5 million to sales and marketing.

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The following table sets forth selected condensed consolidated statements of operations data for each of the periods presented as a percentage of revenues.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenues	100%	100%	100 %	100%
Cost of revenues	22	21	23	21
Gross profit	78	79	77	79
Operating expenses:				
Research and development	19	20	19	19
Sales and marketing	28	30	29	31
General and administrative	15	17	14	16
Total operating expenses				