PROOFPOINT INC
Form 10-Q
November 02, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2012
OR

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 001-35506
PROOFPOINT, INC.
(Exact name of Registrant as specified in its charter)

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

(408) 517-4710

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
YES þ NO o

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ Shares of Proofpoint, Inc. common stock, $0.0001 par value per share, outstanding as of September 30, 2012:

31,887,245 shares.

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PROOFPOINT, INC.
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Quarterly Period Ended September 30, 2012
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

Proofpoint, Inc.
Condensed Consolidated Balance Sheets
(In thousands, except per share amounts)
(Unaudited)

	September 30, 2012	December 31, 2011
Assets		
Current assets		
Cash and cash equivalents	$31,528	$9,767
Short-term investments	49,125	2,947
Accounts receivable, net	17,081	15,789
Inventory	898	729
Deferred product costs, current	1,298	1,803
Prepaid expenses and other current assets	3,690	2,556
Total current assets	103,620	33,591
Property and equipment, net	7,700	7,353
Deferred product costs, noncurrent	371	987
Goodwill	18,557	18,557
Intangible assets, net	3,325	6,189
Other noncurrent assets	253	1,275
Total assets	$133,826	$67,952
Liabilities, Convertible Preferred Stock and Stockholders’ Equity (Deficit)		
Current liabilities		
Accounts payable	$4,385	$3,504
Accrued liabilities	11,568	10,061
Notes payable and lease obligations	1,658	467
Deferred rent	839	517
Deferred revenue	54,170	52,836
Total current liabilities	72,620	67,385
Notes payable and lease obligations, noncurrent	2,767	4,514
Other long term liabilities, noncurrent	257	85
Deferred revenue, noncurrent	24,666	23,404
Total liabilities	100,310	95,388
Convertible preferred stock, $0.0001 par value; no shares authorized, issued and outstanding as of September 30, 2012 and 39,424 shares authorized, 38,942 shares issued and outstanding at December 31, 2011, net of issuance costs and liquidation preference of $110,338	—	109,911
Stockholders’ equity (deficit)		
Preferred stock, $0.0001 par value; 5,000 shares authorized; no shares issued and outstanding at September 30, 2012; no shares authorized, issued and outstanding at December 31, 2011	—	—
Common stock, $0.0001 par value; 200,000 and 71,400 shares authorized at September 30, 2012 and December 31, 2011, respectively; 31,887 and 4,961	3	1

shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively		
Additional paid-in capital	210,484	24,773
Accumulated other comprehensive Income (loss)	10	(3)
Accumulated deficit	(176,981)	(162,118)
Total stockholders’ equity (deficit)	33,516	(137,347)
Total liabilities, convertible preferred stock, and stockholders’ equity (deficit)	$133,826	$67,952

See accompanying Notes to the Condensed Consolidated Financial Statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue:				
Subscription	$25,991	$18,793	$74,010	$52,533
Hardware and services	1,093	1,693	3,636	6,614
Total revenue	27,084	20,486	77,646	59,147
Cost of revenue:(1)(2)				
Subscription	6,967	5,936	21,414	17,553
Hardware and services	1,163	1,313	3,466	4,426
Total cost of revenue	8,130	7,249	24,880	21,979
Gross profit	18,954	13,237	52,766	37,168
Operating expense:(1)(2)				
Research and development	6,262	4,594	18,367	14,416
Sales and marketing	14,126	10,779	39,751	30,070
General and administrative	3,141	2,043	8,871	6,184
Total operating expense	23,529	17,416	66,989	50,670
Operating loss	(4,575)	(4,179)	(14,223)	(13,502)
Interest expense, net	(7)	(70)	(110)	(258)
Other income (expense), net	109	(31)	(100)	212
Loss before provision for income taxes	(4,473)	(4,280)	(14,433)	(13,548)
Provision for income taxes	(119)	(33)	(430)	(169)
Net loss	$(4,592)	$(4,313)	$(14,863)	$(13,717)
Net loss per share, basic and diluted	$(0.14)	$(1.07)	$(0.70)	$(3.49)
Weighted average shares outstanding, basic and diluted	31,844	4,048	21,258	3,931
(1) Includes stock based compensation expense as follows:				
Cost of subscription revenue	$205	$76	$443	$281
Cost of hardware and services revenue	20	7	46	20
Research and development	502	307	1,409	868
Sales and marketing	830	511	2,301	1,418
General and administrative	390	220	1,184	704
(2) Includes intangible amortization expense as follows:				
Cost of subscription revenue	$333	$949	$2,452	$2,809
Research and development	8	—	23	—
Sales and marketing	72	142	389	625

See accompanying Notes to the Condensed Consolidated Financial Statements.

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

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net loss	$(4,592)	$(4,313)	$(14,863)	$(13,717)
Other comprehensive income, before tax and net of reclassification adjustments:				
Unrealized gains (losses) on investments, net	22	(3)	13	(6)
Other comprehensive gain (loss), before tax	22	(3)	13	(6)
Tax benefit (provision) related to items of other comprehensive income	—	—	—	—
Other comprehensive gain (loss), net tax	22	(3)	13	(6)
Comprehensive loss	$(4,570)	$(4,316)	$(14,850)	$(13,723)

See accompanying Notes to the Condensed Consolidated Financial Statements.

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

	Nine Months Ended September 30, 2012	2011
Cash flows from operating activities		
Net loss	$(14,863)	$(13,717)
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation and amortization	6,037	5,693
Stock based compensation	5,383	3,291
Change in fair value of warrant liability	—	(66)
Change in fair value of contingent earn-outs	—	208
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(1,292)	359
Inventory	(169)	122
Deferred products costs	1,121	2,360
Prepaid expenses and other current assets	(1,133)	(342)
Noncurrent assets	54	171
Accounts payable	1,099	(241)
Accrued liabilities	2,778	(1,553)
Deferred rent	321	228
Deferred revenue	2,596	3,158
Net cash provided by (used in) operating activities	$1,932	$(329)
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	$3,151	$721
Purchase of short-term investments	(49,316)	(5,082)
Purchase of property and equipment, net	(3,884)	(3,764)
Acquisitions of business (net of cash acquired)	—	(160)
Net cash used in investing activities	$(50,049)	$(8,285)
Cash flows from financing activities		
Proceeds from issuance of common stock, net of repurchases	$2,106	$866
Proceeds from initial public offering, net of offering costs	68,329	—
Proceeds of equipment financing loans	—	2,926
Repayments of equipment financing loans	(557)	(173)
Net cash provided by financing activities	$69,878	$3,619
Net increase (decrease) in cash and cash equivalents	21,761	(4,995)
Cash and cash equivalents		
Beginning of period	9,767	12,087
End of period	$31,528	$7,092
Supplemental disclosure of cash flow information		
Cash paid for interest	$177	$56
Cash paid for taxes	242	130
Supplemental disclosure of noncash investing and financing information		
Issuance of Series B preferred stock upon net exercise of warrants	—	91

Unpaid initial public offering costs	34	—

See accompanying Notes to the Condensed Consolidated Financial Statements.

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Proofpoint, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)
(Dollars and share amounts in thousands, except per share amounts)

1. The Company and Summary of Significant Accounting Policies

The Company

Proofpoint, Inc. (the “Company”) was incorporated in Delaware in June 2002 and is headquartered in California. Proofpoint is a pioneering security-as-a-service vendor that enables large and mid-sized organizations worldwide to defend, protect, archive and govern their most sensitive data. The Company’s security-as-a-service platform is comprised of a number of data protection solutions, including threat protection, regulatory compliance, archiving and governance, and secure communication.

Reverse Stock Split

On March 30, 2012, the Company's Board of Directors approved a 1-for-2 reverse stock split of the Company's common stock. The reverse stock split became effective on April 2, 2012. Upon the effectiveness of the reverse stock split, (i) every two shares of outstanding common stock was decreased to one share of common stock, (ii) the number of shares of common stock into which each outstanding option to purchase common stock is exercisable was proportionally decreased on a 1-for-2 basis, (iii) the exercise price of each outstanding option to purchase common stock was proportionately increased on a 1-for-2 basis, and (iv) the conversion ratio for each share of preferred stock outstanding was proportionately reduced on a 1-for-2 basis. All of the share numbers, share prices, and exercise prices have been retrospectively adjusted to reflect the reverse stock split.

Basis of Presentation and Consolidation

The accompanying unaudited condensed consolidated financial statements and condensed footnotes have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for fair statement have been included. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results to be expected for the year ended December 31, 2012 or for other interim periods or for future years.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated on consolidation. The condensed consolidated balance sheet as of December 31, 2011 is derived from audited financial statements as of that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Prospectus dated April 19, 2012, filed with the SEC pursuant to Rule 424(b)(4) under the Securities Act of 1933 (the “Securities Act”), as amended.

Use of Estimates

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

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Foreign Currency Remeasurement and Transactions

The Company's sales to international customers are generally U.S. dollar denominated. As a result, there are no significant foreign currency gains or losses related to these transactions. The functional currency for the Company's wholly-owned foreign subsidiaries is the U.S. dollar. Accordingly, the subsidiaries remeasure monetary assets and liabilities at period-end exchange rates, while nonmonetary items are remeasured at historical rates. Income and expense accounts are remeasured at the average exchange rates in effect during the year. Remeasurement adjustments are recognized in the consolidated statement of operations as transaction gains or losses within other income (expense), net, in the period of occurrence. Aggregate transaction gains (losses) included in determining net loss were $109 and $(28) for the three months, and $(108) and $93 for the nine months ended September 30, 2012 and 2011, respectively.

Cash, Cash Equivalents and Short Term Investments

The Company considers all highly liquid instruments purchased with an original maturity date of 90 days or less from the date of purchase to be cash equivalents. Cash equivalents consist of money market funds and certain types of commercial paper. Cash and cash equivalents were $31,528 and $9,767 as of September 30, 2012 and December 31, 2011, respectively. Short-term investments consist of readily marketable securities with remaining maturity of more than three months from the date of purchase and include certain types of commercial paper, corporate bonds, debt securities and certificates of deposit. Short-term investments were $49,125 and $2,947 as of September 30, 2012 and December 31, 2011, respectively, and all were classified as available-for-sale and were carried at fair value, with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss). Realized gains and losses are included in "other income (expense), net." Fair value is estimated based on available market information. The cost of securities sold is based on the specific identification method.

Revenue Recognition

The Company derives its revenue primarily from two sources: (1) subscription revenue for rights related to the use of the security-as-a-service platform and (2) hardware, training and professional services revenue provided to customers related to their use of the platform. Subscription revenue is derived from a subscription based enterprise licensing model with contract terms typically ranging from one to three years, and consist of (i) subscription fees from the licensing of the security-as-a-service platform, (ii) subscription fees for access to the on-demand elements of the platform and (iii) subscription fees for the right to access the Company's customer support services.

The Company applies the provision of ASC 985-605, "Software Revenue Recognition," and related interpretations, to all transactions involving the licensing of software, as well as related support, training, and other professional services. ASC 985-605 requires revenue earned on software arrangements involving multiple elements such as software license, support, training and other professional services to be allocated to each element based on the relative fair values of these elements. The fair value of an element must be based on vendor specific objective evidence ("VSOE") of fair value. VSOE of fair value of each element is based on the price charged when the element is sold separately. Revenue is recognized when all of the following criteria are met as set forth in ASC 985-605:

- Persuasive evidence of an arrangement exists,
- Delivery has occurred,
- The fee is fixed or determinable, and
- Collectability is probable.

The Company has analyzed all of the elements included in its multiple element arrangements and has determined that it does not have sufficient VSOE of fair value to allocate revenue to its subscription and software license agreements, support, training, and professional services. The Company defers all revenue under the software arrangement until the commencement of the subscription services and any associated professional services. Once the subscription services and the associated professional services have commenced, the entire fee from the arrangement is recognized ratably over the remaining period of the arrangement. If the professional services are essential to the functionality of the subscription, then the revenue recognition

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does not commence until such services are completed.
In the consolidated statement of operations, revenue is categorized as "subscription" and "hardware and services." Although the Company is unable to separate its multiple elements under the applicable revenue recognition guidance since it does not have sufficient VSOE of fair value for revenue recognition purposes, the Company has used a systematic and rational estimate to classify revenue between "subscription" and "hardware and services." For presentation purposes only, the Company allocates revenue to hardware and services based upon management's best estimate of fair value of such deliverables using a cost plus model. The remaining consideration of the arrangement is then allocated to subscription services. Management believes that this methodology provides a reasonable basis to allocate revenue between subscription and hardware and services for presentation purposes.
The hosted on-demand service agreements do not provide customers with the right to take possession of the software supporting the hosted service. The Company recognizes revenue from its hosted on-demand services in accordance with ASC 605-20, and as such recognizes revenue when the following criteria are met:

- Persuasive evidence of an arrangement exists,
- Delivery of the Company’s obligations to its customers has occurred,
- Collection of the fees is probable, and
- The amount of fees to be paid by the customer is fixed or determinable.

In October 2009, the FASB amended the accounting guidance for multiple element arrangements (“ASU 2009-13”) to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the arrangement consideration should be allocated among its elements;
- Require an entity to allocate revenue in an arrangement that has separate units of accounting using best estimated selling price (“BESP”) of deliverables if a vendor does not have VSOE of fair value or third-party evidence of selling price (“TPE”), and
- Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method to the separate unit of accounting.

Concurrently, the FASB amended the accounting guidance for revenue recognition (“ASU 2009-14”) to exclude hardware appliances containing software components and hardware components that function together to deliver the hardware appliance’s essential functionality from the scope of the software revenue recognition guidance of ASC 985-605.
The Company elected to adopt this new guidance in the first quarter of fiscal 2011 for new and materially modified revenue arrangements originating after January 1, 2011.
Prior to the adoption of ASU 2009-14, revenue derived from hardware appliance sales were recognized based on the software revenue recognition guidance. The Company could not establish VSOE of fair value for the undelivered elements in the arrangement, and therefore the entire fee from the arrangement was recognized ratably over the contractual term of the agreement. In addition, the Company was unable to establish VSOE of fair value of its hosted on-demand service agreements, and therefore the entire fee for the agreement was recognized ratably over the contractual term of the agreement.
As a result of the adoption of this accounting guidance, revenue derived from our subscription services and hardware appliance sales are no longer subject to industry specific software revenue recognition guidance. For all arrangements within the scope of these new accounting pronouncements, including the Company’s hosted on-demand services, the Company evaluates each element in a multiple element arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company’s control. Revenue derived from the licensing of the security-as-a-service platform

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continues to be accounted for in accordance with the industry specific revenue recognition guidance.

Hardware appliance revenue is recognized upon shipment. Subscription and support revenue are recognized over the contract period commencing on the start date of the contract. Professional services and training, when sold with hardware appliances or subscription and support services, are accounted for separately when those services have standalone value. In determining whether professional services and training services can be accounted for separately from subscription and support services, the Company considers the following factors: availability of the services from other vendors, the nature of the services, and the dependence of the subscription services on the customer's decision to buy the professional services. If professional services and training do not qualify for separate accounting, the Company recognizes the professional services and training ratably over the contract term of the subscription services.

Delivery generally occurs when the hardware appliance is delivered to a common carrier freight on board shipping point by the Company or the hosted service has been activated and communicated to the customer accordingly. The Company's fees are typically considered to be fixed or determinable at the inception of an arrangement and are negotiated at the outset of an arrangement, generally based on specific products and quantities to be delivered. In the event payment terms are provided that differ significantly from the Company's standard business practices, the fees are deemed to not be fixed or determinable and revenue is recognized as the fees become paid.

The Company assesses collectability based on a number of factors, including credit worthiness of the customer and past transaction history of the customer. Through September 30, 2012, the Company has not experienced significant credit losses.

Deferred Revenue

Deferred revenue primarily consists of billings or payments received in advance of revenue recognition from the sale of the Company's subscription fees, training and professional services. Once the revenue recognition criteria are met, this revenue is recognized ratably over the term of the associated contract, which typically ranges from 12 to 36 months.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company's cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair values due to their short maturities. Based on borrowing rates that are available to the Company for loans with similar terms and consideration of the Company's credit risk, the carrying value of the note payable approximates its fair value.

Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity that are not the result of transactions with stockholders. The Company's comprehensive income (loss) consists of its net loss and changes in unrealized gains (losses) from its available-for-sale investments. For the Company's first reporting period beginning after December 15, 2011, the Company adopted guidance issued by FASB amending the presentation of the Statement of Comprehensive Income. The amended guidance eliminates the current option to report other comprehensive income and its components of other comprehensive income as part of the statement of changes in stockholders' equity. In addition, it gives an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The Company has implemented this guidance effective beginning with the quarter ended March 31, 2012.

2. Acquisitions

Spam and Open Relay Blocking System ("SORBS")

On June 30, 2011, the Company entered into an asset purchase agreement (the "SORBS Agreement") with GFI Software Ltd., a British Virgin Islands corporation.

Under the terms of the SORBS agreement, the Company paid consideration of $200 for intellectual property and fixed

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assets with $40 being held in escrow to secure indemnification obligations, which was released from escrow in September 2012. The acquisition related costs of $28 incurred by the Company was charged to operating expenses in the year ended December 31, 2011.

Of the total cash consideration paid, $120 was allocated to goodwill as the intellectual property purchased did not meet the criteria for purchase price allocations as set forth in ASC 805, Business Combinations, and $46 was recorded as fixed assets. The following table summarizes the allocation of the purchase price and the estimated useful lives of the identifiable intangible assets acquired as of the date of the acquisition:

	Estimated Fair Value	Estimated Useful Life
Tangible assets acquired	$46	1 year
Liabilities assumed	—	
Developed technology	34	2 years
Customer relationships	—	
Vendor relationships	—	
Goodwill	120	Indefinite
	$200	

There were no acquisition related activities for the three or nine months ended September 30, 2012.

3. Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price of the acquired enterprise over the fair value of identifiable assets acquired and liabilities assumed. The Company applies ASC 350, “Intangibles—Goodwill and Other,” and performs an annual goodwill impairment test during the fourth quarter of the Company’s fiscal year and more frequently if an event or circumstance indicates that an impairment may have occurred. For the purposes of impairment testing, the Company has determined that it has one reporting unit. A two-step impairment test of goodwill is required pursuant to ASC 350-20-35. In the first step, the fair value of the reporting unit is compared to its carrying value. If the fair value exceeds the carrying value, goodwill is not impaired and further testing is not required. If the carrying value exceeds the fair value, then the second step of the impairment test is required to determine the implied fair value of the reporting unit’s goodwill. The implied fair value of goodwill is calculated by deducting the fair value of all tangible and intangible net assets of the reporting unit, excluding goodwill, from the fair value of the reporting unit as determined in the first step. If the carrying value of the reporting unit’s goodwill exceeds its implied fair value, then an impairment loss must be recorded that is equal to the difference. The identification and measurement of goodwill impairment involves the estimation of the fair value of the Company. The estimate of fair value of the Company, based on the best information available as of the date of the assessment, is subjective and requires judgment, including management assumptions about expected future revenue forecasts and discount rates. No impairment to the carrying value of goodwill was identified to date by the Company during the nine months ended September 30, 2012.

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

Intangible assets are amortized on a straight-line basis over their estimated lives, which approximate the pattern in which the economic benefits of the intangible assets are consumed, typically ranging from two to four years.

Developed technology	4 years
Customer relationships	4 years
Vendor relationships	4 years

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The goodwill activity and balances are presented below:

	September 30, 2012	December 31, 2011
Opening balance	$18,557	$15,932
Add: Goodwill from acquisitions	—	2,625
Closing balance	$18,557	$18,557

The goodwill balance as of September 30, 2012 and December 31, 2011 was the result of the acquisitions of Fortiva, Inc., Secure Data in Motion, Inc (“Sigaba”), Everyone.net, Inc. (“EDN”), GFI Software Ltd., Spam and Open Relay Blocking System or (“SORBS”) and NextPage, Inc..

Intangible Assets

Intangible assets excluding goodwill, consisted of the following:

	September 30, 2012			December 31, 2011		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	$17,641	$(14,830)	$2,811	$17,641	$(12,378)	$5,263
Customer relationships	2,408	(2,042)	366	2,408	(1,685)	723
Vendor relationships	—	—	—	290	(290)	—
Non compete	106	(21)	85	106	(1)	105
Trademark and patents	98	(35)	63	98	—	98
	$20,253	$(16,928)	$3,325	$20,543	$(14,354)	$6,189

In the quarter ended March 31, 2011, the Company revised the useful life of the vendor relationship intangible asset. The Company fully depreciated this intangible asset given that it is no longer using the technology provided by this vendor. Accordingly, the entire remaining balance of $0.3 million was expensed.

Amortization expense of intangibles totaled $413 and $1,091 during the three months, and $2,864 and $3,434 during the nine months ended September 30, 2012 and 2011, respectively.

Future estimated amortization costs of intangible assets as of September 30, 2012 are presented below:

Remainder of 2012	$412
2013	1,479
2014	725
2015	709
	$3,325

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4. Financial Instruments and Fair Value Measurements

The cost and fair value of the Company's available-for-sale investments as of September 30, 2012 and December 31, 2011 were as follows:

	September 30, 2012			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and Cash Equivalents:				
Cash	$9,920	$—	$—	$9,920
Money market funds	21,608	—	—	21,608
Commercial paper	—	—	—	—
Total	$31,528	$—	$—	$31,528
Short term investments:				
Corporate debt securities	$29,118	$12	$(2)	$29,128
Commercial paper	17,978	—	—	17,978
Certificates of deposit	2,019	—	—	2,019
Total	$49,115	$12	$(2)	$49,125

	December 31, 2011			
	Cost Basis	Unrealized Gains	Unrealized Losses	Fair Value
Cash and Cash Equivalents:				
Cash	$2,917	$—	$—	$2,917
Money market funds	6,850	—	—	6,850
Total	$9,767	$—	$—	$9,767
Short term investments:				
Corporate debt securities	$2,650	$—	$(3)	$2,647
Commercial paper	300	—	—	300
Total	$2,950	$—	$(3)	$2,947

As of September 30, 2012 and December 31, 2011, all investments mature in less than one year. Estimated fair values for marketable securities are based on quoted market prices for the same or similar instruments.

Fair Value Measurements

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

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

• Level 1: Quoted (unadjusted) prices in active markets for identical assets or liabilities.

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The Company's Level 1 assets generally consist of money market funds.

- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

The Company's Level 2 assets and liabilities generally consist of corporate bonds and agency debt securities, commercial paper, and certificates of deposit.

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

The Company's Level 3 liabilities have historically consisted of the Series B preferred stock warrants, which were exercised during the year ended December 31, 2011 and the equipment financing loans.

The following tables summarize, for each category of assets or liabilities, the respective fair value as of September 30, 2012 and December 31, 2011 and the classification by level of input within the fair value hierarchy.

	Balance as of September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Cash equivalents:				
Money market funds	$21,608	$21,608	$—	$—
Commercial paper	—	—	—	—
Short-term investments:				
Corporate debt securities	29,128	—	29,128	—
Commercial paper	17,978	—	17,978	—
Certificates of deposit	2,019	—	2,019	—
Total financial assets	$70,733	$21,608	$49,125	$—

	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Cash equivalents:				
Money market funds	$6,850	$6,850	$—	$—
Short-term investments:				
Corporate debt securities	2,647	—	2,647	—
Commercial paper	300	—	300	—
Total financial assets	$9,797	$6,850	$2,947	$—

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5. Commitments and Contingencies

Operating Leases

Thpropere Company leases certain of its facilities under noncancelable operating leases with various expiration dates through May 2017.

Rent expense was $393 and $388 for the three months and $1,165 and $1,084 for the nine months ended September 30, 2012 and 2011, respectively.

Capital Leases

The Company acquired capital leases as part of the EDN acquisition. The leases were secured by fixed assets primarily used in a data center. The leases have various expiration dates through October 2012. The interest rates range from 2.9% to 9.7%.

In July 2012, the Company entered into a lease agreement to lease certain office equipment with an expiration date in July 2015. The lease bears an annual interest rate of 4.5% and is secured by fixed assets used in the Company's corporate office location.

At September 30, 2012, future annual minimum lease payments under noncancelable operating and capital leases were as follows:

	Capital Leases	Operating Leases
2012 remainder	$7	$1,369
2013	18	3,241
2014	18	1,064
2015	10	248
2016		253
2017		107
Total minimum lease payments	53	$6,282
Less: Amount representing interest	(4)	
Present value of capital lease obligations	49	
Less: Current portion	(18)	
Long-term portion of capital lease obligations	$31	

Contingencies

Under the indemnification provisions of the Company’s customer agreements, the Company agrees to indemnify and defend and hold harmless its customers against, among other things, infringement of any patent, trademark or copyright under any country’s laws or the misappropriation of any trade secret arising from the customers’ legal use of the Company’s solutions. The exposure to the Company under these indemnification provisions is generally limited to the total amount paid by the customers under the applicable customer agreement. However, certain indemnification provisions potentially expose the Company to losses in excess of the aggregate amount paid to the Company by the customer under the applicable customer agreement. To date, there have been no claims against the Company or its customers pursuant to these indemnification provisions.

Legal Contingencies

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

The Company determined that subsequent to its acquisition of Fortiva, Inc., a Canadian company, in August 2008, it shipped a particular hardware appliance model to a limited number of international customers that, prior to shipment, required either a one-time product review or application for an encryption registration number in lieu of such product review. The Company has made voluntary submissions to the United States Commerce Department's Bureau of Industry and Security (BIS) to report this potential violation. Based upon the results of the internal investigation completed to date, the Company does not believe that the amount of any loss incurred as a result of this matter would be material to its business, financial condition, results of operations or cash flows.

As part of a pre-IPO due diligence review, the Company discovered a potential export violation involving the provision of web-based, email communication services through its Everyone.net service, which the Company acquired in October 2009. The Company's records indicate that there were two end-users who may have, for a portion of their respective service periods, been located in Iran, a United States designated state sponsor of terrorism. The Company's internal investigation has progressed and the Company has found that the issues identified are specific to the acquired Everyone.net system, which has a separate customer database and billing system from that of Proofpoint's main businesses. The Company does not have any indication that these services were utilized by the Iranian government. The accounts of both end-users were terminated in 2010 and accounted for approximately $15 in payments to us in 2009 and $6 in payments to us in 2010. Although the Company has ceased providing the service, the Company has made voluntary submissions to the U.S. Department of Treasury's Office of Foreign Assets Control, or OFAC, to report this potential violation. Based upon the results of the internal investigation completed to date, the Company does not believe that the amount of any loss incurred as a result of this matter would be material to its business, financial condition, results of operations or cash flows.

6. Debt

Equipment Financing Loans

The Company entered into a new equipment loan agreement with Silicon Valley Bank in April 2011 for an aggregate loan principal amount of $6,000. Interest on the advances is equal to prime rate plus 0.50%. As of September 30, 2012, the interest on the outstanding advances was 4.50%. The Company had the ability to draw down on this equipment line through April 19, 2012. Each drawn amount is due 48 months after funding. Borrowings outstanding under the equipment loan at September 30, 2012 were $4,378. Equipment financed under this loan arrangement is collateralized by the respective assets underlying the loan. The terms of the loan restrict the Company's ability to pay dividends. The loan includes a covenant that requires the Company to maintain cash and cash equivalents plus net accounts receivable of at least two times the amount of all outstanding indebtedness. As of September 30, 2012, the Company was in compliance with the financial covenant.

The Company had a previous equipment loan arrangement with Silicon Valley Bank for $2,000. The loan bore interest at an annual rate of 8.75%. The maturity date was 36 months after the funding date. Borrowings outstanding under the equipment loan at September 30, 2011 were $0, as the loan was completely repaid and terminated in June 2011. Equipment financed under this loan arrangement was collateralized by the respective assets underlying each specific draw down. This loan required the Company to maintain a tangible net worth greater than $18,000 and during the term of the loan, the Company was in compliance with the financial covenant.

Interest expense was $53 and $20 for the three months ended, and $162 and $22 for the nine months ended September 30, 2012 and 2011, respectively.

At September 30, 2012, the remaining repayment commitments related to the equipment loans are as follows:

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2012 remainder	$410
2013	1,642
2014	1,642
2015	684
2016	—
	$4,378

7. Stockholders' Equity

Initial Public Offering

In April 2012, the Company completed its initial public offering of its common stock to the public ("IPO") whereby 5,859 shares of common stock sold by the Company (inclusive of 729 shares of common stock from the partial exercise of the overallotment option granted to the underwriters) and 1,370 shares of common stock sold by the selling shareholders (inclusive of 171 shares of common stock from the partial exercise of the overallotment option granted to the underwriters). The public offering price of the shares sold in the offering was $13.00 per share. The Company did not receive any proceeds from the sales of shares by the selling stockholders. The total gross proceeds from the offering to the Company were $76.2 million. After deducting underwriters' discounts and commissions and offering expenses, the aggregate net proceeds received by the Company totaled approximately $68.3 million. Immediately prior to the closing of the IPO, all shares of the Company's outstanding redeemable convertible preferred stock automatically converted into 19,567 shares of common stock. As a result, following the IPO, the Company has two classes of authorized stock: Common stock and Preferred stock.

As of September 30, 2012, the Company is authorized to issue two classes of stock totaling 205,000 shares, of which 5,000 are designated as preferred stock and 200,000 are designated common stock, each with a par value of $0.0001 per share.

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

The following table presents the shares authorized and issued and outstanding as of the dates presented:

	As of September 30, 2012		As of December 31, 2011		
	Shares Authorized	Outstanding	Shares Authorized	Outstanding	Liquidation Amount
Convertible preferred stock Series A	—	—	7,400	7,400	$7,400
Convertible preferred stock Series B	—	—	7,109	7,080	9,062
Convertible preferred Series C	—	—	8,307	8,307	20,020
Convertible preferred Series D	—	—	665	665	2,001
Convertible preferred Series E	—	—	5,743	5,743	20,001
Convertible preferred Series F	—	—	10,200	9,747	51,854
Common Stock	200,000	31,887	71,400	4,961	—
Undesignated preferred stock	5,000	—	—	—	—
	205,000	31,887	110,824	43,903	$110,338

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

	As of September 30, 2012	As of December 31, 2011
Options available for future grant under the stock plans	5,077	364
Options outstanding under stock option plans	10,205	10,705
Shares available for future issuance under ESPP	745	—
Conversion of convertible preferred stock	—	39,134
Common stock issuable upon exercise of warrant and settlement of outstanding restricted stock units	23	25
Total shares reserved	16,050	50,228

Stock Option Plan

On March 30, 2012, the Board of Directors and the Company’s stockholders approved the 2012 Equity Incentive Plan (the "2012 Plan"), which became effective in April 2012. The Company has two equity incentive plans: the Company’s 2002 stock option plan (the “2002 Plan”) and the 2012 Equity Incentive Plan. Upon the IPO, all shares that were reserved under the 2002 Plan but not issued, and shares issued but subsequently returned to the plan through forfeitures, cancellations and repurchases became part of the 2012 Plan and no further shares will be granted pursuant to the 2002 Plan. All outstanding stock awards under the 2002 and 2012 Plans will continue to be governed by their existing terms. Under the 2012 Plan, the Company has the ability to issue incentive stock options (“ISOs”), nonstatutory stock options (“NSOs”), restricted stock awards, stock bonus awards, stock appreciation rights ("SARs"), restricted stock units (“RSUs”), and performance shares. The 2012 Plan also allows direct issuance of common stock to employees, outside directors and consultants at prices equal to the fair market value at the date of grant of options or issuance of common stock. Additionally, the 2012 Plan provides for the grant of performance cash awards to employees, directors and consultants. The Company has the right to repurchase any unvested shares (at the option exercise price) of common stock issued directly or under option exercises. The right of repurchase generally expires over the vesting period.

Under the 2012 and 2012 Plans, the term of an option grant shall not exceed ten years from the date of its grant and options generally vest over a three to four-year period, with vesting on a monthly or annual interval. 20,316 shares of common stock are reserved for issuance to eligible participants, under the 2012 Plan. As of September 30, 2012, 5,077 shares were available for future grant. Restricted stock awards generally vest over a four-year period with 25% vesting at the end of one year and the remaining vest quarterly thereafter. The number of shares available for grant and issuance under the 2012 Plan will be increased automatically on each January 1 of 2013 through 2016 by an amount equal to 5% of the Company's shares outstanding on the immediately preceding December 31, but not to exceed 3,724 shares, unless the Board of Directors, in its discretion, determines to make a smaller increase.

Employee Stock Purchase Plan

On March 30, 2012, the Board of Directors and the Company’s stockholders approved the 2012 Employee Stock Purchase Plan (the "ESPP"), which became effective in April 2012. A total of 745 shares of the Company's common stock are initially reserved for future issuance under the ESPP. The number of shares reserved for issuance under the ESPP will increase automatically on January 1 of each of the first eight years commencing with 2013 by the number of shares equal to 1% of the Company's shares outstanding on the immediately preceding December 31, but not to exceed 1,490 shares, unless the Board of Directors, in its discretion, determines to make a smaller increase. As of September 30, 2012, there were 745 shares of the Company's common stock available for future issuance under the ESPP.

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Activity under the Plan was as follows:

	Shares subject to Options Outstanding			
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Balance at December 31, 2011	10,705	$3.83	6.77	$44,466
Options granted	1,547	9.79		
Options exercised	(1,500)	1.42		
Options forfeited and canceled	(547)	5.82		
Balance at September 30, 2012	10,205	$4.98	6.94	$100,748

The total intrinsic value of options exercised was $10,725 and $1,505, for the nine months ended September 30, 2012, and for the year ended December 31, 2011 respectively. Total cash proceeds from such option exercises were $2,125 and $1,198 for the nine months ended September 30, 2012, and for the year ended December 31, 2011, respectively.

Restricted Stock Units

During the year ended December 31, 2011, the Company acquired NextPage, Inc. and assumed NextPage's 2007 Stock Plan (the "2007 Plan") and the RSUs granted to certain employees. Under the 2007 Plan, the Company assumed 23 RSUs, which remain subject to their original terms and conditions.

The fair value of each unit is based on the fair value of the Company’s common stock on the date of assumption. A summary of the status of RSUs awarded and unvested under the stock option plans as of September 30, 2012 is presented below (in thousands, except per share amounts):

	RSUs Outstanding Number of Shares	Granted Fair Value Per Unit
Awarded and unvested at December 31, 2011	8	$7.98
Awards assumed	—	7.98
Awards vested	(5)	7.98
Awards forfeited	(1)	7.98
Awarded and unvested at September 30, 2012	2	$7.98

As of September 30, 2012, there was $12 of unamortized stock based compensation expense related to unvested RSUs, which are expected to be recognized over a weighted average period of 0.45 years.

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8. Stock Based Compensation

The Company recognized stock-based compensation expense under the Plan in the consolidated statements of operations as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of subscription revenue	$205	$76	$443	$281
Cost of hardware and services revenue	20	7	46	20
Research and development	502	307	1,409	868
Sales and marketing	830	511	2,301	1,418
General and administrative	390	220	1,184	704
Total stock-based compensation expense	$1,947	$1,121	$5,383	$3,291

The fair value of options granted is estimated on the grant date using the Black Scholes option valuation model. This valuation model for stock based compensation expense requires the Company to make assumptions and judgments about the variables used in the calculation, including the expected term (weighted average period of time that the options granted are expected to be outstanding), the volatility of the common stock price, an assumed risk-free interest rate and the estimated forfeitures of unvested stock options. To the extent actual forfeitures differ from the estimates, the difference will be recorded as a cumulative adjustment in the period estimates are revised. No compensation cost is recorded for options that do not vest and the compensation cost from vested options, whether forfeited or not, is not reversed.

Prior to the Company's IPO, the Board of Directors, in good faith, determined the fair market values of the Company's common stock, based on the best information available to the Board and the Company's management at the time of grant. The Company performed its analysis in accordance with applicable elements of the practice aid issued by the American Institute of Certified Public Accountants entitled Valuation of Privately Held Company Equity Securities Issued as Compensation. The procedures performed to determine the fair value of the Company's common stock were based on a probability weighted expected return method to estimate the aggregate equity value of the Company.

The weighted average fair value of stock options granted to employees was $7.51 and $3.23 during the three months ended, and $5.39 and $3.14 during the nine months ended September 30, 2012 and 2011, respectively. The fair values were estimated on the grant dates using the Black Scholes option pricing model with the following weighted average assumptions:

	Three Months ended September 30,		Nine Months ended September 30,	
	2012	2011	2012	2011
Expected life (in years)	6.08	6.08	5.50-6.08	6.08
Volatility	59%	60%	59-60%	59-60%
Risk-free interest rate	1.0%	1.5%	1.0-1.2%	1.5-2.5%
Dividend yield	—%	—%	—%	—%

The estimate for expected life of options granted reflects the midpoint of the vesting term and the contractual life computed utilizing the simplified method as allowed by the SEC staff. The Company does not have significant historical share option exercise experience and hence considers the expected term assumption calculated using the simplified method to be reasonable. The stock volatility assumptions represent an estimate of the historical volatilities of the common stock of a group of publicly traded peer companies that operate in a similar industry. The estimate was determined based on the average historical volatilities of these peer companies. The risk-free interest rate used was the Federal Reserve Bank's constant maturities interest rate commensurate with the expected life of the options in effect at the time of the grant. The expected dividend yield was zero, as the Company does not anticipate paying a dividend within the relevant time frame. Expected forfeitures are estimated based on the Company's historical experience.

The Company realized no income tax benefit from stock option exercises in each of the periods presented due to recurring losses and defined tax asset valuation allowances.

As of September 30, 2012, the Company had unamortized stock based compensation expense of $13,358 related to stock options, that will be recognized net of forfeitures over the average remaining vesting term of the options of 2.70 years.

The fair value of the option component of the ESPP shares was estimated at the grant date using the Black-Scholes option pricing model with the following weighted average assumptions:

	Three Months ended September 30,		Nine Months ended September 30,	
	2012	2011	2012	2011
Expected life (in years)	n/a	*	0.53	*
Volatility	n/a	*	51%	*
Risk-free interest rate	n/a	*	0.13%	*
Dividend yield	n/a	*	—%	*

* Employee participation in the ESPP did not begin until the second quarter of 2012.

As of September 30, 2012, the Company expects to recognize $85 of the total unamortized compensation cost related to employee purchases under the ESPP over a weighted average period of 0.08 years.

9. Net Loss per Share

Basic net loss per share of common stock is calculated by dividing the net loss by the weighted average number of shares of common stock outstanding for the period. The weighted average number of shares of common stock used to calculate our basic net loss per share of common stock excludes those shares subject to repurchase related to stock options that were exercised prior to vesting as these shares are not deemed to be issued for accounting purposes until they vest. Diluted net loss per share of common stock is computed by dividing the net loss using the weighted average number of shares of common stock, excluding common stock subject to repurchase, and, if dilutive, potential shares of common stock outstanding during the period. Basic and diluted net loss per common share was the same for all periods presented as the impact of all potentially dilutive securities outstanding was anti-dilutive.

The following table presents the calculation of basic and diluted net loss per share:

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Numerator:				
Net loss	$(4,592)	$(4,313)	$(14,863)	$(13,717)
Denominator:				
Weighted average number of common shares used in computing basic and diluted net loss per share	31,844	4,048	21,258	3,931
Net loss per common share				
Basic and diluted net loss per share	$(0.14)	$(1.07)	$(0.70)	$(3.49)

The following table presents the potentially dilutive common shares outstanding that were excluded from the computation of diluted net loss per share of common stock for the periods presented because including them would have been anti-dilutive:

	Nine Months Ended September 30,	
	2012	2011
Convertible preferred stock (as converted)	—	19,567
Stock options to purchase common stock	10,205	10,113
Common stock subject to repurchase	5	2
Convertible preferred stock warrants	—	—
Common stock warrants	—	2
Restricted stock units	23	—
Total	10,233	29,684

10. Segment Reporting

Operating segments are reported in a manner consistent with the internal reporting supported and defined by the components of an enterprise about which separate financial information is available, provided and is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company’s chief operating decision maker is its chief executive officer. The Company’s chief executive officer reviews financial information presented on a consolidated basis and as a result, the Company concluded that there is only one operating and reportable segment.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Total revenue:				
United States	$21,966	$16,221	$63,272	$46,704
Rest of World	5,118	4,265	14,374	12,443
Total revenue	$27,084	$20,486	$77,646	$59,147

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	Nine Months Ended September 30, 2012	Year Ended December 31, 2011
Long-lived assets:		
United States	$6,073	$5,198
Rest of World	1,627	2,155
Total long lived assets	$7,700	$7,353

11. Income Taxes

The Company’s quarterly provision for income taxes is based on an estimated effective annual income tax rate. The Company’s quarterly provision for income taxes also includes the tax impact of certain unusual or infrequently occurring items, if any, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur.

Income tax expense for the three months and nine months ended September 30, 2012 was $119 and $430 on pre-tax losses of $4,473 and $14,433, respectively. Income tax expense for the three months and nine months ended September 30, 2011 was $33 and $169 on pre-tax losses of $4,280 and $13,548, respectively. As of September 30, 2012, the income tax rate varies from the United States statutory income tax rate primarily due to valuation allowances in the United States and certain foreign jurisdictions whereby pre-tax losses in these jurisdictions do not result in the recognition of corresponding income tax benefits.

The Company's effective tax rate for the nine months ended September 30, 2012 increased to 3.0% from 1.2% for the same prior year period. The current period's effective tax rate was negatively impacted by an increase in interest and penalties as a result of the completion of a transfer pricing analysis that occurred in the three months ended June 30, 2012.

The Company reviews the likelihood that it will realize the benefit of its deferred tax assets and, therefore, the need for valuation allowances on a quarterly basis. There is no corresponding income tax benefit recognized with respect to losses incurred and no corresponding income tax expense recognized with respect to earnings generated in jurisdictions with a valuation allowance. This causes variability in the Company’s effective tax rate. The Company intends to maintain the valuation allowances until it is more likely than not that the net deferred tax assets will be realized.

As of September 30, 2012, due to recent net cumulative losses and other negative evidence, a valuation allowance of approximately $4,200 remains on certain non-U.S. deferred tax assets that are not more-likely-than-not to be realized. The Company evaluates its deferred tax asset valuation allowance position on a quarterly basis. As a result, the Company believes a reversal of a significant portion of the Company's valuation allowance on non-U.S. deferred tax assets is possible in the next 12 months.

As of September 30, 2012, the Company's gross uncertain tax benefits totaled $2,635, excluding related accrued interest and penalties of $178. As of September 30, 2012, $257 of the Company's uncertain tax benefits, including related accrued interest and penalties, would affect its effective tax rate if recognized. During the three months ended September 30, 2012, our gross uncertain tax benefits increased $142. The increase is comprised of an $111 increase for tax positions taken in the current period and a $31 decrease for tax positions taken in prior periods.

The Company is not currently under audit by the IRS or any similar taxing authority in any other material jurisdiction. The Company believes it has recorded all appropriate provisions for all jurisdictions and open years. However, the Company can give no assurance that taxing authorities will not propose adjustments that increase the tax liabilities.

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ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the (1) unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q, and (2) the audited consolidated financial statements and notes thereto and management’s discussion and analysis of financial condition and results of operations for the fiscal year ended December 31, 2011 included in the final prospectus for our initial public offering, or IPO, dated as of, and filed with the Securities and Exchange Commission, or the SEC, pursuant to Rule 424(b)(4) on April 19, 2012 (File No. 333-178479). This Quarterly Report on Form 10-Q contains “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These statements are often identified by the use of words such as “may,” “will,” “expect,” “believe,” “anticipate,” “intend,” “could,” “estimate,” or “conti similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified herein, and those discussed in the section titled “Risk Factors”, set forth in Part II, Item 1A of this Form 10-Q and in our other SEC filings, including our final prospectus dated as of April 19, 2012. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

Proofpoint is a pioneering security-as-a-service vendor that enables large and mid-sized organizations worldwide to defend, protect, archive and govern their most sensitive data. Our security-as-a-service platform is comprised of an integrated suite of on-demand data protection solutions, including threat protection, regulatory compliance, archiving and governance, and secure communication.

We were founded in 2002 to provide a unified solution to help enterprises address their growing data security requirements. Our first solution was commercially released in 2003 to combat the burgeoning problem of spam and viruses and their impact on corporate email systems. As the threat environment has continued to evolve, we have dedicated significant resources to meet the ongoing challenges that this highly dynamic environment creates for our customers. In addition, we have invested significantly to expand the breadth of our data protection platform:

- In 2004, we launched our Regulatory Compliance and Digital Asset Security solutions, designed to prevent the loss of critical data. These Data Loss Prevention, or DLP, solutions apply our proprietary machine learning and deep content inspection technologies to screen outbound email to prevent the theft or inadvertent loss of sensitive or confidential information.
- In 2005, we launched Proofpoint Secure Messaging, our first email encryption solution.
- In 2006, we combined our email encryption and DLP technologies to develop a new solution for policy based encryption, enabling each outgoing message to be inspected for confidential content and automatically encrypted accordingly.
- In 2007, we began selling our software based virtual appliance, enabling our customers to deploy our solutions in a private cloud configuration. We also invested in international expansion by establishing a team in the United Kingdom as a precursor to the build out of our data center infrastructure, and launching operations in Germany and the Netherlands to support our customers outside of the United States..
- In 2008, we introduced Proofpoint Enterprise Archive, a cloud based email archiving solution that enables businesses to securely archive both their email and instant message conversations while enabling real-time access to the entire repository for quick and easy electronic discovery, or eDiscovery.
- In 2009, we launched Proofpoint Encryption, a proprietary email encryption solution that improved the level of

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integration across our data protection suite and allowed us to phase out technology licensed from a third party. We also introduced a cloud based email messaging service.

- In 2010, we evolved our solutions to address new forms of messaging and information sharing in the enterprise such as social media and Internet based collaboration and file sharing applications.
- In 2011, we achieved FISMA certification for our cloud based archiving and governance solution, enabling us to serve the rigorous security requirements of U.S. Federal agencies. We also introduced an integrated security offering in conjunction with VMware for its Zimbra Collaboration Server.
- In 2012, we introduced Proofpoint Enterprise Governance, an information governance solution that provides organizations the ability to monitor and apply governance policies to unstructured information across the enterprise. We also introduced Proofpoint Targeted Attack Protection, a solution designed to stop targeted attacks by combining previously disparate email security, Web security and malware analysis technologies into a single comprehensive cloud-based defense.

Our business is based on a recurring revenue model. Our customers pay a subscription fee to license the various components of our security-as-a-service platform for a contract term that is typically one to three years. At the end of the license term, customers may renew their subscription and in each year since the launch of our first solution in 2003, we have retained over 90% of our customers. We derive this retention rate by calculating the total annually recurring subscription revenue from customers currently using our security-as-a-service platform and dividing it by the total annually recurring subscription revenue from both these current customers as well as all business lost through non-renewal. A growing number of our customers increase their annual subscription fees after their initial purchase by broadening their use of our platform or by adding more users, as evidenced by the fact that these sales consistently represent 15% or more of our billings each year since 2008. As our business has grown, our subscription revenue has increased as a percentage of our total revenue, from 87% of total revenue in 2009, to 95% for the nine months ended September 30, 2012.

We market and sell our solutions to large and mid-sized customers both directly through our field and inside sales teams and indirectly through a hybrid model where our sales organization actively assists our network of distributors and resellers. We also derive a lesser portion of our revenue from the license of our solutions to strategic partners who offer our solutions in conjunction with one or more of their own products or services.

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

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

Our solutions are designed to be implemented, configured and operated without the need for any training or professional services. For those customers that seek to develop deeper expertise in the use of our solutions or would like assistance with complex configurations or the importing of data, we offer various training and professional services. In some cases, we provide a hardware appliance to those customers that elect to host elements of our solution behind their firewall. Increasing adoption of virtualization in the data center has led to a decline in the sales of our hardware appliances and a shift towards our software based virtual appliances, which are delivered as a download via the Internet. Our hardware and services offerings carry lower margins and are provided as a courtesy to our customers. The revenue derived from these offerings has declined from 8.3% and 11.2% of total revenue in the three and nine months ended September 30, 2011 to 4.0% and 4.7% of total revenue in the three and nine months ended September 30, 2012. We view this trend as favorable to our business and expect the overall proportion of total revenue derived from these offerings to continue to gradually decline.

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The substantial majority of our revenue is derived from our customers in the United States. We believe the markets outside of the United States offer an opportunity for growth and we intend to make additional investments in sales and marketing to expand in these markets. Customers from outside of the United States represented 18.9% and 18.5% for the three and nine months ended September 30, 2012, respectively, and 20.8% and 21.0% of total revenue for the three and nine months ended September 30, 2011, respectively. We had in excess of 2,400 customers around the world, including 28 of the Fortune 100. There was one partner that accounted for more than 10% of our total revenue in the three and nine months ended September 30, 2012, although the partner sold to a number of end user customers. There were no single partners or customers that accounted for more than 10% of our total revenue in the three and nine months ended September 30, 2011.

We have not been profitable to date and will need to grow revenue at a rate faster than our investments in cost of revenue and operating expenses in order to achieve profitability, as discussed in more detail below.

Key Opportunities and Challenges

The majority of costs associated with generating customer agreements are incurred up front. These upfront costs include direct incremental sales commissions, which are recognized upon the billing of the contract. The costs associated with the teams tasked with closing business with new customers and additional business with our existing customers have represented more than 90% of our total sales and marketing costs since 2008. Although we expect customers to be profitable over the duration of the customer relationship, these upfront costs typically exceed related revenue during the earlier periods of a contract. As a result, while our practice of invoicing our customers for the entire amount of the contract at the start of the term provides us with a relatively immediate contribution to cash flow, the revenue is recognized ratably over the term of the contract, and hence contributions toward operating income are limited in the period where these sales and marketing costs are incurred. Accordingly, an increase in the mix of new customers as a percentage of total customers would likely negatively impact our near term operating results. On the other hand, we expect that an increase in the mix of existing customers as a percentage of total customers would positively impact our operating results over time. As we accumulate customers that continue to renew their contracts, we anticipate that our mix of existing customers will increase, contributing to a decrease in our sales and marketing costs as a percentage of total revenue and a commensurate improvement in our operating income.

As part of maintaining our security-as-a-service platform, we provide ongoing updates and enhancements to the platform services both in terms of the software as well as the underlying hardware and data center infrastructure. These updates and enhancements are provided to our customers at no additional charge as part of the subscription fees paid for the use of our platform. While more traditional products eventually become obsolete and require replacement, we are constantly updating and maintaining our cloud based services and as such they operate with a continuous product life cycle. Much of this work is designed to both maintain and enhance the customers' experience over time while also lowering our costs to deliver the service, as evidenced by our improvements in gross profit over the past three years. Our security-as-a-service platform is a shared infrastructure that is used by all of our more than 2,400 customers. Accordingly, the costs of the platform are spread in a relatively uniform manner across the entire customer base and no specific infrastructure elements are directly attached to any particular customer. As such, in the event that a customer chooses to not renew its subscription, the underlying resources are reallocated either to new customers or to accommodate the expanding needs of our existing customers and, as a result, we do not believe that the loss of any particular customer has a meaningful impact on our gross profit as long as we continue to grow our customer base.

To date, our customers have primarily used our solutions in conjunction with email messaging content. We have developed solutions to address the new and evolving messaging solutions such as social media and file sharing applications, but these solutions are relatively nascent. If customers increase their use of these new messaging solutions in the future, we anticipate that our growth in revenue associated with email messaging solutions may slow over time. Although revenue associated with our social media and file sharing applications has not been material to date, we believe that our ability to provide security, archiving, governance and discovery for these new solutions will be viewed as valuable by our existing customers, enabling us to derive revenue from these new forms of messaging and communication.

While the majority of our current and prospective customers run their email systems on premise, we believe that there is a trend for large and mid sized enterprises to migrate these systems to the cloud. While our current revenue derived from customers using cloud based email systems continues to grow as a percentage of our total revenue, many of these cloud based email solutions offer some form of threat protection and governance services, potentially mitigating the need for customers to buy these capabilities from third parties such as ourselves. We believe that we can continue to provide security, archiving, governance, and discovery solutions that are differentiated from the services offered by cloud based email providers, and as

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such our platform will continue to be viewed as valuable to enterprises once they have migrated their email services to the cloud, enabling us to continue to derive revenue from this new trend toward cloud based email deployment models. We are currently in the midst of a significant investment cycle in which we have taken steps designed to drive future revenue growth and profitability. For example, we plan to build out our infrastructure, develop our technology, offer additional security-as-a-service solutions, and expand our sales and marketing personnel both in the United States and internationally. Accordingly, we expect that our total cost of revenue and operating expenses will continue to increase in absolute dollars, limiting our ability to achieve and maintain positive operating cash flow and profitability in the near term.

With the majority of our business, we invoice our customers for the entire contract amount at the start of the term and these amounts are recorded as deferred revenue on our balance sheet, with the dollar weighted average duration of these contracts for any given period over the past three years typically ranging from 20 to 25 months. As a result, while our practice of invoicing customers for the entire amount of the contract at the start of the term provides us with a relatively immediate contribution to cash flow, the revenue is recognized ratably over the term of the contract, and hence contributions toward operating income are realized over an extended period. As such, our efforts to improve our profitability require us to invest far less in operating expenses than the cash flow generated by our business might otherwise allow. As we strive to invest in an effort to continue to increase the size and scale of our business, we expect that the level of investment afforded by our growth in revenue should be sufficient to fund the investments needed to drive revenue growth and broaden our product line.

Considering all of these factors, we do not expect to be profitable on a GAAP basis in the near term and in order to achieve profitability we will need to grow revenue at a rate faster than our investments in operating expenses and cost of revenue.

We intend to grow our revenue through acquiring new customers by investing in our sales and marketing activities. We believe that an increase in new customers in the near term will result in a larger base of renewal customers, which, over time we expect to be more profitable for us.

Sales and marketing is our greatest expense and hence a significant contributing factor to our operating losses. Given that our costs to acquire new revenue sources, either in the form of new customers or the sale of additional solutions to existing customers, often exceed the actual revenue recognized in the initial periods, we believe that our opportunity to improve our return on investment on sales and marketing costs relies primarily on our ongoing ability to cost effectively renew our business with existing customers, thereby lowering our overall sales and marketing costs as a percentage of revenue as the mix of revenue derived from this more profitable renewal activity increases over time. Therefore, we anticipate that our initial significant investments in sales and marketing activities will over time generate a larger base of more profitable customers. Cost of subscription revenue is also a significant expense for us, and we expect to continue to build on the improvements over the past three years, such as in replacing third-party technology with our proprietary technology and improving the utilization of our fixed investments in equipment and infrastructure, in order to provide the opportunity for improved subscription gross margins over time. Although we plan to continue enhancing our solutions, we intend to lower our rate of investment in research and development as a percentage of revenue over time by deriving additional revenue from our existing platform of solutions rather than by adding entirely new categories of solutions. In addition, as personnel costs are one of the primary drivers of the increases in our operating expenses, we plan to reduce our historical rate of headcount growth over time.

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Key Metrics

We regularly review a number of metrics, including the following key metrics presented in the unaudited table below, to evaluate our business, measure our performance, identify trends in our business, prepare financial projections and make strategic decisions. Many of these key metrics, such as adjusted subscription gross profit, billings and adjusted EBITDA, are non-GAAP measures. This non-GAAP information is not necessarily comparable to non-GAAP information of other companies. Non-GAAP information should not be viewed as a substitute for, or superior to, net loss prepared in accordance with GAAP as a measure of our profitability or liquidity. Users of this financial information should consider the types of events and transactions for which adjustments have been made.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in thousands)		(in thousands)	
Total revenue	$27,084	$20,486		