QUALYS, INC.
Form 10-Q
May 08, 2018
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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 March 31, 2018
o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission file number 001-35662

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

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

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

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

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 April 30, 2018 was 38,978,887.

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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)

	March 31, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$93,174	$86,591
Short-term investments	235,353	201,823
Accounts receivable, net of allowance of $802 and $816 as of March 31, 2018 and December 31, 2017, respectively	49,874	64,412
Prepaid expenses and other current assets	15,488	16,524
Total current assets	393,889	369,350
Long-term investments	65,363	67,224
Property and equipment, net	60,696	58,557
Deferred tax assets, net	24,085	25,066
Intangible assets, net	11,769	12,401
Goodwill	1,549	1,549
Restricted cash	1,200	1,200
Other noncurrent assets	7,061	2,178
Total assets	$565,612	$537,525
Liabilities and Stockholders’ Equity		
Current liabilities:		
Accounts payable	$1,310	$1,144
Accrued liabilities	22,181	21,444
Deferred revenues, current	147,656	143,186
Total current liabilities	171,147	165,774
Deferred revenues, noncurrent	14,995	17,136
Other noncurrent liabilities	13,151	11,071
Total liabilities	199,293	193,981
Commitments and contingencies (Note 6)		
Stockholders’ equity:		
Preferred stock, $0.001 par value; 20,000,000 shares authorized, no shares issued and outstanding at March 31, 2018 and December 31, 2017	—	—
Common stock, $0.001 par value; 1,000,000,000 shares authorized; 38,957,692 and 38,598,117 shares issued and outstanding at March 31, 2018 and December 31, 2017	39	39
Additional paid-in capital	316,694	304,155
Accumulated other comprehensive loss	(965)	(574)
Retained earnings	50,551	39,924
Total stockholders’ equity	366,319	343,544
Total liabilities and stockholders’ equity	$565,612	$537,525

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

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

	Three Months Ended March 31,	
	2018	2017
Revenues	$64,878	$53,121
Cost of revenues	15,901	12,294
Gross profit	48,977	40,827
Operating expenses:		
Research and development	12,553	9,823
Sales and marketing	16,233	16,014
General and administrative	11,785	7,334
Total operating expenses	40,571	33,171
Income from operations	8,406	7,656
Other income (expense), net:		
Interest expense	(38)	(2)
Interest income	1,090	481
Other income (expense), net	193	(26)
Total other income (expense), net	1,245	453
Income before income taxes	9,651	8,109
Provision for (benefit from) income taxes	509	(13,821)
Net income	$9,142	$21,930
Net income per share:		
Basic	$0.24	$0.60
Diluted	$0.22	$0.56
Weighted average shares used in computing net income per share:		
Basic	38,789	36,493
Diluted	41,934	38,845

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

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

	Three Months Ended March 31,	
	2018	2017
Net income	$9,142	$21,930
Available-for-sale investments:		
Change in net unrealized loss on investments, net of tax	(407)	(62)
Less: reclassification adjustment for net realized gain (loss) included in net income, net of tax	16	(8)
Other comprehensive loss, net of tax	(391)	(70)
Comprehensive income	$8,751	$21,860

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

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

	Three Months Ended March 31,	
	2018	2017
Cash flows from operating activities:		
Net income	$9,142	$21,930
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	7,043	4,820
Bad debt expense	—	10
Loss on disposal of property and equipment	7	2
Stock-based compensation	8,891	4,332
Amortization of premiums and accretion of discounts on investments	36	426
Deferred income taxes	140	(22,559)
Excess tax benefits included in deferred tax assets	—	8,368
Changes in operating assets and liabilities:		
Accounts receivable	14,538	5,375
Prepaid expenses and other assets	(2,341)	981
Accounts payable	(302)	255
Accrued liabilities	4,577	463
Deferred revenues	2,330	8,012
Other non-current liabilities	(1,072)	10
Net cash provided by operating activities	42,989	32,425
Cash flows from investing activities:		
Purchases of investments	(72,176)	(60,201)
Sales and maturities of investments	40,080	63,738
Purchases of property and equipment	(5,985)	(4,543)
Net cash used in investing activities	(38,081)	(1,006)
Cash flows from financing activities:		
Proceeds from exercise of stock options	7,933	5,602
Payments for taxes related to net share settlement of equity awards	(4,030)	(14,107)
Principal payments under capital lease obligations	(747)	—
Repurchase of common stock	(1,481)	—
Net cash provided by (used in) financing activities	1,675	(8,505)
Net increase in cash, cash equivalents and restricted cash	6,583	22,914
Cash, cash equivalents and restricted cash at beginning of period	87,791	87,937
Cash, cash equivalents and restricted cash at end of period	$94,374	$110,851
Supplemental disclosures of cash flow information:		
Cash paid for interest expense	$73	$—
Cash paid for income taxes, net of refunds	$437	$380
Non-cash investing and financing activities		
Purchases of property and equipment recorded in accounts payable and accrued liabilities	$1,127	$3,027
Purchase of assets under capital lease	$2,755	$—

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

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

NOTE 1. The Company and Summary of Significant Accounting Policies

Description of Business

Qualys, Inc. (the “Company”, "we", "us", "our") was incorporated in the state of Delaware on December 30, 1999. The Company is headquartered in Foster City, California and has 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, 2017, included herein, was derived from the audited financial statements as of that date but does not include all disclosures, including notes required by U.S. GAAP. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, which include only normal recurring adjustments, necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the three month period ended March 31, 2018 are not necessarily indicative of the results of operations expected for the entire year ending December 31, 2018 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, 2017, filed with the SEC on February 23, 2018.

Except for the changes below, the Company has consistently applied the accounting policies, described in its Annual Report on Form 10-K for the year ended December 31, 2017, to all periods presented in the condensed consolidated financial statements.

The Company adopted Accounting Standards Codification ("ASC") 606 Revenue from Contracts with Customers with a date of initial application of January 1, 2018. The Company adopted ASC 606 using the modified retrospective method and recognized the cumulative effect as an adjustment to the opening balance of equity at January 1, 2018. Therefore, the comparative information from the prior period has not been adjusted and continues to be reported under ASC 605. The impact of adopting ASC 606 was related to the deferral of sales commission costs for new business and when customers increase their renewal orders (“upsells”). The Company previously expensed sales commissions as incurred. Under ASC 606, sales commissions cost related to new business and upsells are recorded as an asset. The Company expenses the commission cost as a selling expense on a straight-line basis over a period of five years. Five years represents the estimated life of the customer relationship taking into account factors such as peer estimates of technology lives and customer lives as well as the Company's own historical data. Applying the practical expedient in ASC 340-40-25-4, the Company expenses commissions related to contract renewals with a renewal contract term of one year or less. The current and noncurrent portions of deferred commissions are included in prepaid expenses and other current assets, and other noncurrent assets, respectively, in its condensed consolidated balance sheets.

On January 1, 2018, the Company recorded an increase to retained earnings of $2.7 million which was the net cumulative impact associated with the capitalization of sales commissions. Additionally, the Company recorded a corresponding commission asset balance of $3.5 million and a related deferred tax liability of $0.8 million. There was no impact to the Company's revenues as a result of adopting ASC 606. Without the adoption of ASC 606, commission expenses would have been $0.5 million higher in the three months ended March 31, 2018. See Note 4, “Revenue from Contracts with Customers”, for additional information regarding the impact on the Company's condensed consolidated financial statements.

Recently Adopted Accounting Pronouncements

In January 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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 ASU will impact the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The Company adopted this ASU in its first quarter of 2018. The adoption of this ASU did not have a material impact on the Company's condensed 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 Company adopted this ASU in its first quarter of 2018. The adoption of this ASU did not have a material impact on the Company's condensed consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash. The update provides guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows. The Company adopted this ASU retrospectively in its first quarter of 2018. The Company reclassified restricted cash of $1.2 million each for the three months ended March 31, 2018 and 2017, in the condensed consolidated statements of cash flows.

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. The Company adopted this ASU prospectively in its first quarter of 2018. The Company will apply the provisions of the update to future acquisitions.

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Recently Issued Accounting Pronouncements Not Yet Adopted

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires lessees to recognize all leases, including operating leases, on the balance sheet as a lease asset or lease liability, unless the lease is a short-term lease. ASU 2016-02 also requires additional disclosures regarding leasing arrangements. ASU 2016-02 is effective for the Company beginning in the first quarter of fiscal 2019 and early adoption is permitted. Pursuant to the leasing criteria, most of the Company's leased space and equipment leases will be required to be accounted for as capitalized assets on the balance sheet with offsetting financing obligations. 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 and expects the ASU will have a material impact on its condensed consolidated financial statements.
In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment (Topic 350). This standard eliminates Step 2 from the goodwill impairment test, instead requiring an entity to recognize a goodwill impairment charge for the amount by which the goodwill carrying amount exceeds the reporting unit’s fair value. This ASU is effective for interim and annual goodwill impairment tests in fiscal years beginning after December 15, 2019 with early adoption permitted. This ASU must be applied on a prospective basis. The adoption of this ASU is not expected to have a material impact on the Company's condensed consolidated financial statements.
In February 2018, the FASB issued ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This ASU eliminates the stranded tax effects in other comprehensive income resulting from the Tax Cuts and Jobs Act (the “TCJA”). Because the amendments only relate to the reclassification of the income tax effects of the TCJA, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. ASU 2018-02 is effective for us beginning in the first quarter of fiscal 2019 and early adoption is permitted. The Company is currently evaluating the impact of this ASU on its condensed consolidated financial statements.

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

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:

	March 31, 2018			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$78,685	$ —	$ —	$78,685
Money market funds	208	—	—	208
Commercial paper	14,284	—	(3)	14,281
Total	93,177	—	(3)	93,174
Short-term investments:				
Commercial paper	11,866	—	(7)	11,859

Corporate bonds	39,296	1	(139)	39,158
U.S. government agencies	184,613	—	(277)	184,336
Total	235,775	1	(423)	235,353
Long-term investments:				
Asset-backed securities	14,665	—	(32)	14,633
U.S. government agencies	19,091	2	(73)	19,020
Corporate bonds	32,097	1	(388)	31,710
Total	65,853	3	(493)	65,363
Total	$394,805	$ 4	$ (919)	$393,890

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

	December 31, 2017			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$86,500	$ —	$ —	$86,500
Money market funds	91	—	—	91
Total	86,591	—	—	86,591
Short-term investments:				
Commercial paper	12,623	—	(3)	12,620
Corporate bonds	38,425	1	(64)	38,362
U.S. government agencies	151,058	—	(217)	150,841
Total	202,106	1	(284)	201,823
Long-term investments:				
Asset-backed securities	4,998	—	(12)	4,986
U.S. government agencies	24,269	—	(54)	24,215
Corporate bonds	38,198	—	(175)	38,023
Total	67,465	—	(241)	67,224
Total	$356,162	$ 1	$ (525)	$355,638

The following table shows the changes to accumulated other comprehensive loss for the three months ended March 31, 2018 (in thousands):

	Unrealized (Loss) Gain, net on Investments
Balance at December 31, 2017	$ (574)
Change in net unrealized loss on investments, net of tax	(407)
Amounts reclassified for net realized gain included in net income, net of tax	16
Other comprehensive loss, net of tax	(391)
Balance at March 31, 2018	$ (965)

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:

	March 31, 2018			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$—	$26,140	$ —	$26,140
U.S. government agencies	—	203,356	—	203,356
Corporate bonds	—	70,868	—	70,868
Asset-backed securities	—	14,633	—	14,633
Total	$—	$314,997	$ —	$314,997

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

	December 31, 2017			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$—	$12,620	$ —	$12,620
U.S. government agencies	—	175,056	—	175,056
Corporate bonds	—	76,385	—	76,385
Asset-backed securities	—	4,986	—	4,986
Total	$—	$269,047	$ —	$269,047

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

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

	March 31, 2018			
	Mature within One Year	After One Year through Two Years	Over Two Years	Fair Value
	(in thousands)			
Commercial paper	$26,140	$—	$—	$26,140
U.S. government agencies	184,336	16,859	2,161	203,356
Corporate bonds	39,158	26,833	4,877	70,868
Asset-backed securities	6,162	8,471	—	14,633
Total	$255,796	$52,163	$7,038	$314,997

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 March 31, 2018, the Company had two outstanding forward contracts with notional amounts of 10.0 million Euros and 6.0 million British Pounds, respectively, which expired on April 30, 2018. At December 31, 2017, the Company had two outstanding forward contracts with notional amounts of 7.0 million Euros and 4.8 million British Pounds, respectively, which expired on January 31, 2018. These forward contracts were entered into at the end of each month, and thus the fair value of these contracts was $0 at March 31, 2018 and December 31, 2017. 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 income (expense), net on the condensed consolidated statement of operations, from forward contracts and other foreign currency transactions:

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

	Three Months Ended March 31,	
	2018	2017
	(in thousands)	
Net loss from forward contracts	$(578)	$(257)
Other foreign currency transactions gain	810	260
Total foreign exchange gain, net	$232	$3

NOTE 3. Property and Equipment, Net

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

	March 31,	December 31,
	2018	2017
	(in thousands)	
Computer equipment	$80,215	$ 77,883
Computer software	21,176	20,447
Furniture, fixtures and equipment	5,408	5,075
Assets under capital lease	3,503	—
Scanner appliances	15,010	14,325
Leasehold improvements	16,348	16,067
Total property and equipment	141,660	133,797
Less: accumulated depreciation and amortization	(80,964)	(75,240)
Property and equipment, net	$60,696	$ 58,557

Physical scanner appliances and other computer equipment that are or will be subject to leases by customers have a net carrying value of $6.9 million and $6.8 million at March 31, 2018 and December 31, 2017, respectively, including assets that have not been placed in service of $1.0 million and $0.9 million, respectively. Depreciation and amortization expense relating to property and equipment, including capitalized leases, was $6.4 million and $4.7 million for the three months ended March 31, 2018 and 2017, respectively. Accumulated depreciation under capital leases was $0.2 million at March 31, 2018.

NOTE 4. Revenue from Contracts with Customers

In May 2014, the FASB issued a new standard related to revenue recognition. Under the standard, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

On January 1, 2018, the Company adopted ASC 606 using the modified retrospective method applied to those contracts which were not completed as of that date. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior period. The Company implemented internal controls and key system functionality to enable the preparation of financial information on adoption. The impact of the standard relates to the Company's accounting for sales commissions. The Company previously expensed sales commissions as incurred. Under ASC 606, the Company is required to capitalize certain contract acquisition costs consisting primarily of commissions paid related to new business and upsells. Applying the practical expedient in ASC 340-40-25-4, the Company expenses commissions related to contract renewals with a renewal contract term of one year or less.

As a result of the adoption, the Company recorded an increase to retained earnings of $2.7 million as of January 1, 2018 which was the net cumulative impact associated with the capitalization of sales commissions. Additionally, the Company recorded a corresponding commission asset balance of $3.5 million and a related deferred tax liability of $0.8 million as of January 1, 2018. There was no impact to the Company's revenues as a result of adopting ASC 606.

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

Commission asset balances are as follows (in thousands):

	March 31, 2018	January 1, 2018
Commission asset, current	$845	$704
Commission asset, noncurrent	$3,142	$2,819

For the three months ended March 31, 2018, the Company recognized $0.2 million of commission expense from amortization of its commission assets. There was no impairment loss related to capitalized costs. No contract costs were capitalized in the three months ended March 31, 2017.
Contract liabilities (deferred revenue) balances are as follows (in thousands):

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

	March 31, 2018		
	ASC 606	Operating Leases	Total
Deferred revenue, current	$135,144	$12,512	$147,656
Deferred revenue, noncurrent	13,603	1,392	14,995
Total	$148,747	$13,904	$162,651

	January 1, 2018		
	ASC 606	Operating Leases	Total
Deferred revenue, current	$130,579	$12,607	$143,186
Deferred revenue, noncurrent	15,419	1,717	17,136
Total	$145,998	$14,324	$160,322

The Company records deferred revenue when cash payments are received or due in advance of its performance. The increase in the Company's deferred revenue balances for the three months ended March 31, 2018 is primarily driven by cash payments received or due in advance of satisfying the Company's performance obligations, offset by $55.6 million of revenue recognized in the three months ended March 31, 2018, which was included in the deferred revenue balance as of December 31, 2017.

The Company's performance obligations are typically satisfied ratably over the subscription term as its cloud-based offerings are delivered to customers electronically and over time. In addition, the Company recognizes revenues for certain limited scan arrangements on an as-used basis. The Company recognizes revenue related to the professional services as they are performed.

The Company allocates the transaction price to all separate performance obligations, including transactions that are comprised of lease revenue, in proportion to the standalone selling prices ("SSP") of the goods or services underlying each of those performance obligations at contract inception. If a SSP is not directly observable, the Company determines the SSP using information that may include market conditions and other observable inputs. We typically have more than one SSP for individual products and services due to the stratification of those products and services by customers and circumstances. In these instances, we may use information such as the size of the customer and volume purchased in determining the SSP. The Company's transaction prices are typically a fixed amount for a specific period of time and majority of contracts are twelve months with certain customers signing longer term deals. In general, the Company does not offer rights of return, performance bonuses, customer loyalty programs, payments via non-cash methods, refunds, volume rebates, incentive payments, penalties, price concessions or payments or discounts contingent on future events. Consideration is fixed at the time of the contract, and governed by the price list to which that particular customer is subject. The Company's customer and partner-specific pricing is negotiated and agreed upon via individual customer contracts. In some of its contracts, the Company incorporates tiered pricing based on the number of IP addresses the customer can scan. As customers are required to purchase larger quantities to qualify for the lower-priced tiers, the Company does not grant its customers any material rights. When customers increase their purchased quantities, the Company accounts for the additional purchased quantities and related price change prospectively as the pricing does not impact subscription services previously provided. Physical equipment (scanners and private cloud platforms) are accounted for as operating leases and revenue is recognized over the subscription term.

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

	March 31, 2018	January 1, 2018
ASC 606 receivables	$46,234	$60,984
Operating lease receivables	4,442	4,244
Less: allowance for doubtful accounts	(802)	(816)
Total accounts receivable, net	$49,874	$64,412

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

The following table sets forth the expected revenue from all remaining performance obligations as of March 31, 2018 (in thousands):

	ASC 606 Revenues	Operating Lease Revenues	Total Revenues
2018 (remaining nine months)	$ 8,290	$ 261	$ 8,551
2019	14,724	1,068	15,792
2020	7,980	387	8,367
2021	2,498	43	2,541
2022	1,775	20	1,795
2023 and thereafter	1,213	4	1,217
Total	$ 36,480	$ 1,783	$ 38,263

Revenue allocated to remaining performance obligations represents contracted revenue that has not yet been recognized, which includes unearned revenue and amounts that will be invoiced and recognized as revenue in future periods. Remaining performance obligations represents the transaction price of firm orders for which service has not been performed and excludes unexercised renewals.

From time to time, the Company enters into contracts with customers that extend beyond one year with certain of its customers electing to pay for more than one year of services upon contract execution. For any discounts associated with these multiple year contracts, the Company does not consider these contracts to contain a financing component as its customers typically initiate the longer terms, and the Company's reasoning for entering into the longer terms is not based on financing.

Revenues by sales channel are as follows:

	Three Months Ended March 31, 2018		
	ASC 606 Revenues	Operating Lease Revenues	Total Revenues
Direct	$34,968	$ 3,742	$ 38,710
Partner	24,235	1,933	26,168
Total	$59,203	$ 5,675	$ 64,878

	Three Months Ended March 31, 2017		
	ASC 606 Revenues	Operating Lease Revenues	Total Revenues

Direct	$27,620	$ 3,394	$ 31,014
Partner	20,259	1,848	22,107
Total	$47,879	$ 5,242	$ 53,121

The Company utilizes partners to enable and accelerate the adoption of its cloud platform by increasing its distribution capabilities and market awareness of its cloud platform as wells as by targeting geographic regions outside the reach of its direct sales force. The Company's channel partners maintain relationships with their customers throughout the territories in which they operate and provide their customers with services and third-party solutions to help meet those customers’ evolving security and compliance requirements. As such, these partners may offer the Company's IT security and compliance solutions in conjunction with one or more of their own products or services and act as a conduit through which the Company can connect with these prospective customers to offer its solutions. For sales involving a channel partner, the channel partner engages with the prospective customer directly and involves

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the Company's sales team as needed to assist in developing and closing an order. When a channel partner secures a sale, the Company sells the associated subscription to the channel partner who in turn resells the subscription to the customer. Sales to channel partners are made at a discount and revenues are recorded at this discounted price over the subscription terms. The Company does not have any influence or specific knowledge of its partners' selling terms with their customers. See Note 11, "Segment Information and Information about Geographic Area" for disaggregation of revenue by geographic area.

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NOTE 5. Goodwill and Intangible Assets, Net

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

				March 31, 2018	
	Weighted Average Life (Years)	Weighted Remaining Average Life (Years)	Cost	Accumulated Amortization	Net Book Value
Developed technology	5	4.5	$12,156	$(1,068)	$11,088
Patent licenses	14	6.4	1,388	(747)	641
Total intangibles subject to amortization			$13,544	$(1,815)	11,729
Intangible assets not subject to amortization					40
Total intangible assets, net					$11,769

				December 31, 2017	
	Weighted Average Life (Years)	Weighted Remaining Average Life (Years)	Cost	Accumulated Amortization	Net Book Value
Developed technology	5	4.8	$14,067	$(2,371)	$11,696
Patent Licenses	14	6.7	1,388	(723)	665
Total intangibles subject to amortization			$15,455	$(3,094)	12,361
Intangible assets not subject to amortization					40
Total intangible assets, net					$12,401

Intangible asset amortization expense was $0.6 million and $0.1 million for the three months ended March 31, 2018 and 2017, respectively.

As of March 31, 2018, the Company expects amortization expense in future periods to be as follows (in thousands):

2018 (remaining nine months)	$	1,899
2019	2,531	
2020	2,531	
2021	2,531	
2022	2,071	
2023 and thereafter	166	
	$	11,729

Total expected future amortization expense

Goodwill, which is not subject to amortization, totaled $1.5 million as of each of March 31, 2018 and December 31, 2017.

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NOTE 6. 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. In January 2018, the Company entered into a $3.5 million financing arrangement for data center storage equipment, accounted for as a capital lease, with an implied interest rate of 5%.

The following are the minimum annual lease payments due under these leases at March 31, 2018 (in thousands):

	Operating Leases	Capital Leases
	(in thousands)	
2018 (remaining nine months)	$6,912	$940
2019	5,786	1,770
2020	5,407	130
2021	4,662	54
2022	4,140	—
2023 and thereafter	22,000	—
Total minimum lease payments	$48,907	2,894
Less: amount representing interest		(139)
Present value of minimum payments		2,755
Less: current portion		(1,289)
Capital lease obligations, noncurrent		$1,466

Rent expense was $2.2 million and $1.9 million for the three months ended March 31, 2018 and 2017, 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. As of March 31, 2018 and December 31, 2017, the Company had accrued $10.2 million and $9.5 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 for its new headquarters office facility. The lease payments commenced on May 1, 2018 and the lease 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. In connection with this lease, the Company has provided the landlord with a $1.2 million standby letter of credit to secure the Company’s obligations through the end of the lease term, which was classified as restricted cash in the accompanying condensed consolidated balance sheets.

Indemnifications
The Company from time to time enters into certain types of contracts that contingently require it to indemnify various parties against claims from third parties. These contracts primarily relate to (i) the Company's by-laws, under which it must indemnify directors and executive officers, and may indemnify other officers and employees, for liabilities arising out of their relationship, (ii) contracts under which the Company must indemnify directors and certain officers

for liabilities arising out of their relationship, and (iii) contracts under which the Company may be required to indemnify customers or resellers from certain liabilities arising from potential infringement of intellectual property rights, as well as potential damages caused by limited product defects. To date, the Company has not incurred and has not recorded any liability in connection with such indemnifications.

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

Contingencies

The Company regularly licenses technology from various third party licensors. From time to time, the Company is audited by its licensors for compliance with the terms of the license agreements. During the quarter ended March 31, 2018, the Company commenced discussions with one of its vendors with respect to compliance with the terms of the license agreement. The Company intends to cooperate with the licensor while defending itself vigorously to bring the review process to a resolution. The Company accrues for losses on individual matters that are both probable and reasonably estimable. Estimates are based on currently available information and assumptions. Significant judgment is required in both the determination of probability and the determination of whether a matter is reasonably estimable. The Company's estimates may change and actual expenses could differ in the future as additional information becomes available or as the Company reaches agreements with its vendors. Management currently estimates that it has sufficiently accrued for licensing agreement matters and that the range of loss (in excess of amounts accrued) is not significant.

NOTE 7. Stock-based Compensation

Equity Incentive Plans

2012 Equity Incentive Plan

Under the 2012 Equity Incentive Plan (the "2012 Plan"), the Company is authorized to grant to eligible participants incentive stock options ("ISOs"), non-statutory stock options ("NSOs"), stock appreciation rights ("SARs"), restricted stock awards ("RSAs"), restricted stock units ("RSUs"), performance units and performance shares equivalent to up to 11,791,139 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 March 31, 2018, 4,186,394 shares were available for grant under the 2012 Plan.

2000 Equity Incentive Plan

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

Stock-based compensation

The following table shows a summary of the stock-based compensation expense included in the condensed consolidated statements of operations for the three months ended March 31, 2018 and 2017:

	Three Months Ended March 31,	
	2018	2017
	(in thousands)	

Cost of revenues	$654	$501
Research and development	1,841	1,221
Sales and marketing	1,401	1,084
General and administrative	4,995	1,526
Total stock-based compensation	$8,891	$4,332

As of March 31, 2018, the Company had $14.5 million of total unrecognized employee compensation cost related to unvested options that it expects to recognize over a weighted-average period of 2.2 years, and $41.8 million of unrecognized employee compensation cost related to unvested awards that it expects to recognize over a weighted-average period of 2.9 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)
Balance as of December 31, 2017	4,495,891	$ 25.29	6.6	$ 153,129
Granted	61,850	$ 59.95		
Exercised	(286,597)	$ 27.68		
Canceled	(83,608)	$ 38.62		
Balance as of March 31, 2018	4,187,536	$ 25.37	6.5	$ 198,395,610
Vested and expected to vest - March 31, 2018	3,969,350	$ 24.76	6.4	$ 190,509,569
Exercisable - March 31, 2018	2,895,704	$ 21.89	5.7	$ 147,268,457

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
Balance as of December 31, 2017	1,410,588	$ 40.34
Granted	92,232	$ 59.95
Vested	(158,561)	$ 37.96
Canceled	(54,410)	$ 39.92
Balance as of March 31, 2018	1,289,849	$ 42.05