QUALYS, INC.
Form 10-Q
August 04, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2016

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

For the transition period from to

Commission file number 001-35662

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

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

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

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

(Do not check if a smaller reporting company)

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

The number of shares of the Registrant's common stock outstanding as of July 29, 2016 was 35,373,537.

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

	June 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$118,194	$91,698
Short-term investments	96,186	87,268
Accounts receivable, net of allowance of $742 and $769 as of June 30, 2016 and December 31, 2015, respectively	40,387	42,325
Prepaid expenses and other current assets	7,635	7,945
Total current assets	262,402	229,236
Long-term investments	46,534	43,277
Property and equipment, net	40,025	31,329
Deferred tax assets, net	16,123	16,079
Intangible assets, net	1,174	1,360
Goodwill	317	317
Other noncurrent assets	2,276	1,916
Total assets	$368,851	$323,514
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$5,853	$2,368
Accrued liabilities	16,851	11,786
Deferred revenues, current	103,753	98,025
Total current liabilities	126,457	112,179
Deferred revenues, noncurrent	13,073	14,564
Other noncurrent liabilities	1,884	1,205
Total liabilities	141,414	127,948
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 20,000,000 shares authorized, no shares issued and outstanding at June 30, 2016 and December 31, 2015	—	—
Common stock, $0.001 par value; 1,000,000,000 shares authorized; 35,369,968 and 34,414,631 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively	35	34
Additional paid-in capital	246,454	223,228
Accumulated other comprehensive income (loss)	112	(211)
Accumulated deficit	(19,164)	(27,485)
Total stockholders' equity	227,437	195,566
Total liabilities and stockholders' equity	$368,851	$323,514

See accompanying Notes to Condensed Consolidated Financial Statements

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
Revenues	$48,466	$39,877	$94,714	$77,370
Cost of revenues	10,092	8,157	19,508	16,121
Gross profit	38,374	31,720	75,206	61,249
Operating expenses:				
Research and development	9,143	7,205	16,977	14,355
Sales and marketing	14,451	12,776	28,384	24,219
General and administrative	9,068	6,427	16,536	12,443
Total operating expenses	32,662	26,408	61,897	51,017
Income from operations	5,712	5,312	13,309	10,232
Other income (expense), net:				
Interest expense	(1)	(4)	(14)	(4)
Interest income	290	132	540	233
Other expense, net	(249)	—	(318)	(178)
Total other income, net	40	128	208	51
Income before income taxes	5,752	5,440	13,517	10,283
Provision for income taxes	2,214	2,124	5,196	3,965
Net income	$3,538	$3,316	$8,321	$6,318
Net income per share:				
Basic	$0.10	$0.10	$0.24	$0.19
Diluted	$0.09	$0.09	$0.22	$0.16
Weighted average shares used in computing net income per share:				
Basic	35,120	34,003	34,869	33,889
Diluted	38,143	38,475	37,988	38,363

See accompanying Notes to Condensed Consolidated Financial Statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income	$3,538	$3,316	$8,321	$6,318
Available-for-sale investments:				
Change in net unrealized gain (loss) on investments, net of tax	80	(8)	273	16
Less: reclassification adjustment for net realized gain (loss) included in net income	2	—	50	1
Net change, net of tax	82	(8)	323	17
Other comprehensive income (loss), net	82	(8)	323	17
Comprehensive income	$3,620	$3,308	$8,644	$6,335

See accompanying Notes to Condensed Consolidated Financial Statements

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

	Six Months Ended June 30, 2016			2015		
Cash flows from operating activities:						
Net income	$	8,321		$	6,318	
Adjustments to reconcile net income to net cash provided by operating activities:						
Depreciation and amortization expense	7,828			6,586		
Bad debt expense	106			333		
Loss on disposal of property and equipment	39			4		
Stock-based compensation	10,019			8,257		
Amortization of premiums and accretion of discounts on investments	390			324		
Excess tax benefits from stock-based compensation	(3,713		)	(191		)
Deferred income taxes	(85		)	3,064		
Changes in operating assets and liabilities:						
Accounts receivable	1,833			(1,892		)
Prepaid expenses and other assets	(83		)	(534		)
Accounts payable	(2		)	(4,619		)
Accrued liabilities	4,886			1,846		
Deferred revenues	4,237			5,911		
Other noncurrent liabilities	685			143		
Net cash provided by operating activities	34,461			25,550		
Cash flows from investing activities:						
Purchases of investments	(87,364		)	(61,442		)
	75,156			48,214		

Sales and maturities of investments				
Purchases of property and equipment	(8,966	)	(10,407	)
Capitalized software development costs	—		(99	)
Net cash used in investing activities	(21,174	)	(23,734	)
Cash flows from financing activities:				
Proceeds from exercise of stock options	9,496		5,547	
Excess tax benefits from stock-based compensation	3,713		191	
Net cash provided by financing activities	13,209		5,738	
Net increase in cash and cash equivalents	26,496		7,554	
Cash and cash equivalents at beginning of period	91,698		76,504	
Cash and cash equivalents at end of period	$ 118,194		$ 84,058	

Non-cash investing and financing activities:		
Purchases of property and equipment recorded in accrued liabilities	$ 7,379	$ —
Vesting of early exercised common stock options	$ —	$ 11

See accompanying Notes to Condensed Consolidated Financial Statements

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. The Company and Summary of Significant Accounting Policies

Description of Business

Qualys, Inc. (the "Company") was incorporated in the state of Delaware on December 30, 1999. The Company is headquartered in Redwood City, California and has majority-owned subsidiaries throughout the world. The Company is a pioneer and leading provider of cloud-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, 2015, included herein, was derived from the audited financial statements as of that date but does not include all disclosures, including notes required by U.S. GAAP. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, which include only normal recurring adjustments, necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the three and six month periods ended June 30, 2016 are not necessarily indicative of the results of operations expected for the entire year ending December 31, 2016 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, 2015 filed with the SEC on February 26, 2016.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany transactions and balances have been eliminated upon consolidation.

Use of Estimates

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

Concentration of Credit Risk

The Company invests its cash and cash equivalents with major financial institutions. Cash balances with any one institution at times may be in excess of federally insured limits. Cash equivalents are invested in high-quality investment grade financial instruments and are diversified. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk.

Credit risk with respect to accounts receivable is dispersed due to the large number of customers. Collateral is not required for accounts receivable. The Company maintains an allowance for potential credit losses based upon the expected collectability of accounts receivable. The Company writes off its receivables once collection efforts are unsuccessful. As of June 30, 2016 and December 31, 2015, no customer or channel partner accounted for more than 10% of the Company's accounts receivable balance.

Cash, Cash Equivalents, Short-Term and Long-Term Investments

Cash and cash equivalents include cash held in banks, highly liquid money market funds, commercial paper and fixed-income U.S. government agency securities, all with original maturities of three months or less when acquired. The Company’s investments consist of fixed-income U.S. government agency securities, corporate bonds, asset-backed securities, and commercial paper. Management determines the appropriate classification of the Company's investments at the time of purchase and reevaluates such designation at each balance sheet date. The Company classifies its investments as either short-term or long-term based on each instrument's underlying contractual maturity date.

Cash equivalents are stated at cost, which approximates fair market value. Short-term and long-term investments are classified as available-for-sale and are carried at fair value. Unrealized gains and losses in fair value are reported in other comprehensive income (loss). When the available-for-sale securities are sold, cost is based on the specific identification method, and the realized gains and losses are included in other income (expense) in the condensed consolidated statements of operations. Short-term and long-term investments are reviewed quarterly for impairment that is deemed to be other-than-temporary. An investment is considered other-than-temporarily impaired when its fair value is below its amortized cost and (1) there is an intent to sell the security, (2) it is “more likely than not” that the security will be sold before recovery of its amortized cost basis or (3) the present value of expected cash flows from the investment is not expected to recover the entire amortized cost basis. Declines in value that are considered to be other-than-temporary and adjustments to amortized cost for the amortization of premiums and the accretion of discounts are recorded in other income (expense). Interest and dividends are recorded in interest income as earned.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued an Accounting Standard Update (“ASU”) amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The ASU will be effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, but entities will be permitted to early adopt the standard only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized on date of adoption. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

In January 2016, the FASB issued an ASU that will impact certain aspects of recognition, measurement, presentation and disclosure of financial instruments. This guidance is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

In February 2016, the FASB issued an ASU which requires, among other things, lease assets and lease liabilities arising from leases, including operating leases, to be recognized on the balance sheet. In addition, the ASU requires disclosing key information about leasing arrangements. This guidance supersedes existing lease guidance and is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

In March 2016, the FASB issued an ASU intended to simplify and improve various aspects related to how employee-share based payment transactions are accounted for and presented in the financial statements. The ASU addresses income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows and forfeiture rate calculations. This guidance is effective for public business entities in fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

NOTE 2. Fair Value of Financial Instruments

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

The Company measures and reports certain cash equivalents, investments and derivative foreign currency forward contracts at fair value in accordance with the provisions of the authoritative accounting guidance that addresses fair value measurements. This guidance establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

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

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

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

The Company's financial instruments consist of assets and liabilities measured using Level 1 and 2 inputs. Level 1 assets include a highly liquid money market fund, which is valued using unadjusted quoted prices that are available in an active market for an identical asset. Level 2 assets include fixed-income U.S. government agency securities, commercial paper, corporate bonds, asset-backed securities and derivative financial instruments consisting of foreign currency forward contracts. The securities, bonds and commercial paper are valued using prices from independent pricing services based on quoted prices in active markets for similar instruments or on industry models using data inputs such as interest rates and prices that can be directly observed or corroborated in active markets. The foreign currency forward contracts are valued using observable inputs, such as quotations on forward foreign exchange points and foreign interest rates.

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

The Company's cash and cash equivalents, short-term investments, and long-term investments consist of the following:

	June 30, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$69,227	$ —	$ —	$69,227
Money market funds	15,228	—	—	15,228
Commercial paper	33,737	2	—	33,739
Total	118,192	2	—	118,194
Short-term investments:				
Commercial paper	16,417	2	(1)	16,418
Corporate bonds	10,728	3	—	10,731
Asset-backed securities	697	—	—	697
U.S. government agencies	68,300	42	(2)	68,340
Total	96,142	47	(3)	96,186
Long-term investments:				
Asset-backed securities	6,222	7	—	6,229
U.S. government agencies	31,395	83	—	31,478
Corporate bonds	8,817	12	(2)	8,827
Total	46,434	102	(2)	46,534
Total	$260,768	$ 151	$ (5)	$260,914

	December 31, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
	(in thousands)			
Cash and cash equivalents:				
Cash	$61,372	$ —	$ —	$61,372
Money market funds	3,980	—	—	3,980
U.S. government agencies	8,999	1	—	9,000
Commercial paper	17,345	1	—	17,346
Total	91,696	2	—	91,698
Short-term investments:				
Commercial paper	10,447	1	—	10,448
Corporate bonds	12,448	—	(13)	12,435
U.S. government agencies	64,422	3	(40)	64,385
Total	87,317	4	(53)	87,268
Long-term investments:				
Asset-backed securities	7,007	—	(18)	6,989
U.S. government agencies	32,683	—	(142)	32,541
Corporate bonds	3,751	—	(4)	3,747
Total	43,441	—	(164)	43,277
Total	$222,454	$ 6	$ (217)	$222,243

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

The following table shows the changes to accumulated other comprehensive income for the six months ended June 30, 2016:

	Unrealized Gain (Loss) on Investments
Balance at December 31, 2015	$ (211)
Change in net realized gain (loss) on investments	307
Amounts reclassified for net realized gain (loss) included in net income	50
Tax effect	(34)
Other comprehensive income	323
Balance at June 30, 2016	$ 112

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

	June 30, 2016			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$ —	$ 50,157	$ —	$ 50,157
U.S. government agencies	—	99,818	—	99,818
Corporate bonds	—	19,558	—	19,558
Asset-backed securities	—	6,926	—	6,926
Total	$ —	$ 176,459	$ —	$ 176,459

	December 31, 2015			
	Level 1	Level 2	Level 3	Fair Value
	(in thousands)			
Commercial paper	$ —	$ 27,794	$ —	$ 27,794
U.S. government agencies	—	105,926	—	105,926
Corporate bonds	—	16,182	—	16,182
Asset-backed securities	—	6,989	—	6,989
Total	$ —	$ 156,891	$ —	$ 156,891

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

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

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

	June 30, 2016			
	Mature within One Year	After One Year through Two Years	Over Two Years	Fair Value
	(in thousands)			
Commercial paper	$50,157	$—	$ —	$50,157
U.S. government agencies	68,340	31,478	—	99,818
Corporate bonds	12,385	7,173	—	19,558
Asset-backed securities	5,582	1,344	—	6,926
Total	$136,464	$39,995	$ —	$176,459

Derivative Financial Instruments

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

At June 30, 2016, the Company had two outstanding forward contracts with notional amounts of 7.8 million Euros and 4.0 million British Pounds, which expired on July 29, 2016. At December 31, 2015, the Company had two outstanding forward contracts with notional amounts of 6.1 million Euros and 2.6 million British Pounds, which expired on January 31, 2016. These forward contracts were entered into at the end of each month, and thus the fair value of these contracts was $0 at June 30, 2016 and December 31, 2015. For the three months ended June 30, 2016, the Company recorded a gain of $0.6 million from these forward contracts, which partially offset other foreign currency transaction losses of $0.7 million. For the three months ended June 30, 2015, the Company recorded a loss of $0.4 million from these forward contracts, which offset other foreign currency transaction gains of $0.4 million. For the six months ended June 30, 2016, the Company recorded a gain of $0.1 million from these forward contracts, which partially offset other foreign currency transaction losses of $0.3 million. For the six months ended June 30, 2015, the Company recorded a gain of $0.4 million from these forward contracts, which partially offset other foreign currency transaction losses of $0.5 million. These derivatives did not meet the criteria to be designated as hedges. These instruments were valued using Level 2 inputs.

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

NOTE 3. Property and Equipment, Net

Property and equipment consists of the following:

	June 30, 2016	December 31, 2015
	(in thousands)	
Computer equipment	$55,268	$ 48,192
Computer software	19,243	12,484
Furniture, fixtures and equipment	3,155	2,804
Scanner appliances	23,917	22,627
Leasehold improvements	3,438	3,367
Total property and equipment	105,021	89,474
Less: accumulated depreciation and amortization	(64,996)	(58,145)
Property and equipment, net	$40,025	$ 31,329

Physical scanner appliances and other computer equipment that are or will be subject to subscriptions by customers have a net carrying value of $8.7 million and $8.4 million at June 30, 2016 and December 31, 2015, respectively, including assets that have not been placed in service of $1.6 million and $1.4 million, respectively. Other fixed assets not placed in service at June 30, 2016 and December 31, 2015, included in computer equipment and leasehold improvements, are approximately $3.9 million and $4.3 million, respectively. Depreciation and amortization expense relating to property and equipment was $3.9 million and $3.3 million for the three months ended June 30, 2016 and 2015, respectively, and $7.6 million and $6.4 million for the six months ended June 30, 2016 and 2015, respectively.

NOTE 4. Goodwill and Intangible Assets, Net

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

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

			June 30, 2016		December 31, 2015	
	Estimated Lives	Cost	Accumulated Amortization	Net Book Value	Accumulated Amortization	Net Book Value
Existing technology	7 years	$1,910	$(1,592)	$318	$(1,456)	$454
Patent license	14 years	1,388	(572)	816	(522)	866
Total intangibles subject to amortization		$3,298	$(2,164)	1,134	$(1,978)	1,320
Intangible assets not subject to amortization				40		40
Total intangible assets, net				$1,174		$1,360

Intangibles amortization expense was $0.1 million for the three months ended June 30, 2016 and 2015 and $0.2 million for the six months ended June 30, 2016 and 2015.

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

As of June 30, 2016, the Company expects amortization expense in future periods to be as follows (in thousands):

Remainder of 2016	$	187
2017	282	
2018	100	
2019	100	
2020	100	
2021 and thereafter	365	
Total expected future amortization expense	$	1,134

Goodwill, which is not subject to amortization, totaled $0.3 million as of June 30, 2016 and December 31, 2015.

NOTE 5. Commitments and Contingencies
Leases
The Company leases certain computer equipment and its corporate office and data center facilities under noncancelable operating leases for varying periods through 2022.

The following are the minimum annual lease payments due under operating leases at June 30, 2016 (in thousands):

Remainder of 2016	$2,067
2017	3,089
2018	1,544
2019	1,143
2020	949
2021 and thereafter	703
Total minimum lease payments	$9,495

Rent expense was $1.8 million and $1.7 million for the three months ended June 30, 2016 and 2015, respectively, and $3.5 million and $3.3 million for the six months ended June 30, 2016 and 2015, respectively. Although certain of the operating lease agreements provide for escalating rent payments over the terms of the leases, rent expense under these agreements is recognized on a straight-line basis. As of June 30, 2016 and December 31, 2015, the Company has accrued $0.4 million and $0.5 million, respectively, of deferred rent related to these agreements, which is reflected in accrued liabilities and other noncurrent liabilities 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.

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

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Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues a liability for such matters when it is probable a loss has been incurred and such loss can be reasonably estimated. At June 30, 2016, the Company has not recorded any material liabilities in accordance with accounting for contingencies.

NOTE 6. Stock-based Compensation

Equity Incentive Plans

2012 Equity Incentive Plan

Under the 2012 Equity Incentive Plan (the "2012 Plan"), the Company is authorized to grant to eligible participants incentive stock options (“ISOs”), non-statutory stock options (“NSOs”), stock appreciation rights ("SARs"), restricted stock awards ("RSAs"), restricted stock units ("RSUs"), performance units and performance shares equivalent to up to 8,069,184 shares of common stock. Options may be granted with an exercise price that is at least equal to the fair market value of the Company's stock at the date of grant and are exercisable when vested. As of June 30, 2016, 1,574,751 shares were available for grant under the 2012 Plan.

2000 Equity Incentive Plan

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

Stock-based compensation

The following table shows a summary of the stock-based compensation expense included in the condensed consolidated statements of operation for the three and six months ended June 30, 2016 and 2015.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
Cost of revenues	$423	$344	$802	$672
Research and development	1,493	1,138	2,788	2,290
Sales and marketing	1,389	980	2,638	1,791
General and administrative	2,017	1,920	3,791	3,504
Total stock-based compensation	$5,322	$4,382	$10,019	$8,257

As of June 30, 2016, the Company had $28.1 million of total unrecognized employee compensation cost related to unvested option awards that it expects to recognize over a weighted-average period of 3.0 years, and $7.3 million of unrecognized compensation cost related to unvested stock awards that it expects to recognize over a weighted-average period of 3.6 years. Compensation cost is recognized on a straight-line basis over the service period. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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

Stock Options

Employee Stock-based Compensation

The fair value of each option granted to employees is estimated on the date of grant using the Black-Scholes option-pricing model based on the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Expected term (in years)	5.0 to 5.9	4.9 to 5.9	5.0 to 5.9	4.9 to 5.9
Volatility	46%	46%	45% to 46%	46% to 48%
Risk-free interest rate	1.3%	1.5% to 1.65%	1.3%	1.3% to 1.65%
Dividend yield	—%	—%	—%	—%

The expected term of the options is based on evaluations of historical and expected future employee exercise behavior. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected term at the grant date. Volatility is based on historical volatility of several public entities that are similar to the Company, as the Company does not have sufficient historical transactions in its own shares on which to base expected volatility. The Company has not historically declared any dividends and does not expect to in the future.

Non-Employee Stock-based Compensation

The Company records compensation representing the fair value of stock options granted to non-employees. Non-employee stock-based compensation is recognized over the vesting periods of the options. The value of options granted to non-employees is remeasured as they vest over their respective performance period.

Stock Option Plan Activity

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

	Outstanding Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
December 31, 2015	7,579,058	$ 16.88	5.9	$ 131,345
Granted	1,807,583	$ 25.44		
Exercised	(949,337)	$ 10.00		
Canceled	(456,894)	$ 33.19		
June 30, 2016	7,980,410	$ 18.70	6.4	$ 99,582
Vested and expected to vest - June 30, 2016	7,117,832	$ 17.52	6.0	$ 96,606
Exercisable - June 30, 2016	4,922,644	$ 12.42	4.7	$ 89,245

Restricted Stock

The terms and conditions of RSUs and RSAs, including vesting criteria and timing are set by the board of directors. The cost of RSUs and RSAs is determined using the fair value of the Company's common stock on the date of grant. Compensation cost is recognized on a straight-line basis over the requisite service period of each grant, adjusted for estimated forfeitures.

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

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

	Outstanding RSUs	Weighted Average Fair Value Per Share
December 31, 2015	47,500	$ 37.28
Granted	470,383	$ 26.07
Released	(6,000)	$ 35.33
Canceled	(56,768)	$ 34.33
June 30, 2016	455,115	$ 26.08
Outstanding and expected to vest	288,843	$ 26.21

NOTE 7. Other Income (Expense), Net

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
	(in thousands)			
Foreign exchange gain (loss)	$(169)	$27	$(200)	$(124)
Other income (expense)	(80)	(27)	(118)	(54)
Other expense, net	$(249)	$—	$(318)	$(178)

NOTE 8. Income Taxes

The Company recorded an income tax provision of $2.2 million and $2.1 million for the three months ended June 30, 2016 and 2015, respectively. The effective income tax rate was approximately 38.5% and 39.0% for the three months ended June 30, 2016 and 2015, respectively.

The Company recorded an income tax provision of $5.2 million and $4.0 million for the six months ended June 30, 2016 and 2015, respectively. The effective income tax rate was approximately 38.4% and 38.6% for the six months ended June 30, 2016 and 2015, respectively.

As of June 30, 2016, the Company had unrecognized tax benefits of $4.1 million, of which $2.5 million, if recognized, would favorably impact the Company's effective tax rate. As of December 31, 2015, the Company had unrecognized tax benefits of $3.5 million, of which $2.1 million, if recognized, would favorably impact the Company's effective tax rate.

The Company does not anticipate a material change in its unrecognized tax benefits in the next 12 months.

NOTE 9. Segment Information and Information about Geographic Area

The Company operates in one segment. The Company's chief operating decision maker is the Chairman, President and Chief Executive Officer, who makes operating decisions, assesses performance and allocates resources on a consolidated basis. All of the Company's principal operations and decision-making functions are located in the United States. Revenues by geographic area, based on the location of the customer, are as follows:

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
United States	$34,190	$28,130	$66,879	$54,470
Foreign	14,276	11,747	27,835	22,900
Total revenues	$48,466	$39,877	$94,714	$77,370

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

	June 30,	December 31,
	2016	2015
	(in thousands)	
United States	$34,187	$ 25,623
Foreign	5,838	5,706
Total property and equipment, net	$40,025	$ 31,329

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

NOTE 10. Net Income Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands, except per share data)			
Numerator:				
Net income	$3,538	$3,316	$8,321	$6,318
Denominator:				
Weighted-average shares used in computing net income per share:				
Basic	35,120	34,003	34,869	33,889
Effect of potentially dilutive securities:				
Common stock options	2,989	4,472	3,107	4,474
Restricted stock units	34	—	12	—
Diluted	38,143	38,475	37,988	38,363
Net income per share:				
Basic	$0.10	$0.10	$0.24	$0.19
Diluted	$0.09	$0.09	$0.22	$0.16

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
Common stock options	3,892	424	3,540	305
Restricted stock units	10	—	20	—
	3,902	424	3,560	305

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

This Quarterly Report on Form 10-Q, including this Management's Discussion and Analysis of Financial Condition and Results of Operations, should be read in conjunction with (1) our condensed consolidated financial statements (unaudited) and the related notes included elsewhere in this report, and (2) the audited consolidated financial statements and the related notes and management's discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, filed with the Securities and Exchange Commission, or SEC, on February 26, 2016.

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

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

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

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Overview

We are a pioneer and leading provider of cloud-based security and compliance solutions that enable organizations to identify security risks to their IT infrastructures, help protect their IT systems and applications from ever-evolving cyber-attacks and achieve compliance with internal policies and external regulations. Our cloud solutions address the growing security and compliance complexities and risks that are amplified by the dissolving boundaries between internal and external IT infrastructures and web environments, the rapid adoption of cloud computing and the proliferation of geographically dispersed IT assets. Our integrated suite of security and compliance solutions delivered on our Qualys Cloud Platform enables our customers to identify their IT assets, collect and analyze large amounts of IT security data, discover and prioritize vulnerabilities, recommend remediation actions and verify the implementation of such actions. Organizations use our integrated suite of solutions delivered on our Qualys Cloud Platform to cost-effectively obtain a unified view of their security and compliance posture across globally-distributed IT infrastructures.

We were founded and incorporated in December 1999 with a vision of transforming the way organizations secure and protect their IT infrastructure and applications and initially launched our first cloud solution, Qualys Vulnerability Management (VM), in 2000. As this solution gained acceptance, we introduced new solutions to help customers manage increasing IT security and compliance requirements, including PCI Compliance, Policy Compliance, Web Application Scanning, Malware Detection Service and Qualys SECURE Seal. In 2012, we introduced our virtualized private cloud platform as an additional deployment option of our solutions for customers and partners. In 2014, we released Continuous Monitoring (CM) for internet-facing systems, which allows customers to continuously monitor their mission-critical assets and to be alerted to security vulnerabilities or misconfigurations that may make them more susceptible to a cyber-attack and in 2015, we introduced our Cloud Agent Platform (CAP), which provides customers with the ability to secure IT assets on a continuous basis regardless of where they reside, inside the enterprise, in the cloud or mobile endpoints. Additional offerings, such as CM and CAP, add functionality to our core VM and POL services and expand the scope of our capabilities. We expect the sales of multiple, fully-integrated cloud based security offerings on our platform will contribute to the continuing trend of revenue growth.

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

We market and sell our solutions to enterprises, government entities and to small and medium-sized businesses across a broad range of industries, including education, financial services, government, healthcare, insurance, manufacturing, media, retail, technology and utilities. In the six month period ended June 30, 2016, approximately 71% of our revenues were derived from customers in the United States. We sell our solutions to enterprises and government entities primarily through our field sales force and to small and medium-sized businesses through our inside sales force. We generate a significant portion of sales through our channel partners, including managed service providers, value-added resellers and consulting firms in the United States and internationally.

Our revenues increased to $94.7 million in the six months ended June 30, 2016 from $77.4 million for the comparable period in 2015, representing an increase of $17.3 million or 22%.

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Key Metrics

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands, except percentages)			
Adjusted EBITDA	$15,744	$13,098	$31,872	$25,075
Percentage of revenues	32 %	33 %	34 %	32 %

	Six Months Ended June 30,	
	2016	2015
	(in thousands)	
Free cash flow	$25,495	$15,044

Adjusted EBITDA

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

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

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The following unaudited table presents the reconciliation of net income to Adjusted EBITDA for the three and six months ended June 30, 2016 and 2015:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
Net income	$3,538	$3,316	$8,321	$6,318
Other (income) expense, net	(40)	(128)	(208)	(51)
Provision for income taxes	2,214	2,124	5,196	3,965
Depreciation and amortization of property and equipment	3,885	3,306	7,609	6,390
Amortization of intangible assets	109	98	219	196
Stock-based compensation	5,322	4,382	10,019	8,257
One-time tax related expense	716	—	716	—
Adjusted EBITDA [1]	$15,744	$13,098	$31,872	$25,075

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

Free Cash Flow

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

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

	Six Months Ended June 30,	
	2016	2015
	(in thousands)	
Net cash provided by operating activities	$34,461	$25,550
Less:		
Purchases of property and equipment	(8,966)	(10,407)
Capitalized software development costs	—	(99)
Free cash flow	$	