

MICROSTRATEGY Inc
Form 10-Q
October 25, 2018
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2018

OR

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 000-24435

MICROSTRATEGY INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

51-0323571

(I.R.S. Employer

Identification Number)

1850 Towers Crescent Plaza, Tysons Corner, VA

(Address of Principal Executive Offices)

22182

(Zip Code)

(703) 848-8600

(Registrant's telephone number, including area code)

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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 No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes 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	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

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.

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

The number of shares of the registrant’s class A common stock and class B common stock outstanding on October 15, 2018 was 9,432,210 and 2,035,184, respectively.

MICROSTRATEGY INCORPORATED

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MICROSTRATEGY INCORPORATED

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	September 30, 2018 (unaudited)	December 31, 2017 (as adjusted, unaudited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 112,082	\$ 420,244
Restricted cash	901	938
Short-term investments	587,093	254,927
Accounts receivable, net	110,761	165,364
Prepaid expenses and other current assets	27,629	19,180
Total current assets	838,466	860,653
Property and equipment, net	51,861	53,359
Capitalized software development costs, net	0	2,499
Deposits and other assets	7,549	7,411
Deferred tax assets, net	15,628	9,297
Total assets	\$ 913,504	\$ 933,219
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 23,002	\$ 30,711
Accrued compensation and employee benefits	37,819	41,498
Deferred revenue and advance payments	151,043	198,734
Total current liabilities	211,864	270,943
Deferred revenue and advance payments	4,923	6,400
Other long-term liabilities	61,290	50,146
Deferred tax liabilities	4	4
Total liabilities	278,081	327,493
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock undesignated, \$0.001 par value; 5,000 shares authorized; no shares issued or outstanding	0	0
Class A common stock, \$0.001 par value; 330,000 shares authorized; 15,837 shares issued and 9,432 shares outstanding, and 15,817 shares issued and 9,412 shares outstanding, respectively	16	16
Class B convertible common stock, \$0.001 par value; 165,000 shares authorized; 2,035 shares issued and outstanding, and 2,035 shares issued and outstanding, respectively	2	2
Additional paid-in capital	573,474	559,918
Treasury stock, at cost; 6,405 shares	(475,184)	(475,184)

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Accumulated other comprehensive loss	(8,718)	(5,659)
Retained earnings	545,833	526,633
Total stockholders' equity	635,423	605,726
Total liabilities and stockholders' equity	\$ 913,504	\$ 933,219

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

MICROSTRATEGY INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Three Months Ended September 30,	
	2018	2017
		(as adjusted, (unaudited)unaudited)
Revenues:		
Product licenses	\$ 20,264	\$ 22,356
Subscription services	7,240	7,725
Total product licenses and subscription services	27,504	30,081
Product support	74,463	72,881
Other services	20,185	23,048
Total revenues	122,152	126,010
Cost of revenues:		
Product licenses	377	1,763
Subscription services	3,259	3,592
Total product licenses and subscription services	3,636	5,355
Product support	5,079	4,218
Other services	14,674	14,816
Total cost of revenues	23,389	24,389
Gross profit	98,763	101,621
Operating expenses:		
Sales and marketing	45,429	42,005
Research and development	25,829	19,360
General and administrative	20,285	19,082
Total operating expenses	91,543	80,447
Income from operations	7,220	21,174
Interest income, net	3,441	1,449
Other income (expense), net	798	(1,903)
Income before income taxes	11,459	20,720
(Benefit from) provision for income taxes	(1,240)	2,536
Net income	12,699	18,184
Basic earnings per share (1)	\$ 1.11	\$ 1.59
Weighted average shares outstanding used in computing basic earnings per share	11,467	11,447
Diluted earnings per share (1)	\$ 1.10	\$ 1.58
Weighted average shares outstanding used in computing diluted earnings per share	11,538	11,499

(1) Basic and fully diluted earnings per share for class A and class B common stock are the same.
The accompanying notes are an integral part of these Consolidated Financial Statements.

MICROSTRATEGY INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Nine Months Ended September 30,	
	2018	2017
		(as adjusted, (unaudited)unaudited)
Revenues:		
Product licenses	\$56,857	\$ 62,730
Subscription services	22,486	23,843
Total product licenses and subscription services	79,343	86,573
Product support	222,554	214,159
Other services	63,824	66,730
Total revenues	365,721	367,462
Cost of revenues:		
Product licenses	4,255	5,182
Subscription services	9,953	10,031
Total product licenses and subscription services	14,208	15,213
Product support	14,685	13,094
Other services	44,721	43,589
Total cost of revenues	73,614	71,896
Gross profit	292,107	295,566
Operating expenses:		
Sales and marketing	147,742	123,213
Research and development	74,471	57,347
General and administrative	63,756	58,921
Total operating expenses	285,969	239,481
Income from operations	6,138	56,085
Interest income, net	8,698	3,449
Other income (expense), net	3,665	(6,377)
Income before income taxes	18,501	53,157
(Benefit from) provision for income taxes	(699)	9,463
Net income	19,200	43,694
Basic earnings per share (1)	\$ 1.68	\$ 3.82
Weighted average shares outstanding used in computing basic earnings per share	11,458	11,443
Diluted earnings per share (1)	\$ 1.67	\$ 3.78
Weighted average shares outstanding used in computing diluted earnings per share	11,502	11,567

(1) Basic and fully diluted earnings per share for class A and class B common stock are the same.

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

MICROSTRATEGY INCORPORATED

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended September 30,	
	2018	2017
		(as adjusted, (unaudited)unaudited)
Net income	\$ 12,699	\$ 18,184
Other comprehensive (loss) income, net of applicable taxes:		
Foreign currency translation adjustment	(607)	1,120
Total other comprehensive (loss) income	(607)	1,120
Comprehensive income	\$ 12,092	\$ 19,304

	Nine Months Ended September 30,	
	2018	2017
		(as adjusted, (unaudited)unaudited)
Net income	\$ 19,200	\$ 43,694
Other comprehensive (loss) income, net of applicable taxes:		
Foreign currency translation adjustment	(3,059)	4,425
Unrealized loss on short-term investments	0	(30)
Total other comprehensive (loss) income	(3,059)	4,395
Comprehensive income	\$ 16,141	\$ 48,089

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

MICROSTRATEGY INCORPORATED

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30,	
	2018	2017
		(as adjusted, (unaudited) unaudited)
Operating activities:		
Net income	\$ 19,200	\$ 43,694
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,483	12,009
Bad debt expense	1,053	1,726
Deferred taxes	(6,667)	(5,508)
Share-based compensation expense	11,132	10,557
Changes in operating assets and liabilities:		
Accounts receivable	9,300	18,804
Prepaid expenses and other current assets	(1,075)	(5,042)
Deposits and other assets	(956)	(1,288)
Accounts payable and accrued expenses	(5,816)	(14,468)
Accrued compensation and employee benefits	(3,901)	(10,437)
Deferred revenue and advance payments	(4,032)	1,140
Other long-term liabilities	1,527	(1,904)
Net cash provided by operating activities	23,248	49,283
Investing activities:		
Proceeds from redemption of short-term investments	348,980	340,920
Purchases of property and equipment	(4,457)	(2,282)
Purchases of short-term investments	(674,528)	(411,666)
Net cash used in investing activities	(330,005)	(73,028)
Financing activities:		
Proceeds from sale of class A common stock under exercise of employee stock options	2,471	1,677
Payments on capital lease obligations and other financing arrangements	(9)	(17)
Net cash provided by financing activities	2,462	1,660
Effect of foreign exchange rate changes on cash, cash equivalents, and restricted cash	(3,904)	6,992
Net decrease in cash, cash equivalents, and restricted cash	(308,199)	(15,093)
Cash, cash equivalents and restricted cash, beginning of period	421,182	402,712
Cash, cash equivalents and restricted cash, end of period	\$ 112,983	\$ 387,619

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

MICROSTRATEGY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying Consolidated Financial Statements of MicroStrategy Incorporated (“MicroStrategy” or the “Company”) are unaudited. In the opinion of management, all adjustments necessary for a fair statement of financial position and results of operations have been included. All such adjustments are of a normal recurring nature, unless otherwise disclosed. Interim results are not necessarily indicative of results for a full year.

Certain amounts in the prior year’s Consolidated Financial Statements have been restated upon the adoption of Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) and its subsequent amendments (“ASU 2014-09”), as discussed in Note 2, Recent Accounting Standards, to the Consolidated Financial Statements.

The Consolidated Financial Statements and Notes to Consolidated Financial Statements are presented as required by the United States Securities and Exchange Commission (“SEC”) and do not contain certain information included in the Company’s annual financial statements and notes. These financial statements should be read in conjunction with the Company’s audited financial statements and the notes thereto filed with the SEC in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017. There have been no significant changes in the Company’s accounting policies since December 31, 2017, except as discussed below with respect to the Company’s adoption of ASU 2014-09.

The accompanying Consolidated Financial Statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The Company is not aware of any subsequent event which would require recognition or disclosure.

(b) Revenue Recognition

The Company adopted ASU 2014-09 effective as of January 1, 2018 and has adjusted its prior period consolidated financial statements to reflect full retrospective adoption. Refer to Note 2, Recent Accounting Standards, to the Consolidated Financial Statements for a summary of the significant changes in accounting principles and the impact to the Company’s previously reported consolidated financial statements.

Under ASU 2014-09, the Company recognizes revenue using a five-step model:

- (i) Identifying the contract(s) with a customer,
- (ii) Identifying the performance obligation,
- (iii) Determining the transaction price,
- (iv) Allocating the transaction price to the performance obligations in the contract, and
- (v) Recognizing revenue when, or as, the Company satisfies a performance obligation.

The Company has elected to exclude taxes assessed by government authorities in determining the transaction price, and therefore revenue is recognized net of taxes collected from customers.

Performance Obligations and Timing of Revenue Recognition

The Company primarily sells goods and services that fall into the categories discussed below. Each category contains one or more performance obligations that are either (i) capable of being distinct (i.e., the customer can benefit from the good or service on its own or together with readily available resources, including those purchased separately from the Company) and distinct within the context of the contract (i.e., separately identifiable from other promises in the contract), or (ii) a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Aside from the Company's term and perpetual software licenses, which are delivered at a point in time, the majority of the Company's other services are delivered over time.

MICROSTRATEGY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Product Licenses

The Company sells different types of on-premise business intelligence software, licensed on a term or perpetual basis. Although license arrangements are sold with product support, the software is fully functional at the outset of the arrangement and is considered a distinct performance obligation. Revenue from product license sales is recognized when control of the software license has transferred to the customer, which is the later of delivery or commencement of the license term. The Company may also sell through resellers and original equipment manufacturers (“OEMs”) who purchase the Company’s products for resale. In reseller arrangements, revenue is recognized when control of the product is transferred to the end user. In OEM arrangements, revenue is recognized upon delivery to the OEM.

Subscription Services

The Company also sells access to its software through a subscription-based cloud offering, wherein customers access the software through a third-party hosting service. Control of the software itself does not transfer to the customer under this arrangement and is not considered a separate performance obligation. Subscription services are regularly sold on a standalone basis with telephone support only. Revenue related to this subscription service is recognized on a straight-line basis over the contract period, which is the period over which the customer has continuous access to the software.

Product Support

In all license arrangements, customers are required to purchase a standard product support package and may also purchase a premium product support package for a fixed annual fee. All product support packages include both technical support and when-and-if-available software upgrades, which are treated as a single performance obligation as they are considered a series of distinct services that are substantially the same and have the same duration and measure of progress. Revenue from product support is recognized on a straight-line basis over the contract period, which is the period over which the customer has continuous access to product support.

Consulting Services

The Company sells consulting services to help customers plan and execute deployment of the Company’s software. Customers are not required to use consulting services to fully benefit from the software license. Consulting services are regularly sold on a standalone basis and either (i) prepaid upfront or (ii) sold on a time and materials basis. Consulting arrangements are each considered separate performance obligations because they do not integrate with each other or with other products and services to deliver a combined output to the customer, do not modify or customize (or are not modified or customized by) each other or other products and services, and do not affect the customer’s ability to use the other consulting offerings or other products and services. Revenue under consulting arrangements is recognized over time as services are delivered. For time and materials-based consulting arrangements, the Company has elected the practical expedient of recognizing revenue upon invoicing since the invoiced amount corresponds directly to the value of the Company’s service to date.

Education Services

The Company sells various education and training services to its customers. Education services are sold on a standalone basis under three different arrangements: (i) prepaid bulk training units that may be redeemed on training courses based on standard redemption rates, (ii) an annual subscription to unlimited training courses, and (iii) individual courses purchased a la carte. Education arrangements are each considered separate performance obligations because they do not integrate with each other or with other products and services to deliver a combined output to the customer, do not modify or customize (or are not modified or customized by) each other or other products and services, and do not affect the customer's ability to use the other education offerings or other products and services. Revenue on prepaid bulk training units and individual course purchases are recognized when the courses are delivered. Revenue on the annual subscription is recognized on a straight-line basis over the contract period, which is the period over which the customer has continuous access to unlimited training courses.

Refer to Note 10, Segment Information, to the Consolidated Financial Statements for information regarding total revenues by geographic region.

MICROSTRATEGY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Significant Judgments and Estimates

The adoption of ASU 2014-09 requires the Company to make significant judgments to determine the transaction price of a contract and subsequently allocate the transaction price based on an estimated standalone selling price (“SSP”). The Company is also required to make significant judgments with respect to capitalizing incremental costs to obtain a customer contract and determining the subsequent amortization period. These significant judgments and estimates are discussed further below.

Determining the Transaction Price

The transaction price includes both fixed and variable consideration. Variable consideration is included in the transaction price to the extent it is probable that a significant reversal will not occur. The amount of variable consideration excluded from the transaction price was not material for the three and nine months ended September 30, 2018 and 2017. The Company’s estimates of variable consideration are also subject to subsequent true-up adjustments and may result in changes to its transaction prices, but such true-up adjustments are not expected to be material. The Company has the following sources of variable consideration:

- (i) Performance penalties – Subscription services and product support arrangements generally contain performance response time guarantees. For subscription services arrangements, the Company estimates variable consideration using a portfolio approach because performance penalties are tied to standard up-time requirements. For product support arrangements, the Company estimates variable consideration on a contract basis because such arrangements are customer-specific. For both subscription services and product support arrangements, the Company uses an expected value approach to estimate variable consideration based on historical business practices and current and future performance expectations to determine the likelihood of incurring penalties.
- (ii) Extended payment terms – The Company’s standard payment terms are generally within 180 days of invoicing. If extended payment terms are granted to customers, those terms generally do not exceed one year. For contracts with extended payment terms, the Company estimates variable consideration on a contract basis because such estimates are customer-specific, and uses an expected value approach to analyze historical business experience on a customer-by-customer basis to determine the likelihood that extended payment terms lead to an implied price concession.
- (iii) Sales and usage-based royalties – Certain product license arrangements include sales or usage-based royalties, covering both the software license and product support. In these arrangements, the Company uses an expected value approach to estimate and recognize revenue for royalty sales each period, utilizing historical data on a contract-by-contract basis. True-up adjustments are recorded in subsequent periods when royalty reporting is received from the OEM partners.

The Company provides a standard software assurance warranty to repair, replace, or refund software that does not perform in accordance with documentation. The standard software assurance warranty period is generally less than one year. Assurance warranty claims were not material for the three and nine months ended September 30, 2018 and 2017.

The Company does not adjust the transaction price for significant financing components where the time period between cash payment and performance is one year or less. However, there are circumstances where the timing between cash payment and performance may exceed one year. These circumstances generally involve prepaid multi-year product support and subscription services arrangements where the customer determines when the service is utilized (e.g., when to request on-call support services or when to use and access the software on the cloud). In these circumstances, the Company has determined no significant financing component exists because the customer controls when to utilize the service and because there are significant business purposes behind the timing difference between payment and performance (e.g., maximizing profit in the case of product support services and ensuring collectability in the case of subscription services).

Allocating the Transaction Price Based on Standalone Selling Prices

The Company allocates the transaction price to each performance obligation in a contract based on its relative SSP. The SSP is the price at which the Company sells the product or service on a standalone basis at contract inception. In circumstances where SSP is not directly observable, the Company estimates SSP using the following methodologies:

- (i) Product licenses – Product licenses are not sold on a standalone basis and pricing is highly variable. The Company establishes SSP of product licenses using a residual approach after first establishing the SSP of standard product support. Standard product support is sold on a standalone basis within a narrow range of the net license fee, and because an economic relationship exists between product licenses and standard product support, the Company has concluded that the residual method to estimate SSP of product licenses sold on both a perpetual and term basis is a fair allocation of the transaction price.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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- (ii) Subscription services – Given the highly variable selling price of subscription services, the Company establishes the SSP of its subscription services arrangements using a similar residual approach after first establishing the SSP of consulting and education services. The Company has concluded that the residual method to estimate SSP of its subscription services is a fair allocation of the transaction price.
- (iii) Standard product support – The Company establishes SSP of standard product support as a percentage of the stated net license fee, given such pricing is consistent with its normal pricing practices and there exists sufficient history of customers renewing at similar percentages. Each quarter, the Company tracks renewal rates negotiated when standard product support is initially sold with a perpetual license in order to determine the SSP of standard product support within each geographic region for the upcoming quarter. If the stated standard product support fee falls within the SSP range, the specific rate in the contract will be used to estimate SSP. If the stated fee is above or below SSP, the highest or lowest end of the range, respectively, will generally be used to estimate SSP of standard product support.
- (iv) Premium product support, consulting services, and education services – SSP of premium product support, consulting services, and education services is established by using a bell-shaped curve approach to define a narrow range within each geographic region in which the services are discounted off of the list price on a standalone basis.

The Company often provides options to purchase future products or services at a discount. The Company analyzes the option price against the previously established SSP of the goods or services to determine if the options represent material rights that should be accounted for as separate performance obligations. In general, options sold at or above SSP are not considered separate performance obligations because the customer could have received that right without entering into the contract. If a material right exists, revenue associated with the option is recognized when the future goods or services are transferred, or when the option expires. During the three and nine months ended September 30, 2018 and 2017, rights arising from future purchase options have not been material.

Incremental Costs to Obtain Customer Contracts

Incremental costs incurred to obtain contracts with customers include certain variable compensation (e.g., commissions and bonuses) paid to the Company's sales team. Although the Company may bundle its goods and services into one contract, commissions are individually determined on each distinct good or service in the contract. The Company expenses as incurred those amounts earned on consulting and education services, which are generally performed within a one-year period and primarily sold on a standalone basis. The Company also expenses as incurred those amounts earned on product license sales, since the amount is earned when the license is delivered. The Company capitalizes those amounts earned on product support and amortizes the costs over a period of time that is

consistent with the pattern of transfer of the product support to the customer, which the Company has determined to be a period of three years. Although the Company typically sells product support for a period of one year, a majority of customers renew their product support arrangements. Three years is generally the period after which platforms are no longer supported by the Company's support team and when customers generally choose to upgrade their software platform. The Company does not pay variable compensation on product support renewals. Variable compensation earned on subscription cloud services are expensed as incurred due to their immaterial nature. As of September 30, 2018 and December 31, 2017, capitalized costs to obtain customer contracts, net of accumulated amortization, were \$3.9 million and \$4.5 million, respectively, and are presented within "Deposits and other assets" in the Consolidated Balance Sheets. During the three and nine months ended September 30, 2018 and 2017, amortization expense related to these capitalized costs were \$0.6 million and \$1.6 million, and \$0.8 million and \$2.2 million, respectively, and are reflected within "Sales and marketing" in the Consolidated Statements of Operations.

(2) Recent Accounting Standards

Revenue from contracts with customers

The Company adopted ASU 2014-09 effective as of January 1, 2018 and adjusted prior period consolidated financial statements to reflect full retrospective adoption. In adopting ASU 2014-09, the Company has made the following significant changes in accounting principles:

- (i) Timing of revenue recognition for term license sales. Under ASU 2014-09, the Company now recognizes product licenses revenue from term licenses upon delivery of the software. Previously, this revenue was recognized over the term of the arrangement.

MICROSTRATEGY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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- (ii) Timing of revenue recognition for sales to channel partners. Under ASU 2014-09, the Company now recognizes revenue from sales made to OEMs when control of the products transfers to the OEM, less adjustments for returns or price protection. Previously, this revenue was not recognized until the product was sold by the OEM to the end user. Revenue from sales made to resellers continues to be recognized when control of the product has transferred to the end user.
- (iii) Allocating the transaction price to the performance obligations in the contract. Under ASU 2014-09, the Company will allocate the transaction price to the various performance obligations in the contract based on their relative SSP. Except for SSP of product support, the Company's methodologies for estimating SSP of its various performance obligations are generally consistent with the Company's previous methodologies used to establish vendor specific objective evidence of fair value on multiple element arrangements. The SSP of product support will result in a difference in the allocation of the transaction price between product support and product license performance obligations. The impact from SSP-based allocations was not material to the Company's prior or current period financial statements and is not expected to be material in future periods.
- (iv) Material rights. The Company's contracts with customers may include options to acquire additional goods and services at a discount. Under ASU 2014-09, certain of these options may be considered material rights if sold below SSP and would be treated as separate performance obligations and included in the allocation of the transaction price. Previously, none of the Company's options were considered material rights. The impact from material rights was not material to the Company's prior or current period financial statements and is not expected to be material in future periods.
- (v) Presentation of accounts receivable, contract assets, and contract liabilities (deferred revenue). Under ASU 2014-09, the Company's rights to consideration are presented separately depending on whether those rights are conditional ("contract assets") or unconditional ("accounts receivable"). See Note 4, Contract Balances, to the Consolidated Financial Statements for further discussion on balance sheet presentation. Under ASU 2014-09, the Company cannot net accounts receivable with contract liabilities ("deferred revenue") and the Company no longer offsets its accounts receivable and deferred revenue balances for unpaid items that are included in the deferred revenue balance. Previously, this offsetting of accounts receivable and deferred revenue balances for unpaid amounts was applied in the Company's prior period financial statements.
- (vi) Deferral of incremental direct costs to obtaining a contract with a customer. Under ASU 2014-09, the Company now capitalizes certain variable compensation payable to its sales force and subsequently amortizes the capitalized costs over a period of time that is consistent with the transfer of the related good or service to the customer, which the Company has determined to be three years. Previously, the Company elected to expense these incremental direct costs as incurred.

Upon adoption of ASU 2014-09, the Company recorded a cumulative \$13.0 million increase to its 2016 beginning retained earnings balance, offset by a \$12.9 million decrease in gross deferred revenues, a \$5.2 million decrease in deferred tax assets, net of deferred tax liabilities, a \$4.4 million increase in other non-current assets, and a \$0.9 million increase in other current assets.

The following line items as of December 31, 2017 and for the three and nine months ended September 30, 2017 have been adjusted in the Consolidated Financial Statements to reflect the adoption of ASU 2014-09:

December 31, 2017

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	As Reported (audited)	Effect of the Adoption of ASU 2014-09 (unaudited)	As Adjusted (unaudited)
Consolidated Balance Sheet			
Accounts receivable, net	\$69,500	\$ 95,864	\$ 165,364
Prepaid expenses and other current assets	18,002	1,178	19,180
Deposits and other assets	2,868	4,543	7,411
Deferred tax assets, net	13,391	(4,094)	9,297
Deferred revenue and advance payments	112,649	86,085	198,734
Deferred revenue and advance payments, non-current	10,181	(3,781)	6,400
Accumulated other comprehensive loss	(5,968)	309	(5,659)
Retained earnings	511,755	14,878	526,633

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(unaudited)

Three Months Ended September 30,
2017

	As Reported	Effect of the Adoption of ASU 2014-09	As Adjusted
Consolidated Statement of Operations:	(unaudited)	(unaudited)	(unaudited)
Product licenses revenue	\$21,553	\$ 803	\$ 22,356
Product support revenues	72,886	(5)	72,881
Sales and marketing expenses	41,806	199	42,005
Provision for income taxes	2,197	339	2,536
Net income	17,924	260	18,184
Diluted earnings per share	1.56	0.02	1.58

Nine Months Ended September 30,
2017

	As Reported	Effect of the Adoption of ASU 2014-09	As Adjusted
Consolidated Statement of Operations:	(unaudited)	(unaudited)	(unaudited)
Product licenses revenue	\$61,683	\$ 1,047	\$ 62,730
Product support revenues	214,142	17	214,159
Sales and marketing expenses	122,635	578	123,213
Provision for income taxes	8,804	659	9,463
Net income	43,867	(173)	43,694
Diluted earnings per share	3.79	(0.01)	3.78

Three Months Ended September 30,
2017

	As Reported	Effect of the Adoption of ASU 2014-09	As Adjusted
Consolidated Statement of Comprehensive Income:	(unaudited)	(unaudited)	(unaudited)
Net income	\$17,924	\$ 260	\$ 18,184

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Foreign currency translation adjustment	1,060	60	1,120
Comprehensive income	18,984	320	19,304

Nine Months Ended September 30,
2017

	As Reported (unaudited)	Effect of the Adoption of ASU 2014-09 (unaudited)	As Adjusted (unaudited)
Consolidated Statement of Comprehensive Income:			
Net income	\$43,867	\$ (173)	\$ 43,694
Foreign currency translation adjustment	4,090	335	4,425
Comprehensive income	47,927	162	48,089

Nine Months Ended September 30,
2017

	As Reported (unaudited)	Effect of the Adoption of ASU 2014-09 (unaudited)	As Adjusted (unaudited)
Consolidated Statement of Cash Flows:			
Net income	\$43,867	\$ (173)	\$ 43,694
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,838	2,171	12,009
Deferred taxes	(6,214)	706	(5,508)
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(3,954)	(1,088)	(5,042)
Deposits and other assets	(1,280)	(8)	(1,288)
Accrued compensation and employee benefits	(8,845)	(1,592)	(10,437)
Deferred revenue and advance payments	1,156	(16)	1,140

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Intra-entity asset transfers

In October 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), to improve the accounting for income tax effects of intra-entity transfers of assets other than inventory. Under ASU 2016-16, the deferral of the income tax consequences of intra-entity transfers of assets other than inventory is eliminated. Entities will be required to recognize the income tax consequences of intra-entity transfers of assets other than inventory when the transfers occur. The standard requires a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption using a modified retrospective approach. The Company adopted this guidance effective as of January 1, 2018. The adoption of this guidance did not have a material impact on the Company’s consolidated financial position, results of operations, or cash flows. No cumulative-effect adjustment to retained earnings was made.

Lease accounting

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases (Topic 842) (“ASU 2016-02”), which requires lease assets and lease liabilities be recognized for all leases, in addition to the disclosure of key information to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from an entity’s leasing arrangements. ASU 2016-02 defines a lease as a contract, or part of a contract, that conveys both (i) the right to obtain economic benefits from and (ii) direct the use of an identified asset for a period of time in exchange for consideration. Under ASU 2016-02, leases are classified as either finance or operating leases. For finance leases, a lessee shall recognize in profit or loss the amortization of the lease asset and interest on the lease liability. For operating leases, a lessee shall recognize in profit or loss a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term, generally on a straight-line basis. The initial release of ASU 2016-02 requires the recognition and measurement of leases at the beginning of the earliest period presented using a modified retrospective approach. However, in July 2018, the FASB issued Accounting Standards Update No. 2018-11, Leases (Topic 842): Targeted Improvements, which adds a transition option to allow application of the new standard at the adoption date, with a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Under this transition option, comparative periods presented in the financial statements would not be restated. Instead, the comparative periods would continue to be presented in the financial statements and related notes to the financial statements under current U.S. generally accepted accounting principles (“GAAP”). The standard and its subsequent amendments are effective for interim and annual periods beginning January 1, 2019. Early adoption is permitted. The Company is currently evaluating the impact of this guidance on its consolidated financial position, results of operations, cash flows, and disclosures and continues to re-evaluate its inventory of leases, including reviewing contracts for potential embedded leases. The Company’s current leases are primarily related to office space in the United States and foreign locations and are classified as operating leases under GAAP. The Company plans to elect the package of practical expedients described in ASU 2016-02, which includes not reassessing the lease classification on these existing leases. The Company also plans to elect the transition option to apply the new lease requirements at the adoption date without restating comparative periods presented in its financial statements. The Company has selected a lease management system and is currently validating the completeness and accuracy of the relevant lease information within the system.

Cloud computing arrangements

In August 2018, the FASB issued Accounting Standards Update No. 2018-15, Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (“ASU 2018-15”). ASU 2018-15 requires customers in a hosting arrangement that is a service contract to follow existing internal-use software guidance to determine which implementation costs to capitalize and which costs to expense. Under this model, customers would need to determine the nature of the implementation costs and the project stage in which they are incurred to determine which costs to capitalize or expense. Customers would be required to amortize the capitalized implementation costs over the term of the hosting arrangement, which might extend beyond the noncancelable period if there are options to extend or terminate. ASU 2018-15 specifies the financial statement presentation of capitalized implementation costs and related amortization, in addition to required disclosures for material capitalized implementation costs related to hosting arrangements that are service contracts. The standard is effective for interim and annual periods beginning January 1, 2020. Early adoption is permitted. Entities can choose to adopt this guidance prospectively to eligible costs incurred on or after the date the guidance is first applied, or to adopt the guidance retrospectively. The Company is currently evaluating the impact of this guidance on its consolidated financial position, results of operations, and cash flows.

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(3) Short-term Investments

The Company periodically invests a portion of its excess cash in short-term investment instruments. Substantially all of the Company's short-term investments are in U.S. Treasury securities, and the Company has the ability and intent to hold these investments to maturity. The stated maturity dates of these investments are between three months and one year from the purchase date. These held-to-maturity investments are recorded at amortized cost and included within "Short-term investments" on the accompanying Consolidated Balance Sheets. The fair value of held-to-maturity investments is determined based on quoted market prices in active markets for identical securities (Level 1 inputs).

The amortized cost, carrying value, and fair value of held-to-maturity investments at September 30, 2018 were \$587.1 million, \$587.1 million, and \$586.2 million, respectively. The amortized cost, carrying value, and fair value of held-to-maturity investments at December 31, 2017 were \$254.9 million, \$254.9 million, and \$254.8 million, respectively. The gross unrecognized holding gains and losses were not material for each of the three and nine months ended September 30, 2018 and 2017. No other-than-temporary impairments related to these investments have been recognized as of September 30, 2018 and December 31, 2017.

(4) Contract Balances

The Company invoices its customers in accordance with billing schedules established in each contract. The Company's rights to consideration from customers are presented separately in the Company's Consolidated Balance Sheets depending on whether those rights are conditional or unconditional.

The Company presents unconditional rights to consideration from customers within "Accounts receivable, net" in its Consolidated Balance Sheets. All of the Company's contracts are generally non-cancellable and/or non-refundable and therefore an unconditional right generally exists when the customer is billed or amounts are billable per the contract.

Accounts receivable (in thousands) consisted of the following, as of:

	September 30, 2018	December 31, 2017 (as adjusted)
Billed and billable	\$ 114,483	\$ 169,554
Less: allowance for doubtful accounts	(3,722)	(4,190)
Accounts receivable, net	\$ 110,761	\$ 165,364

The Company maintains an allowance for doubtful accounts which represents its best estimate of probable losses inherent in the accounts receivable balances. The Company evaluates specific accounts when it becomes aware that a customer may not be able to meet its financial obligations due to deterioration of its liquidity or financial viability, credit ratings, or bankruptcy. In addition, the Company periodically adjusts this allowance based on its review and assessment of the aging of receivables. For the three and nine months ended September 30, 2018 and 2017, the Company's bad debt expense and write-offs (reversals) totaled \$0.1 million and \$1.1 million, and \$(0.1) million and \$1.7 million, respectively.

In contrast, rights to consideration that are subject to a condition other than the passage of time are considered contract assets and presented within "Prepaid expenses and other current assets" in the Consolidated Balance Sheets since the rights to consideration are expected to become unconditional and transfer to accounts receivable within one year. Contract assets generally consist of accrued sales and usage-based royalty revenue. In these arrangements, consideration is not billed or billable until the royalty reporting is received, generally in the subsequent quarter, at which time the contract asset will transfer to accounts receivable and a true-up adjustment will be recorded to revenue. During the three and nine months ended September 30, 2018 and 2017, there were no significant impairments to the Company's contract assets, nor were there any significant changes in the timing of the Company's contract assets being reclassified to accounts receivable. Contract assets included in "Prepaid expenses and other current assets" in the Consolidated Balance Sheets consisted of \$0.4 million and \$1.2 million in accrued sales and usage-based royalty revenue, as of September 30, 2018 and December 31, 2017, respectively.

Contract liabilities are amounts received or due from customers in advance of the Company transferring the products or services to the customer. Revenue is subsequently recognized in the period(s) in which control of the products or services are transferred to the customer. The Company's contract liabilities are presented as either current or non-current "Deferred revenues and advance

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payments” in the Consolidated Balance Sheets, depending on whether the products or services are expected to be transferred to the customer within the next year.

Deferred revenue and advance payments (in thousands) from customers consisted of the following, as of:

	September 30, 2018	December 31, 2017 (as adjusted)
Current:		
Deferred product licenses revenue	\$ 584	\$ 3,760
Deferred subscription services revenue	11,736	17,324
Deferred product support revenue	131,185	168,185
Deferred other services revenue	7,538	9,465
Total current deferred revenue and advance payments	\$ 151,043	\$ 198,734
Non-current:		
Deferred product licenses revenue	\$ 730	\$ 820
Deferred subscription services revenue	0	126
Deferred product support revenue	3,701	4,826
Deferred other services revenue	492	628
Total non-current deferred revenue and advance payments	\$ 4,923	\$ 6,400

During the three and nine months ended September 30, 2018 and 2017, the Company recognized revenues of \$39.2 million and \$170.6 million, and \$40.4 million and \$170.9 million, respectively, from amounts included in the total current deferred revenue and advance payments balances at the beginning of the respective year. For the three and nine months ended September 30, 2018 and 2017, there were no significant changes in the timing of revenue recognition on the Company’s deferred balances.

As of September 30, 2018, the Company had an aggregate transaction price of \$156.0 million allocated to unsatisfied performance obligations related to product support, subscription services, other services, and product licenses contracts. The Company expects to recognize \$151.0 million within the next year and \$4.9 million thereafter.

(5) Commitments and Contingencies

(a) Commitments

From time to time, the Company enters into certain types of contracts that require it to indemnify parties against third-party claims. These contracts primarily relate to agreements under which the Company assumes indemnity

obligations for intellectual property infringement, as well as other obligations from time to time depending on arrangements negotiated with customers and other third parties. The conditions of these obligations vary. Thus, the overall maximum amount of the Company's indemnification obligations cannot be reasonably estimated. Historically, the Company has not been obligated to make significant payments for these obligations and does not currently expect to incur any material obligations in the future. Accordingly, the Company has not recorded an indemnification liability on its balance sheets as of September 30, 2018 or December 31, 2017.

The Company leases office space under operating lease agreements. Under the lease agreements, in addition to base rent, the Company is generally responsible for certain taxes, utilities and maintenance costs, and other fees. Several of these leases include options for renewal. The Company does not have any material capital leases. The Company leases approximately 214,000 square feet of office space at a location in Northern Virginia that began serving as its corporate headquarters in October 2010. In January 2018, the Company amended the lease to extend the lease term through December 2030. The amended lease also provides for certain tenant allowances and incentives. At September 30, 2018 and December 31, 2017, deferred rent of \$27.1 million and \$8.5 million, respectively, was included in other long-term liabilities.

As a result of the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"), the Company estimated and recorded a one-time \$40.3 million tax expense related to the mandatory deemed repatriation transition tax ("Transition Tax") during the year ended December 31, 2017. The Company subsequently recorded a measurement-

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period adjustment to reduce the Transition Tax by \$3.1 million during the three months ended September 30, 2018. At September 30, 2018, \$28.9 million of the Transition Tax was unpaid and was included in “Other long-term liabilities.”

(b) Contingencies

Following an internal review, the Company believes that its Brazilian subsidiary failed or likely failed to comply with local procurement regulations in conducting business with certain Brazilian government entities. While the Company believes that it is probable that the resolution of this matter will result in a loss, the amount or range of loss is not reasonably estimable at this time. Given the early state of the matter, no assurance can be given that the outcome will not result in a material impact on the Company’s earnings and financial results for the period in which any such liability is accrued. However, the Company believes that the outcome of this matter will not have a material effect on the Company’s financial position.

The Company is also involved in various legal proceedings arising in the normal course of business. Although the outcomes of these legal proceedings are inherently difficult to predict, management does not expect the resolution of these legal proceedings to have a material adverse effect on the Company’s financial position, results of operations, or cash flows.

The Company has contingent liabilities that, in management’s judgment, are not probable of assertion. If such unasserted contingent liabilities were to be asserted, or become probable of assertion, the Company may be required to record significant expenses and liabilities in the period in which these liabilities are asserted or become probable of assertion.

(6) Treasury Stock

The Board of Directors previously authorized the Company’s repurchase of up to an aggregate of \$800.0 million of its class A common stock from time to time on the open market through April 29, 2018 (the “2005 Share Repurchase Program”). In April 2018, the Board of Directors extended the term of the 2005 Share Repurchase Program through April 29, 2023, although the program may be suspended or discontinued by the Company at any time. The timing and amount of any shares repurchased will be determined by the Company’s management based on its evaluation of market conditions and other factors. The 2005 Share Repurchase Program may be funded using the Company’s working capital, as well as proceeds from any other funding arrangements that the Company may enter into in the future. During the three and nine months ended September 30, 2018 and 2017, the Company did not repurchase any shares of its class A common stock pursuant to the 2005 Share Repurchase Program. As of September 30, 2018, the Company had repurchased an aggregate of 3,826,947 shares of its class A common stock at an average price per share of \$90.23 and an aggregate cost of \$345.3 million. The average price per share and aggregate cost amounts disclosed above include broker commissions.

(7) Income Taxes

The Company and its subsidiaries conduct business in the United States and various foreign countries and are subject to taxation in numerous domestic and foreign jurisdictions. As a result of its business activities, the Company files tax returns that are subject to examination by various federal, state and local, and foreign tax authorities. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or foreign income tax examination by tax authorities for years before 2014. However, due to its use of state net operating loss (“NOL”) and federal tax credit carryovers in the United States, U.S. tax authorities may attempt to reduce or fully offset the amount of state NOL or federal tax credit carryovers from tax years ended 2007 and forward that were used in later tax years. The Company’s major foreign tax jurisdictions and tax years that remain subject to potential examination are Germany for tax years 2016 and forward, Italy, Poland and China for tax years 2013 and forward, Spain for tax years 2014 and forward, and the United Kingdom for tax years 2016 and forward. To date there have been no material audit assessments related to audits in any of the applicable foreign jurisdictions.

As of September 30, 2018, the Company had unrecognized tax benefits of \$4.5 million, which are recorded in “Other long-term liabilities” in the Company’s Consolidated Balance Sheets. If recognized, \$4.0 million of these unrecognized tax benefits would impact the effective tax rate. The Company recognizes estimated accrued interest related to unrecognized income tax benefits in the (benefit from) provision for income tax accounts. Penalties relating to income taxes, if incurred, would also be recognized as a component of the Company’s (benefit from) provision for income taxes. Over the next 12 months, the amount of the Company’s liability for unrecognized tax benefits is not expected to change by a material amount. As of September 30, 2018, the amount of cumulative accrued interest expense on unrecognized income tax benefits was approximately \$0.7 million.

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The following table summarizes the Company's deferred tax assets, net of deferred tax liabilities and valuation allowance (in thousands), as of:

	September 30, 2018	December 31, 2017 (as adjusted)
Deferred tax assets, net of deferred tax liabilities	\$ 16,783	\$ 10,308
Valuation allowance	(1,159)	(1,015)
Deferred tax assets, net of deferred tax liabilities and valuation allowance	\$ 15,624	\$ 9,293

The valuation allowance as of September 30, 2018 and December 31, 2017 related to certain foreign tax credit carryforwards that, in the Company's present estimation, more likely than not will not be realized.

The Company has estimated its annual effective tax rate for the full fiscal year 2018 and applied that rate to its income before income taxes in determining its benefit from income taxes for the nine months ended September 30, 2018. The Company also records discrete items in each respective period as appropriate. The estimated effective tax rate is subject to fluctuation based on the level and mix of earnings and losses by tax jurisdiction, foreign tax rate differentials, and the relative impact of permanent book to tax differences (e.g., non-deductible expenses). Each quarter, a cumulative adjustment is recorded for any fluctuations in the estimated annual effective tax rate as compared to the prior quarter. As a result of these factors, and due to potential changes in the Company's period-to-period results, fluctuations in the Company's effective tax rate and respective tax provisions or benefits may occur.

For the nine months ended September 30, 2018, the Company recorded a benefit from income taxes of \$0.7 million that resulted in an effective tax rate of (3.8)%, as compared to a provision for income taxes of \$9.5 million that resulted in an effective tax rate of 17.8% for the nine months ended September 30, 2017. The change in the effective tax rate in 2018 is mainly due to discrete items, such as the adjustment to the Transition Tax recorded in the three months ended September 30, 2018.

The Tax Act reduced the U.S. corporate tax rate from 35% to 21%, effective January 1, 2018. Additionally, the Tax Act requires certain Global Intangible Low Taxed Income ("GILTI") earned by controlled foreign corporations ("CFCs") to be included in the gross income of the CFCs' U.S. shareholder. GAAP allows the Company to either: (i) treat taxes due on future U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the "period cost method"); or (ii) factor such amounts into its measurement of deferred taxes (the "deferred method"). The Company has elected the period cost method. The Tax Act allows a U.S. corporation a deduction equal to a certain percentage of its foreign-derived intangible income ("FDII"). The Company estimated the impact of the GILTI tax and FDII deduction in determining its 2018 annual effective tax rate that is reflected in its benefit from income taxes for the nine months ended September 30, 2018. The Company will continue to refine its calculation for the GILTI tax and FDII deduction in future quarters. The Tax Act also imposes a Transition Tax on previously untaxed accumulated and current earnings and profits ("E&P") of certain foreign subsidiaries of the Company.

The SEC staff issued Staff Accounting Bulletin (“SAB”) 118, which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the related accounting under FASB Accounting Standards Codification 740, Income Taxes (“ASC 740”). In accordance with SAB 118, a company must disclose the income tax effects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but reasonable estimates can be determined, it must record provisional estimates in the financial statements. If a company cannot determine provisional estimates to be included in the financial statements, it should continue to apply ASC 740 based on the tax laws that were in effect immediately before the enactment of the Tax Act.

The Company’s accounting for certain elements of the Tax Act was incomplete as of December 31, 2017 and remains incomplete as of September 30, 2018. However, the Company was able to make reasonable estimates of certain tax effects and recorded provisional estimates for these items. In connection with its initial analysis of the impact of the Tax Act, the Company recorded an initial provisional net tax expense of \$40.3 million, of which \$36.8 million was recorded in “Other long-term liabilities” in the Company’s Consolidated Balance Sheet as of December 31, 2017 related to the one-time Transition Tax. To determine the Transition Tax, the Company must determine the amount of post-1986 accumulated E&P of the relevant subsidiaries, as well as the amount of non-U.S. income taxes paid on such earnings. Upon refining its non-U.S. E&P and associated income taxes during the three months ended September 30, 2018, the Company recorded a measurement-period adjustment to reduce the Transition Tax by \$3.1 million. As of September 30, 2018, the Company’s total provisional estimate for the Transition Tax was \$37.2 million, of which \$8.3 million had been paid and \$28.9 million was recorded in “Other long-term liabilities” in the Company’s Consolidated Balance Sheets. As the

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Company continues to analyze the impact of foreign exchange gains or losses and gathers support for non-U.S. income taxes paid, and as regulators issue further guidance, the Company's estimates may change in the fourth quarter of 2018. The Company will continue to refine such amounts within the measurement period allowed, which it expects to complete no later than December 22, 2018. Likewise, while the Company was able to make a reasonable estimate of the impact of the reduced U.S. corporate tax rate, its effective tax rate may be affected by other aspects of the Tax Act, including, but not limited to, the impact of the Tax Act on state taxes.

Except as discussed below, the Company intends to indefinitely reinvest its undistributed earnings of all of its foreign subsidiaries. U.S. federal tax laws require the Company to include in its U.S. taxable income certain investment income earned outside of the United States in excess of certain limits ("Subpart F deemed dividends"). Because Subpart F deemed dividends are already required to be recognized in the Company's U.S. federal income tax return, the Company regularly repatriates Subpart F deemed dividends to the United States and no additional tax is incurred on the distribution. As of September 30, 2018 and December 31, 2017, the amount of cash and cash equivalents and short-term investments held by the Company's U.S. entities was \$297.0 million and \$293.8 million, respectively, and by the Company's non-U.S. entities was \$402.2 million and \$381.4 million, respectively. If the cash and cash equivalents and short-term investments held by the Company's non-U.S. entities were to be repatriated to the United States, after taking into account the \$37.2 million Transition Tax, the Company does not expect such repatriation to generate any additional U.S. federal taxable income to the Company.

In determining the Company's benefit from or provision for income taxes, net deferred tax assets, liabilities, and valuation allowances, management is required to make judgments and estimates related to projections of domestic and foreign profitability, the timing and extent of the utilization of NOL carryforwards, applicable tax rates, transfer pricing methods, and prudent and feasible tax planning strategies. As a multinational company, the Company is required to calculate and provide for estimated income tax liabilities for each of the tax jurisdictions in which it operates. This process involves estimating current tax obligations and exposures in each jurisdiction, as well as making judgments regarding the future recoverability of deferred tax assets. Changes in the estimated level of annual pre-tax income, changes in tax laws, particularly changes related to the utilization of NOLs in various jurisdictions, and changes resulting from tax audits can all affect the overall effective income tax rate which, in turn, impacts the overall level of income tax expense or benefit and net income.

Judgments and estimates related to the Company's projections and assumptions are inherently uncertain. Therefore, actual results could differ materially from projections. Currently, the Company expects to use its deferred tax assets, subject to Internal Revenue Code limitations, within the carryforward periods. Valuation allowances have been established where the Company has concluded that it is more likely than not that such deferred tax assets are not realizable. If the Company is unable to sustain profitability in future periods, it may be required to increase the valuation allowance against the deferred tax assets, which could result in a charge that would materially adversely affect net income in the period in which the charge is incurred.

(8) Share-based Compensation

The Company's 2013 Stock Incentive Plan (as amended, the "2013 Equity Plan") authorizes the issuance of various types of share-based awards to the Company's employees, officers, directors, and other eligible participants. As of September 30, 2018, the total number of shares of the Company's class A common stock authorized for issuance under the 2013 Equity Plan was 2,300,000 shares. As of September 30, 2018, there were 556,250 shares of class A common stock reserved and available for future issuance under the 2013 Equity Plan.

Stock option awards

During the third quarter of 2018, stock options to purchase an aggregate of 75,000 shares of class A common stock were granted pursuant to the 2013 Equity Plan. As of September 30, 2018, there were options to purchase 1,489,983 shares of class A common stock outstanding under the 2013 Equity Plan.

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The following table summarizes the Company's stock option activity (in thousands, except per share data and years) for the three months ended September 30, 2018:

	Stock Options Outstanding		Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term (Years)
	Shares	Weighted Average Exercise Price Per Share		
Balance as of July 1, 2018	1,481	\$ 139.26		
Granted	75	127.93		
Exercised	0	0.00	\$ 0	
Forfeited/Expired	(66)	135.36		
Balance as of September 30, 2018	1,490	\$ 138.87		
Exercisable as of September 30, 2018	735	138.16	9,935	5.3
Expected to vest as of September 30, 2018	755	139.55	6,123	9.2
Total	1,490	\$ 138.87	16,058	7.3

Stock options outstanding as of September 30, 2018 are comprised of the following range of exercise prices per share (in thousands, except per share data and years):

	Stock Options Outstanding at September 30, 2018		
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)
Range of Exercise Prices per Share		Per Share	
\$117.85 - \$120.00	23	\$ 118.50	3.3
\$120.01 - \$150.00	1,124	\$ 126.78	7.7
\$150.01 - \$180.00	173	\$ 167.40	4.2
\$180.01 - \$201.25	170	\$ 192.44	7.6
Total	1,490	\$ 138.87	7.3

An aggregate of 15,000 stock options with an aggregate fair value of \$1.2 million vested during the three months ended September 30, 2018. The weighted average grant date fair value of stock option awards using the Black-Scholes pricing model was \$50.57 for each share subject to a stock option granted during the three months ended September 30, 2018, based on the following assumptions:

Three months ended

	September 30, 2018	
Expected term of options in years	6.3	
Expected volatility	34.5	%
Risk-free interest rate	2.9	%
Expected dividend yield	0.0	

No stock option awards were granted during the three months ended September 30, 2017.

For the three and nine months ended September 30, 2018, the Company recognized approximately \$3.0 million and \$11.1 million, respectively, in share-based compensation expense from stock options granted under the 2013 Equity Plan. For the three and nine months ended September 30, 2017, the Company recognized approximately \$3.7 million and \$10.6 million, respectively, in share-based compensation expense from stock options granted under the 2013 Equity Plan. As of September 30, 2018, there was approximately \$35.1 million of total unrecognized share-based compensation expense related to unvested stock options. The Company expects to recognize this remaining share-based compensation expense over a weighted average vesting period of approximately 3.1 years.

Other stock-based awards

During the second quarter of 2018, the Company granted certain awards characterized as “other stock-based awards” under the 2013 Equity Plan. These other stock-based awards are similar to stock options, but these awards are settled in cash only and not in shares of

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the Company's class A common stock. Upon exercise of one of these awards, the participant would be entitled to receive an amount in cash equal to the fair market value of the Company's class A common stock in excess of a stated exercise price. These awards vest in equal annual installments over a four-year period (unless accelerated upon a change in control event (as defined in the applicable award agreement) or otherwise in accordance with the provisions of the 2013 Equity Plan or applicable award agreement). During the second quarter of 2018, the Company granted such other stock-based awards with respect to an aggregate of 10,000 underlying shares of class A common stock with a weighted average exercise price per share of \$129.90 pursuant to the 2013 Equity Plan. Similar to stock option awards, the Company recognizes share-based compensation expense associated with these awards on a straight-line basis over the award's requisite service period (generally, the vesting period), with share-based compensation expense based on the fair value of the award estimated using the Black-Scholes option pricing model. However, due to the required cash settlement feature, these awards are classified as liabilities in the Company's Consolidated Balance Sheets and the fair value of the awards is remeasured each quarterly reporting period with resulting adjustments to share-based compensation expense recorded until the earlier of settlement or expiration. For each of the three and nine months ended September 30, 2018, the Company did not recognize a material amount in share-based compensation expense from these awards. As of September 30, 2018, there was approximately \$0.5 million of total unrecognized share-based compensation expense related to these awards. The Company expects to recognize this remaining share-based compensation expense over a weighted average vesting period of approximately 3.7 years, subject to additional fair value adjustments through the earlier of settlement or expiration.

(9) Common Equity and Earnings per Share

The Company has two classes of common stock: class A common stock and class B common stock. Holders of class A common stock generally have the same rights, including rights to dividends, as holders of class B common stock, except that holders of class A common stock have one vote per share while holders of class B common stock have ten votes per share. Each share of class B common stock is convertible at any time, at the option of the holder, into one share of class A common stock. As such, basic and fully diluted earnings per share for class A common stock and for class B common stock are the same. The Company has never declared or paid any cash dividends on either class A or class B common stock. As of September 30, 2018 and December 31, 2017, there were no shares of preferred stock issued or outstanding.

Potential shares of common stock are included in the diluted earnings per share calculation when dilutive. Potential shares of common stock, consisting of common stock issuable upon exercise of outstanding stock options, are calculated using the treasury stock method. For the three and nine months ended September 30, 2018, stock options issued under the 2013 Equity Plan to purchase a weighted average of approximately 979,000 and 880,000 shares of class A common stock, respectively, were excluded from the diluted earnings per share calculation because their impact would have been anti-dilutive. For the three and nine months ended September 30, 2017, stock options issued under the 2013 Equity Plan to purchase a weighted average of approximately 412,000 and 385,000 shares of class A common stock, respectively, were excluded from the diluted earnings per share calculation because their impact would have been anti-dilutive.

MICROSTRATEGY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(10) Segment Information

The Company manages its business in one reportable operating segment. The Company's one reportable operating segment is engaged in the design, development, marketing, and sales of its software platform through licensing arrangements and cloud-based subscriptions and related services. The following table presents total revenues, gross profit, and long-lived assets, excluding long-term deferred tax assets, (in thousands) according to geographic region:

Geographic regions:	Domestic	EMEA	Other Regions	Consolidated
Three months ended September 30, 2018				
Total revenues	\$ 70,611	\$ 37,628	\$ 13,913	\$ 122,152
Gross profit	\$ 56,549	\$ 30,779	\$ 11,435	\$ 98,763
Three months ended September 30, 2017 (as adjusted)				
Total revenues	\$ 73,443	\$ 40,081	\$ 12,486	\$ 126,010
Gross profit	\$ 58,720	\$ 32,779	\$ 10,122	\$ 101,621
Nine months ended September 30, 2018				
Total revenues	\$ 210,715	\$ 113,834	\$ 41,172	\$ 365,721
Gross profit	\$ 166,839	\$ 91,540	\$ 33,728	\$ 292,107
Nine months ended September 30, 2017 (as adjusted)				
Total revenues	\$ 222,245	\$ 107,833	\$ 37,384	\$ 367,462
Gross profit	\$ 177,882	\$ 87,008	\$ 30,676	\$ 295,566
As of September 30, 2018				
Long-lived assets	\$ 50,215	\$ 5,825	\$ 3,370	\$ 59,410
As of December 31, 2017 (as adjusted)				
Long-lived assets	\$ 55,355	\$ 5,626	\$ 2,288	\$ 63,269

The domestic region consists of the United States and Canada. The EMEA region includes operations in Europe, the Middle East, and Africa. The other regions include all other foreign countries, generally comprising Latin America and the Asia Pacific region. For the three and nine months ended September 30, 2018 and 2017, no individual foreign country accounted for 10% or more of total consolidated revenues.

For the three and nine months ended September 30, 2018 and 2017, no individual customer accounted for 10% or more of total consolidated revenues.

As of September 30, 2018 and December 31, 2017, no individual foreign country accounted for 10% or more of total consolidated assets.

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

FORWARD-LOOKING 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 (the "Exchange Act"). For this purpose, any statements contained herein that are not statements of historical fact, including without limitation, certain statements regarding industry prospects and our results of operations or financial position, may be deemed to be forward-looking statements. Without limiting the foregoing, the words "believes," "anticipates," "plans," "expects," and similar expressions are intended to identify forward-looking statements. The important factors discussed under "Part II. Item 1A. Risk Factors," among others, could cause actual results to differ materially from those indicated by forward-looking statements made herein and presented elsewhere by management from time to time. Such forward-looking statements represent management's current expectations and are inherently uncertain. Investors are warned that actual results may differ from management's expectations.

Overview

MicroStrategy® is a leading worldwide provider of enterprise analytics and mobility software. Our mission is to provide enterprise customers with a world-class software platform and expert services so they can deploy unique intelligence applications.

The MicroStrategy Intelligent Enterprise™ platform consolidates analytics and mobility in a single unified platform and is available on Windows, Linux, and Amazon Web Services ("AWS") and as a hosted service offering through MicroStrategy Cloud™. Our platform offers a comprehensive suite of business intelligence functionality, from data discovery to mobile analytics, data mining, Big Data analytics, enterprise reporting and powerful identity intelligence generated by digital credentials. Our platform builds on proven enterprise capabilities to make sophisticated, high-performance analytics more accessible, easier to use, and faster. The Intelligent Enterprise platform consists of MicroStrategy Analytics™, MicroStrategy Mobile™, and Usher

MicroStrategy Analytics empowers large organizations to analyze vast amounts of data and securely distribute actionable business insight throughout an enterprise, while also being able to cater to smaller workgroups and departmental use via MicroStrategy Desktop™. MicroStrategy Analytics delivers reports and dashboards, and enables users to conduct ad hoc analysis and share insights anywhere, anytime, via mobile devices (via MicroStrategy Mobile) or the web (via MicroStrategy Web™). It also combines the agility and productivity of self-service visual data discovery with the security, scalability, and governance features of enterprise-grade business intelligence. Additionally, MicroStrategy Analytics delivers powerful identity intelligence on user behavior and resource utilization (via Usher).

MicroStrategy Web is the primary interface for analysts, data scientists, consumers and developers, offering interactive reporting, dashboarding, and ad-hoc data discovery capabilities through a web browser. With MicroStrategy Web, users can design and deliver reports and dashboards across various styles of business intelligence, including scorecards, pixel-perfect documents and invoices, and interactive reports and dashboards, as well as for visual data discovery. MicroStrategy Web can also connect to a wide range of data sources, and be used to build sophisticated advanced analytical models that may be inserted within reports and dashboards. MicroStrategy reports and dashboards can be personalized and automatically delivered to thousands of users with MicroStrategy Server™'s advanced distribution capabilities. Web applications can also be extensively customized and embedded into other applications using MicroStrategy Web SDK for a branded experience.

MicroStrategy Desktop is a free, standalone, on-premise, single-user tool for fast, powerful, and easy-to-use self-service visual data discovery. It enables business users to analyze and gain valuable insight and understanding into their organizations' data by quickly creating stunning and useful visualizations, without assistance from the IT department. MicroStrategy Desktop can be readily downloaded and installed on a PC or Mac, making the power of our platform easily available. MicroStrategy Desktop can be used while offline and while not connected to MicroStrategy Server. MicroStrategy Desktop connects to MicroStrategy Server when needed, allowing for governance workflows that deliver data discovery capabilities to the enterprise at scale.

MicroStrategy Mobile is fully integrated into the MicroStrategy Analytics platform, so it is easy to leverage existing reports and dashboards to instantly deploy mobile business intelligence. In addition, MicroStrategy Mobile extends beyond analytics to enable organizations to rapidly build custom enterprise mobility applications that deliver analytics combined with transactions, multimedia, and mapping to support business workflows. The robust code-free application development platform is designed to reduce development costs and accelerate the deployment of native mobile business apps optimized for both iOS and Android. Companies can build fully native iOS and Android apps that take advantage of the unique device and operating system capabilities (e.g., GPS/location, calendar, and camera) on those devices. MicroStrategy Mobile is an easy, fast, and cost-effective vehicle for mobilizing an organization's information systems, including its data warehouses, business intelligence, ERP, CRM, and web applications that are currently accessible only on the desktop. With MicroStrategy Mobile, businesses can transform their entire

workforce into a connected and more productive mobile workforce. With mobile access to critical corporate data and systems that drive the business, employees can have a virtual office in their hands at all times. MicroStrategy Mobile also enables companies to deploy customized, white-labeled mobile apps to business partners and customers. These apps can serve as new or enhanced offerings that differentiate an organization's product or service to business partners or customers.

Usher delivers to its users unique mobile identity badges, each cryptographically linked to its owner's smartphone and dynamically linked to the enterprise's existing identity repositories, that are highly secure and convenient for organizations to deploy. Usher badges work on standard smartphones running on iOS and Android and include an Apple Watch integration. Through the use of Bluetooth, QR codes, NFC tags, biometrics, push notifications, time-limited codes, and other authentication methods, Usher badge users can log into applications, VPNs, and workstations; unlock doors and other physical gateways; and validate each other's identities. Usher badge users are also able to scan barcodes for asset tracking applications. Usher can additionally serve as a powerful enterprise productivity tool with Usher Professional™, a dynamic and searchable user directory that facilitates communication among users, and gives managers insight into the location and activity of their distributed workforce. Usher Professional users with the administrator role can view user activity on a nearly real-time map and manage or direct their workforce by engaging in two-way communication with badge users. In the enterprise Internet of Things ("EIoT") paradigm, interactions between Usher users and enterprise resources generate real-time physical and logical telemetry, which can be efficiently harnessed on our platform, creating actionable intelligence. By delivering strong yet convenient authentication that can be extended to nearly every corporate system, Usher can uncover insights, reduce infrastructure complexity, and secure assets—all to help businesses flourish in the age of connected devices and connected people. Usher addresses some of the biggest challenges facing corporations today, including multi-factor authentication, identity and access management, and resource authorization, while applying industry-leading business intelligence and analytics to an enterprise's infrastructure.

MicroStrategy on AWS allows organizations to harness the power of data through our enterprise solutions via the cloud. Compared to traditional on-premise approaches, MicroStrategy on AWS is architected to deliver best-of-breed MicroStrategy software via the cloud, with pre-configured, ready-to-go servers, coupled with the required supporting infrastructure. With MicroStrategy on AWS, customers can launch enterprise analytics environments within minutes via a web-based provisioning tool, and use the full MicroStrategy offering. MicroStrategy on AWS deploys the Intelligent Enterprise platform directly into the customer's AWS account where the customer maintains and manages the environment.

For customers looking for a Platform-as-a-Service (PaaS) experience, MicroStrategy Cloud offers managed services that deliver the full breadth of platform capabilities along with a dedicated cloud operations team to deploy the platform in the cloud. MicroStrategy Cloud is well suited for organizations without extensive IT resources to maintain and manage the cloud infrastructure on their own. MicroStrategy Cloud offers a 99.9% Service Level Agreement for availability, and is backed by a team of experts and dedicated tech support staff that provides continuous monitoring and alerting. MicroStrategy Cloud maintains and keeps up to date on compliance and security certifications to help ensure the environments adhere to the Service Organization Control 2, ISO 27001, Payment Card Industry, Health Insurance Portability and Accountability Act ("HIPAA"), and Privacy Shield standards.

Channel partners around the world rely on the capabilities of the Intelligent Enterprise platform, including its functionality, workflows, report presentation, user management, security, administration, system configuration, and monitoring, to build branded and custom applications of their own. Our platform's open architecture and APIs make it especially suitable for developing custom functionality or integrating with other applications. Organizations seeking to add analytics features to their own offerings can easily and directly embed the platform into their business applications or portals with white labeling and single sign-on options.

We adopted ASU 2014-09 and its subsequent amendments effective January 1, 2018 and adjusted our prior period consolidated financial statements to reflect full retrospective adoption. Refer to Note 2, Recent Accounting Standards, to the Consolidated Financial Statements for a summary of the significant changes in accounting principles and the impact to the Company's previously reported consolidated financial statements. Where applicable, prior period information within Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations has also been adjusted to reflect the full retrospective adoption of ASU 2014-09.

The following table sets forth certain operating highlights (in thousands) for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2017	(as adjusted)	2017	(as adjusted)
Revenues				
Product licenses	\$20,264	\$22,356	\$56,857	\$62,730
Subscription services	7,240	7,725	22,486	23,843
Total product licenses and subscription services	27,504	30,081	79,343	86,573
Product support	74,463	72,881	222,554	214,159
Other services	20,185	23,048	63,824	66,730
Total revenues	122,152	126,010	365,721	367,462
Cost of revenues				
Product licenses	377	1,763	4,255	5,182
Subscription services	3,259	3,592	9,953	10,031
Total product licenses and subscription services	3,636	5,355	14,208	15,213
Product support	5,079	4,218	14,685	13,094
Other services	14,674	14,816	44,721	43,589
Total cost of revenues	23,389	24,389	73,614	71,896
Gross profit	98,763	101,621	292,107	295,566
Operating expenses				
Sales and marketing	45,429	42,005	147,742	123,213
Research and development	25,829	19,360	74,471	57,347
General and administrative	20,285	19,082	63,756	58,921
Total operating expenses	91,543	80,447	285,969	239,481
Income from operations	\$7,220	\$21,174	\$6,138	\$56,085

The analytics market is highly competitive and our results of operations depend on our ability to market and sell offerings that provide customers with greater value than those offered by our competitors. Our success depends on the effectiveness with which we can differentiate our products from both large software vendors that provide products across multiple lines of business, including one or more products that directly compete with our products, and other analytics vendors across large, mid-sized, and small opportunities. A key differentiator that we believe distinguishes our offerings is that we offer a single platform with comprehensive analytics that supports both the needs of IT and business users, by delivering easy-to-use data discovery combined with enterprise governance.

Organizations recently have sought, and we expect may continue to seek, to standardize their various analytics applications around a single software platform. This trend presents both opportunities and challenges for our business. It offers us the opportunity to increase the size of transactions with new customers and to expand the size of our analytics installations with existing customers. On the other hand, it presents the challenge that we may not be able to penetrate accounts that a competitor has penetrated or in which a competitor is the incumbent analytics provider.

In addition, there is increased market demand for analysis of a wider variety of data sources, including sensor data, social data, web log data, and other data types. These new data sources are driving massive increases in the volume of data that can potentially be analyzed (these large-scale data sets are known as “Big Data”), which in turn is accelerating development of new storage technologies like Hadoop and NoSQL databases. The demand for analytics on Big Data represents an opportunity for us, as it opens up new potential applications and use cases for our technology. It also creates a challenge as we will need to continually enhance our technology to support emerging data sources, deliver faster performance necessary to support analysis of Big Data, and support analysis of a wider variety of data types, such as unstructured, semi-structured, and streaming data.

The market for enterprise mobility apps is rapidly changing, highly competitive, and complex with many competitors and different offerings ranging from fully custom-coded applications to plug-and-play solutions. While organizations vary greatly in their approach to, and pace of adoption of, mobile solutions, they are increasingly accelerating the transition of their businesses onto mobile devices, such as tablets and smartphones. Over the next few years, we expect that organizations will continue to construct their information and systems to take advantage of the efficiencies and cost savings of mobile computing. Ultimately, we expect that the majority of routine business tasks and workflows will become available as mobile-optimized touch-enabled apps.

We have undertaken multiple initiatives to address these opportunities and challenges, including:

- introducing Dossier™, a new way to consume analytics on our platform using an interactive book of reports and dashboards that combines relevant analytics into a single place, with a new streamlined interface that goes beyond reports and dashboards and brings key data into a format that users can understand and use to make better, actionable decisions and identify new opportunities (available on MicroStrategy Web and MicroStrategy Mobile via native apps for both iOS and Android);
- launching MicroStrategy Library™, a personalized interface for business users to access Dossier apps, which lets users quickly locate the content they need by scanning thumbnail tiles or using our advanced search functionality to locate specific dossiers, objects, or visualizations;
- releasing MicroStrategy on AWS, which allows customers to spin up their own instance of the full Intelligent Enterprise platform in the cloud, and expanding support for MicroStrategy on AWS in more locations (such as London, Sydney, Frankfurt, Tokyo, Ireland, Ohio, Oregon, and Northern Virginia) and in nine different languages (English, French, Italian, Portuguese, Spanish, Dutch, Japanese, Korean, and Chinese);
- improving access to our platform via easy-to-access trial and evaluation versions of products on our website, including a free 30-day trial to MicroStrategy on AWS that lets prospects experience our enterprise capabilities and allows existing customers to try new features;
- making our MicroStrategy Desktop product freely available to new and existing users, which helps to (i) increase public awareness, (ii) increase the adoption of the product into existing accounts by empowering MicroStrategy Web users to seamlessly connect MicroStrategy Desktop to their existing projects, upload and download reports and dashboards from the server, work offline, and try new functionality such as data blending and wrangling, and (iii) generate upsell opportunities for us by seeding the need for bigger enterprise capabilities like pixel-perfect dashboards, automated distribution, governance and security, all of which are available with our platform;
- releasing MicroStrategy Workstation, a client tool for both PC and Mac that complements the tasks performed by MicroStrategy Web and offers all the features of MicroStrategy Desktop, while also allowing administrators to manage users, user groups, reports, documents, and datasets and assign user roles;
- offering real-time telemetry capabilities and usage information via Platform Analytics, enabling administrators to get a 360-degree view of their system across different environments;
- offering new collaboration tools that allow more users to interact and collaborate on analytics content, which can ultimately drive adoption to more users across the enterprise;
- enabling analysts and business users to find insights with natural language queries by simply typing business questions or Google-like queries in plain text, which automatically generates interactive visualizations displaying the answer;
- delivering new out-of-the-box connectors that help analysts visualize log files and semi-structured data, such as Solr, Box, One Drive, Elasticsearch and others, introducing greater flexibility to visualize and interact with multi-level or ragged hierarchy reports against MDX (Multidimensional Expressions) sources such as Essbase and MSAS, and delivering enhancements such as dynamic filtering and support for derived attributes and metrics;
- offering new pre-packaged custom connectors for other data discovery tools, including Power BI, Qlik, and Tableau, that can help organizations resolve issues with fragmented analytical silos and bring governance and security to their analytics deployment with a consolidated semantic architecture; and
- introducing MicroStrategy Geospatial Services™, a new service for geospatial analytics that leverages vector-based maps through integration with Mapbox to deliver more mapping capabilities so our customers can gain additional insights from their location data.

As part of our efforts to take greater advantage of the opportunities in the market and grow our market share, we expect to continue sales and marketing expenditures at the current pace and to further increase research and development expenditures as we invest in our technology products and personnel in future periods.

As of September 30, 2018, we had a total of 2,464 employees, of whom 1,214 were based in the United States and 1,250 were based internationally. Of our 2,464 employees, 699 were engaged in sales and marketing, 688 in research and development, 751 in subscription, product support, consulting, and education services, and 326 in finance, administration, and corporate operations. The following table summarizes employee headcount, as of the dates indicated:

	September 30, 2018	December 31, 2017	September 30, 2017
Subscription services	55	53	50
Product support	194	172	163
Consulting	458	441	447
Education	44	41	41
Sales and marketing	699	652	635
Research and development	688	559	539
General and administrative	326	298	303
Total headcount	2,464	2,216	2,178

We lease approximately 214,000 square feet of office space at a location in Northern Virginia that began serving as our corporate headquarters in October 2010. In January 2018, we amended the lease on this property to extend the lease term through December 2030. We recognize lease expense on continuing operating leases ratably over the term of the applicable lease.

As discussed in Note 8, Share-based Compensation, to the Consolidated Financial Statements, we have outstanding stock options to purchase shares of our class A common stock and certain other stock-based awards under our 2013 Equity Plan. Share-based compensation expense (in thousands) from these awards was recognized in the following operating expense line items in our Consolidated Statements of Operations for the periods indicated:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2018	2017	2018	2017
Cost of product support revenues	\$83	\$0	\$211	\$0
Cost of consulting revenues	16	0	42	0
Cost of education revenues	50	0	127	0
Sales and marketing	703	635	2,425	1,553
Research and development	824	291	2,248	1,191
General and administrative	1,335	2,742	6,079	7,813
Total share-based compensation expense	\$3,011	\$3,668	\$11,132	\$10,557

As of September 30, 2018, we estimated that approximately \$35.7 million of additional share-based compensation expense for awards granted under the 2013 Equity Plan will be recognized over a remaining weighted average period of 3.2 years.

We base our internal operating expense forecasts on expected revenue trends and strategic objectives. Many of our expenses, such as office leases and certain personnel costs, are relatively fixed. Accordingly, any shortfall in revenue may cause significant variation in our operating results. We therefore believe that quarter-to-quarter comparisons of our operating results may not be a good indication of our future performance.

Non-GAAP Financial Measures

We are providing supplemental financial measures for income from operations that excludes the impact of our share-based compensation arrangements and for net income and diluted earnings per share that exclude the impact from the Tax Act. These supplemental financial measures are not measurements of financial performance under GAAP and, as a result, these supplemental financial measures may not be comparable to similarly titled measures of other companies. Management uses these non-GAAP financial measures internally to help understand, manage, and evaluate our business performance and to help make operating decisions. We believe that these non-GAAP financial measures are also useful to investors and analysts in comparing our performance across reporting periods on a consistent basis because in the case of the supplemental measure for income from operations, it excludes a significant non-cash expense that we believe is not reflective of our general business performance, and in the case of the supplemental measures for net income and diluted earnings per share, they exclude one-time tax adjustments related to the Tax Act. In addition, accounting for share-based compensation arrangements requires significant management judgment and the

resulting expense could vary significantly in comparison to other companies. Therefore, we believe the use of these non-GAAP financial measures can also facilitate comparison of our operating results to those of our competitors.

Non-GAAP financial measures are subject to material limitations as they are not in accordance with, or a substitute for, measurements prepared in accordance with GAAP. For example, we expect that share-based compensation expense, which is excluded from our non-GAAP financial measure, will continue to be a significant recurring expense over the coming years and is an important part of the compensation provided to certain employees, officers, and directors. Our non-GAAP financial measures are not meant to be considered in isolation and should be read only in conjunction with our Consolidated Financial Statements, which have been prepared in accordance with GAAP. We rely primarily on such Consolidated Financial Statements to understand, manage, and evaluate our business performance, and use the non-GAAP financial measures only supplementally.

The following is a reconciliation of our non-GAAP financial measures to their most directly comparable GAAP measures (in thousands, except per share data) for the periods indicated:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2017	(as adjusted)	2017	(as adjusted)
Reconciliation of non-GAAP income from operations:				
Income from operations	\$7,220	\$ 21,174	\$6,138	\$ 56,085
Share-based compensation expense	3,011	3,668	11,132	10,557
Non-GAAP income from operations	\$10,231	\$ 24,842	\$17,270	\$ 66,642
Reconciliation of non-GAAP net income:				
Net income	\$12,699	\$ 18,184	\$19,200	\$ 43,694
Measurement-period adjustment related to U.S. tax reform	(3,106)	0	(3,106)	0
Non-GAAP net income	\$9,593	\$ 18,184	\$16,094	\$ 43,694
Reconciliation of non-GAAP diluted earnings per share:				
Diluted earnings per share	\$1.10	\$ 1.58	\$1.67	\$ 3.78
Impact of measurement-period adjustment related to U.S. tax reform (per diluted share)	(0.27)	0.00	(0.27)	0.00
Non-GAAP diluted earnings per share	\$0.83	\$ 1.58	\$1.40	\$ 3.78

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based on our Consolidated Financial Statements, which have been prepared in accordance with GAAP.

The preparation of our Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, and equity, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates, particularly estimates relating to revenue recognition, have a material impact on our financial statements. In some

cases, changes in accounting estimates are reasonably likely to occur from period to period. Actual results and outcomes could differ from these estimates and assumptions.

The section “Critical Accounting Policies” included in Item 7 and the section “Summary of Significant Accounting Policies” (Note 2) included in Item 15 of our Annual Report on Form 10-K for the year ended December 31, 2017 provides a more detailed explanation of the judgments made and a discussion of our accounting estimates and policies related to revenue recognition prior to the adoption of ASU 2014-09. We adopted ASU 2014-09 effective January 1, 2018. Refer to Note 1, Summary of Significant Accounting Policies, to the Consolidated Financial Statements for our current accounting policies related to revenue recognition.

Impact of Foreign Currency Exchange Rate Fluctuations on Results of Operations

We conduct a significant portion of our business in currencies other than the U.S. dollar, the currency in which we report our Consolidated Financial Statements. As currency rates change from quarter over quarter and year over year, our results of operations may be impacted. The table below summarizes the impact (in thousands) of fluctuations in foreign currency exchange rates on certain

components of our Consolidated Statements of Operations by showing the increase (decrease) in international revenues or expenses, as applicable, from the same period in the prior year. The term “international” refers to operations outside of the United States and Canada.

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2017	(as adjusted)	2017	(as adjusted)
Product licenses revenues	\$(861)	\$ 280	\$(197)	\$ 73
Subscription services revenues	(11)	16	261	(215)
Product support revenues	(1,206)	836	2,902	(674)
Other services revenues	(273)	329	1,320	(233)
Cost of product support revenues	(66)	10	133	(105)
Cost of other services revenues	(277)	273	982	64
Sales and marketing expenses	(959)	319	1,002	(412)
Research and development expenses	(102)	(2)	657	(353)
General and administrative expenses	(184)	45	327	(258)

For example, if there had been no change to foreign currency exchange rates from 2017 to 2018, international product licenses revenues would have been \$10.9 million rather than \$10.1 million and \$27.7 million rather than \$27.5 million for the three and nine months ended September 30, 2018, respectively. If there had been no change to foreign currency exchange rates from 2017 to 2018, international product support revenues would have been \$31.3 million rather than \$30.1 million and \$88.4 million rather than \$91.3 million for the three and nine months ended September 30, 2018, respectively. If there had been no change to foreign currency exchange rates from 2017 to 2018, sales and marketing expenses would have been \$46.4 million rather than \$45.4 million and \$146.7 million rather than \$147.7 million for the three and nine months ended September 30, 2018, respectively.

Results of Operations

Comparison of the three and nine months ended September 30, 2018 and 2017

Revenues

Except as otherwise indicated herein, the term “domestic” refers to operations in the United States and Canada, and the term “international” refers to operations outside of the United States and Canada.

Product licenses and subscription services revenues. The following table sets forth product licenses and subscription services revenues (in thousands) and related percentage changes for the periods indicated:

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	Three Months Ended September 30, 2018			% Change		Nine Months Ended September 30, 2018			% Change
	2017	(as adjusted)				2017	(as adjusted)		
Product Licenses and Subscription Services Revenues:									
Product Licenses									
Domestic	\$10,192	\$13,412	-24.0	%		\$29,341	\$37,866	-22.5	%
International	10,072	8,944	12.6	%		27,516	24,864	10.7	%
Total product licenses revenues	20,264	22,356	-9.4	%		56,857	62,730	-9.4	%
Subscription Services									
Domestic	5,710	5,981	-4.5	%		17,676	18,926	-6.6	%
International	1,530	1,744	-12.3	%		4,810	4,917	-2.2	%
Total subscription services revenues	7,240	7,725	-6.3	%		22,486	23,843	-5.7	%
Total product licenses and subscription services revenues	\$27,504	\$30,081	-8.6	%		\$79,343	\$86,573	-8.4	%

The following table sets forth a summary, grouped by size, of the number of recognized product licenses transactions for the periods indicated:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	2017	(as adjusted)	2017	(as adjusted)
Product Licenses Transactions with Recognized Licenses Revenue in the Applicable Period:				
More than \$1.0 million in licenses revenue recognized	2	3	6	6
Between \$0.5 million and \$1.0 million in licenses revenue recognized	7	7	14	12
Total	9	10	20	18
Domestic:				
More than \$1.0 million in licenses revenue recognized	1	3	3	6
Between \$0.5 million and \$1.0 million in licenses revenue recognized	2	4	6	7
Total	3	7	9	13
International:				
More than \$1.0 million in licenses revenue recognized	1	0	3	0
Between \$0.5 million and \$1.0 million in licenses revenue recognized	5	3	8	5
Total	6	3	11	5

The following table sets forth the recognized revenue (in thousands) attributable to product licenses transactions, grouped by size, and related percentage changes for the periods indicated:

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	2017	% Change	(as adjusted)	2017	% Change	(as adjusted)
Product Licenses Revenue Recognized in the Applicable Period:						
More than \$1.0 million in licenses revenue recognized	\$2,834	\$ 3,800	-25.4 %	\$7,790	\$ 8,954	-13.0 %
Between \$0.5 million and \$1.0 million in licenses revenue recognized	4,252	4,824	-11.9 %	8,994	7,960	13.0 %
Less than \$0.5 million in licenses revenue recognized	13,178	13,732	-4.0 %	40,073	45,816	-12.5 %
Total	20,264	22,356	-9.4 %	56,857	62,730	-9.4 %
Domestic:						
More than \$1.0 million in licenses revenue recognized	1,367	3,800	-64.0 %	4,216	8,954	-52.9 %

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Between \$0.5 million and \$1.0 million in licenses revenue recognized	1,252	3,084	-59.4 %	3,872	5,045	-23.3 %
Less than \$0.5 million in licenses revenue recognized	7,573	6,528	16.0 %	21,253	23,867	-11.0 %
Total	10,192	13,412	-24.0 %	29,341	37,866	-22.5 %
International:						
More than \$1.0 million in licenses revenue recognized	1,467	0	n/a	3,574	0	n/a
Between \$0.5 million and \$1.0 million in licenses revenue recognized	3,000	1,740	72.4 %	5,122	2,915	75.7 %
Less than \$0.5 million in licenses revenue recognized	5,605	7,204	-22.2 %	18,820	21,949	-14.3 %
Total	\$10,072	\$8,944	12.6 %	\$27,516	\$24,864	10.7 %

Product licenses revenues decreased \$2.1 million and \$5.9 million for the three and nine months ended September 30, 2018, respectively, as compared to the same periods in the prior year. For the three months ended September 30, 2018 and 2017, product licenses transactions with more than \$0.5 million in recognized revenue represented 35.0% and 38.6%, respectively, of our product licenses revenues. For the nine months ended September 30, 2018, our top three product licenses transactions totaled \$4.6 million in recognized revenue, or 8.1% of total product licenses revenues, compared to \$5.5 million, or 8.7% of total product licenses revenues, for the nine months ended September 30, 2017.

Domestic product licenses revenues. Domestic product licenses revenues decreased \$3.2 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a decrease in the number of transactions with more than \$1.0 million in recognized revenue and a decrease in the number and average deal size of transactions with recognized revenue between \$0.5 million and \$1.0 million, partially offset by an increase in the average deal size of transactions with less than \$0.5 million in recognized revenue.

Domestic product licenses revenues decreased \$8.5 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a decrease in the number and average deal size of transactions.

International product licenses revenues. International product licenses revenues increased \$1.1 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to an increase in the number of transactions with more than \$0.5 million in recognized revenue, partially offset by a \$0.9 million unfavorable foreign currency exchange impact. See “Impact of Foreign Currency Exchange Rate Fluctuations on Results of Operations” for further information on the foreign currency exchange impact on our results of operations for the three and nine months ended September 30, 2018.

International product licenses revenues increased \$2.7 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to an increase in the number of transactions with more than \$0.5 million in recognized revenue, partially offset by a decrease in the number of transactions with less than \$0.5 million in recognized revenue.

Subscription services revenues. Subscription services revenues are derived primarily from our cloud services offerings that are recognized on a subscription basis over the service period of the contract. Subscription services revenues decreased \$0.5 million and \$1.4 million for the three and nine months ended September 30, 2018, respectively, as compared to the same periods in the prior year, primarily due to a decrease in the use of subscription services by existing customers.

Product support revenues. The following table sets forth product support revenues (in thousands) and related percentage changes for the periods indicated:

	Three Months Ended September 30, 2018				Nine Months Ended September 30, 2018		
	2017	% Change			2017	% Change	
	(as adjusted)				(as adjusted)		
Product Support Revenues:							
Domestic	\$44,396	\$43,077	3.1	%	\$131,221	\$130,373	0.7
International	30,067	29,804	0.9	%	91,333	83,786	9.0
Total product support revenues	\$74,463	\$72,881	2.2	%	\$222,554	\$214,159	3.9

Product support revenues are derived from providing technical software support and software updates and upgrades to customers. Product support revenues are recognized ratably over the term of the contract, which is generally one year. Product support revenues increased \$1.6 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to new product and premium support contracts, partially offset by a

\$1.2 million unfavorable foreign currency exchange impact. Product support revenues increased \$8.4 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to new product and premium support contracts and a \$2.9 million favorable foreign currency exchange impact.

Other services revenues. The following table sets forth other services revenues (in thousands) and related percentage changes in these revenues for the periods indicated:

	Three Months Ended September 30, 2018			%	Nine Months Ended September 30, 2018			%
	2017		Change		2017		Change	
Other Services Revenues:								
Consulting								
Domestic	\$8,866	\$9,550	-7.2	%	\$28,157	\$30,346	-7.2	%
International	9,135	11,095	-17.7	%	28,841	29,136	-1.0	%
Total consulting revenues	18,001	20,645	-12.8	%	56,998	59,482	-4.2	%
Education	2,184	2,403	-9.1	%	6,826	7,248	-5.8	%
Total other services revenues	\$20,185	\$23,048	-12.4	%	\$63,824	\$66,730	-4.4	%

Consulting revenues. Consulting revenues are derived from helping customers plan and execute the deployment of our software. Consulting revenues decreased \$2.6 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a decrease in billable hours worldwide and a \$0.3 million unfavorable foreign currency exchange impact. Consulting revenues decreased \$2.5 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a decrease in billable hours worldwide, partially offset by a \$1.2 million favorable foreign currency exchange impact.

Education revenues. Education revenues are derived from the education and training that we provide to our customers to enhance their ability to fully utilize the features and functionality of our software. These offerings include self-tutorials, custom course development, joint training with customers' internal staff, and standard course offerings, with pricing dependent on the specific offering delivered. Education revenues decreased \$0.2 million and \$0.4 million for the three and nine months ended September 30, 2018, respectively, as compared to the same periods in the prior year, primarily due to a decrease in overall contract values.

Costs and Expenses

Cost of revenues. The following table sets forth cost of revenues (in thousands) and related percentage changes for the periods indicated:

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018					
	2017		% Change	2017		% Change			
Cost of Revenues:									
Product licenses and subscription services:									
Product licenses	\$377	\$1,763	-78.6 %	\$4,255	\$5,182	-17.9 %			
Subscription services	3,259	3,592	-9.3 %	9,953	10,031	-0.8 %			
Total product licenses and subscription services	3,636	5,355	-32.1 %	14,208	15,213	-6.6 %			
Product support	5,079	4,218	20.4 %	14,685	13,094	12.2 %			
Other services:									
Consulting	12,996	13,295	-2.2 %	39,859	38,579	3.3 %			
Education	1,678	1,521	10.3 %	4,862	5,010	-3.0 %			
Total other services	14,674	14,816	-1.0 %	44,721	43,589	2.6 %			
Total cost of revenues	\$23,389	\$24,389	-4.1 %	\$73,614	\$71,896	2.4 %			

Cost of product licenses revenues. Cost of product licenses revenues consists of amortization of capitalized software development costs, referral fees paid to channel partners, the costs of product manuals and media, and royalties paid to third-party software vendors. Capitalized software development costs are generally amortized over a useful life of three years.

Cost of product licenses revenues decreased \$1.4 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$1.5 million decrease in amortization of capitalized software development costs related to MicroStrategy 10, which became fully amortized in May 2018, and a \$0.2 million decrease in referral fees related to channel partners, partially offset by a \$0.3 million increase in royalties paid to third-party software vendors. Cost of product licenses revenues decreased \$0.9 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$2.0 million decrease in

amortization of capitalized software development costs related to MicroStrategy 10, which became fully amortized in May 2018, partially offset by a \$0.8 million increase in royalties paid to third-party software vendors and a \$0.2 million increase in referral fees related to channel partners. As of September 30, 2018, our capitalized software development costs have been fully amortized.

Cost of subscription services revenues. Cost of subscription services revenues consists of equipment, facility and other related support costs, and personnel and related overhead costs. Cost of subscription services revenues decreased \$0.3 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$0.3 million decrease in third-party hosting service provider fees and a \$0.2 million decrease in facility and other related support costs. Subscription services headcount increased 10.0% to 55 at September 30, 2018 from 50 at September 30, 2017.

Cost of subscription services revenues did not materially change for the nine months ended September 30, 2018, as compared to the same period in the prior year.

Cost of product support revenues. Cost of product support revenues consists of product support personnel and related overhead costs. Cost of product support revenues increased \$0.9 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$0.5 million increase in compensation and related costs due to an increase in staffing levels and a \$0.2 million increase in recruiting costs. Product support headcount increased 19.0% to 194 at September 30, 2018 from 163 at September 30, 2017.

As a result of the grant of awards under the 2013 Equity Plan, we expect that share-based compensation expense, a portion of which is recognized as cost of product support revenues, will continue to be a recurring expense. As of September 30, 2018, we estimated that approximately \$1.1 million of additional share-based compensation expense will be recognized as cost of product support revenues over a remaining weighted average period of 3.4 years. See “Overview” and Note 8, Share-based Compensation, to the Consolidated Financial Statements for further information regarding the 2013 Equity Plan and related share-based compensation expense.

Cost of product support revenues increased \$1.6 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$1.0 million increase in compensation and related costs due to an increase in staffing levels, a \$0.3 million increase in recruiting costs, and a \$0.2 million net increase in share-based compensation expense. The \$0.2 million net increase in share-based compensation expense is due to the grant of additional awards under the 2013 Equity Plan.

Cost of consulting revenues. Cost of consulting revenues consists of personnel and related overhead costs. Cost of consulting revenues decreased \$0.3 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$0.3 million decrease in compensation and related costs and a \$0.2 million decrease in travel and entertainment expenditures, partially offset by a \$0.2 million increase in recruiting costs. Included in cost of consulting revenues is an aggregate \$0.3 million favorable foreign currency exchange impact. Consulting headcount increased 2.5% to 458 at September 30, 2018 from 447 at September 30, 2017.

As a result of the grant of awards under the 2013 Equity Plan, we expect that share-based compensation expense, a portion of which is recognized as cost of consulting revenues, will continue to be a recurring expense. As of September 30, 2018, we estimated that approximately \$0.2 million of additional share-based compensation expense will be recognized as cost of consulting revenues over a remaining weighted average period of 3.4 years. See “Overview” and Note 8, Share-based Compensation, to the Consolidated Financial Statements for further information regarding the 2013 Equity Plan and related share-based compensation expense.

Cost of consulting revenues increased \$1.3 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$1.1 million increase in compensation and related costs and a \$0.3 million increase in recruiting costs, partially offset by a \$0.2 million decrease in subcontractor costs. Included in cost of consulting revenues is an aggregate \$0.9 million unfavorable foreign currency exchange impact.

Cost of education revenues. Cost of education revenues consists of personnel and related overhead costs. Cost of education revenues increased \$0.2 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$0.1 million increase in subcontractor costs. Education headcount increased 7.3% to 44 at September 30, 2018 from 41 at September 30, 2017.

As a result of the grant of awards under the 2013 Equity Plan, we expect that share-based compensation expense, a portion of which is recognized as cost of education revenues, will continue to be a recurring expense. As of September 30, 2018, we estimated that approximately \$0.7 million of additional share-based compensation expense will be recognized as cost of education revenues over a remaining weighted average period of 3.4 years. See “Overview” and Note 8, Share-based Compensation, to the Consolidated Financial Statements for further information regarding the 2013 Equity Plan and related share-based compensation expense.

Cost of education revenues did not materially change for the nine months ended September 30, 2018, as compared to the same period in the prior year.

Sales and marketing expenses. Sales and marketing expenses consist of personnel costs, commissions, office facilities, travel, advertising, public relations programs, and promotional events, such as trade shows, seminars, and technical conferences. The following table sets forth sales and marketing expenses (in thousands) and related percentage changes for the periods indicated:

	Three Months Ended				Nine Months Ended		
	September 30,		%		September 30,		%
	2018	2017	Change		2018	2017	Change
		(as				(as	
		adjusted)				adjusted)	
Sales and marketing expenses	\$45,429	\$42,005	8.2	%	\$147,742	\$123,213	19.9
							%

Sales and marketing expenses increased \$3.4 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$1.3 million increase in compensation and related costs due to an increase in staffing levels, a \$0.7 million increase in subcontractor costs, a \$0.6 million increase in recruiting costs, a \$0.5 million increase in travel and entertainment expenditures, and a \$0.4 million increase in facility and other related support costs, partially offset by a \$0.2 million decrease in the amortization of capitalized variable compensation. The increase in sales and marketing expenses reflects our previously announced strategy to seek to take greater advantage of the opportunities in the market by increasing our sales and marketing expenditures. Share-based compensation expense did not materially change for the three months ended September 30, 2018, as compared to the same period in the prior year. Included in sales and marketing expenses for the three months ended September 30, 2018 is an aggregate \$1.0 million favorable foreign currency exchange impact. Sales and marketing headcount increased 10.1% to 699 at September 30, 2018 from 635 at September 30, 2017. We expect sales and marketing expenses to continue at the current pace in future periods as described in the “Overview” section above.

As a result of the grant of awards under the 2013 Equity Plan, we expect that share-based compensation expense, a significant portion of which is recognized as sales and marketing expense, will continue to be a significant recurring expense. As of September 30, 2018, we estimated that approximately \$12.9 million of additional share-based compensation expense will be recognized as sales and marketing expense over a remaining weighted average period of 3.5 years. See “Overview” and Note 8, Share-based Compensation, to the Consolidated Financial Statements for further information regarding the 2013 Equity Plan and related share-based compensation expense.

Sales and marketing expenses increased \$24.5 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$9.7 million increase in marketing and advertising costs, an \$8.3 million increase in compensation and related costs due to an increase in staffing levels, a \$3.3 million increase in travel and entertainment expenditures, a \$1.1 million increase in subcontractor costs, a \$1.1 million increase in facility and other related support costs, a \$0.9 million increase in recruiting costs, and a \$0.9 million net increase in share-based compensation expense, partially offset by a \$0.5 million decrease in the amortization of capitalized variable compensation and a \$0.2 million decrease in non-income taxes. The \$0.9 million net increase in share-based compensation expense is primarily due to the grant of additional awards under the 2013 Equity Plan, partially offset by reversals of previously recorded share-based compensation expenses due to pre-vesting forfeitures of certain stock options. Included in sales and marketing expenses for the nine months ended September 30, 2018 is an aggregate \$1.0 million unfavorable foreign currency exchange impact.

Research and development expenses. Research and development expenses consist of the personnel costs for our software engineering personnel, depreciation of equipment, and other related costs. The following table summarizes research and development expenses and amortization of capitalized software development costs (in thousands) and related percentage changes for the periods indicated:

	Three Months Ended September 30,				Nine Months Ended September 30,		
	2018	2017	% Change		2018	2017	% Change
Research and development expenses	\$25,829	\$19,360	33.4 %		\$74,471	\$57,347	29.9 %
Amortization of capitalized software development costs included in cost of product licenses revenues	\$0	\$1,499	-100.0 %		\$2,499	\$4,498	-44.4 %

Research and development expenses increased \$6.5 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$4.5 million increase in compensation and related costs due to an increase in staffing levels, a \$0.8 million increase in facility and other related support costs, a \$0.5 million net increase in share-based compensation expense, a \$0.3 million increase in consulting and advisory costs, and a \$0.2 million increase in recruiting costs. The increase in research and development expenses reflects our previously announced strategy to seek to take greater advantage of the opportunities in the market by increasing our research and development expenditures as we invest in our technology products and personnel. The \$0.5 million net increase in share-based compensation expense is primarily due to the grant of additional awards under the 2013 Equity Plan. Research and development headcount increased 27.6% to 688 at September 30, 2018 from 539 at September 30, 2017. We expect to further increase our investment in our technology products and personnel in future periods as described in the “Overview” section above. We have significantly accelerated the pace of our software development efforts and increased the frequency of our software releases subsequent to the release of MicroStrategy 10, which has resulted in our software development costs in recent periods being expensed as incurred. We do not expect to capitalize material software development costs in the near term.

As a result of the grant of awards under the 2013 Equity Plan, we expect that share-based compensation expense, a significant portion of which is recognized as research and development expense, will continue to be a significant recurring expense. As of September 30, 2018, we estimated that approximately \$7.0 million of additional share-based compensation expense will be recognized as research and development expense over a remaining weighted average period of 2.9 years. See “Overview” and Note 8, Share-based

Compensation, to the Consolidated Financial Statements for further information regarding the 2013 Equity Plan and related share-based compensation expense.

Research and development expenses increased \$17.1 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$12.0 million increase in compensation and related costs due to an increase in staffing levels, a \$2.1 million increase in facility and other related support costs, a \$1.3 million increase in recruiting costs, a \$1.1 million net increase in share-based compensation expense, a \$0.5 million increase in consulting and advisory costs, and a \$0.2 million increase in travel and entertainment expenditures. The \$1.1 million net increase in share-based compensation expense is primarily due to the grant of additional awards under the 2013 Equity Plan.

General and administrative expenses. General and administrative expenses consist of personnel and related overhead costs, and other costs of our executive, finance, human resources, information systems, and administrative departments, as well as third-party consulting, legal, and other professional fees. The following table sets forth general and administrative expenses (in thousands) and related percentage changes for the periods indicated:

	Three Months Ended				Nine Months Ended		
	September 30, 2018	2017	% Change		September 30, 2018	2017	% Change
General and administrative expenses	\$20,285	\$19,082	6.3	%	\$63,756	\$58,921	8.2

General and administrative expenses increased \$1.2 million for the three months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$1.0 million increase in subcontractor costs, a \$0.9 million increase in compensation and related costs due to an increase in staffing levels, a \$0.3 million increase in facility and other related support costs, a \$0.2 million increase in bad debt expense, and a \$0.2 million increase in recruiting costs, partially offset by a \$1.4 million net decrease in share-based compensation expense. The \$1.4 million net decrease in share-based compensation expense is primarily due to certain awards becoming fully vested in the second quarter of 2018, partially offset by the grant of additional awards under the 2013 Equity Plan. General and administrative headcount increased 7.6% to 326 at September 30, 2018 from 303 at September 30, 2017.

As a result of the grant of awards under the 2013 Equity Plan, we expect that share-based compensation expense, a significant portion of which is recognized as general and administrative expense, will continue to be a significant recurring expense. As of September 30, 2018, we estimated that approximately \$13.8 million of additional share-based compensation expense will be recognized as general and administrative expense over a remaining weighted average period of 2.9 years. See “Overview” and Note 8, Share-based Compensation, to the Consolidated Financial Statements for further information regarding the 2013 Equity Plan and related share-based compensation expense.

General and administrative expenses increased \$4.8 million for the nine months ended September 30, 2018, as compared to the same period in the prior year, primarily due to a \$2.7 million increase in subcontractor costs, a \$1.7 million increase in compensation and related costs due to an increase in staffing levels, a \$0.8 million increase in recruiting costs, a \$0.6 million increase in facility and other related support costs, a \$0.5 million increase in travel and entertainment expenditures, and a \$0.5 million increase in employee relations expenses, partially offset by a \$1.7 million net decrease in share-based compensation expense and a \$0.5 million decrease in aircraft-related operating costs. The \$1.7 million net decrease in share-based compensation expense is primarily due to certain awards becoming

fully vested in the second quarter of 2018, partially offset by the grant of additional awards under the 2013 Equity Plan.

Other Income (Expense), Net

Other income (expense), net is comprised primarily of foreign currency transaction gains and losses. For the three and nine months ended September 30, 2018, other income, net, of \$0.8 million and \$3.7 million, respectively, were comprised primarily of foreign currency transaction net gains arising mainly from the revaluation of U.S. dollar-denominated cash balances held at international locations.

For the three and nine months ended September 30, 2017, other expense, net, of \$1.9 million and \$6.4 million, respectively, were comprised primarily of foreign currency transaction net losses arising mainly from the revaluation of U.S. dollar-denominated cash balances held at international locations.

(Benefit from) provision for income taxes

We have estimated an annual effective tax rate for the full fiscal year 2018 and applied that rate to the income before income taxes in determining the benefit from income taxes for the nine months ended September 30, 2018. We also record discrete items in each respective period as appropriate. The estimated effective tax rate is subject to fluctuation based on the level and mix of earnings and

losses by tax jurisdiction, foreign tax rate differentials, and the relative impact of permanent book to tax differences (e.g., non-deductible expenses). Each quarter, a cumulative adjustment is recorded for any fluctuations in the estimated annual effective tax rate as compared to the prior quarter. As a result of these factors, and due to potential changes in our period-to-period results, fluctuations in our effective tax rate and respective tax provisions or benefits may occur.

For the nine months ended September 30, 2018, we recorded a benefit from income taxes of \$0.7 million that resulted in an effective tax rate of (3.8)%, as compared to a provision for income taxes of \$9.5 million that resulted in an effective tax rate of 17.8% for the nine months ended September 30, 2017. The change in the effective tax rate in 2018 is mainly due to discrete items, such as the adjustment to the Transition Tax recorded in the three months ended September 30, 2018.

As of September 30, 2018, we had no U.S. federal NOL carryforwards and estimated that we had \$2.5 million of foreign NOL carryforwards. As of September 30, 2018, we estimated that we had foreign NOL carryforwards, other temporary differences and carryforwards, and credits that resulted in deferred tax assets, net of valuation allowances and deferred tax liabilities, of \$15.6 million. As of September 30, 2018, we had a valuation allowance of \$1.2 million related to certain foreign tax credit carryforwards that, in our present estimation, more likely than not will not be realized.

If we are unable to sustain profitability in future periods, we may be required to increase the valuation allowance against our deferred tax assets, which could result in a charge that would materially adversely affect net income in the period in which the charge is incurred. We will continue to regularly assess the realizability of deferred tax assets.

Deferred Revenue and Advance Payments

Deferred revenue and advance payments represent subscription services, product support, and other services fees that are collected in advance and recognized over the contract service period, and product licenses revenues relating to multiple-element software arrangements that include future deliverables.

The following table summarizes deferred revenue and advance payments (in thousands), as of:

	September 30, 2018	December 31, 2017 (as adjusted)	September 30, 2017 (as adjusted)
Current:			
Deferred product licenses revenue	\$ 584	\$ 3,760	\$ 2,752
Deferred subscription services revenue	11,736	17,324	15,583
Deferred product support revenue	131,185	168,185	141,675
Deferred other services revenue	7,538	9,465	8,743
Total current deferred revenue and advance payments	\$ 151,043	\$ 198,734	\$ 168,753
Non-current:			
Deferred product licenses revenue	\$ 730	\$ 820	\$ 646
Deferred subscription services revenue	0	126	406
Deferred product support revenue	3,701	4,826	5,790
Deferred other services revenue	492	628	990
Total non-current deferred revenue and advance payments	\$ 4,923	\$ 6,400	\$ 7,832
Total current and non-current:			

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Deferred product licenses revenue	\$ 1,314	\$ 4,580	\$ 3,398
Deferred subscription services revenue	11,736	17,450	15,989
Deferred product support revenue	134,886	173,011	147,465
Deferred other services revenue	8,030	10,093	9,733
Total current and non-current deferred revenue and advance payments	\$ 155,966	\$ 205,134	\$ 176,585

Total deferred revenue and advance payments decreased \$49.2 million as of September 30, 2018, as compared to December 31, 2017, primarily due to the recognition of previously deferred product support, subscription services, product licenses and other services revenues. Total deferred revenue and advance payments decreased \$20.6 million as of September 30, 2018, as compared to September 30, 2017, primarily due to the recognition of previously deferred product support, subscription services, product licenses and other services revenues.

We expect to recognize approximately \$151.0 million of deferred revenue and advance payments over the next 12 months. However, the timing and ultimate recognition of our deferred revenue and advance payments depend on our performance of various service obligations, and the amount of deferred revenue and advance payments at any date should not be considered indicative of revenues for any succeeding period.

Liquidity and Capital Resources

Liquidity. Our principal sources of liquidity are cash and cash equivalents and on-going collection of our accounts receivable. Cash and cash equivalents include holdings in bank demand deposits, money market instruments, certificates of deposit, and U.S. Treasury securities. We also periodically invest a portion of our excess cash in short-term investments with stated maturity dates between three months and one year from the purchase date.

As of September 30, 2018 and December 31, 2017, the amount of cash and cash equivalents and short-term investments held by our U.S. entities was \$297.0 million and \$293.8 million, respectively, and by our non-U.S. entities was \$402.2 million and \$381.4 million, respectively. We earn a significant amount of our revenues outside the United States and, except for Subpart F deemed dividends, we intend to indefinitely reinvest undistributed earnings of all of our non-U.S. entities. We do not anticipate needing to repatriate the cash or cash equivalents held by non-U.S. entities to the United States to finance our U.S. operations. Under the Tax Act, our undistributed earnings (as computed for U.S. federal income tax purposes) as of December 31, 2017 are subject to the Transition Tax, which was recorded at an initial provisional amount of \$40.3 million during the year ended December 31, 2017 and subsequently reduced by \$3.1 million during the three months ended September 30, 2018. We elected to pay this tax over an eight-year period beginning in 2018. If we were to elect to repatriate these amounts, after taking into account the Transition Tax described above, we do not expect such repatriation to generate any additional U.S. federal taxable income to us.

We believe that existing cash and cash equivalents and short-term investments held by us and cash and cash equivalents anticipated to be generated by us are sufficient to meet working capital requirements, anticipated capital expenditures, and contractual obligations for at least the next 12 months.

The following table sets forth a summary of our cash flows (in thousands) and related percentage changes for the periods indicated:

	Nine Months Ended		
	September 30,		%
	2018	2017	Change
Net cash provided by operating activities	\$23,248	\$49,283	-52.8 %
Net cash used in investing activities	\$(330,005)	\$(73,028)	351.9 %
Net cash provided by financing activities	\$2,462	\$1,660	48.3 %

Net cash provided by operating activities. The primary source of our cash provided by operating activities is cash collections of our accounts receivable from customers following the sales and renewals of our software licenses, technical software support, software updates and upgrades, as well as consulting, education, and subscription services. Our primary uses of cash in operating activities are for personnel related expenditures for software development, personnel related expenditures for providing consulting, education, and subscription services, and for sales and marketing costs, general and administrative costs, and income taxes.

Net cash provided by operating activities was \$23.2 million and \$49.3 million for the nine months ended September 30, 2018 and 2017, respectively. The decrease in net cash provided by operating activities during the nine months ended September 30, 2018, as compared to the same period in the prior year, was due to a \$24.5 million decrease in net income and a \$9.8 million decrease from changes in non-cash items, offset by an \$8.2 million increase from changes in operating assets and liabilities. Non-cash items consist of depreciation and amortization, bad debt expense, deferred taxes, and share-based compensation expense.

Net cash used in investing activities. The changes in net cash used in investing activities relate to purchases and redemptions of short-term investments and expenditures on property and equipment. Net cash used in investing activities was \$330.0 million and \$73.0 million for the nine months ended September 30, 2018 and 2017, respectively. The increase in net cash used in investing activities for the nine months ended September 30, 2018, as compared to the same period in the prior year, was due to a \$262.9 million increase in purchases of short-term investments and a \$2.2 million increase in purchases of property and equipment, offset by an \$8.1 million increase in proceeds from the redemption of short-term investments.

Net cash provided by financing activities. The changes in net cash provided by financing activities primarily relate to the exercise of stock options under the 2013 Equity Plan. Net cash provided by financing activities was \$2.5 million and \$1.7 million for the nine months ended September 30, 2018 and 2017, respectively. The increase in net cash provided by financing activities for the nine

months ended September 30, 2018, as compared to the same period in the prior year, was primarily due to a \$0.8 million increase in proceeds from the exercise of stock options under the 2013 Equity Plan.

Contractual obligations. As disclosed in Note 5, Commitments and Contingencies, to the Consolidated Financial Statements, we lease office space under operating lease agreements. Under the lease agreements, in addition to base rent, we are generally responsible for certain taxes, utilities and maintenance costs, and other fees. Several of these leases include options for renewal. We do not have any material capital leases.

As of September 30, 2018, we have estimated and recorded a \$37.2 million Transition Tax resulting from the Tax Act. We elected to pay this tax over an eight-year period beginning in 2018.

The following table shows future minimum rent payments under noncancellable operating leases and agreements with initial terms of greater than one year and anticipated payments related to the Transition Tax resulting from the Tax Act, based on the expected due dates of the various installments as of September 30, 2018 (in thousands):

	Payments due by period ended September 30,				
	Total	2019	2020-2021	2022-2023	Thereafter
Contractual Obligations:					
Operating leases and other arrangements	\$ 190,399	\$ 22,846	\$ 39,199	\$ 32,043	\$ 96,311
Transition tax	28,935	0	3,848	8,485	16,602
Total	\$ 219,334	\$ 22,846	\$ 43,047	\$ 40,528	\$ 112,913

Unrecognized tax benefits. As of September 30, 2018, we had \$4.5 million of total gross unrecognized tax benefits, including penalty and interest accrued, recorded in other long-term liabilities. The timing of any payments that could result from these unrecognized tax benefits will depend on a number of factors, and accordingly the amount and period of any future payments cannot be estimated. We do not expect a significant tax payment related to these obligations during 2018.

Off-balance sheet arrangements. As of September 30, 2018, we did not have any off-balance sheet arrangements that had a material impact on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. As discussed in Note 2, Recent Accounting Standards, to the Consolidated Financial Statements, the adoption of ASU 2016-02 is effective for interim and annual periods beginning January 1, 2019 and, amongst other changes, requires the recognition of lease assets and lease liabilities. We are currently evaluating the impact of this guidance on our consolidated financial statements.

Recent Accounting Standards

Refer to Note 2, Recent Accounting Standards, to the Consolidated Financial Statements for further information.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discussion about our market risk exposures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. Where applicable, prior period information in this “Item 3. Quantitative and Qualitative Disclosures About Market Risk” has been adjusted to reflect the full retrospective adoption of ASU 2014-09.

We are exposed to the impact of both interest rate changes and foreign currency fluctuations.

Interest Rate Risk. We face exposure to changes in interest rates primarily relating to our investments. We generally invest our excess cash in short-term, highly-rated, fixed-rate financial instruments. These fixed-rate instruments are subject to interest rate risk and may fall in value if interest rates increase. We do not hold or invest in these fixed-rate instruments for trading purposes or speculation. As of September 30, 2018, we held approximately \$587.1 million of investments in U.S. Treasury securities and certificates of deposit with stated maturity dates between three months and one year from the purchase date, and we intend to hold these investments until maturity.

Foreign Currency Risk. We conduct a significant portion of our business in currencies other than the U.S. dollar, the currency in which we report our Consolidated Financial Statements. International revenues accounted for 42.2% and 41.7% of our total revenues for the three months ended September 30, 2018 and 2017, respectively, and 42.4% and 39.5% of our total revenues for the nine months ended September 30, 2018 and 2017, respectively. We anticipate that international revenues will continue to account for a significant portion of our total revenues. The functional currency of each of our foreign subsidiaries is generally the local currency.

Assets and liabilities of our foreign subsidiaries are translated into U.S. dollars at exchange rates in effect as of the applicable balance sheet date and any resulting translation adjustments are included as an adjustment to stockholders' equity. Revenues and expenses generated from these subsidiaries are translated at average monthly exchange rates during the quarter in which the transactions occur. Gains and losses from transactions in local currencies are included in net income.

As a result of transacting in multiple currencies and reporting our financial statements in U.S. dollars, our operating results may be adversely impacted by currency exchange rate fluctuations in the future. The impact of foreign currency exchange rate fluctuations on current and comparable periods is described in "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations."

We cannot predict the effect of exchange rate fluctuations upon our future results. We attempt to minimize our foreign currency risk by converting our excess foreign currency held in foreign jurisdictions to U.S. dollar-denominated cash and investment accounts.

As of September 30, 2018 and December 31, 2017, a 10% adverse change in foreign currency exchange rates versus the U.S. dollar would have decreased our aggregate reported cash and cash equivalents and short-term investments by 0.2% and 0.3%, respectively. If average exchange rates during the nine months ended September 30, 2018 had changed unfavorably by 10%, our revenues for the nine months ended September 30, 2018 would have decreased by 3.8%. During the nine months ended September 30, 2018, our revenues were higher by 1.2% as a result of a 4.1% favorable change in weighted average exchange rates, as compared to the same period in the prior year.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their control objectives. Based on the evaluation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Controls. We believe that we have maintained appropriate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2018. We implemented new internal controls during fiscal year 2017 to facilitate our adoption of ASU 2014-09 and believe our existing internal control over financial reporting has not been materially affected by the adoption of ASU 2014-09 in the first nine months of 2018. Additionally, late in the third quarter of 2018, we implemented a new system to configure, price, and quote our products and service offerings and manage revenue contract-related processes and approvals. We continue to assess the impact of this new system on our internal control over financial reporting, but do not currently expect to make significant changes to our existing internal controls. In the interim, we have performed additional procedures and manual reconciliations to validate the completeness and accuracy of data generated by the new system in the third quarter of 2018.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

We are involved in various legal proceedings arising in the normal course of business. Although the outcomes of these legal proceedings are inherently difficult to predict, we do not expect the resolution of these legal proceedings to have a material adverse effect on our financial position, results of operations, or cash flows.

Item 1A. Risk Factors

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations.

If any of the following risks occurs, our business, financial condition, or results of operations could be materially adversely affected. In such case, the market price of our class A common stock could decline and you may lose all or part of your investment.

Where applicable, prior period information in this “Item 1A. Risk Factors” has been adjusted to reflect the full retrospective adoption of ASU 2014-09.

Our quarterly operating results, revenues, and expenses may fluctuate significantly, which could have an adverse effect on the market price of our stock

For many reasons, including those described below, our operating results, revenues, and expenses have varied in the past and may vary significantly in the future from quarter to quarter. These fluctuations could have an adverse effect on the market price of our class A common stock.

Fluctuations in Quarterly Operating Results. Our quarterly operating results may fluctuate, in part, as a result of:

- the size, timing, volume, and execution of significant orders and shipments;
- the mix of products and services ordered by customers, including product licenses and subscription offerings, which can affect the extent to which revenue is recognized immediately or over future quarterly periods;
- the timing of the release or delivery of new or enhanced offerings, which may affect the period in which we can recognize revenue;
- the timing of announcements of new offerings by us or our competitors;
- changes in our pricing policies or those of our competitors;
- market acceptance of new and enhanced versions of our products and services;
- the length of our sales cycles;
- seasonal or other buying patterns of our customers;
- changes in our operating expenses;
- planned major maintenance activities related to our corporate aircraft;
- the timing of research and development projects and the capitalization of software development costs;
- personnel changes;
- our use of channel partners;
- utilization of our consulting and education services, which can be affected by delays or deferrals of customer implementation of our software products;
- changes in foreign currency exchange rates;
-

our profitability and expectations for future profitability and their effect on our deferred tax assets and net income for the period in which any adjustment to our net deferred tax asset valuation allowance may be made; increases or decreases in our liability for unrecognized tax benefits; and changes in customer decision making processes or customer budgets.

Limited Ability to Adjust Expenses. We base our operating expense budgets on expected revenue trends and strategic objectives. Many of our expenses, such as office leases and certain personnel costs, are relatively fixed. We may be unable to adjust spending quickly enough to offset any unexpected revenue shortfall. Accordingly, any shortfall in revenue may cause significant variation in operating results in any quarter. For example, if our revenues in the future are not sufficient to offset our operating expenses, or we are unable to adjust our operating expenses in a timely manner in response to any shortfall in anticipated revenue, we may incur operating losses.

Based on the above factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. It is possible that in one or more future quarters, our operating results may be below the expectations of public market analysts and investors. In that event, the market price of our class A common stock may fall.

The market price of our class A common stock has been and may continue to be volatile

The market price of our class A common stock historically has been volatile and may continue to be volatile. The market price of our class A common stock may fluctuate widely in response to various factors, some of which are beyond our control. These factors include, but are not limited to:

- quarterly variations in our results of operations or those of our competitors;
- announcements about our earnings that are not in line with analyst expectations, the likelihood of which may be enhanced because it is our policy not to give guidance relating to our anticipated financial performance in future periods;
- announcements by us or our competitors of acquisitions, dispositions, new offerings, significant contracts, commercial relationships, or capital commitments;
- the emergence of new sales channels in which we are unable to compete effectively;
- our ability to develop, market, and deliver new and enhanced offerings on a timely basis;
- commencement of, or our involvement in, litigation;
 - any major change in our Board of Directors, management, or governing documents;
- changes in government regulations or in the status of our regulatory approvals;
- recommendations by securities analysts or changes in earnings estimates and our ability to meet those estimates;
- investor perception of our Company;
- announcements by our competitors of their earnings that are not in line with analyst expectations;
- the volume of shares of our class A common stock available for public sale;
- sales or purchases of stock by us or by our stockholders, and issuances of awards under our stock incentive plan;
- short sales, hedging, and other derivative transactions involving shares of our class A common stock; and
- general economic conditions and slow or negative growth of related markets.

In addition, the stock market in general, and the market for technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of companies in those markets. These broad market and industry factors may seriously harm the market price of our class A common stock, regardless of our actual operating performance.

We may not be able to sustain or increase profitability in the future

We generated net income for the nine months ended September 30, 2018; however, we may not be able to sustain or increase profitability on a quarterly or annual basis in the future. If our revenues are not sufficient to offset our operating expenses, or we are unable to adjust our operating expenses in a timely manner in response to any shortfall in anticipated revenue, our profitability may decrease, we may cease to be profitable, or we may incur operating losses. As a result, our business, results of operations, and financial condition may be materially adversely affected.

As of September 30, 2018, we had \$15.6 million of deferred tax assets, net of a \$1.2 million valuation allowance. If we are unable to sustain profitability in the future, we may be required to increase the valuation allowance against these deferred tax assets, which could result in a charge that would materially adversely affect net income in the period in which the charge is incurred.

Economic uncertainty and increased competition for our customers, particularly in the retail industry, could materially adversely affect our business and results of operations

The U.S. and other significant markets have experienced cyclical downturns and worldwide economic conditions remain uncertain. Economic uncertainty and associated macroeconomic conditions make it extremely difficult for our customers and us to accurately forecast and plan future business activities, and could cause our customers to slow spending on our products and services, which could delay and lengthen sales cycles. Furthermore, during uncertain economic times, our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may be required to increase our allowance for doubtful accounts and our results would be negatively impacted.

Furthermore, we have a significant number of customers in the retail industry, which has recently experienced intense competition and structural changes. A significant downturn or the intensification of competition in this industry may cause organizations to reduce their capital expenditures in general or specifically reduce their spending on information technology. In addition, customers in this industry may delay or cancel information technology projects or seek to lower their costs by renegotiating vendor contracts. Customers with excess information technology resources may choose to develop in-house software solutions rather than obtain those solutions from us. In recent years, consumers have increasingly migrated toward large e-commerce platforms and other online applications. As a result, the retail industry has experienced consolidation and other ownership changes. In the future, retailers may further consolidate, undergo restructurings or reorganizations, or realign their affiliations, any of which could decrease the number of competitors within the retail industry, reducing the number of potential customers for our offerings. Moreover, our competitors may respond to challenging market conditions by lowering prices and attempting to lure away our customers.

We cannot predict the timing, strength, or duration of any economic slowdown or any subsequent recovery generally, or competitive and structural changes in the retail industry. If the conditions in the general economy and the markets in which we operate worsen from present levels, our business, financial condition, and results of operations could be materially adversely affected.

We may have exposure to greater than anticipated tax liabilities

We are subject to income taxes and non-income taxes in a variety of domestic and foreign jurisdictions. Our future income taxes could be materially adversely affected by earnings that are lower than anticipated in jurisdictions where we have lower statutory rates, earnings that are higher than anticipated in jurisdictions where we have higher statutory rates, changes in the valuation of our deferred tax assets and liabilities, changes in the amount of unrecognized tax benefits, or changes in tax laws, regulations, accounting principles, or interpretations thereof.

Further changes in the tax laws of foreign jurisdictions could arise, including as a result of the project undertaken by the Organisation for Economic Co-operation and Development ("OECD") to combat base erosion and profit shifting ("BEPS"). The OECD, which represents a coalition of member countries, has issued recommendations that, in some cases, make substantial changes to numerous long-standing tax positions and principles. These changes, many of which have been adopted or are under active consideration by OECD members and/or other countries, could increase tax uncertainty and may adversely affect our provision for income taxes.

In the United States, legislation bringing about broad changes in the existing corporate tax system was enacted in December 2017. Over time, this legislation may result in material impacts to our results of operations due to changes to the valuation of our tax assets and tax expense, and may affect customer behavior and our ability to forecast our effective tax rate. Many aspects of the legislation are unclear at this time and, as a result, we have not yet been able to determine the full impact of the legislation on our business, operating results, and financial condition.

Our determination of our tax liability is subject to review by applicable domestic and foreign tax authorities. Any adverse outcome of such reviews could have an adverse effect on our operating results and financial condition. The determination of our worldwide provision for income taxes and other tax liabilities requires significant judgment and, in the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain. Moreover, as a multinational business, we have subsidiaries that engage in many intercompany transactions in a variety of tax jurisdictions where the ultimate tax determination is uncertain.

We also have contingent tax liabilities that, in management's judgment, are not probable of assertion. If such unasserted contingent liabilities were to be asserted, or become probable of assertion, we may be required to record significant expenses and liabilities in the period in which these liabilities are asserted or become probable of assertion.

As a result of these and other factors, the ultimate amount of tax obligations owed may differ from the amounts recorded in our financial statements and any such difference may materially affect our financial results in future periods in which we change our estimates of our tax obligations or in which the ultimate tax outcome is determined.

Uncertainties in the interpretation and application of the Tax Cuts and Jobs Act could materially affect our tax obligations and effective tax rate

In December 2017, the U.S. government enacted the Tax Act, which significantly affected U.S. tax law by changing how the United States imposes income tax on multinational corporations. The U.S. Department of Treasury has broad authority to issue regulations and interpretative guidance that may significantly impact how we will apply the law and impact our results of operations in the period issued.

The Tax Act requires complex computations not previously provided in U.S. tax law. As such, the application of accounting guidance for such items is currently uncertain. Further, compliance with the Tax Act and the accounting for such provisions require accumulation of information not previously required or regularly produced. As a result, we have provided a provisional estimate on the effect of the Tax Act in our financial statements. As additional regulatory guidance is issued by the applicable taxing authorities, as accounting treatment is clarified, as we perform additional analysis on the application of the law, and as we refine estimates in calculating the effect, our final analysis, which will be recorded in the period completed, may be different from our current provisional amounts, which could materially affect our tax obligations and effective tax rate.

If the market for analytics products fails to grow as we expect or if businesses fail to adopt our offerings, our business, operating results, and financial condition could be materially adversely affected

Nearly all of our revenues to date have come from sales of analytics products and related technical support, consulting, and education services. We expect these sales to account for a large portion of our revenues for the foreseeable future. Although demand for analytics products has grown in recent years, the market for analytics offerings continues to evolve. Resistance from consumer and privacy groups to commercial collection, use, and sharing of data on spending patterns and other personal behavior (including individuals' online or offline activities, mobile data, sensor data, social data, web log data, Internet of Things data, and other personal data) has grown in recent years and our customers, potential customers or the public in general may perceive that use of our analytics products could violate individual privacy rights. In addition, increasing government restrictions on the collection, use, and transfer of personal data could impair the further growth of the market for analytics products. We cannot be sure that this market will continue to grow or, even if it does grow, that businesses will adopt our solutions.

We have spent, and intend to keep spending, considerable resources to educate potential customers about analytics offerings in general and our offerings in particular. However, we cannot be sure that these expenditures will help any of our offerings achieve any additional market acceptance. If the market fails to grow or grows more slowly than we currently expect or businesses fail to adopt our offerings, our business, operating results, and financial condition could be materially adversely affected.

Our products face intense competition, which may lead to lower prices for our products and services, reduced gross margins, loss of market share, and reduced revenue

The analytics market is highly competitive and subject to rapidly changing technology paradigms. Within the analytics space, we compete with many different types of vendors, including (i) large software vendors, such as IBM (Cognos), SAP (BO), Microsoft (Power BI), and Oracle (OBIEE), that provide one or more products that directly compete with our products, (ii) open source analytics vendors, such as OpenText Analytics and Hitachi (Pentaho), (iii) various other analytics software providers, such as Qlik, Tableau Software, TIBCO, Information Builders, and the SAS Institute, (iv) other vendors offering cloud-based offerings, such as GoodData and Birst, an Infor Company, and (v) companies with EIoT technologies or technologies categorized as user authentication products that are primarily focused on traditional forms of identity verification such as smart cards, tokens, and password managers. Our future success depends on the effectiveness with which we can differentiate and compete with these vendors and other

potential competitors across analytics implementation projects of varying sizes. Failure to maintain adequate technology differentiation from these competitors could materially adversely affect our revenue from both existing and prospective customers.

Some of our competitors have longer operating histories and significantly greater financial, technical, and marketing resources than we do. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion, sale, and marketing of their offerings than we can, such as offering certain analytics products free of charge when bundled with other software offerings. In addition, many of our competitors have strong relationships with current and potential customers, extensive industry and specialized business knowledge, as well as corresponding proprietary technologies that they can leverage, such as multidimensional databases and enterprise resource planning repositories. As a result, they may be able to prevent us from penetrating new accounts or expanding within existing accounts.

Increased competition may lead to price cuts, reduced gross margins, and loss of market share. We may not be able to compete successfully against current and future competitors, and the failure to meet the competitive pressures we face may have a material adverse effect on our business, operating results, and financial condition.

Current and future competitors may also make strategic acquisitions or establish cooperative relationships among themselves or with others. By doing so, these competitors may increase their ability to meet the needs of our potential customers by their expanded offerings. Our current or prospective channel partners may establish cooperative relationships with our current or future competitors. These relationships may limit our ability to sell our analytics offerings through specific distribution channels. Accordingly, new competitors or alliances among current and future competitors may emerge and rapidly gain significant market share. These developments could limit our ability to obtain revenues from new customers and to sustain software maintenance revenues from our installed customer base. In addition, basic office productivity software suites, such as Microsoft Office, could evolve to offer advanced analysis and reporting capabilities that may reduce the demand for our analytics offerings.

We depend on revenue from a single suite of products and related services as well as revenue from our installed customer base

Our MicroStrategy 10 platform and related services account for a substantial portion of our revenue. Because of this revenue concentration, our business could be harmed by a decline in demand for, or in the adoption or prices of, these products and related services as a result of, among other factors, any change in our pricing or packaging model, increased competition, maturation in the markets for these products, or other risks described in this Quarterly Report.

We also depend on our installed customer base for a substantial portion of our revenue. We have contracts with our license customers for ongoing support and maintenance, as well as contracts for cloud-based subscription services that provide recurring revenues to us. In addition, our installed customer base has historically generated additional new license and services revenues for us. If our existing customers cancel or fail to renew their service contracts or fail to purchase additional products or services, our revenue could decrease and our operating results could be materially adversely affected.

If we are unable to develop and release product enhancements and new offerings to respond to rapid technological change in a timely and cost-effective manner, our business, operating results, and financial condition could be materially adversely affected

The market for our offerings is characterized by rapid technological change, frequent new product introductions and enhancements, changing customer demands, and evolving industry standards. The introduction of offerings embodying new technologies can quickly make existing offerings obsolete and unmarketable. We believe that our future success depends largely on our ability to:

- continue to support a number of popular operating systems and databases;
- maintain and improve our current offerings;
- rapidly develop new offerings and product enhancements that achieve market acceptance;
- maintain technological competitiveness; and
- meet an expanding range of customer requirements.

Analytics applications are inherently complex, and it can take a long time and require significant research and development expenditures to develop and test new offerings and product enhancements. In addition, customers may delay their purchasing decisions because they anticipate that new or enhanced versions of our offerings will soon become available. We cannot be sure that we will succeed in developing, marketing, and delivering, on a timely and cost-effective basis, new or enhanced offerings that respond to technological change or new customer requirements, nor can we be sure that any new or enhanced offerings will achieve market acceptance. Moreover, even if we introduce a new offering, we may experience a decline in revenues of our existing offerings that is not fully matched by the new offering's revenue. For example, customers may delay making purchases of a new offering to permit them to make a more thorough evaluation of the offering, or until industry and marketplace reviews become widely available. Some customers may hesitate migrating to a new offering due to concerns regarding the complexity of

migration and product infancy issues on performance. In addition, we may lose existing customers who choose a competitor's offering rather than migrate to our new offering. This could result in a temporary or permanent revenue shortfall and materially adversely affect our business.

A substantial customer shift in the deployment of MicroStrategy Analytics from a perpetual software license model to our cloud services model could affect the timing of revenue recognition and materially adversely affect our operating results

We offer our analytics platform in the form of a perpetual software license and a cloud-based subscription. The payment streams and revenue recognition timing for our perpetual software licenses are different from those for our cloud-based subscriptions. For perpetual software licenses, customers typically pay us a lump sum soon after entering into a software license agreement and revenue is typically recognized upon delivery of the software to the customer. For cloud-based subscriptions, customers typically make periodic payments over the subscription period and revenue is typically recognized ratably over the subscription period. As a result, if a substantial number of current or new customers shift to subscribing to our cloud services offerings instead of purchasing perpetual software licenses for MicroStrategy Analytics, the resulting change in payment terms and revenue recognition may materially adversely affect our operating results and cash flows for the reporting periods during which such a shift occurs.

Our investment in new business strategies and initiatives could disrupt the operations of our ongoing business and present risks that we have not adequately anticipated

We have invested, and in the future may invest, in new business strategies and initiatives. For example, in recent years we have introduced a number of innovative technologies designed to enable companies to capitalize on Big Data, mobile applications, cloud-based services, security, and Internet of Things trends in the marketplace. These endeavors may involve significant risks and uncertainties, including distraction of management from other business operations, the dedication of significant research and development, sales and marketing, and other resources to these new initiatives at the expense of our other business operations, generation of insufficient revenue to offset expenses associated with new initiatives, incompatibility of our new technologies with third-party platforms, inadequate return of capital, and other risks that we may not have adequately anticipated. Because new strategies and initiatives are inherently risky, these strategies and initiatives may not be successful and could materially adversely affect our financial condition and operating results.

Business disruptions, including interruptions, delays, or failures of our systems, third-party data center hosting facilities or other third-party services, could materially adversely affect our operating results or result in a material weakness in our internal controls that could adversely affect the market price of our stock

A significant portion of our research and development activities or certain other critical business operations are concentrated in facilities in Northern Virginia, China, and Poland. In addition, we serve our customers, and manage certain critical internal processes, using third-party data center hosting facilities located in the United States and England and other third-party services, including AWS and other cloud services. We could experience a disruption or failure of our systems, or the third-party hosting facilities or other services that we use. Such disruptions or failures could include a natural disaster, fire, cyber-attack, act of terrorism, geopolitical conflict, or other catastrophic event, as well as power outages or telecommunications infrastructure outages, or a decision by one of our third-party service providers to close facilities that we use without adequate notice or to materially change the pricing or terms of their services, or other unanticipated problems with the third-party services that we use, including a failure to meet service standards.

We are a highly automated business and any such disruptions or failures could (i) result in the destruction or disruption of any of our critical business operations, controls or procedures, or information technology systems, (ii) severely affect our ability to conduct normal business operations, including delaying completion of sales and provision of services, (iii) result in a material weakness in our internal control over financial reporting, (iv) cause our customers to terminate their subscriptions, (v) result in our issuing credits to customers or paying penalties or fines, (vi) harm our reputation, (vii) adversely affect our attrition rates or our ability to attract new customers, or (viii) cause our offerings to be perceived as not being secure, any of which could materially adversely affect our future operating results.

We use channel partners and if we are unable to maintain successful relationships with them, our business, operating results, and financial condition could be materially adversely affected

In addition to our direct sales force, we use channel partners such as resellers, value-added resellers, system integrators, consulting firms, OEMs, and technology partners to license and support our products. For the nine months ended September 30, 2018, transactions by channel partners for which we recognized revenues accounted for 23.8% of our total product licenses revenues. Our channel partners may offer customers the products and services of several different companies, including offerings that compete with ours. Because our channel partners generally do not have exclusive relationships with us, we cannot be certain that they will prioritize or devote adequate resources to selling our products. Moreover, divergence in strategy or contract defaults by any of these channel partners may materially adversely affect our ability to develop, market, sell, or support our offerings.

Although we believe that direct sales will continue to account for a majority of our product licenses revenues, we seek to maintain a significant level of sales activities through our channel partners. There can be no assurance that our channel partners will continue to cooperate with us. In addition, actions taken or not taken by such parties may materially adversely affect us. Our ability to achieve revenue growth in the future will depend in part on our ability to maintain successful relationships with our channel partners. If we are unable to maintain our relationships with these channel partners, our business, operating results, and financial condition could be materially adversely affected.

In addition, we rely on our channel partners to operate in accordance with the terms of their contractual agreements with us. For example, some of our agreements with our channel partners prescribe the terms and conditions pursuant to which they are authorized to resell or distribute our software and offer technical support and related services. If our channel partners do not comply with their contractual obligations to us, our business, operating results, and financial condition may be materially adversely affected.

Our recognition of deferred revenue and advance payments is subject to future performance obligations and may not be representative of revenues for succeeding periods

Our current and non-current deferred revenue and advance payments totaled \$156.0 million as of September 30, 2018. The timing and ultimate recognition of our deferred revenue and advance payments depend on various factors, including our performance of various service obligations.

Because of the possibility of customer changes or delays in customer development or implementation schedules or budgets, and the need for us to satisfactorily perform product support and other services, deferred revenue and advance payments at any particular date may not be representative of actual revenue for any succeeding period.

Our international operations are complex and expose us to risks that could have a material adverse effect on our business, operating results, and financial condition

We receive a significant portion of our total revenues from international sales, and conduct our business activities in various foreign countries, including some emerging markets where we have limited experience, where the challenges of conducting our business can be significantly different from those we have faced in more developed markets, and where business practices may create internal control risks. International revenues accounted for 42.2% and 41.7% of our total revenues for the three months ended September 30, 2018 and 2017, respectively, and 42.4% and 39.5% of our total revenues for the nine months ended September 30, 2018 and 2017, respectively. Our international operations require significant management attention and financial resources.

There are certain risks inherent in our international business activities, including:

- fluctuations in foreign currency exchange rates;
- new, or changes in, regulatory requirements;
- tariffs, export and import restrictions, restrictions on foreign investments, sanctions, and other trade barriers or protection measures;
- costs of localizing offerings;
- lack of acceptance of localized offerings;
- difficulties in and costs of staffing, managing, and operating our international operations;
- tax issues, including restrictions on repatriating earnings;
- weaker intellectual property protection;
- economic weakness or currency related crises;
- the burden of complying with a wide variety of laws, including those relating to labor matters, government procurement and contracting requirements, consumer and data protection, privacy, data localization, network security, and encryption;
- generally longer payment cycles and greater difficulty in collecting accounts receivable;
- our ability to adapt to sales practices and customer requirements in different cultures;
- corporate espionage; and
- political instability and security risks in the countries where we are doing business.

Disruptions to trade, weakening of economic conditions, economic and legal uncertainties, or changes in currency rates may adversely affect our business, financial condition, operating results and cash flows. For example, we may face heightened risks in connection with our international operations as a result of the impending withdrawal of the United Kingdom from the European Union, commonly referred to as “Brexit.” The future effects of Brexit are uncertain and will depend on any agreements the United Kingdom makes to retain access to E.U. markets either during a transitional period or more permanently. Brexit could, among other outcomes, disrupt the free movement of goods, services and people between the United Kingdom and the European Union, and significantly disrupt trade between the United Kingdom and the European Union. Brexit could also lead to legal uncertainty and potentially divergent

national laws and regulations, including tax laws and regulations, as the United Kingdom determines which E.U. laws to replace or replicate. In addition, the Trump administration has called for substantial changes to U.S. foreign trade policy, including the imposition of greater restrictions on international trade and significant increases in tariffs on goods imported into the United States, and has recently increased tariffs on certain goods imported into the United States from a number of foreign markets, following which retaliatory tariffs have been imposed on exports of certain U.S. goods to those markets. These tariffs and any further escalation of protectionist trade measures could adversely affect the markets in which we sell our products and services, and in turn our business, financial condition, operating results and cash flows.

In addition, the Tax Act brings about, among other items, corporate income tax rate changes, the modification or elimination of certain tax incentives, changes to the existing regime for taxing overseas earnings, and measures to prevent BEPS. The changes to the U.S. taxation of our international income could have a material effect on our future operating results. From time to time, we may undertake various potential intercompany transactions and legal entity restructurings that involve our international subsidiaries. We consider various factors in evaluating these potential transactions and restructurings, including the alignment of our corporate structure with our organizational objectives, the operational and tax efficiency of our corporate structure, and the long-term cash flows and cash needs of our business. Such transactions and restructurings could negatively impact our overall tax rate and result in additional tax liabilities.

Moreover, compliance with foreign and U.S. laws and regulations that are applicable to our international operations is complex and may increase our cost of doing business in international jurisdictions, and our international operations could expose us to fines and penalties if we fail to comply with these regulations. These laws and regulations include anti-bribery laws, such as the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act, local laws prohibiting corrupt payments to government officials, and local laws relating to government procurement and contracting requirements. These laws and regulations also include import and export requirements and economic and trade sanctions administered by the Office of Foreign Assets Control and the U.S. Commerce Department based on U.S. foreign policy and national security goals against targeted foreign states, organizations, and individuals. Although we have implemented policies and procedures designed to help ensure compliance with these laws, there can be no assurance that our employees, channel partners, and other persons with whom we do business will not take actions in violation of our policies or these laws. Any violations of these laws could subject us to civil or criminal penalties, including substantial fines or prohibitions on our ability to offer our products and services to one or more countries, and could also materially damage our reputation and our brand.

These factors may have a material adverse effect on our future sales and, consequently, on our business, operating results, and financial condition.

We may lose sales, or sales may be delayed, due to the long sales and implementation cycles of certain of our products and services, which could reduce our revenues

To date, our customers have typically invested substantial time, money, and other resources, and involved many people in the decision to license our software products and purchase our related services. As a result, we may wait nine months or more after the first contact with a customer for that customer to place an order while it seeks internal approval for the purchase of our products or services. During this long sales cycle, events may occur that affect the size and/or timing of the order or even cause it to be canceled. For example, our competitors may introduce new offerings, or the customer's own budget and purchasing priorities may change.

Even after an order is placed, the time it takes to deploy our products and complete services engagements can vary widely. Implementing some of our offerings can take several months, depending on the customer's needs, and may begin only with a pilot program. It may be difficult to deploy our products if the customer has complicated deployment requirements, which typically involve integrating databases, hardware, and software from different vendors. If a customer hires a third party to deploy our products, we cannot be sure that our products will be deployed successfully.

Our results in any particular period may depend on the number and volume of large transactions in that period and these transactions may involve lengthier, more complex, and more unpredictable sales cycles than other transactions

As existing and potential customers seek to standardize on a single analytics vendor or require greater vendor capacity to meet their growing analytics needs, our business may experience larger transactions at the enterprise level and

larger transactions may account for a greater proportion of our business. The presence or absence of one or more large transactions in a particular period may have a material positive or negative effect on our revenue and operating results for that period. For the nine months ended September 30, 2018 and 2017, our top three product licenses transactions with recognized revenue totaled \$4.6 million and \$5.5 million, respectively, or 8.1% and 8.7% of total product licenses revenues, respectively. These transactions represent significant business and financial decisions for our customers, require considerable effort on the part of customers to assess alternative products, and often require additional levels of management approval. In addition, large transactions are often more complex than smaller transactions. These factors generally lengthen the typical sales cycle and increase the risk that customers may postpone or delay purchasing decisions from one period to another subsequent or later period, or that customers will alter their purchasing requirements. We may also encounter greater competition and pricing pressure in larger transactions, and the sales effort and service delivery scope for larger transactions may require us to use additional resources to execute the transaction. These factors could result in lower than anticipated revenue and earnings for a particular period or in lower estimated revenue and earnings in future periods.

We face a variety of risks in doing business with U.S., foreign, state, and local governments and government agencies, including risks related to the procurement process, budget constraints and cycles, termination of contracts, and compliance with government contracting requirements

Our customers include the U.S. government and a number of state and local governments and government agencies. There are a variety of risks in doing business with government entities, including:

Procurement. Contracting with public sector customers is highly competitive and can be time-consuming and expensive, requiring us to incur significant up-front time and expense without any assurance that we will win a contract.

Budgetary Constraints and Cycles. Demand and payment for our products and services are impacted by public sector budgetary cycles and funding availability, with funding reductions or delays adversely impacting public sector demand for our products and services.

Termination of Contracts. Public sector customers often have contractual or other legal rights to terminate current contracts for convenience or due to a default. If a contract is terminated for convenience, which can occur if the customer's needs change, we may only be able to collect fees for products or services delivered prior to termination and settlement expenses. If a contract is terminated due to a default, we may not recover even those amounts, and we may be liable for excess costs incurred by the customer for procuring alternative products or services.

Compliance with Government Contracting Requirements. Government contractors are required to comply with a variety of complex laws, regulations, and contractual provisions relating to the formation, administration, or performance of government contracts that give public sector customers substantial rights and remedies, many of which are not typically found in commercial contracts. These may include rights with respect to price protection, the accuracy of information provided to the government, contractor compliance with socio-economic policies, and other terms that are particular to government contracts. Federal, state, and local governments and government agencies routinely investigate and audit contractors for compliance with these requirements. If, as a result of an audit or review, it is determined that we have failed to comply with these requirements, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, cost associated with the triggering of price reduction clauses, fines, and suspensions or debarment from future government business, and we may suffer harm to our reputation.

Our customers also include a number of foreign governments and government agencies. Similar procurement, budgetary, contract, and audit risks also apply to our doing business with these entities. In addition, compliance with complex regulations and contracting provisions in a variety of jurisdictions can be expensive and consume significant management resources. In certain jurisdictions, our ability to win business may be constrained by political and other factors unrelated to our competitive position in the market. Each of these difficulties could materially adversely affect our business and results of operations.

We depend on technology licensed to us by third parties, and the loss of this technology could impair our software, delay implementation of our offerings, or force us to pay higher license fees

We license third-party technologies that are incorporated into or utilized by our existing offerings. There can be no assurance that the licenses for such third-party technologies will not be terminated or that we will be able to license third-party software for future offerings. In addition, we may be unable to renegotiate acceptable third-party license terms, or we may be subject to infringement liability if third-party software that we license is found to infringe intellectual property rights of others. Changes in or the loss of third-party licenses could lead to a material increase in our costs, or to our software offerings becoming inoperable or their performance being materially reduced. As a

result, we may need to incur additional development costs to help ensure continued performance of our offerings, and we may experience a decreased demand for our offerings.

If we are unable to recruit or retain skilled personnel, or if we lose the services of our Chairman of the Board of Directors, President & Chief Executive Officer, our business, operating results, and financial condition could be materially adversely affected

Our future success depends on our continuing ability to attract, train, assimilate, and retain highly skilled personnel. Competition for these employees is intense, and competition may be amplified by evolving restrictions on immigration, travel, or availability of visas for skilled technology workers. We may not be able to retain our current key employees, or attract, train, assimilate, and retain other highly skilled personnel in the future. Our future success also depends in large part on the continued service of Michael J. Saylor, our Chairman of the Board of Directors, President & Chief Executive Officer. If we lose the services of Mr. Saylor, or if we are unable to attract, train, assimilate, and retain the highly skilled personnel we need, our business, operating results, and financial condition could be materially adversely affected.

The emergence of new industry standards may materially adversely affect the demand for our existing offerings

The emergence of new industry standards in related fields may materially adversely affect the demand for our existing offerings. This could happen if new web standards and technologies or new standards in the field of operating system support emerge that are incompatible with customer deployments of our software offerings. For example, if we are unable to adapt our software offerings on a timely basis to new standards in database access technology, the ability of our software offerings to access customer databases could be impaired.

The nature of our software offerings makes them particularly susceptible to undetected errors, bugs, or security vulnerabilities, which could cause problems with how the offerings perform and which could, in turn, reduce demand for our offerings, reduce our revenue, and lead to product liability claims against us

Software as complex as ours may contain undetected errors, bugs, or security vulnerabilities. Although we test our software offerings extensively, we have in the past discovered software errors, bugs, or security vulnerabilities in our offerings after their introduction. Despite testing by us and our current and potential customers, errors, bugs, or security vulnerabilities may be found in new offerings or releases after commercial shipments begin. This could result in lost revenue, damage to our reputation, or delays in market acceptance, which could have a material adverse effect on our business, operating results, and financial condition. We may also need to expend resources and capital to correct these defects.

Our agreements with customers typically contain provisions designed to limit our exposure to product liability, warranty, and other claims. It is possible, however, that these provisions may not be effective under the laws of certain domestic or international jurisdictions and we may be exposed to product liability, warranty, and other claims. A successful product liability claim against us could have a material adverse effect on our business, operating results, and financial condition.

Changes in laws or regulations relating to privacy or the collection, processing, disclosure, storage, localization, or transmission of personal data, or any actual or perceived failure by us or our third-party service providers to comply with such laws and regulations, contractual obligations, or applicable privacy policies, could materially adversely affect our business

Aspects of our business, including our cloud services offerings and Usher, involve collecting, processing, disclosing, storing, and transmitting personal data, which are subject to certain privacy policies, contractual obligations, and certain federal, state, and foreign laws, regulations, and directives relating to privacy and data protection. The amount of customer and employee data that we store through our cloud services offerings, networks, and other systems, including personal data, is increasing. In addition, the types of data subject to protection as personal data in the European Union, the United States, and elsewhere have been expanding. In recent years, the collection and use of personal data by companies have come under increased regulatory and public scrutiny, especially in relation to the collection and processing of sensitive data, such as healthcare, biometric, genetic, financial services, and government data, children's data, precise location data, and data regarding a person's race or ethnic origins, political opinions, religious or philosophical beliefs, trade union membership, or sex life or sexual orientation. For example, in the United States, protected health information is subject to HIPAA. HIPAA has been supplemented by the Health Information Technology for Economic and Clinical Health Act with the result of increased civil and criminal penalties for noncompliance. Entities performing certain functions that engage in creating, receiving, maintaining, or transmitting protected health information provided by covered entities and other business associates are directly subject to enforcement under HIPAA. Our access to protected health information through our cloud services offerings triggers obligations to comply with certain privacy rules and data security requirements under HIPAA.

Any systems failure or security breach that results in the release of, or unauthorized access to, personal data, or any failure or perceived failure by us or our third-party service providers to comply with applicable privacy policies, contractual obligations, or any applicable laws or regulations relating to privacy or data protection, could result in proceedings against us by domestic or foreign government entities or others, including private plaintiffs in litigation. Such proceedings could result in the imposition of sanctions, fines, penalties, liabilities, and/or government orders requiring that we change our data practices, any of which could have a material adverse effect on our business, operating results, reputation, and financial condition.

Various federal, state, and foreign legislative, regulatory, or other government bodies may enact new or additional laws or regulations, or issue rulings that invalidate prior laws or regulations, concerning privacy, data storage, data protection, and cross-border transfer of data that could materially adversely impact our business. For example, in October 2015, the Court of Justice of the European Union issued a ruling that declared the U.S.-EU Safe Harbor Framework invalid. Following this ruling, U.S. and European authorities agreed to, and in July 2016 the European Commission formally adopted, a new mechanism for lawfully transferring personal data from the European Union to the United States, referred to as the “Privacy Shield.” In addition, in April 2016, the European Parliament and the Council of the European Union formally adopted a comprehensive general data protection regulation (“GDPR”), which took effect in May 2018. GDPR governs data practices and privacy, establishes new requirements regarding the handling and security of personal data, requires disclosure of data breaches to individuals, customers, and data protection authorities in certain circumstances, requires companies to honor data subjects’ requests relating to their personal data, permits regulators to impose fines of up to 4% of

global annual revenue, and establishes a private right of action. Furthermore, a new ePrivacy regulation, regulating electronic communications, was proposed in 2017 and is under negotiation in the European Union. Complying with these and other changing requirements could cause us or our customers to incur substantial costs or pay substantial fines or penalties, require us to change our business practices, require us to take on more onerous obligations in our contracts, or limit our ability to provide certain products and services in certain jurisdictions, any of which could materially adversely affect our business and operating results. In addition, the Privacy Shield, as well as other mechanisms for lawfully transferring personal data from the European Union to the United States and certain other countries, are being challenged in European courts, which could lead to uncertainty about the legality of such transfers, or burdensome or inconsistent legal requirements. The Privacy Shield is also subject to annual review by the European Commission and the U.S. Department of Commerce, which could result in modifications to the Privacy Shield or its enforcement, or even its invalidation. In addition, we may be subject to a cybersecurity law that went into effect in China in June 2017 that has uncertain but broad application and imposes a number of new privacy and data security obligations, including a data localization requirement for certain types of data. New laws or regulations restricting or limiting the collection or use of mobile data could also reduce demand for certain of our services or require changes to our business practices, which could materially adversely affect our business and operating results.

If we or our third-party service providers experience a security breach and unauthorized parties obtain access to our customers', prospects', vendors', or channel partners' data, our data, or our cloud services offerings, networks, or other systems, our offerings may be perceived as not being secure, our reputation may be harmed, demand for our offerings may be reduced, our operations may be disrupted, we may incur significant legal and financial liabilities, and our business could be materially adversely affected

As part of our business, we process, store, and transmit our customers', prospects', vendors', and channel partners' information and data as well as our own, including in our cloud services offerings, networks, and other systems. There can be no assurance that any security measures that we or our third-party service providers have implemented will be effective against all current or future security threats. For example, security measures may be breached as a result of technological error, computer viruses, or third-party action, including intentional misconduct by computer hackers, physical break-ins, the actions of state actors, industrial espionage, fraudulent inducement of employees, customers, or channel partners to disclose sensitive information such as user names or passwords, and employee, customer, or channel partner error or malfeasance. We have experienced attempts by third parties to identify and exploit product and service vulnerabilities, penetrate or bypass our security measures, and gain unauthorized access to our or our customers' or service providers' cloud offerings, networks, and other systems. A security breach could result in unauthorized access to or disclosure, modification, misuse, loss, or destruction of our customers', prospects', vendors', or channel partners' data, our data (including our proprietary information, intellectual property, or trade secrets), or our cloud services offerings, networks, or other systems. Because there are many different security breach techniques and such techniques continue to evolve, we may be unable to anticipate, detect, or mitigate attempted security breaches and implement adequate preventative measures. Third parties may also conduct attacks designed to prevent access to critical data or systems through ransomware or temporarily deny customers access to our cloud services. Any security breach or successful denial of service attack could result in a loss of customer confidence in the security of our offerings and damage to our brand, reduce the demand for our offerings, disrupt our normal business operations, require us to spend material resources to investigate or correct the breach, require us to notify affected customers or individuals and/or applicable regulators and others, and provide identity theft protection services to individuals under applicable laws, expose us to legal liabilities, including litigation, regulatory enforcement, and indemnity obligations, and materially adversely affect our revenue and operating results. These risks will increase as we continue to grow the number and scale of our cloud-based offerings, and process, store, and transmit increasingly large amounts of our customers', prospects', vendors', channel partners', and our own information and data, which may include proprietary or confidential data or personal or identifying information. Moreover, if a high-profile security breach occurs with respect to an industry peer, our customers and potential customers may lose trust in the security of business intelligence or analytics platforms generally, which

could adversely impact our ability to retain existing customers or attract new ones.

Our intellectual property is valuable, and any inability to protect it could reduce the value of our products, services, and brand

We rely on a combination of copyrights, patents, trademarks, trade secrets, confidentiality procedures, and contractual commitments to protect our intellectual property. Despite our efforts, these measures can only provide limited protection. Unauthorized third parties may try to copy or reverse engineer portions of our products or otherwise obtain and use our intellectual property. Any patents owned by us may be invalidated, circumvented, or challenged. Any of our pending or future patent applications, whether or not currently being challenged, may not be issued with the scope of the claims we seek, if at all. Moreover, amendments to and developing jurisprudence regarding U.S. patent law may affect our ability to protect our intellectual property and defend against claims of patent infringement. In addition, although we generally enter into confidentiality agreements with our employees, our former employees may seek employment with our business partners, customers, or competitors, and there can be no assurance that the confidential nature of our intellectual property will be maintained. Furthermore, the laws of some countries do not provide the same level of protection of our intellectual property as do the laws of the United States. If we cannot protect our intellectual property against unauthorized copying or use, we may not remain competitive.

Third parties may claim we infringe their intellectual property rights

We periodically receive notices from third parties claiming we are infringing their intellectual property rights, principally patent and trademark rights. We expect the number of such claims will increase as we continue to expand our offerings and branding, the number of offerings and level of competition in our industry segments grow, the functionality of offerings overlaps, and the volume of issued patents, patent applications, and trademark registrations continues to increase. Responding to any infringement claim, regardless of its validity, could:

- be time-consuming, costly, and/or result in litigation;
- divert management's time and attention from developing our business;
- require us to pay monetary damages or enter into royalty and licensing agreements that we would not normally find acceptable;
- require us to stop selling certain of our offerings;
- require us to redesign certain of our offerings using alternative non-infringing technology or practices, which could require significant effort and expense;
- require us to rename certain of our offerings or entities; or
- require us to satisfy indemnification obligations to our customers and channel partners.

Additionally, while we monitor our use of third-party software, including open source software, we cannot assure you that our processes for controlling such use in our products will be effective. If we inadvertently embed certain types of open source software into one or more of our products, or if third-party software that we license is found to infringe intellectual property rights of others, we could subject ourselves to infringement liability and be required to re-engineer our products, discontinue the sale of our products if re-engineering could not be accomplished on a timely or cost-effective basis, or make available to certain third parties or generally available, in source code form, our proprietary code, any of which could materially adversely affect our business, operating results, and financial condition.

If a successful infringement claim is made against us and we fail to develop or license a substitute technology or brand name, as applicable, our business, results of operations, financial condition, or cash flows could be materially adversely affected.

Because of the rights of our two classes of common stock and because we are controlled by Michael J. Saylor, who beneficially owns the majority of our class B common stock, Mr. Saylor could transfer control of MicroStrategy to a third party without the approval of our Board of Directors or our other stockholders, prevent a third party from acquiring us, or limit your ability to influence corporate matters

We have two classes of common stock: class A common stock and class B common stock. Holders of our class A common stock generally have the same rights as holders of our class B common stock, except that holders of class A common stock have one vote per share while holders of class B common stock have ten votes per share. As of October 15, 2018, holders of our class B common stock owned 2,035,184 shares of class B common stock, or 68.3% of the total voting power. As of October 15, 2018, Mr. Saylor, our Chairman of the Board of Directors, President & Chief Executive Officer, beneficially owned 2,011,668 shares of class B common stock, or 67.5% of the total voting power. Accordingly, Mr. Saylor can control MicroStrategy through his ability to determine the outcome of elections of our directors, amend our certificate of incorporation and by-laws, and take other actions requiring the vote or consent of stockholders, including mergers, going-private transactions, and other extraordinary transactions and their terms.

Our certificate of incorporation allows holders of class B common stock to transfer shares of class B common stock, subject to the approval of stockholders holding a majority of the outstanding class B common stock. Mr. Saylor or a group of stockholders holding a majority of the outstanding class B common stock could, without the approval of our

Board of Directors or our other stockholders, transfer voting control of MicroStrategy to a third party. Such a transfer of control could have a material adverse effect on our business, operating results, and financial condition. Mr. Saylor or a group of stockholders holding a majority of the outstanding class B common stock could also prevent a change of control of MicroStrategy, regardless of whether holders of class A common stock might otherwise receive a premium for their shares over the then current market price. In addition, this concentrated control limits stockholders' ability to influence corporate matters and, as a result, we may take actions that our non-controlling stockholders do not view as beneficial or that conflict with their interests. As a result, the market price of our class A common stock could be materially adversely affected.

Our status as a “controlled company” could make our class A common stock less attractive to some investors or otherwise materially adversely affect our stock price

Because we qualify as a “controlled company” under the corporate governance rules for Nasdaq-listed companies, we are not required to have independent directors comprise a majority of our Board of Directors. Additionally, our Board of Directors is not required to have an independent compensation or nominating committee, or to have the independent directors exercise the nominating function. We are also not required to have the compensation of our executive officers be determined by a compensation committee of independent directors. In addition, we are not required to empower our Compensation Committee with the authority to engage the services of any compensation consultants, legal counsel, or other advisors, or to have the Compensation Committee assess the independence of compensation consultants, legal counsel, and other advisors that it engages.

In light of our status as a controlled company, our Board of Directors has determined not to establish an independent nominating committee or have its independent directors exercise the nominating function, and has elected instead to have the Board of Directors be directly responsible for nominating members of the Board. A majority of our Board of Directors is currently comprised of independent directors, and our Board of Directors has established a Compensation Committee comprised entirely of independent directors. The Compensation Committee determines the compensation of our Chief Executive Officer. However, our Board of Directors has authorized our Chief Executive Officer to determine the compensation of executive officers other than himself, rather than having such compensation determined by the Compensation Committee, except that certain performance-based executive officer compensation is determined by the Compensation Committee. Awards under our 2013 Equity Plan are also approved by the Compensation Committee. Additionally, while our Compensation Committee is empowered with the authority to retain and terminate outside counsel, compensation consultants, and other experts or consultants, it is not required to assess their independence.

Although currently a majority of our Board of Directors is comprised of independent directors and the Compensation Committee is comprised entirely of independent directors, we may elect in the future not to have independent directors constitute a majority of the Board of Directors or the Compensation Committee, have our Chief Executive Officer’s compensation determined by a compensation committee of independent directors, or have a compensation committee of the Board of Directors at all.

Accordingly, should the interests of our controlling stockholder differ from those of other stockholders, the other stockholders may not have the same protections that are afforded to stockholders of companies that are required to follow all of the corporate governance rules for Nasdaq-listed companies. Our status as a controlled company could make our class A common stock less attractive to some investors or otherwise materially adversely affect our stock price.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended September 30, 2018, we did not repurchase any equity securities registered by us pursuant to Section 12 of the Exchange Act. See Note 6, Treasury Stock, to the Consolidated Financial Statements in “Part I. Item 1. Financial Statements” for further information regarding our share repurchase plan.

Item 5. Other Information

On October 25, 2018, we issued a press release announcing the Company’s financial results for the quarter ended September 30, 2018. A copy of this press release is attached as Exhibit 99.1 to this Quarterly Report on Form 10-Q. The information in this Item 5 (including Exhibit 99.1) shall not be deemed “filed” for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in

any filing under the Securities Act of 1933, as amended, or the Exchange Act, except as expressly set forth by specific reference in such a filing.

Item 6. Exhibits

We hereby file as part of this Quarterly Report on Form 10-Q the exhibits listed in the Index to Exhibits.

All other items not included in this Quarterly Report on Form 10-Q are omitted because they are not applicable or the answers thereto are “none.”

INDEX TO EXHIBITS

Exhibit

Number Description

- 3.1 Second Restated Certificate of Incorporation of the registrant (incorporated herein by reference to Exhibit 3.1 to the registrant's Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2003 (File No. 000-24435)).
- 3.2 Amended and Restated By-Laws of the registrant (incorporated herein by reference to Exhibit 3.1 to the registrant's Current Report on Form 8-K filed with the SEC on January 30, 2015 (File No. 000-24435)).
- 4.1 Form of Certificate of Class A Common Stock of the registrant (incorporated herein by reference to Exhibit 4.1 to the registrant's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2003 (File No. 000-24435)).
- 10.1† Summary of Compensation for Senior Executive Vice President & Chief Marketing Officer.
- 31.1 Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Chairman of the Board of Directors, President & Chief Executive Officer.
- 31.2 Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Senior Executive Vice President, Chief Operating Officer & Chief Financial Officer.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 Press release, dated October 25, 2018, regarding the Company's financial results for the quarter ended September 30, 2018.
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Taxonomy Extension Schema.
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase.
- 101.DEF XBRL Taxonomy Extension Definition Linkbase.
- 101.LAB XBRL Taxonomy Extension Label Linkbase.
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase.

Management contracts and compensatory plans or arrangements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MICROSTRATEGY INCORPORATED

By: /s/ Michael J. Saylor

Michael J. Saylor
Chairman of the Board of Directors,
President & Chief Executive Officer

By: /s/ Phong Le

Phong Le
Senior Executive Vice President,
Chief Operating Officer & Chief Financial Officer

Date: October 25, 2018