

HUBSPOT INC
Form 10-Q
November 07, 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 001-36680

HubSpot, Inc.

(Exact name of registrant as specified in its charter)

Delaware 20-2632791
(State or other jurisdiction of (I.R.S. Employer

incorporation or organization) Identification No.)

25 First Street, 2nd Floor

Cambridge, Massachusetts, 02141

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(Address of principal executive offices)

(888) 482-7768

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES 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, 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.

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. YES NO

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

There were 39,232,269 shares of the registrant's Common Stock issued and outstanding as of November 2, 2018.

HUBSPOT, INC.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and these statements involve substantial risks and uncertainties. All statements other than statements of historical fact contained in this Quarterly Report on Form 10-Q are forward-looking statements. Forward-looking statements generally relate to future events or our future financial or operating performance. In some cases, you can identify forward-looking statements because they contain words such as “may,” “should,” “expects,” “plans,” “anticipates,” “could,” “intends,” “target,” “contemplates,” “believes,” “estimates,” “predicts,” “potential” or “continue” or the negative of these words or other similar terms or expressions that concern our expectations, strategy, plans or intentions. Forward-looking statements contained in this Quarterly Report on Form 10-Q include, but are not limited to, statements about:

- our future financial performance, including our expectations regarding our revenue, cost of revenue, gross margin and operating expenses;
- maintaining and expanding our customer base and increasing our average subscription revenue per customer;
- the impact of competition in our industry and innovation by our competitors;
- our anticipated growth and expectations regarding our ability to manage our future growth;
- our anticipated areas of investments, including sales and marketing, research and development, customer service and support, data center infrastructure and service capabilities, and expectations relating to such investments;
- our predictions about industry and market trends;
- our ability to anticipate and address the evolution of technology and the technological needs of our customers, to roll-out upgrades to our existing software platform and to develop new and enhanced applications to meet the needs of our customers;
- our ability to maintain our brand and inbound marketing, selling and servicing thought leadership position;
- the impact of our corporate culture and our ability to attract, hire and retain necessary qualified employees to expand our operations;
- the anticipated effect on our business of litigation to which we are or may become a party;
- our ability to successfully acquire and integrate companies and assets;
- the U.S. federal tax consequences due to dividends received as part of the move to a territorial tax system for foreign subsidiary earnings;
- our plans regarding declaring or paying cash dividends in the foreseeable future; and
- our ability to stay abreast of new or modified laws and regulations that currently apply or become applicable to our business both in the United States and internationally.

We caution you that the foregoing list may not contain all of the forward-looking statements made in this Quarterly Report on Form 10-Q.

You should not rely upon forward-looking statements as predictions of future events. We have based the forward-looking statements contained in this Quarterly Report on Form 10-Q primarily on our current expectations and projections about future events and trends that we believe may affect our business, financial condition, results of operations and prospects. The outcome of the events described in these forward-looking statements is subject to risks, uncertainties and other factors described in “Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q. Moreover, we operate in a very competitive and rapidly changing environment. New risks and uncertainties emerge from time to time, and it is not possible for us to predict all risks and uncertainties that could have an impact on the forward-looking statements contained in this Quarterly Report on Form 10-Q. The results, events and circumstances reflected in the forward-looking statements may not be achieved or occur, and actual results, events or circumstances could differ materially from those described in the forward-looking statements.

The forward-looking statements made in this Quarterly Report on Form 10-Q relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statements made in this

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Quarterly Report on Form 10-Q to reflect events or circumstances after the date of this Quarterly Report on Form 10-Q or to reflect new information or the occurrence of unanticipated events, except as required by law.

We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

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In this Quarterly Report on Form 10-Q, the terms “HubSpot,” “we,” “us,” and “our” refer to HubSpot, Inc. and its subsidiaries, unless the context indicates otherwise.

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PART I — Financial Information

Item 1. Financial Statements

HubSpot, Inc.

Unaudited Consolidated Balance Sheets

(in thousands)

	September 30, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 96,122	\$ 87,680
Short-term investments	465,166	416,663
Accounts receivable — net of allowance for doubtful accounts of \$1,389 and \$638 at September 30, 2018 and December 31, 2017, respectively	63,107	60,676
Deferred commission expense	18,759	13,343
Restricted cash	5,175	4,757
Prepaid expenses and other current assets	18,132	19,382
Total current assets	666,461	602,501
Long-term investments	13,234	31,394
Property and equipment, net	51,913	43,294
Capitalized software development costs, net	12,539	8,760
Deferred commission expense, net of current portion	15,176	—
Other assets	5,656	4,964
Intangible assets, net	5,719	6,312
Goodwill	14,950	14,950
Total assets	\$ 785,648	\$ 712,175
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 8,817	\$ 4,657
Accrued compensation costs	19,182	16,329
Other accrued expenses	22,781	20,430
Deferred revenue	160,509	136,880
Total current liabilities	211,289	178,296
Deferred rent, net of current portion	24,549	18,868
Deferred revenue, net of current portion	2,132	2,277
Other long-term liabilities	4,715	3,927
Convertible senior notes	313,550	298,447
Total liabilities	556,235	501,815
Commitments and contingencies (Note 10)		

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Stockholders' equity:		
Common stock	40	38
Additional paid-in capital	563,034	496,461
Accumulated other comprehensive loss	(769)	(57)
Accumulated deficit	(332,892)	(286,082)
Total stockholders' equity	229,413	210,360
Total liabilities and stockholders' equity	\$ 785,648	\$ 712,175

The accompanying notes are an integral part of the consolidated financial statements.

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HubSpot, Inc.

Unaudited Consolidated Statements of Operations

(in thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenues:				
Subscription	\$ 125,478	\$ 93,164	\$ 350,646	\$ 255,030
Professional services and other	6,348	4,562	18,312	14,041
Total revenue	131,826	97,726	368,958	269,071
Cost of revenues:				
Subscription	17,777	12,933	49,976	36,834
Professional services and other	7,988	6,077	23,017	17,839
Total cost of revenues	25,765	19,010	72,993	54,673
Gross profit	106,061	78,716	295,965	214,398
Operating expenses:				
Research and development	30,761	18,828	85,598	48,087
Sales and marketing	71,293	57,904	196,484	155,284
General and administrative	19,057	14,110	54,309	41,730
Total operating expenses	121,111	90,842	336,391	245,101
Loss from operations	(15,050)	(12,126)	(40,426)	(30,703)
Other expense:				
Interest income	2,416	1,274	6,332	2,311
Interest expense	(5,393)	(5,063)	(15,893)	(7,947)
Other expense	(277)	(26)	(1,087)	(251)
Total other expense	(3,254)	(3,815)	(10,648)	(5,887)
Loss before income tax (expense) benefit	(18,304)	(15,941)	(51,074)	(36,590)
Income tax (expense) benefit	(359)	5,358	(1,262)	8,411
Net loss	\$(18,663)	\$(10,583)	\$(52,336)	\$(28,179)
Net loss per share, basic and diluted	\$(0.48)	\$(0.29)	\$(1.37)	\$(0.77)
Weighted average common shares used in computing basic				
and diluted net loss per share:	38,762	37,047	38,319	36,639

The accompanying notes are an integral part of the consolidated financial statements.

HubSpot, Inc.

Unaudited Consolidated Statements of Comprehensive Loss

(in thousands)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net loss	\$(18,663)	\$(10,583)	\$(52,336)	\$(28,179)
Other comprehensive loss:				
Foreign currency translation adjustment	(127)	319	(548)	883
Changes in unrealized gain (loss) on investments, net of income taxes of \$0 for the three and nine months ended September 30, 2018 and \$34 and \$56 for the three and nine months ended September 30, 2017, respectively	72	32	(164)	64
Comprehensive loss	\$(18,718)	\$(10,232)	\$(53,048)	\$(27,232)

The accompanying notes are an integral part of the consolidated financial statements.

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HubSpot, Inc.

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	For the Nine Months Ended September 30,	
	2018	2017
Operating Activities:		
Net loss	\$(52,336)	\$(28,179)
Adjustments to reconcile net loss to net cash and cash equivalents provided		
by operating activities		
Depreciation and amortization	16,539	11,123
Stock-based compensation	55,334	34,419
Provision (benefit) for deferred income taxes	43	(9,125)
Amortization of debt discount and issuance costs	15,103	7,482
Accretion of bond discount	(4,517)	(747)
Noncash rent expense	1,972	4,343
Unrealized currency translation	215	(348)
Changes in assets and liabilities, net of acquisition		
Accounts receivable	(3,266)	(8,510)
Prepaid expenses and other assets	823	(5,363)
Deferred commission expense	(15,887)	(2,011)
Accounts payable	4,262	1,556
Accrued expenses	3,755	6,838
Deferred rent	3,987	3,581
Deferred revenue	25,713	20,561
Net cash and cash equivalents provided by operating activities	51,740	35,620
Investing Activities:		
Purchases of investments	(524,838)	(572,636)
Maturities of investments	498,850	313,060
Purchases of property and equipment	(16,688)	(15,089)
Capitalization of software development costs	(8,726)	(5,306)
Acquisition of a business and purchase of technology	—	(9,415)
Purchases of strategic investments	(300)	(2,800)
Net cash and cash equivalents used in investing activities	(51,702)	(292,186)
Financing Activities:		
Employee taxes paid related to the net share settlement of stock-based awards	(5,933)	(3,154)
Proceeds related to the issuance of common stock under stock plans	16,769	10,409
Repayments of capital lease obligations	(592)	(787)
Proceeds of the issuance of convertible notes, net of issuance costs paid of \$10,767	—	389,233
Purchase of note hedge related to convertible notes	—	(78,920)
Proceeds from the issuance of warrants related to convertible notes, net of issuance costs of \$200	—	58,880
Net cash and cash equivalents provided by financing activities	10,244	375,661
Effect of exchange rate changes on cash, cash equivalents, and restricted cash	(1,319)	2,569

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Net increase in cash, cash equivalents and restricted cash	8,963	121,664
Cash, cash equivalents and restricted cash, beginning of period	92,784	60,185
Cash, cash equivalents and restricted cash, end of period	\$101,747	\$181,849
Supplemental cash flow disclosure:		
Cash paid for interest	\$527	\$201
Cash paid for income taxes	\$1,016	\$436
Non-cash investing and financing activities:		
Property and equipment acquired under capital lease	\$—	\$1,053
Capital expenditures incurred but not yet paid	\$2,018	\$836
Asset retirement obligations	\$347	\$403

The accompanying notes are an integral part of the consolidated financial statements.

HubSpot, Inc.

Notes to Unaudited Consolidated Financial Statements

1. Organization and Operations

HubSpot, Inc. (the “Company”) provides a cloud-based inbound marketing, sales and customer service platform which features integrated applications to help businesses attract visitors to their websites, convert visitors into leads, close leads into customers and delight customers so they become promoters of those businesses. These integrated applications include social media, search engine optimization, blogging, website content management, marketing automation, email, sales productivity, CRM, analytics, reporting, helpdesk, chat, and knowledge base.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) applicable to interim periods, under the rules and regulations of the United States Securities and Exchange Commission (“SEC”). In the opinion of management, the Company has prepared the accompanying unaudited consolidated financial statements on a basis substantially consistent with the audited consolidated financial statements of the Company as of and for the year ended December 31, 2017, and these consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results of the interim periods presented. All intercompany balances and transactions have been eliminated in consolidation.

The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire year ending December 31, 2018. The year-end balance sheet data was derived from audited financial statements, but this Form 10-Q does not include all disclosures required under GAAP. Certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been omitted under the rules and regulations of the SEC.

These interim financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company’s Annual Report on Form 10-K filed with the SEC on February 13, 2018. There have been no changes in the Company’s significant accounting policies from those that were disclosed in the Company’s Annual Report on Form 10-K that have had a material impact on our consolidated financial statements and related notes, except the adoption of updated guidance related to revenue recognition and costs to obtain a contract with a customer as described within Note 2 of these consolidated financial statements.

Recent Accounting Pronouncements

Recent accounting standards not included below are not expected to have a material impact on our consolidated financial position and results of operations.

In June 2018, the Financial Accounting Standards Board (“FASB”) issued guidance to expand the guidance for stock-based compensation, to include share-based payment transactions for acquiring goods and services from nonemployees. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. The Company does not believe the adoption of this guidance will have a material impact on the consolidated financial statements.

In January 2017, the FASB issued guidance simplifying the accounting for goodwill impairment by removing Step 2 of the goodwill impairment test. Under current guidance, Step 2 of the goodwill impairment test requires entities to calculate the implied fair value of goodwill in the same manner as the amount of goodwill recognized in a business combination by assigning the fair value of a reporting unit to all of the assets and liabilities of the reporting unit. The carrying value in excess of the implied fair value is recognized as goodwill impairment. Under the new standard, goodwill impairment is recognized based on Step 1 of the current guidance, which calculates the carrying value in excess of the reporting unit's fair value. The new standard is effective beginning in January 2020, with early adoption permitted. The Company does not believe the adoption of this guidance will have a material impact on the consolidated financial statements.

In November 2016, the FASB issued guidance related to the presentation of restricted cash within the statement of cash flows. The guidance requires entities to show the changes in cash, cash equivalents, and restricted cash in the statement of cash flows. Entities will no longer present transfers between cash and cash equivalents and restricted cash in the statement of cash flows. The Company adopted the updated guidance as of January 1, 2018. As a result of adopting this guidance cash and cash equivalents used in investing activities increased by \$521 thousand and net increase in cash, cash equivalents, and restricted cash also increased by \$521 thousand for the nine months ended September 30, 2018. Cash and cash equivalents used in investing activities increased by \$4.6

million and net increase in cash, cash equivalents, and restricted cash increased by \$4.6 million for the nine months ended September 30, 2017 in the consolidated statements of cash flows.

In February 2016, the FASB issued guidance that requires lessees to recognize most leases on their balance sheets but record expenses on their income statements in a manner similar to current accounting. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. The guidance is effective in 2019 with early adoption permitted. The Company will adopt the standard on January 1, 2019. The Company has established a team that is continuing to assess the potential impacts of the standard on its consolidated financial statements and footnote disclosures. The Company currently believes the most significant changes will be related to the recognition of right-of-use assets and lease liabilities on its consolidated balance sheet for operating leases, which will increase total assets and total liabilities reported relative to such amounts prior to adoption. The guidance is required to be adopted using a modified retrospective approach. Upon adoption, the Company also expects to elect the transition relief package, permitted within the new standard, in which the Company will not reassess the classification of existing leases, whether any expired or existing contracts contain a lease, and if existing leases have any initial direct costs. The Company is unable to quantify the impact at this time as the ultimate impact of adopting this new standard will depend on the total amount of lease commitments as of the adoption date.

In January 2016, the FASB issued guidance that requires entities to measure equity instruments at fair value and recognize changes in fair value within the statement of operations. The Company adopted the updated guidance as of January 1, 2018. The guidance provides for electing a measurement alternative or defaulting to the fair value option for equity investments that do not have readily determinable fair values. The Company elected the measurement alternative for its equity investments in privately held companies, which are included in other assets in the accompanying consolidated balance sheets. These investments are measured at cost, less any impairment, plus or minus adjustments resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer, which will be recorded within the statement of operations. The adoption of this guidance did not have a material impact on the consolidated financial statements.

In May 2014, the FASB issued updated guidance and disclosure requirements for recognizing revenue. The new revenue recognition standard provides a five-step analysis of transactions to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also provides guidance on the recognition of costs related to obtaining customer contracts. The Company adopted the updated guidance as of January 1, 2018 using the modified retrospective transition method. See Note 2 of these consolidated financial statements for further details.

2. Revenues

Adoption of Updated Revenue Guidance

On January 1, 2018, the Company adopted new revenue guidance using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after December 31, 2017 are presented under the new guidance, while prior period amounts are not adjusted and continue to be reported in accordance with historic revenue guidance. The Company applied the new standard using practical

expedients where:

- the measurement of the transaction price excludes all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the Company from a customer;
- the new revenue guidance has been applied to portfolios of contracts with similar characteristics;
- the modified retrospective approach has been applied only to contracts that are not completed contracts at the date of initial adoption; and
- the value of unsatisfied performance obligations for contracts with an original expected length of one year or less has not been disclosed.

The impact of applying the new guidance in 2018 versus the prior guidance resulted in a change to the period over which sales commissions are amortized to incorporate an estimated customer life and the amortization period over which internally developed new features and increased functionality for our software platform is recorded, in addition to the initial contract period. This resulted in a longer amortization period for deferred commission expense, which reduces expense compared to the application of the prior guidance. There was also a change to the scope of sales commissions that are capitalized based on the definition of incremental costs of obtaining a contract. This increased the amount of commissions cost that was capitalized compared to the application of the prior guidance. In addition, there was a change in the timing of revenue recognition for certain sales contracts where free or discounted

services are bundled with subscription services due to the removal of the limitation on recording contingent revenue that existed in the prior guidance. Removing the limitation of recording contingent revenue resulted in an acceleration of revenue recognition on these contracts compared to the application of the prior guidance.

The Company recorded a net increase to opening retained earnings of \$5.5 million as of January 1, 2018 due to the cumulative impact of adopting the new revenue guidance, with the impact primarily related to the recognition of costs associated with obtaining customer contracts. The Company had previously recorded a net increase of \$5.8 million to opening retained earnings as of January 1, 2018 to reflect the adoption of the new revenue guidance. During the three months ended June 30, 2018, the Company recorded an immaterial \$274 thousand adjustment to the initial opening retained earnings adjustment to account for the deferred tax impact of the adoption of the new revenue standard.

The resulting impact to the consolidated statements of operations and comprehensive loss of applying the new guidance in the three months ended September 30, 2018 versus the prior guidance was a decrease to subscription revenue of \$224 thousand, an increase to professional services and other revenue of \$125 thousand, a decrease to total revenues of \$99 thousand, and a decrease to selling and marketing expense and total operating expenses of \$4.1 million for the three months ended September 30, 2018. The resulting impact to loss from operations, loss before income tax (expense) benefit, net loss and comprehensive loss was \$4.0 million. The resulting impact on basic earnings per share was \$0.10.

The resulting impact to the consolidated statements of operations and comprehensive loss of applying the new guidance in the nine months ended September 30, 2018 versus the prior guidance was a decrease to subscription revenue of \$580 thousand, an increase to professional services and other revenue of \$372 thousand, a decrease to total revenues of \$208 thousand, and a decrease to selling and marketing expense and total operating expenses of \$11.5 million for the nine months ended September 30, 2018. The resulting impact to loss from operations, loss before income tax (expense) benefit, net loss and comprehensive loss was \$11.3 million. The resulting impact on basic earnings per share was \$0.30.

The resulting impact to the consolidated balance sheet of applying the new guidance in 2018 versus the prior guidance was an increase to short-term deferred commissions and total current assets of \$1.8 million, an increase to long-term deferred commissions of \$15.2 million, a decrease to other assets of \$255 thousand, an increase in total assets of \$16.7 million, a decrease to short-term deferred revenue, and total current liabilities of \$122 thousand, an increase to other liabilities of \$19 thousand, a decrease to total liabilities of \$103 thousand, a decrease to accumulated deficit and increase to total stockholders' equity of \$16.8 million, and an increase to total liabilities and stockholders' equity of \$16.7 million. There was no impact to total cash flow from operations of applying the new guidance in 2018 versus the prior guidance because the decrease in net loss of \$11.3 million, increase in the change in deferred commission expense of \$11.5 million and increase in the change in deferred revenue of \$208 thousand net to \$0 within cash flows from operations.

Revenue Recognition

The Company generates revenue from arrangements with multiple performance obligations, which typically include subscriptions to its online software products and professional services which include on-boarding and training services. The Company's customers do not have the right to take possession of the online software products. The Company recognizes revenue from contracts with customers using a five-step model, which is described below:

- 1 Identify the customer contract;
- 2 Identify performance obligations that are distinct;
- 3 Determine the transaction price;
- 4 Allocate the transaction price to the distinct performance obligations; and
- 5 Recognize revenue as the performance obligations are satisfied.

Identify the customer contract

A customer contract is generally identified when the Company and a customer have executed an arrangement that calls for the Company to grant access to its online software products and provide professional services in exchange for consideration from the customer.

Identify performance obligations that are distinct

A performance obligation is a promise to provide a distinct good or service or a series of distinct goods or services. A good or service that is promised to a customer is distinct if the customer can benefit from the good or service either on its own or together

with other resources that are readily available to the customer, and a company's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. The Company has determined that subscriptions for its online software products are distinct because, once a customer has access to the online software product that it purchased, the online software product is fully functional and does not require any additional development, modification, or customization. Professional services sold are distinct because the customer benefits from the on-boarding and training to make better use of the online software products it purchased.

Determine the transaction price

The transaction price is the amount of consideration to which the Company expects to be entitled in exchange for transferring goods or services to a customer, excluding sales taxes that are collected on behalf of government agencies. The Company estimates any variable consideration to which it will be entitled at contract inception, and reassesses at each reporting date, when determining the transaction price. The Company does not include variable consideration to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will occur when any uncertainty associated with the variable consideration is resolved.

Allocate the transaction price to the distinct performance obligations

The transaction price is allocated to each performance obligation based on the relative standalone selling prices ("SSP") of the goods or services being provided to the customer. The Company determines the SSP of its goods and services based upon the average sales prices for each type of online software product and professional services sold. In instances where there are not sufficient data points, or the selling prices for a particular online software product or professional service are disparate, the Company estimates the SSP using other observable inputs, such as similar products or services.

Recognize revenue as the performance obligations are satisfied

Revenues are recognized when or as control of the promised goods or services is transferred to customers. Revenue from online software products is recognized ratably over the subscription period beginning on the date the Company's online software products are made available to customers. Most subscription contracts are one year or less. The Company recognizes revenue from on-boarding and training services as the services are provided.

Disaggregation of Revenue

The Company provides disaggregation of revenue based on geographic region (Note 14) and based on the subscription versus professional services and other classification on the consolidated statements of operations as it believes these best depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

Deferred Revenue and Deferred Commission Expense

Amounts that have been invoiced are recorded in accounts receivable and deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. Deferred revenue represents amounts billed for which revenue has not yet been recognized. Deferred revenue that will be recognized during the succeeding 12-month period is recorded as current deferred revenue, and the remaining portion is recorded as long-term deferred revenue. Deferred revenue during the nine months ended September 30, 2018 increased by \$23.5 million resulting from \$392.5 million of additional invoicing and was offset by revenue recognized of \$369.0 million during the same period. \$83.2 million of revenue was recognized during the three month period ended September 30, 2018 that was included in deferred revenue at the beginning of the period. \$128.4 million of revenue was recognized during the nine month period ended September 30, 2018 that was included in deferred revenue at the beginning of the period. As of September 30, 2018, approximately \$89.4 million of revenue is expected to be recognized from remaining performance obligations for contracts with original performance obligations that exceed one year. The Company expects to recognize revenue on approximately 94% of these remaining performance obligations over the next 24 months, with the balance recognized thereafter.

The incremental direct costs of obtaining a contract, which primarily consist of sales commissions paid for new subscription contracts, are deferred and amortized on a straight-line basis over a period of approximately two to three years. The two to three-year period has been determined by taking into consideration the type of product sold, the commitment term of the customer contract, the nature of the Company's technology development life-cycle, and an estimated customer relationship period. Sales commissions for upgrade contracts are deferred and amortized on a straight-line basis over the remaining estimated customer relationship period of the related customer. Deferred commission expense that will be recorded as expense during the succeeding 12-month period is recorded as current deferred commission expense, and the remaining portion is recorded as long-term deferred commission expense. Deferred

commission expense during the three months ended September 30, 2018 increased by \$5.4 million as a result of deferring incremental costs of obtaining a contract of \$10.6 million and was offset by amortization of \$5.2 million during the same period. Deferred commission expense during the nine months ended September 30, 2018 increased by \$15.3 million as a result of deferring incremental costs of obtaining a contract of \$29.5 million and was offset by amortization of \$14.2 million during the same period.

Partner Commissions

The Company pays its partners a commission based on the online software product sales price for sales to end-customers. The classification of the commission paid on the Company's consolidated statements of operations depends on who purchases the online software product. In instances where the end-customer purchases the online software product from the Company, the Company is the principal and it records the commission paid to the partner as sales and marketing expense. When the partner purchases the online software product directly from the Company, the Company is the agent and it nets the consideration paid to the partner against the associated revenue it recognizes, as in these instances the Company's customer is the partner and the Company's remaining obligation is to the partner. The Company does not believe that it receives a tangible benefit from the commission payment to the partner.

3. Net Loss per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed by giving effect to all potential dilutive common stock equivalents outstanding for the period. For purposes of this calculation, options to purchase common stock, restricted stock units ("RSUs"), Employee Stock Purchase Plan ("ESPP"), common stock warrants, and the Conversion Option of the 2022 Notes are considered to be potential common stock equivalents.

A reconciliation of the denominator used in the calculation of basic and diluted net loss per share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net loss	\$(18,663)	\$(10,583)	\$(52,336)	\$(28,179)
Weighted-average common shares				
outstanding — basic	38,762	37,047	38,319	36,639
Dilutive effect of share equivalents resulting				
from stock options, RSUs, ESPP,				
common stock warrants and the Conversion				
Option of the 2022 Notes	—	—	—	—
Weighted-average common shares,				
outstanding — diluted	38,762	37,047	38,319	36,639

Net loss per share, basic and diluted	\$ (0.48)	\$ (0.29)	\$ (1.37)	\$ (0.77)
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Additionally, since the Company incurred net losses for each of the periods presented, diluted net loss per share is the same as basic net loss per share. The Company's outstanding stock options, RSUs, ESPP, common stock warrants, and Conversion Option of the 2022 Notes were not included in the calculation of diluted net loss per share as the effect would be anti-dilutive. The following table contains all potentially dilutive common stock equivalents.

	As of	
	September 30,	September 30,
	2018	2017
	(in thousands)	
Options to purchase common shares	1,905	2,398
RSUs	2,020	2,173
Conversion option of the 2022 Notes	1,311	—
Common stock warrants	664	—
ESPP	29	3

The Company expects to settle the principal amount of the 2022 Notes (Note 9) in cash, and therefore, the Company uses the treasury stock method for calculating any potential dilutive effect of the Conversion Option on diluted net income per share, if applicable. The Conversion Option will have a dilutive impact on net income per share of common stock when the average market price of the Company's common stock for a given period exceeds the conversion price of the 2022 Notes of \$94.77 per share. Because the last reported sale price of the Company's common stock for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the calendar quarter ended September 30, 2018 was equal to or greater than 130% of the

applicable conversion price on each applicable trading day, the 2022 Notes are convertible at the option of the holders thereof during the calendar quarter ending December 31, 2018. As of November 6, 2018, no holders have converted or indicated their intention to convert the 2022 Notes.

4. Fair Value of Financial Instruments

The Company measures certain financial assets at fair value. Fair value is determined based upon the exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants, as determined by either the principal market or the most advantageous market. Inputs used in the valuation techniques to derive fair values are classified based on a three-level hierarchy, as follows:

Level 1 — Quoted prices in active markets for identical assets or liabilities.

Level 2 — Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 — Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

The following table details the fair value measurements within the fair value hierarchy of the Company's financial assets and liabilities at September 30, 2018 and December 31, 2017:

	September 30, 2018			Total
	Level 1	Level 2	Level 3	
	(in thousands)			
Cash equivalents and investments:				
Money market funds	\$4,353	\$—	\$ —	\$4,353
Commercial paper	—	8,191	—	8,191
Corporate bonds	—	84,188	—	84,188
U.S. Treasury securities	—	386,021	—	386,021
Restricted cash:				
Certificates of deposit	—	5,625	—	5,625
Total	\$4,353	\$484,025	\$ —	\$488,378

	December 31, 2017			Total
	Level 1	Level 2	Level 3	
	(in thousands)			
Cash equivalents and investments:				
Money market funds	\$12,845	\$—	\$ —	\$12,845
Commercial paper	—	5,867	—	5,867
Corporate bonds	—	81,668	—	81,668
U.S. government agency obligations	—	3,987	—	3,987

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U.S. Treasury securities	—	356,535	—	356,535
Restricted cash:				
Certificates of deposit	—	5,105	—	5,105
Total	\$12,845	\$453,162	\$ —	\$466,007

The Company considers all highly liquid investments purchased with a remaining maturity of three months or less to be cash equivalents. The fair value of the Company's investments in certain money market funds is their face value and such instruments are classified as Level 1 and are included in cash and cash equivalents on the consolidated balance sheets. At September 30, 2018 and December 31, 2017, our Level 2 securities were priced by pricing vendors. These pricing vendors utilize the most recent observable market information in pricing these securities or, if specific prices are not available for these securities, use other observable inputs like market transactions involving identical or comparable securities.

As of September 30, 2018, the fair value of the 2022 Notes was \$658.0 million. The fair value was determined based on the quoted price of the 2022 Notes in an inactive market on the last trading day of the reporting period and has been classified as

Level 2 within the fair value hierarchy.

For certain other financial instruments, including accounts receivable, accounts payable, capital leases and other current liabilities, the carrying amounts approximate their fair value due to the relatively short maturity of these balances.

Strategic investments consist of non-controlling equity investments in privately held companies. The Company elected the measurement alternative for these investments without readily determinable fair values and for which the Company does not have the ability to exercise significant influence. These investments are accounted for under the cost method of accounting. Under the cost method of accounting, the non-marketable equity securities are carried at cost less any impairment, plus or minus adjustments resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer, which is recorded within the statement of operations. The Company holds \$3.8 million of strategic investments without readily determinable fair values at September 30, 2018 and \$3.5 million of strategic investments without readily determinable fair values at December 31, 2017. These investments are included in other assets on the consolidated balance sheets. There have been no adjustments to the carrying value of strategic investments resulting from impairments or observable price changes.

The following tables summarize the composition of our short- and long-term investments at September 30, 2018 and December 31, 2017.

	September 30, 2018			
	Amortized	Unrealized	Unrealized	Aggregate
	Cost	Gains	Losses	Fair Value
	(in thousands)			
Commercial paper	\$8,202	\$ —	\$ (11)	\$ 8,191
Corporate bonds	84,472	—	(284)	\$ 84,188
U.S. Treasury securities	386,325	—	(304)	386,021
Total	\$478,999	\$ —	\$ (599)	\$ 478,400