Zendesk, Inc.
Form 10-Q
November 03, 2016
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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, 2016
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: 001-36456

ZENDESK, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	26-4411091
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1019 Market Street
San Francisco, California 94103
(Address of principal executive offices)
415.418.7506
(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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No
As of October 31, 2016 there were 95,338,742 shares of the registrant's common stock outstanding.

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PART I — FINANCIAL INFORMATION

PART II — OTHER INFORMATION

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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 the federal securities laws, which statements involve substantial risks and uncertainties. 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," "will," "should," "might," "expects," "plans," "anticipates," "could," "i "target," "projects," "contemplates," "believes," "estimates," "predicts," "potential," or "continue" or the negative of these wo 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 revenue, cost of revenue, gross profit, operating expenses, ability to generate positive cash flow, and ability to achieve and maintain profitability;
- the sufficiency of our cash and cash equivalents, and marketable securities to meet our liquidity needs;
- our ability to attract and retain customers to use our customer service platform, live chat software, and analytics software, and to optimize the pricing for such software;
- the evolution of technology affecting our platform, services, and markets;
- our ability to innovate and provide a superior customer experience;
- our ability to successfully expand in our existing markets and into new markets;
- the attraction and retention of qualified employees and key personnel;
- worldwide economic conditions and their impact on information technology spending;
- our ability to effectively manage our growth and future expenses;
- our ability to successfully offer our live chat software and our analytics software as standalone services or further integrate such software with our customer service platform;
- our ability to maintain, protect, and enhance our intellectual property;
- our ability to comply with modified or new laws and regulations applying to our business, including privacy and data security regulations;
- our ability to securely maintain customer data;
- our ability to maintain and enhance our brand; and
- the increased expenses and administrative workload associated with being a public company.

We caution you that the foregoing list does 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, operating results, and prospects. The outcome of the events described in these forward-looking statements is subject to risks, uncertainties, and other factors described in the section titled "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. We cannot assure you that the results, events, and circumstances reflected in the forward-looking statements will be achieved or occur, and actual results, events, or circumstances could differ materially from those described in the forward-looking statements.

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 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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PART I — FINANCIAL INFORMATION
Item 1. Financial Statements
ZENDESK, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value and shares)

	September 30, 2016 (Unaudited)	December 31, 2015
Assets		
Current Assets:		
Cash and cash equivalents	$ 77,589	$ 216,226
Marketable securities	133,758	29,414
Accounts receivable, net of allowance for doubtful accounts of $1,213 and $763 as of September 30, 2016 and December 31, 2015, respectively	37,645	26,168
Prepaid expenses and other current assets	19,437	11,423
Total current assets	268,429	283,231
Marketable securities, noncurrent	71,139	22,336
Property and equipment, net	57,507	56,540
Goodwill and intangible assets, net	54,848	57,050
Other assets	4,504	3,529
Total assets	$ 456,427	$ 422,686
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$ 5,491	$ 9,332
Accrued liabilities	12,839	9,742
Accrued compensation and related benefits	17,929	14,115
Deferred revenue	110,174	84,210
Total current liabilities	146,433	117,399
Deferred revenue, noncurrent	1,538	1,405
Other liabilities	9,922	10,592
Total liabilities	157,893	129,396
Commitments and contingencies (Note 7)		
Stockholders’ equity:		
Preferred stock	—	—
Common stock	953	905
Additional paid-in capital	595,135	511,183
Accumulated other comprehensive loss	(1,730)	(2,225)
Accumulated deficit	(295,172)	(215,921)
Treasury stock at cost (0.5 million shares as of September 30, 2016 and December 31, 2015)	(652)	(652)
Total stockholders’ equity	298,534	293,290
Total liabilities and stockholders’ equity	$ 456,427	$ 422,686

See Notes to Condensed Consolidated Financial Statements.

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ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$80,717	$55,661	$223,376	$146,122
Cost of revenue (1)	23,866	17,039	68,318	47,491
Gross profit	56,851	38,622	155,058	98,631
Operating expenses (1)				
Research and development	22,953	16,031	66,683	43,517
Sales and marketing	43,899	29,079	119,421	79,725
General and administrative	16,212	12,319	48,149	33,982
Total operating expenses	83,064	57,429	234,253	157,224
Operating loss	(26,213)	(18,807)	(79,195)	(58,593)
Other income (expense), net	681	145	745	(428)
Loss before provision for income taxes	(25,532)	(18,662)	(78,450)	(59,021)
Provision for income taxes	294	262	800	554
Net loss	$(25,826)	$(18,924)	$(79,250)	$(59,575)
Net loss per share, basic and diluted	$(0.27)	$(0.22)	$(0.86)	$(0.71)
Weighted-average shares used to compute net loss per share, basic and diluted	94,085	87,777	92,274	83,536

(1) Includes share-based compensation expense as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Cost of revenue	$1,919	$1,131	$5,355	$3,136
Research and development	7,172	4,974	20,548	13,484
Sales and marketing	6,657	3,786	17,780	10,154
General and administrative	4,247	3,551	12,654	10,283

See Notes to Condensed Consolidated Financial Statements.

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ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss	$(25,826)	$(18,924)	$(79,250)	$(59,575)
Other comprehensive gain (loss), before tax:				
Net change in unrealized gain (loss) on available-for-sale investments	(35)	39	80	70
Foreign currency translation gain (loss)	(227)	(781)	570	(1,019)
Net change in unrealized gain (loss) on derivative instruments	416	(101)	139	(101)
Other comprehensive gain (loss), before tax	154	(843)	789	(1,050)
Tax effect	(61)	—	(295)	—
Other comprehensive gain (loss), net of tax	93	(843)	494	(1,050)
Comprehensive loss	$(25,733)	$(19,767)	$(78,756)	$(60,625)

See Notes to Condensed Consolidated Financial Statements.

ZENDESK, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2016	2015
Cash flows from operating activities		
Net loss	$(79,250)	$(59,575)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	20,000	13,672
Share-based compensation	56,337	37,057
Other	1,219	525
Excess tax benefit from share-based award activity	(133)	(124)
Changes in operating assets and liabilities:		
Accounts receivable	(11,782)	(13,082)
Prepaid expenses and other current assets	(7,401)	(4,161)
Other assets and liabilities	(1,829)	(1,622)
Accounts payable	(2,220)	(1,919)
Accrued liabilities	2,645	2,261
Accrued compensation and related benefits	812	(2,355)
Deferred revenue	25,596	24,372
Net cash provided by (used in) operating activities	3,994	(4,951)
Cash flows from investing activities		
Purchases of property and equipment	(12,494)	(14,231)
Internal-use software development costs	(4,313)	(3,548)
Purchases of marketable securities	(216,640)	(56,991)
Proceeds from maturities of marketable securities	23,971	30,425
Proceeds from sale of marketable securities	39,244	29,650
Cash paid for the acquisition of Zopim, net of cash acquired	—	(1,099)
Net cash used in investing activities	(170,232)	(15,794)
Cash flows from financing activities		
Proceeds from follow-on public offering, net of issuance costs	—	190,110
Proceeds from exercise of employee stock options	19,886	5,773
Taxes paid related to net share settlement of equity awards	(626)	(481)
Proceeds from employee stock purchase plan	8,704	7,243
Excess tax benefit from share-based award activity	133	124
Principal payments on debt	(323)	(6,952)
Principal payments on capital lease obligations	—	(10)
Net cash provided by financing activities	27,774	195,807
Effect of exchange rate changes on cash and cash equivalents	(173)	59
Net increase (decrease) in cash and cash equivalents	(138,637)	175,121
Cash and cash equivalents at beginning of period	216,226	80,265
Cash and cash equivalents at end of period	$77,589	$255,386
Supplemental cash flow data:		
Cash paid for interest and income taxes	$968	$710
Non-cash investing and financing activities:		
Balance of property and equipment in accounts payable and accrued expenses	$2,466	$4,250

Share-based compensation capitalized in internal-use software development costs	$1,761	$1,674
Vesting of early exercised stock options	$509	$815
Property and equipment acquired through tenant improvement allowances	$64	$174

See Notes to Condensed Consolidated Financial Statements.

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ZENDESK, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Overview and Basis of Presentation

Company and Background

Zendesk was founded in Denmark in 2007 and reincorporated in Delaware in April 2009.

Our mission is to help organizations and their customers build better relationships. We are a software development company that provides a SaaS customer service platform that enables our customers to provide tailored support through multiple channels, establish effective self-service support resources, proactively serve customers through customer engagement capabilities, integrate with other applications, and consolidate and analyze data from customer interactions. We also provide SaaS live chat software that can be utilized independently to facilitate proactive communications between organizations and their customers or integrated easily into our platform.

In October 2015, we completed the acquisition of We Are Cloud SAS, or WAC, the maker of BIME Analytics software. With the acquisition, we added technology that we anticipate will allow our customers to understand the ever-increasing diversity of data about their end customers. Over time, we expect this analytics software to become a core technology within our customer service platform, enabling us to further integrate data analytics capabilities across our products. We also continue to sell our analytics software on a standalone basis.

References to Zendesk, the “Company”, “our”, or “we” in these notes refer to Zendesk, Inc. and its subsidiaries on a consolidated basis.

Basis of Presentation

These unaudited condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles, or GAAP, and applicable rules and regulations of the Securities and Exchange Commission, or SEC, regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Therefore, these condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2015, filed on February 26, 2016. There have been no changes to our significant accounting policies described in the Annual Report on Form 10-K that have had a material impact on our condensed consolidated financial statements and related notes.

The consolidated balance sheet as of December 31, 2015 included herein was derived from the audited financial statements as of that date. The unaudited condensed consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial position, results of operations, our comprehensive loss and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year ending December 31, 2016.

Follow-On Public Offering

In March 2015, we completed a follow-on public offering, in which we issued 8.8 million shares of our common stock at a public offering price of $22.75 per share. We received net proceeds of $190.1 million after deducting underwriting discounts and commissions of $8.7 million and other offering expenses of $0.9 million.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reported periods.

Significant items subject to such estimates and assumptions include the fair value of share-based awards, acquired intangible assets and goodwill, unrecognized tax benefits, the useful lives of acquired intangible assets and property and

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equipment, the capitalization and estimated useful life of capitalized internal-use software, and financial forecasts used in currency hedging.

These estimates are based on information available as of the date of the financial statements; therefore, actual results could differ from those estimates.

Concentrations of Risk

As of September 30, 2016, no customers represented 10% or greater of our total accounts receivable balance. There were no customers that individually exceeded 10% of our revenue during the three and nine months ended September 30, 2016 or 2015.

Recently Issued and Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board, or the FASB, issued new revenue guidance that provides principles for recognizing revenue to which an entity expects to be entitled for the transfer of promised goods or services to customers. In August 2015, the FASB deferred the effective date of adoption by one year. As currently issued and amended, the new guidance is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, though early adoption is permitted for annual reporting periods beginning after December 15, 2016. The amendment may be applied retrospectively to each prior period presented, or with the cumulative effect recognized as of the date of initial adoption. We have not yet selected a transition method and continue to evaluate the effect of the standard on our consolidated financial statements, including revenue and commissions.

In February 2016, the FASB issued Accounting Standards Update, or ASU, 2016-2 regarding Accounting Standards Codification, or ASC, Topic 842 "Leases." This new standard requires lessees to recognize most leases on their balance sheets as lease liabilities with corresponding right-of-use assets and eliminates certain real estate-specific provisions. The new guidance is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period. Early adoption is permitted. We are currently evaluating the effect of this standard on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-9 regarding ASC Topic 718 "Compensation - Stock Compensation." This amendment changes certain aspects of accounting for share-based compensation to employees, including the recognition of income tax effects of awards when the awards vest or are settled, requirements on net share settlement to cover tax withholding, and accounting for forfeitures. The new guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is permitted. We do not expect the adoption of this standard to have a significant effect on our consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, regarding ASC Topic 230 "Statement of Cash Flows." This update addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The new guidance is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is permitted. We do not expect the adoption of this standard to have a significant effect on our consolidated financial statements.

Note 2. Business Combination

On October 13, 2015, we completed the acquisition of WAC, the maker of BIME Analytics software. We acquired 100 percent of the outstanding shares of WAC in exchange for purchase consideration of $46.4 million in cash, including working capital adjustments. As partial security for standard indemnification obligations, $7.0 million of the consideration will be held in escrow for a period of up to 18 months, with a portion released 12 months following the closing of the acquisition. We incurred transaction costs of $1.0 million in connection with the acquisition. The transaction costs were expensed as incurred and recognized within general and administrative expenses.

As of September 30, 2016, we finalized our purchase accounting for the acquisition. The total purchase price was allocated to the assets acquired and liabilities assumed as set forth below (in thousands). The excess of the purchase price over the net assets acquired was recorded as goodwill. Goodwill generated from the acquisition is primarily attributable to expected synergies, including cost savings from integrating the analytics technology with our customer service platform and the opportunity to sell the analytics software alongside our existing products. Goodwill is not expected to be deductible for income tax purposes. Goodwill will not be amortized but instead will be tested for impairment at least annually and more frequently if certain indicators of impairment are present.

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Net tangible assets acquired	$2,140
Net deferred tax liability recognized	(1,979)
Identifiable intangible assets:	
Developed technology	8,800
Customer relationships	500
Goodwill	36,896
Total purchase price	$46,357

The developed technology and customer relationship intangible assets were each assigned useful lives of 4.5 years.
In connection with the acquisition, we entered into retention arrangements with certain employees of WAC, pursuant to which we issued RSUs for approximately 0.5 million shares of our common stock, most of which vest in three annual installments from the date of acquisition. The expense related to the RSUs is accounted for as share-based compensation expense over the required service periods and was not included in the purchase consideration.
The results of operations of WAC have been included in our consolidated financial statements from the date of the acquisition.

Note 3. Financial Instruments

Investments

The following tables present information about our cash equivalents and marketable securities measured at fair value on a recurring basis as of September 30, 2016 and December 31, 2015 based on the three-tier fair value hierarchy (in thousands):

	Fair Value Measurement at September 30, 2016		
	Level 1	Level 2	Total
Description			
Corporate bonds	$—	$118,443	$118,443
Asset-backed securities	—	28,458	28,458
U.S. treasury securities	—	28,256	28,256
Commercial paper	—	19,239	19,239
Agency securities	—	10,501	10,501
Money market funds	4,841	—	4,841
Total	$4,841	$204,897	$209,738
Included in cash and cash equivalents			$4,841
Included in marketable securities			$204,897

	Fair Value Measurement at December 31, 2015		
	Level 1	Level 2	Total
Description			
Corporate bonds	$—	$31,761	$31,761
Money market funds	21,338	—	21,338
Asset-backed securities	—	7,998	7,998
Commercial paper	—	5,992	5,992
U.S. treasury securities	—	4,001	4,001
Agency securities	—	1,998	1,998
Total	$21,338	$51,750	$73,088
Included in cash and cash equivalents			$21,338
Included in marketable securities			$51,750

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As of September 30, 2016 and December 31, 2015, there were no securities within Level 3 of the fair value hierarchy. There were no transfers between fair value measurement levels during the three and nine months ended September 30, 2016. Gross unrealized gains and losses for cash equivalents and marketable securities as of September 30, 2016 and December 31, 2015 were not material. As of September 30, 2016 and December 31, 2015, there were no securities that were in an unrealized loss position for more than 12 months.
The following table classifies our marketable securities by contractual maturity as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Due in one year or less	$ 133,758	$ 29,414
Due after one year	71,139	22,336
Total	$ 204,897	$ 51,750

For certain other financial instruments, including accounts receivable, accounts payable and other current liabilities, the carrying amounts approximate their fair value due to the relatively short maturity of these balances.
Derivative Instruments and Hedging
Our foreign currency exposures typically arise from foreign operations and sales in foreign currencies for subscriptions to our customer service platform. In September 2015, we implemented a hedging program to mitigate the impact of foreign currency fluctuations on our future cash flows and earnings. We enter into foreign currency forward contracts with certain financial institutions and designate those contracts as cash flow hedges. Our foreign currency forward contracts generally have maturities of 15 months or less. As of September 30, 2016, the balance of accumulated other comprehensive loss included an unrealized loss of $0.6 million related to the effective portion of changes in the fair value of foreign currency forward contracts designated as cash flow hedges. We expect to reclassify $0.4 million from accumulated other comprehensive loss into earnings over the next 12 months associated with our cash flow hedges.
The following tables present information about derivative instruments on our consolidated balance sheets as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016			
	Asset Derivatives		Liability Derivatives	
Derivative Instrument	Balance Sheet Location	Fair Value (Level 2)	Balance Sheet Location	Fair Value (Level 2)
Foreign currency forward contracts	Other current assets	$ 1,215	Accrued liabilities	$ 1,688
Foreign currency forward contracts	Other assets	79	Other liabilities	330
Total		$ 1,294		$ 2,018

	December 31, 2015			
	Asset Derivatives		Liability Derivatives	
Derivative Instrument	Balance Sheet Location	Fair Value (Level 2)	Balance Sheet Location	Fair Value (Level 2)
Foreign currency forward contracts	Other current assets	$ 408	Accrued liabilities	$ 1,081
Total		$ 408		$ 1,081

Our foreign currency forward contracts had a total notional value of $88.5 million and $60.8 million as of September 30, 2016 and December 31, 2015, respectively. We have a master netting agreement with certain counterparties, which permits net settlement of multiple, separate derivative contracts with a single payment. We have elected to present our derivative instruments on a gross basis in our consolidated financial statements. We may also be required to exchange cash collateral with certain of our counterparties on a regular basis. We have not exchanged cash collateral with any counterparties as of September 30, 2016 and December 31, 2015, respectively.

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The following table presents information about our derivative instruments on the statement of operations for the three and nine months ended September 30, 2016 and 2015 (in thousands):

		Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
Hedging Instrument	Location of Loss Reclassified into Earnings	Gain Recognized in AOCI	Loss Reclassified from AOCI into Earnings	Loss Recognized in AOCI	Loss Reclassified from AOCI into Earnings
Foreign currency forward contracts	Revenue, cost of revenue, operating expenses	$207	$ (209)	$(218)	$ (357)
Total		$207	$ (209)	$(218)	$ (357)

		Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
Hedging Instrument	Location of Gain (Loss) Reclassified into Earnings	Loss Recognized in AOCI	Gain (Loss) Reclassified from AOCI into Earnings	Loss Recognized in AOCI	Gain(Loss) Reclassified from AOCI into Earnings
Foreign currency forward contracts	Revenue, cost of revenue, operating expenses	$ (101)	$ —	$ (101)	$ —
Total		$ (101)	$ —	$ (101)	$ —

All derivatives have been designated as hedging instruments. Amounts recognized in earnings related to excluded time value and hedge ineffectiveness for the three and nine months ended September 30, 2016 were not material.

Note 4. Property and Equipment

Property and equipment, net consists of the following (in thousands):

	September 30, 2016	December 31, 2015
Hosting equipment	$ 31,514	$ 26,920
Capitalized internal-use software	25,277	22,418
Leasehold improvements	23,167	19,577
Computer equipment and software	10,735	7,682
Furniture and fixtures	6,988	5,739
Construction in progress	5,937	4,157
Total	103,618	86,493
Less: accumulated depreciation and amortization	(46,111)	(29,953)
Property and equipment, net	$ 57,507	$ 56,540

Depreciation expense was $4.1 million and $2.8 million for the three months ended September 30, 2016 and 2015, respectively, and $11.8 million and $7.7 million for the nine months ended September 30, 2016 and 2015, respectively.

Amortization expense of capitalized internal-use software totaled $1.8 million and $1.6 million for the three months ended September 30, 2016 and 2015, respectively, and $5.2 million and $4.6 million for the nine months ended September 30, 2016 and 2015, respectively. The carrying value of capitalized internal-use software at September 30, 2016 and December 31, 2015 was $15.0 million and $14.1 million, respectively, including $4.1 million and $1.5 million in construction in progress, respectively.

Note 5. Goodwill and Acquired Intangible Assets

The changes in the carrying amount of goodwill for the nine months ended September 30, 2016 are as follows (in thousands):

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Balance as of December 31, 2015	$45,346
Goodwill adjustments	166
Foreign currency translation adjustments	359
Balance as of September 30, 2016	$45,871

Acquired intangible assets subject to amortization as of September 30, 2016 and December 31, 2015 consist of the following (in thousands):

	As of September 30, 2016				
	Cost	Accumulated Amortization	Foreign Currency Translation Adjustments	Net	Remaining Useful Life
					(In years)
Developed technology	$14,000	$ (5,717)	$ (135)	$8,148	3.1
Customer relationships	1,800	(934)	(38)	828	2.4
	$15,800	$ (6,651)	$ (173)	$8,976	

	As of December 31, 2015				
	Cost	Accumulated Amortization	Foreign Currency Translation Adjustments	Net	Remaining Useful Life
					(In years)
Developed technology	$14,000	$ (3,133)	$ (279)	$10,587	3.7
Customer relationships	1,800	(606)	(78)	1,117	3.1
	$15,800	$ (3,739)	$ (357)	$11,704	

Amortization expense of purchased intangible assets for the three months ended September 30, 2016 and 2015 was $1.0 million and $0.4 million, respectively, and $2.9 million and $1.4 million for the nine months ended September 30, 2016 and 2015, respectively.
Estimated future amortization expense as of September 30, 2016 is as follows (in thousands):

Remainder of 2016	$936
2017	3,330
2018	2,131
2019	2,067
2020	512
	$8,976

Note 6. Credit Facility
Until its termination in June 2015, we had a credit facility with Silicon Valley Bank consisting of a $20.0 million revolving line of credit and a $10.0 million equipment line of credit. The revolving line of credit bore interest at the prime rate plus 2.0% per annum prior to our initial public offering, or IPO, in May 2014 and was reduced to the prime rate upon the consummation of our IPO. Borrowings on the equipment line of credit bore interest of 2.5% per annum. In June 2014, we repaid all outstanding principal and accrued interest under the revolving line of credit. In June 2015, we repaid all outstanding principal and interest under the equipment line of credit and terminated the Silicon Valley Bank credit facility.

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Note 7. Commitments and Contingencies

Leases

We lease office space under noncancelable operating leases with various expiration dates. Certain of the office space lease agreements contain rent holidays or rent escalation provisions. Rent holiday and rent escalation provisions are considered in determining the straight-line expense to be recorded over the lease term. The lease term begins on the date of initial possession of the leased property for purposes of recognizing lease expense on a straight-line basis over the term of the lease. Rent expense was $2.6 million and $2.0 million for the three months ended September 30, 2016 and 2015, respectively, and $7.2 million and $5.4 million for the nine months ended September 30, 2016 and 2015, respectively.

In June 2016, we entered into an operating lease agreement for approximately 18,000 square feet of additional office space in San Francisco, CA. The lease began on July 11, 2016 and will expire on January 31, 2021. The total anticipated amount of rent to be paid over the initial term of the lease is approximately $4.6 million. In addition to monthly rent obligations, we are responsible for certain operating costs and taxes associated with the leased premises.

We leased computer equipment from various parties under capital lease agreements that expired in March 2015.

Litigation and Loss Contingencies

We accrue estimates for resolution of legal and other contingencies when losses are probable and estimable. From time to time, we may become a party to litigation and subject to claims incident to the ordinary course of business, including intellectual property claims, labor and employment claims, and threatened claims, breach of contract claims, tax, and other matters. We currently have no material pending litigation.

We are not currently aware of any litigation matters or loss contingencies that would be expected to have a material adverse effect on our business, consolidated financial position, results of operations, comprehensive loss, or cash flows.

Indemnifications

In the ordinary course of business, we enter into contractual arrangements under which we agree to provide indemnification of varying scope and terms to customers, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of the breach of such agreements, intellectual property infringement claims made by third parties, and other liabilities relating to or arising from our customer service platform, live chat software, analytics software, or our acts or omissions. In these circumstances, payment may be conditional on the other party making a claim pursuant to the procedures specified in the particular contract. Further, our obligations under these agreements may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments. In addition, we have indemnification agreements with our directors and executive officers that require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The terms of such obligations may vary. To date, we have not incurred any material costs, and we have not accrued any liabilities in the accompanying condensed consolidated financial statements, as a result of these obligations.

Certain of our product offerings include service-level agreements warranting defined levels of uptime reliability and performance and permitting those customers to receive credits for future services in the event that we fail to meet those levels. To date, we have not accrued for any significant liabilities in the accompanying condensed consolidated financial statements as a result of these service-level agreements.

Note 8. Common Stock and Stockholders’ Equity

Common Stock

As of each of September 30, 2016 and December 31, 2015, there were 400 million shares authorized for issuance with a par value of $0.01 per share. There were 95.4 million and 90.9 million shares of common stock issued and 94.9 million and 90.3 million shares outstanding as of September 30, 2016 and December 31, 2015, respectively. Included within the number of shares issued and outstanding were 0.1 million and 0.3 million shares of common stock subject to repurchase, as of September 30, 2016 and December 31, 2015, respectively.

Preferred Stock

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As of each of September 30, 2016 and December 31, 2015, 10.0 million shares of preferred stock were authorized for issuance with a par value of $0.01 per share and no shares of preferred stock were issued or outstanding.

Employee Equity Plans

Employee Stock Purchase Plan

Under our Employee Stock Purchase Plan, or ESPP, eligible employees are granted options to purchase shares of our common stock through payroll deductions. The ESPP provides for eighteen-month offering periods, which include three six-month purchase periods. At the end of each purchase period, employees are able to purchase shares at 85% of the lower of the fair market value of our common stock at the beginning of an offering period or the fair market value of our common stock at the end of the purchase period. For the three and nine months ended September 30, 2016, 0.3 million shares of common stock were purchased under the ESPP. Pursuant to the terms of the ESPP, the number of shares reserved under the ESPP increased by 0.9 million shares on January 1, 2016. As of September 30, 2016, 3.5 million shares of common stock were available for issuance under the ESPP.

Stock Option and Incentive Plans

Our board of directors adopted the 2009 Stock Option and Grant Plan, or the 2009 Plan, in July 2009. The 2009 Plan was terminated in connection with our IPO in May 2014, and accordingly, no shares are available for issuance under this plan. The 2009 Plan continues to govern outstanding awards granted thereunder.

Our 2014 Stock Option and Incentive Plan, or the 2014 Plan, serves as the successor to our 2009 Plan. Pursuant to the terms of the 2014 Plan, the number of shares reserved for issuance under the 2014 Plan increased by 4.5 million shares on January 1, 2016. As of September 30, 2016, we had 5.8 million shares of common stock available for future grants under the 2014 Plan.

On May 6, 2016, the compensation committee of our board of directors granted equity awards representing 1.2 million shares. These awards were granted outside of the 2014 Plan pursuant to an exemption provided for “employment inducement awards” within the meaning of Section 303A.08 of the New York Stock Exchange Listed Manual and accordingly do not require approval from our stockholders.

The following table summarizes our stock option and RSU award activities for the nine months ended September 30, 2016 (in thousands, except per share information):

		Options Outstanding				RSUs Outstanding	
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value	Outstanding RSUs	Weighted Average Grant Date Fair Value
				(In years)			
Outstanding — January 1, 2016	4,323	10,778	$ 11.94	7.96	$ 156,262	6,417	$ 19.54
Increase in authorized shares	5,716						
Stock options granted	(1,363)	1,363	23.82				
RSUs granted	(3,719)					3,719	20.41
Stock options exercised		(2,275)	8.75				
RSUs vested						(2,080)	18.42
Unvested shares repurchased	38						
Stock options forfeited or canceled	334	(334)	16.70				
RSUs forfeited or cancelled	491					(491)	20.42
Outstanding — September 30, 2016	5,820	9,532	$ 14.23	7.69	$ 157,057	7,565	$ 20.22

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Aggregate intrinsic value for options outstanding represents the difference between the closing stock price of our common stock and the exercise price of outstanding, in-the-money options. Our closing stock price as reported on the New York Stock Exchange as of September 30, 2016 was $30.71.

As of September 30, 2016, we had a total of $188.9 million in future share-based compensation expense related to all equity awards, net of estimated forfeitures, to be recognized over a weighted average period of 2.8 years.

Early Exercise of Stock Options and Purchase of Unvested Stock Awards

Certain of our stock options permit early exercise. Common stock purchased pursuant to an early exercise of stock options or unvested stock awards is not deemed to be outstanding for financial reporting purposes until those shares vest. Therefore, cash received in exchange for unvested shares is recorded as a liability and is transferred into common stock and additional paid-in capital as the shares vest. Upon termination of service, we may, at our discretion, repurchase unvested shares acquired through early exercise of stock options or purchase of unvested stock awards at a price equal to the price per share paid upon the exercise of such options or the purchase of such unvested stock awards. As of September 30, 2016 and December 31, 2015, there were 0.1 million and 0.3 million shares, respectively, outstanding as a result of the early exercise of stock options and purchase of unvested stock awards by our employees and directors that were classified as accrued liabilities for an aggregated amount of $0.5 million and $1.0 million, respectively.

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Note 9. Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share is computed by giving effect to all potential shares of common stock, including outstanding share-based awards, to the extent dilutive. Basic and diluted net loss per share were the same for each period presented as the inclusion of all potential common stock outstanding would have been anti-dilutive.

The following table presents the calculation of basic and diluted net loss per share for the periods presented (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss	$(25,826)	$(18,924)	$(79,250)	$(59,575)
Weighted-average shares used to compute basic and diluted net loss per share	94,085	87,777	92,274	83,536
Net loss per share, basic and diluted	$(0.27)	$(0.22)	$(0.86)	$(0.71)

The anti-dilutive securities excluded from the shares used to calculate the diluted net loss per share are as follows (in thousands):

	As of September 30,	
	2016	2015
Shares subject to outstanding common stock options and employee stock purchase plan	9,753	12,067
Restricted stock units	7,565	5,217
	17,318	17,284

Note 10. Income Taxes

The effective tax rates for the three and nine months ended September 30, 2016 and 2015 were less than 2%. The effective tax rates differ from the statutory rate primarily as a result of not recognizing a deferred tax asset for U.S. losses due to having a full valuation allowance against U.S. deferred tax assets.

In April 2009, Zendesk’s entity in Denmark, or Zendesk Denmark, transferred certain assets to Zendesk’s U.S. entity. In April 2015, the Danish Tax Authority, or SKAT, issued a letter of intent in contemplation of adjusting the value of the reported asset transfer. We submitted a written rebuttal to SKAT’s proposal in August 2015. In March 2016, we received an assessment from SKAT that gave rise to a potential payment of $1.9 million, including income tax and interest. We further contested the assessment and reached a settlement with SKAT. In September 2016, we paid the amount due of $0.9 million, including income tax and interest, and released the associated reserve for the uncertain tax position.

Note 11. Geographic Information

Our chief operating decision maker reviews the financial information presented on a consolidated basis for purposes of allocating resources and evaluating our financial performance. Accordingly, we have determined that we operate in a single reporting segment.

Revenue

The following table presents our revenue by geographic area, as determined based on the billing address of our customers (in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
United States	$43,587	$31,388	$121,222	$81,094
EMEA	22,601	15,397	62,208	41,434
Other	14,529	8,876	39,946	23,594
Total	$80,717	$55,661	$223,376	$146,122

Long-Lived Assets

The following table presents our long-lived assets by geographic area (in thousands):

	As of September 30, 2016	As of December 31, 2015
United States	$ 24,637	$ 26,696
EMEA	10,420	10,351
APAC	7,460	5,332
Total	$ 42,517	$ 42,379

The carrying values of capitalized internal-use software and intangible assets are excluded from the balance of long-lived assets presented in the table above.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2015, filed with the SEC on February 26, 2016. As discussed in the section titled "Special Note Regarding Forward-Looking Statements," the following discussion and analysis contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included under Part II, Item 1A below.

Overview

Zendesk's mission is to help organizations and their customers build better relationships. We are a software development company that provides a SaaS customer service platform that enables our customers to provide tailored support through multiple channels, establish effective self-service support resources, proactively serve customers through customer engagement capabilities, integrate with other applications, and consolidate and analyze data from customer interactions. We also provide SaaS live chat software that can be utilized independently to facilitate proactive communications between organizations and their customers or integrated easily into our platform.

Our business model is designed to drive organic growth, leverage positive word-of-mouth, and remove friction from the evaluation and purchasing process. We offer a range of subscription account plans for our customer service platform, live chat software and analytics software that vary in price based on functionality, type and, for our customer service platform and live chat software, the amount of product support we offer. We also offer a range of additional features that customers can purchase and add to their subscriptions.

Our largest source of qualified sales leads is free trials of our customer service platform commenced by prospects. For larger organizations, our sales team focuses on a land and expand strategy, which leverages this grassroots adoption and seeks to expand our footprint within organizations. As we continue to focus on and become more dependent on sales to larger organizations and increase our investments in paid sources of qualified leads, we expect the percentage of qualified leads that come from unpaid sources, such as organic search and customer referrals, to decrease and our sales cycles to lengthen and become less predictable.

In October 2015, we completed the acquisition of WAC, the maker of BIME Analytics software. With the acquisition, we added technology that we anticipate will allow our customers to understand the ever-increasing diversity of data about their end customers. Over time, we expect this analytics software to become a core technology within our customer service platform, enabling us to further integrate data analytics capabilities across our products. We also continue to sell our analytics software on a standalone basis.

For the three months ended September 30, 2016 and 2015, our revenue was $80.7 million and $55.7 million, respectively, representing a 45% growth rate. For the nine months ended September 30, 2016 and 2015, our revenue was $223.4 million and $146.1 million, respectively, representing a 53% growth rate. For the three months ended September 30, 2016 and 2015, we derived $37.1 million, or 46%, and $24.3 million, or 44%, respectively, of our revenue from customers located outside of the United States. For the nine months ended September 30, 2016 and 2015, we derived $102.2 million, or 46%, and $65.0 million, or 44%, respectively, of our revenue from customers located outside of the United States. We expect that the rate of growth in our revenue will decline as our business scales, even if our revenue continues to grow in absolute terms. For the three months ended September 30, 2016 and 2015, we generated net losses of $25.8 million and $18.9 million, respectively. For the nine months ended September 30, 2016 and 2015, we generated net losses of $79.3 million and $59.6 million, respectively. We intend to invest aggressively to drive continued growth and market leadership.

The growth of our business and our future success depend on many factors, including our ability to continue to innovate, maintain our leadership in the small and medium-sized business, or SMB, market, expand our customer base, and increase our global customer footprint. While these areas represent significant opportunities for us, we also face significant risks and challenges that we must successfully address in order to sustain the growth of our business and improve our operating results. We anticipate that we will continue to expand our operations and headcount in the near term. The expected addition of new personnel and the expenditures that we anticipate will be necessary to manage our anticipated growth, including expenditures relating to hosting capacity, leasehold improvements and related fixed assets, will make it more difficult for us to achieve profitability. Many of these investments will occur in advance of us experiencing any direct benefit and will make it difficult to determine if we are allocating our resources efficiently.

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We have focused on rapidly growing our business and plan to continue to invest for long-term growth. To support our growth, we expect to continue to develop our hosting capabilities through investments in our self-managed colocation data centers and incur expenditures for third-party managed hosting services. The amount and timing of these disbursements will vary based on our estimates of projected growth and planned use of hosting resources. Over time, we anticipate that we will continue to gain economies of scale by efficiently utilizing our hosting and personnel resources to support the growth in our number of customers. We also expect to continue to grow our customer support organization, including expanding our product support and professional services teams. As a result, we expect our gross margin to improve in the future, although our gross margin may fluctuate from period to period as our revenue fluctuates and as a result of the timing and amount of investments to expand our product support team, investments in additional personnel, equipment, services, and facilities to support our platform architecture, increased share-based compensation expense, as well as amortization costs associated with acquired intangible assets and capitalized internal-use software.

We expect our operating expenses to continue to increase in absolute dollars in future periods. We have invested, and expect to continue to invest, in our software development efforts to introduce new products, broaden the functionality of our customer service platform, our live chat software, and our analytics software, and to further integrate these products and services. We plan to continue to expand our sales and marketing organizations, particularly in connection with our efforts to expand our customer base. We also expect to continue to incur additional general and administrative costs in order to support the growth of our business and the infrastructure required to comply with our obligations as a public company.

Key Business Metrics

We review a number of operating metrics, including the following key metrics, to evaluate our business, measure our performance, identify trends affecting our business, formulate business plans, and make strategic decisions.

Number of Paid Customer Accounts. We believe that our ability to increase our number of paid accounts on our customer service platform and live chat software is an indicator of our market penetration, the growth of our business, and our potential future business opportunities. We define the number of paid customer accounts as the sum of the number of accounts on our customer service platform, exclusive of our legacy Starter plan, free trials or other free services, and the number of accounts using our live chat software, exclusive of free trials or other free services, each as of the end of the period and as identified by a unique account identifier. Use of our customer service platform and live chat software requires separate subscriptions, and each of these accounts are treated as a separate paid customer account. Existing customers may also expand their utilization of our customer service platform or live chat software by adding new accounts, and a single consolidated organization or customer may have multiple accounts across each of our customer service platform and live chat software to service separate subsidiaries, divisions, or work processes. Each of these accounts is also treated as a separate paid customer account. An increase in the number of paid customer accounts generally correlates to an increase in the number of authorized agents licensed to use our platform, which directly affects our revenue and results of operations. We view growth in this metric as a measure of our success in converting new sales opportunities. We do not currently incorporate accounts using our analytics software into the determination of the number of paid customer accounts. We had approximately 87,400 paid customer accounts as of September 30, 2016, including approximately 47,400 paid customer accounts on our customer service platform and approximately 40,000 paid customer accounts using our live chat software. As the total number of paid customer accounts increases, we expect the rate of growth in the number of paid customer accounts to decline.

In the quarter ended December 31, 2015, we introduced our Essential plan for our customer service platform. This plan replaced our Starter plan as the least expensive paid plan on our customer service platform. Following the introduction of our Essential plan, we no longer made our Starter plan available for new accounts. Accounts that subscribe to our Essential plan are included in the determination of the number of paid customer accounts.

Dollar-Based Net Expansion Rate. Our ability to generate revenue is dependent upon our ability to maintain our relationships with our customers and to increase their utilization of our customer service platform and live chat software. We believe we can achieve this by focusing on delivering value and functionality that retains our existing customers, expands the number of authorized agents associated with an existing paid customer account on our customer service platform or live chat software, and results in upgrades to higher-priced subscription plans and the purchase of additional features on our customer service platform, such as voice subscriptions. Maintaining customer relationships allows us to sustain and increase revenue to the extent customers maintain or increase the number of authorized agents licensed to use our customer service platform and live chat software. We assess our performance in this area by measuring our dollar-based net expansion rate. Starting in the quarter ended March 31, 2016, we began incorporating operating metrics associated with our live chat software into our dollar-based net expansion rate. Our dollar-based net expansion rate provides a measurement of our ability to increase revenue across our existing customer base through expansion of authorized agents associated with a paid customer account on our customer

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service platform and live chat software, and upgrades in subscription plans, as offset by churn, contraction in authorized agents associated with a paid customer account on our customer service platform and live chat software, and downgrades in subscription plans. We do not currently incorporate operating metrics associated with our analytics software into our measurement of dollar-based net expansion rate.

Our dollar-based net expansion rate is based upon our monthly recurring revenue for a set of paid customer accounts on our customer service platform and live chat software. Monthly recurring revenue for a paid customer account is a legal and contractual determination made by assessing the contractual terms of each paid customer account, as of the date of determination, as to the revenue we expect to generate in the next monthly period for that paid customer account, assuming no changes to the subscription and without taking into account any one-time discounts or any platform usage above the subscription base, if any, that may be applicable to such subscription. Monthly recurring revenue is not determined by reference to historical revenue, deferred revenue or any other GAAP financial measure over any period. It is forward-looking and contractually derived as of the date of determination.

We calculate our dollar-based net expansion rate by dividing our retained revenue net of contraction and churn by our base revenue. We define our base revenue as the aggregate monthly recurring revenue of the paid customer accounts on our customer service platform and live chat software as of the date one year prior to the date of calculation. We define our retained revenue net of contraction and churn as the aggregate monthly recurring revenue of the same customer base included in our measure of base revenue at the end of the annual period being measured. Our dollar-based net expansion rate is also adjusted to eliminate the effect of certain activities that we identify involving the transfer of agents between paid customer accounts, consolidation of customer accounts, or the split of a single paid customer account into multiple paid customer accounts. In addition, our dollar-based net expansion rate is adjusted to include paid customer accounts in the customer base used to determine retained revenue net of contraction and churn that share common corporate information with customers in the customer base that are used to determine our base revenue. Giving effect to this consolidation results in our dollar-based net expansion rate being calculated across approximately 74,300 customers, as compared to the approximately 87,400 total paid customer accounts as of September 30, 2016. To the extent that we can determine that the underlying customers do not share common corporate information, we do not aggregate paid customer accounts associated with reseller and other similar channel arrangements for the purposes of determining our dollar-based net expansion rate. While not material, we believe the failure to account for these activities would otherwise skew our dollar-based net expansion metrics associated with customers that maintain multiple paid customer accounts on our customer service platform or live chat software and paid customer accounts associated with reseller and other similar channel arrangements.

Our dollar-based net expansion rate was 114% as of September 30, 2016. We expect that, among other factors, our continued focus on adding paid customer accounts with significant monthly recurring revenue at the time of addition, the upcoming anniversaries of significant expansion transactions within certain customer accounts, and the growth in our aggregate monthly recurring revenue will result in an overall decline in our dollar-based net expansion rate over time, and in particular over the course of the next year.

Components of Results of Operations

Revenue

We derive substantially all of our revenue from subscription services, which are comprised of subscription fees from customer accounts on our customer service platform and, to a lesser extent, live chat and analytics software. Each subscription may have multiple authorized users, and we refer to each user as an “agent.” The number of agents ranges from one to thousands for various customer accounts. Our pricing is generally established on a per agent basis. We offer a range of subscription account plans for our customer service platform, live chat software and analytics software that vary in price based on functionality, type and, for our customer service platform and live chat software, the amount of product support we offer. We also offer a range of additional features that customers can purchase and add to their subscriptions. Certain arrangements provide for incremental fees above a fixed maximum number of monthly agents during the subscription term. We sell subscription services under contractual agreements that vary in length, ranging between one month and multiple years, with the majority of subscriptions having a term of either one month or one year.

Subscription fees are generally non-refundable regardless of the actual use of the service. Subscription revenue is typically affected by the number of customer accounts, number of agents, and the type of plan purchased by our customers, and is recognized ratably over the term of the arrangement beginning on the date that our services are made available to our customers. Subscription services purchased online are typically paid for via a credit card on the date of purchase while subscription services purchased through our internal sales organization are generally billed with monthly, quarterly, or annual payment frequencies. Due to our mixed contract lengths and billing frequencies, the annualized value of the arrangements we

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enter into with our customers may not be fully reflected in deferred revenue at any single point in time. Additionally, because of the mix of payment frequencies and contract lengths, we do not believe that backlog is a meaningful performance metric.

We derive an immaterial amount of revenue from implementation, voice usage, and training services, for which we recognize revenue upon completion.

Cost of Revenue, Gross Margin, and Operating Expenses

Cost of Revenue. Cost of revenue consists primarily of personnel costs (including salaries, share-based compensation, and benefits) for employees associated with our platform infrastructure, product support, and professional service organizations, and expenses for data center capacity, primarily including depreciation and hosting. Cost of revenue also includes amortization expense associated with capitalized internal-use software, payment processing fees, third-party license fees, amortization expense associated with acquired intangible assets, and allocated shared costs. We allocate shared costs such as facilities, shared information technology and security costs to all departments based on headcount. As such, allocated shared costs are reflected in cost of revenue and each operating expense category.

We currently operate out of four self-managed colocation data centers, in which we manage our own network equipment and systems, located in California, Virginia, Ireland, and Germany. In addition, we utilize third-party managed hosting facilities located in North America, Europe, and Asia to host our services, support our platform infrastructure, and support certain research and development functions. We currently intend to continue to operate our self-managed colocation data centers and incur expenditures for third-party managed hosting services over time to support our growth.

We intend to continue to invest additional resources in our platform infrastructure, product support, and professional service organizations through acquisitions and organically. We expect that recent and future business acquisitions will result in increased amortization expense of intangible assets such as acquired technology. As we continue to invest in technology innovation, we expect to incur ongoing capitalized internal-use software costs and related amortization. We expect these investments in technology to not only expand the capability of our customer service platform, live chat software, and analytics software but also to increase the efficiency of how we deliver these services, enabling us to improve our gross margin over time. The level and timing of investment in these areas could affect our cost of revenue in the future. To the extent that we continue to rely on third-party technology to provide certain functionality within our products or for certain subscription plans, we expect third-party license fees for technology that is incorporated in such products and subscription plans to remain significant over time as we increase the number of customers using such products and subscription plans.

Gross Margin. Gross margin is gross profit expressed as a percentage of revenue. Our gross margin may fluctuate from period to period as our revenue fluctuates and as a result of the timing and amount of investments to expand our product support and professional services teams, investments in additional personnel, equipment, services, and facilities to support our platform architecture, increased share-based compensation expense, as well as the amortization of certain acquired intangible assets and costs associated with capitalized internal-use software. Although we expect that certain third-party technology license fees will remain significant, we expect these costs to decrease over time as we take steps necessary to secure long-term access to such technology.

Research and Development. Research and development expenses consist primarily of personnel costs (including salaries, share-based compensation, and benefits) for employees associated with our research and development organization and allocated shared costs.

We focus our research and development efforts on the continued development of our customer service platform, live chat software, and analytics software, including the development and deployment of new features and functionality and enhancements to our software architecture and integration across our products. We expect that, in the future, research and development expenses will increase in absolute dollars. However, we expect our research and development expenses to decrease modestly as a percentage of our revenue in the long-term, although this may fluctuate from period to period depending on fluctuations in revenue and the timing and the extent of our research and development expenses.

Sales and Marketing. Sales and marketing expenses consist of personnel costs (including salaries, commissions, share-based compensation, and benefits) for employees associated with our sales and marketing organizations, costs of marketing activities, and allocated shared costs. Marketing activities include online lead generation, advertising, promotional events, and public and community relations. Sales commissions and other incremental costs to acquire contracts are expensed as incurred.

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We focus our sales and marketing efforts on generating awareness of our products, establishing and promoting our brand, and cultivating a community of successful and vocal customers. We plan to continue investing in sales and marketing by increasing the number of sales employees, developing our marketing teams, expanding our indirect sales channels, building brand awareness, and sponsoring additional marketing events, which we believe will enable us to add new customers and increase penetration within our existing customer base. Because we do not have a long history of undertaking or growing many of these activities, we cannot predict whether, or to what extent, our revenue will increase as we invest in these strategies. We expect our sales and marketing expenses to continue to increase in absolute dollars and continue to be our largest operating expense category for the foreseeable future. Our sales and marketing expenses as a percentage of our revenue over time may fluctuate from period to period depending on fluctuations in revenue and the timing and extent of our sales and marketing expenses.

General and Administrative. General and administrative expenses consist primarily of personnel costs (including salaries, share-based compensation, and benefits) for our executive, finance, legal, human resources, and other administrative employees. In addition, general and administrative expenses include fees for third-party professional services, including legal, accounting, and tax related services, and other corporate expenses and allocated shared costs. We expect to incur incremental costs associated with supporting the growth of our business, both in terms of size and geographic expansion, and the infrastructure required to be a public company. Such costs include increases in our finance, legal, and human resources personnel, additional legal, accounting, tax, and compliance related services fees, insurance costs, and costs of executing significant transactions, including business acquisitions, and other costs associated with being a public company. As a result, we expect our general and administrative expenses to continue to increase in absolute dollars for the foreseeable future. However, we expect our general and administrative expenses to decrease modestly as a percentage of our revenue in the long-term, although this may fluctuate from period to period depending on fluctuations in revenue and the timing and extent of our general and administrative expenses.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income from marketable securities and foreign currency gains and losses, offset by interest expense associated with our credit facility (terminated in June 2015).

Provision for (Benefit from) Income Taxes

Provision for (benefit from) income taxes consists of federal and state income taxes in the United States and income taxes in certain foreign jurisdictions. See Note 10 of the notes to our unaudited condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.

Results of Operations

The following tables set forth our results of operations for the periods presented in dollars and as a percentage of our revenue:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$80,717	$55,661	$223,376	$146,122
Cost of revenue (1)	23,866	17,039	68,318	47,491
Gross profit	56,851	38,622	155,058	98,631
Operating expenses (1):				
Research and development	22,953	16,031	66,683	43,517
Sales and marketing	43,899	29,079	119,421	79,725
General and administrative	16,212	12,319	48,149	33,982
Total operating expenses	83,064	57,429	234,253	157,224
Operating loss	(26,213)	(18,807)	(79,195)	(58,593)
Other income (expense), net	681	145	745	(428)
Loss before provision for income taxes	(25,532)	(18,662)	(78,450)	(59,021)
Provision for income taxes	294	262	800	554
Net loss	$(25,826)	$(18,924)	$(79,250)	$(59,575)

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(1) Includes share-based compensation expense as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Cost of revenue	$1,919	$1,131	$5,355	$3,136
Research and development	7,172	4,974	20,548	13,484
Sales and marketing	6,657	3,786	17,780	10,154
General and administrative	4,247	3,551	12,654	10,283

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenue (2)	29.6	30.6	30.6	32.5
Gross profit	70.4	69.4	69.4	67.5
Operating expenses (2):				
Research and development	28.4	28.8	29.9	29.8
Sales and marketing	54.4	52.2	53.5	54.6
General and administrative	20.1	22.1	21.6	23.3
Total operating expenses	102.9	103.2	105.0	107.6
Operating loss	(32.5)	(33.8)	(35.6)	(40.1)
Other income (expense), net	0.8	0.3	0.3	(0.3)
Loss before provision for income taxes	(31.7)	(33.5)	(35.3)	(40.4)
Provision for income taxes	0.4	0.5	0.4	0.4
Net loss	(32.1)%	(34.0)%	(35.7)%	(40.8)%

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(2) Includes share-based compensation expense as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Cost of revenue	2.4%	2.0%	2.4%	2.1%
Research and development	8.9	8.9	9.2	9.2
Sales and marketing	8.2	6.8	8.0	6.9
General and administrative	5.3	6.4	5.7	7.0

Revenue

Three Months Ended September 30,			Nine Months Ended September 30,		
2016	2015	% Change	2016	2015	% Change
(In thousands, except percentages)					

Revenue	$80,717	$55,661	45 %	$223,376	$146,122	53 %

Revenue increased $25.1 million, or 45%, in the three months ended September 30, 2016 compared to the same period in 2015. Of the total increase in revenue, $11.2 million, or 45%, was attributable to revenue from new customer accounts acquired from October 1, 2015 through September 30, 2016, net of churn and contraction, and $13.9 million, or 55%, was attributable to revenue from accounts existing on or before September 30, 2015, net of churn and contraction. Revenue increased $77.3 million, or 53%, in the nine months ended September 30, 2016 compared to the same period in 2015 due to the addition of new customer accounts and the continued expansion of existing customer accounts.

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Revenue from certain customer accounts that share common corporate information is treated as being generated from a single customer account. The acquisition date of customer accounts that share common corporate information is determined using the establishment date of the earliest customer account.

Cost of Revenue and Gross Margin

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	2015	% Change	2016	2015	% Change
	(In thousands, except percentages)					
Cost of Revenue	$23,866	$17,039	40 %	$68,318	$47,491	44 %
Gross Margin	70.4 %	69.4 %		69.4 %	67.5 %	

Cost of revenue increased $6.8 million, or 40%, and $20.8 million, or 44%, in the three and nine months ended September 30, 2016, respectively, compared to the same periods in 2015. The overall increases were primarily due to increased employee compensation-related costs of $2.4 million and $8.6 million, driven by headcount growth, increased data center costs of $1.7 million and $4.0 million, and increased amortization expense from acquired intangible assets of $0.5 million and $1.5 million for the three and nine months ended September 30, 2016, respectively. The increase in data center costs was driven by increased depreciation expense from our investments in our self-managed colocation data centers and expenditures for third-party managed hosting services, and the increase in amortization expense from acquired intangible assets was related to our acquisition of WAC. Further contributing to the overall increases was an increase in allocated shared facilities and information technology costs of $0.8 million and $2.8 million for the