Zendesk, Inc.
Form 10-Q
November 06, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2015

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (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 x

As of October 31, 2015, there were 88,697,514 shares of the registrant's common stock outstanding.

ZENDESK, 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 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 wor 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, ability to improve our gross margin, 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 and live chat software, and to optimize the pricing for our customer service platform and live chat 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;
- our ability to effectively manage our growth and future expenses;
- our ability to successfully offer our live chat software as a standalone service or further integrate it with our customer service platform;
- our ability to integrate We Are Cloud SAS with our existing corporate operations, to sell our analytics software as a standalone service and to integrate our analytics 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;
- worldwide economic conditions and their impact on information technology spending;
- our ability to securely maintain customer data; and
- our ability to maintain and enhance our brand.

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.

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

ZENDESK, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value and shares)

	September 30, 2015 (Unaudited)	December 31, 2014
Assets		
Current Assets:		
Cash and cash equivalents	$ 255,386	$ 80,265
Marketable securities	25,247	42,204
Accounts receivable, net of allowance for doubtful accounts of $1,070 and $264 as of September 30, 2015 and December 31, 2014, respectively	24,121	11,523
Prepaid expenses and other current assets	9,904	5,013
Total current assets	314,658	139,005
Marketable securities, noncurrent	22,513	9,205
Property and equipment, net	52,747	41,895
Goodwill and intangible assets, net	11,888	14,152
Other assets	2,450	1,531
Total assets	$ 404,256	$ 205,788
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$ 4,390	$ 4,763
Accrued liabilities	10,445	7,841
Accrued compensation and related benefits	11,872	11,738
Deferred revenue	74,295	50,756
Current portion of credit facility	—	3,041
Current portion of capital leases	—	10
Total current liabilities	101,002	78,149
Deferred revenue, noncurrent	1,657	823
Credit facility, noncurrent	—	3,911
Other liabilities	8,966	9,199
Total liabilities	111,625	92,082
Commitments and contingencies (Note 7)		
Stockholders’ equity:		
Preferred stock	—	—
Common stock	887	755
Additional paid-in capital	485,417	246,000
Accumulated other comprehensive loss	(1,578)	(528)

Accumulated deficit	(191,443)	(131,869)
Treasury stock at cost (0.5 million shares as of September 30, 2015 and December 31, 2014)	(652)	(652)
Total stockholders’ equity	292,631	113,706
Total liabilities and stockholders’ equity	$ 404,256	$ 205,788

See Notes to Condensed Consolidated Financial Statements.

ZENDESK, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue	$55,661	$33,910	$146,122	$88,508
Cost of revenue [1]	17,039	11,684	47,491	32,410
Gross profit	38,622	22,226	98,631	56,098
Operating expenses [1]:				
Research and development	16,031	9,550	43,517	25,227
Sales and marketing	29,079	21,548	79,725	56,174
General and administrative	12,319	8,940	33,982	23,639
Total operating expenses	57,429	40,038	157,224	105,040
Operating loss	(18,807)	(17,812)	(58,593)	(48,942)
Other income (expense), net	145	(343)	(428)	(1,252)
Loss before provision for (benefit from) income taxes	(18,662)	(18,155)	(59,021)	(50,194)
Provision for (benefit from) income taxes	262	(236)	554	(272)
Net loss	(18,924)	(17,919)	(59,575)	(49,922)
Accretion of redeemable convertible preferred stock	—	—	—	(18)
Net loss attributable to common stockholders	$(18,924)	$(17,919)	$(59,575)	$(49,940)
Net loss per share attributable to common stockholders, basic and diluted	$(0.22)	$(0.25)	$(0.71)	$(1.07)
Weighted-average shares used to compute net loss per share attributable to common stockholders, basic and diluted	87,777	71,732	83,536	46,751

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Cost of revenue	$1,131	$591	$3,136	$1,691
Research and development	4,974	3,052	13,484	7,530
Sales and marketing	3,786	4,877	10,154	8,635

General and administrative	3,551	2,298	10,283	5,769

See Notes to Condensed Consolidated Financial Statements.

ZENDESK, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Net loss	$(18,924)	$(17,919)	$(59,575)	$(49,922)
Other comprehensive loss, net of tax:				
Net change in unrealized gain (loss) on available-for-sale investments	39	(58)	70	(66)
Foreign currency translation gain (loss)	(781)	(303)	(1,019)	17
Net change in unrealized loss on derivative instruments	(101)	—	(101)	—
Comprehensive loss	$(19,767)	$(18,280)	$(60,625)	$(49,971)

See Notes to Condensed Consolidated Financial Statements.

ZENDESK, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended September 30, 2015	Nine Months Ended September 30, 2014
Cash flows from operating activities		
Net loss	$(59,575)	$(49,922)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	13,672	7,673
Share-based compensation	37,057	23,625
Other	525	331
Excess tax benefit from share-based award activity	(124)	—
Changes in operating assets and liabilities:		
Accounts receivable	(13,082)	(5,104)
Prepaid expenses and other current assets	(4,161)	(1,960)
Other assets and liabilities	(1,622)	1,321
Accounts payable	(1,919)	591
Accrued liabilities	2,261	922
Accrued compensation and related benefits	(2,355)	5,215
Deferred revenue	24,372	17,290
Net cash used in operating activities	(4,951)	(18)
Cash flows from investing activities		
Purchases of property and equipment	(14,231)	(19,121)
Internal-use software development costs	(3,548)	(6,268)
Purchases of marketable securities	(56,991)	(43,006)
Proceeds from maturities of marketable securities	30,425	6,950
Proceeds from sale of marketable securities	29,650	—
Cash paid for the acquisition of Zopim, net of cash acquired	(1,099)	(1,896)
Net cash used in investing activities	(15,794)	(63,341)
Cash flows from financing activities		
Proceeds from initial public offering, net of issuance costs	—	103,110
Proceeds from follow-on public offering, net of issuance costs	190,110	—
Proceeds from exercise of employee stock options	5,773	2,745
Taxes paid related to net share settlement of equity awards	(481)	(1,750)
Proceeds from issuance of common stock from employee stock purchase plan	7,243	2,346
Proceeds from issuance of debt	—	3,940
Excess tax benefit from share-based award activity	124	—
Principal payments on debt	(6,952)	(20,000)
Principal payments on capital lease obligations	(10)	(271)
Net cash provided by financing activities	195,807	90,120
Effect of exchange rate changes on cash and cash equivalents	59	(50)

Net increase in cash and cash equivalents	175,121	26,711
Cash and cash equivalents at the beginning of period	80,265	53,725
Cash and cash equivalents at the end of period	$255,386	$80,436
Supplemental cash flow data:		
Cash paid for interest and income taxes	$710	$930
Non-cash investing and financing activities:		
Purchases of property and equipment in accounts payable and accrued expenses	$3,766	$998
Share-based compensation capitalized in internal-use software development costs	$1,674	$1,856
Vesting of early exercised stock options	$815	$1,196
Property and equipment acquired through tenant improvement allowances	$174	$3,932
Issuance of common stock for the acquisition of Zopim	$—	$10,893

See Notes to Condensed Consolidated Financial Statements.

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 software-as-a-service, or SaaS, customer service platform. Our platform helps organizations engage with people in new ways that foster long-term customer loyalty and satisfaction. We empower organizations to better answer customers' questions, and to solve their problems through the channels that people use every day when seeking help, such as email, chat, voice, social media and websites. Our customer service platform also helps people find answers on their own through knowledge bases and communities, capitalizing on the increasing customer preference for self-service. Our customer engagement capabilities allow organizations to proactively serve their customers, reaching out to those who may need help and soliciting feedback about their experience. The openness of our customer service platform makes it easy for organizations to integrate with their other applications. Our customer service platform consolidates the data from customer interactions and provides organizations with powerful analytics and performance benchmarking.

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, 2014, filed on February 17, 2015. 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, 2014 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, 2015.

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.

Initial Public Offering

In May 2014, we completed our initial public offering, or IPO, in which we issued and sold 12.8 million shares of common stock at a public offering price of $9.00 per share. We received net proceeds of $103.1 million after deducting underwriting discounts and commissions of $8.1 million and other offering expenses of $3.8 million. Upon the closing of the IPO, all shares of our then-outstanding redeemable convertible preferred stock automatically converted into an aggregate of 34.3 million shares of common stock.

Immaterial Error Correction

We corrected an immaterial prior period error on the statement of operations for the nine months ended September 30, 2014 related to the calculation of weighted average shares used to compute net loss per share attributable to common stockholders. As a result of this error, basic and diluted net loss per share attributable to common stockholders decreased by $0.01 for the nine months ended September 30, 2014. The adjustment did not affect any other financial statements presented.

Reclassification

Certain prior year amounts have been reclassified for consistency with the current year presentation. These reclassifications had no effect on the reported results of operations.

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 our common stock (through the date of our IPO) and share-based awards, fair value of acquired intangible assets, goodwill, unrecognized tax benefits, useful lives of intangible assets and property and equipment, and the capitalization and estimated useful life of our capitalized internal-use software.

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, 2015, one customer represented 10% of our total accounts receivable balance. As of December 31, 2014, no customers represented more than 10% of our accounts receivable balance. There were no customers that individually exceeded 10% of our revenue during the three and nine months ended September 30, 2015 or 2014.

Recently Issued and Adopted Accounting Pronouncements

In September 2015, the FASB issued ASU 2015-16 “Simplifying the Accounting for Measurement-Period Adjustments”, which requires that an acquirer in a business combination recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The new standard is required to be applied prospectively. We plan to adopt this guidance in the first quarter of 2016. The adoption of this new standard is not expected to have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09 regarding ASC Topic 606 “Revenue from Contracts with Customers.” This standard 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 issued ASU 2015-14, which deferred the effective date of ASU 2014-09 by one year. Early adoption is permitted. 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 are currently evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

Note 2. Acquisition

On March 21, 2014, we completed the acquisition of Zopim Technologies Pte Ltd., or Zopim, a software development company that provides a SaaS live chat service. As of December 31, 2014, we finalized our purchase accounting after adjustments were made to the preliminary purchase price allocation. The total adjusted acquisition date fair value of consideration transferred was $15.8 million ($4.9 million of cash and $10.9 million of our common stock), which included $1.1 million of cash and $2.4 million of common stock consideration that was held back between 12 and 18 months as partial security for standard indemnification obligations. These hold back amounts were released in equal installments in March and September 2015. The total adjusted purchase price was allocated to 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 attributable to expected synergies from future growth and potential future monetization opportunities, and is not deductible for income tax purposes.

Net tangible liabilities assumed	$(385)
Intangible assets	6,560
Goodwill	9,594
Total purchase price	$15,769

In connection with the acquisition, we also established a retention plan pursuant to which we issued RSUs for 0.9 million shares of our common stock, which vest in three annual installments from the date of acquisition. In addition, we agreed to pay cash in an aggregate amount of $3.0 million in two annual installments from the date of acquisition to Zopim employees in connection with their continued employment, which is recorded as compensation expense over the associated service periods of such employees. In the three months ended March 31, 2015, RSUs for 0.3 million shares of our common stock became vested pursuant to the terms of the retention plan, and we paid the first installment of the cash retention bonus in the amount of $1.5 million.

Pro forma revenue and results of operations have not been presented because the historical results of Zopim were not material to our consolidated financial statements in any period presented.

Note 3. Financial Instruments

Investments

The following tables present information about our financial assets measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014 based on the three-tier fair value hierarchy (in thousands):

	Fair Value Measurement at September 30, 2015		
	Level 1	Level 2	Total
Description			
Corporate securities	$—	$35,736	$35,736
Money market funds	25,368	—	25,368
Asset-backed securities	—	6,030	6,030
Commercial paper	—	3,991	3,991
Agency securities	—	2,003	2,003
Total	$25,368	$47,760	$73,128
Included in cash and cash equivalents			$25,368
Included in marketable securities			$47,760

	Fair Value Measurement at December 31, 2014		
	Level 1	Level 2	Total
Description			
Corporate securities	$—	$40,345	$40,345
Money market funds	21,382	—	21,382
Asset-backed securities	—	5,080	5,080
U.S. treasury securities	—	1,991	1,991
Commercial paper	—	3,993	3,993
Total	$21,382	$51,409	$72,791
Included in cash and cash equivalents			$21,382
Included in marketable securities			$51,409

As of September 30, 2015 and December 31, 2014, there were no securities within Level 3 of the fair value hierarchy. Gross unrealized gains or losses for cash equivalents and available-for-sale marketable securities as of September 30, 2015 and December 31, 2014 were not material. As of September 30, 2015 and December 31, 2014, there were no securities that were in an unrealized loss position for more than 12 months.

The following table classifies our available-for-sale marketable securities by contractual maturities as of September 30, 2015 and December 31, 2014 (in thousands):

	September 30, 2015	December 31, 2014
Due in one year or less	$ 25,247	$ 42,204
Due after one year	22,513	9,205
Total	$ 47,760	$ 51,409

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. Based on borrowing rates available to us for loans with similar terms and maturities, the carrying value of borrowings approximates fair value within Level 2 of the fair value hierarchy.

There were no transfers between fair value measurement levels during the three and nine months ended September 30, 2015.

Derivative Instruments and Hedging

Our foreign currency exposures typically arise from foreign operations and, to a lesser extent, 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 entered into foreign currency forward contracts with certain financial institutions and designated those hedges as cash flow hedges. Our foreign currency forward contracts generally have maturities of fifteen months or less.

These derivative instruments expose us to credit risk to the extent that our counterparties are unable to meet the terms of the arrangement. We seek to mitigate this risk by transacting with major financial institutions with high credit ratings. In addition, we have a master netting agreement with each of our counterparties, which permits net settlement of multiple, separate derivative contracts with a single payment. We may also be required to exchange cash collateral with certain of our counterparties on a regular basis. ASC 815 permits companies to present the fair value of derivative instruments on a net basis according to master netting arrangements. We have elected to present our derivative instruments on a gross basis in our consolidated financial statements.

Cash Flow Hedges

Our foreign currency forward contracts are designated as cash flow hedges of foreign currency forecasted revenues and expenses. We recognize all derivative instruments on our balance sheet at fair value as either assets or liabilities. The effective portion of the gain or loss on each forward contract is reported as a component of accumulated other comprehensive income (loss) and reclassified into earnings to either revenue or operating expense in the same period, or periods, during which the hedged transaction affects earnings. The ineffective portion of the gains or losses, if any, is recorded immediately in other income (expense), net. The change in time value related to our cash flow hedges is excluded from the assessment of hedge effectiveness and is recorded immediately in other income (expense), net. We evaluate the effectiveness of our cash flow hedges on a quarterly basis.

As of September 30, 2015, $0.1 million of unrealized losses related to the effective portion of changes in the fair value of foreign currency forward contracts designated as cash flow hedges were included in the balance of other accumulated comprehensive loss. We expect to reclassify $0.1 million from accumulated other comprehensive loss into earnings over the next twelve months associated with our cash flow hedges.

The following table presents information about our derivative instruments on the consolidated balance sheet as of September 30, 2015 (in thousands):

	September 30, 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	69	Accrued liabilities	163
Foreign currency forward contracts	Other assets	10	Other liabilities	25
Total		$ 79		$ 188

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Our foreign currency contracts are classified within Level 2 because the valuation inputs are based on quoted prices and market observable data of similar instruments in active markets, such as currency spot and forward rates. Our foreign currency forward contracts had a total notional value of $47.6 million as of September 30, 2015. There were no derivative assets or liabilities on our consolidated balance sheet as of December 31, 2014.

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

		Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
Hedging Instrument	Location of Gain (Loss) Reclassified into Earnings	Gain (Loss) Recognized in AOCI	Gain (Loss) Reclassified from AOCI into Earnings	Gain (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)	$ —

There were no gains or losses on derivative instruments for the three and nine months ended September 30, 2014.

All derivatives have been designated as hedging instruments. Amounts recognized in earnings related to excluded time value and hedge ineffectiveness were not material for the three and nine months ended September 30, 2015.

Note 4. Property and Equipment

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

	September 30, 2015	December 31, 2014
Capitalized internal-use software	$ 25,613	$ 18,541
Hosting equipment	24,740	14,085
Leasehold improvements	16,651	15,144
Computer equipment and software	5,949	4,310
Furniture and fixtures	5,092	4,524
Construction in progress	4,575	3,546
Total	82,620	60,150
Less: accumulated depreciation and amortization	(29,873)	(18,255)
Property and equipment, net	$ 52,747	$ 41,895

Depreciation expense was $2.8 million and $1.7 million for the three months ended September 30, 2015 and 2014, respectively, and $7.7 million and $4.0 million for the nine months ended September 30, 2015 and 2014, respectively.

Amortization expense of capitalized internal-use software totaled $1.6 million and $0.9 million for the three months ended September 30, 2015 and 2014, respectively, and $4.6 million and $2.6 million for the nine months ended September 30, 2015 and 2014, respectively. The carrying value of capitalized internal-use software at September 30, 2015 and December 31, 2014 was $14.2 million and $13.6 million, respectively, including $1.7 million and $3.5 million in construction in progress, respectively.

Note 5. Goodwill and Purchased Intangible Assets

The changes in the carrying amount of goodwill for the nine months ended September 30, 2015 are as follows (in thousands):

Balance as of December 31, 2014	$9,240
Foreign currency translation adjustments	(670)
Balance as of September 30, 2015	$8,570

Purchased intangible assets subject to amortization as of September 30, 2015 and December 31, 2014 consist of the following (in thousands).

	September 30, 2015				
	Cost	Accumulated Amortization	Foreign Currency Translation Adjustment	Net	Remaining Useful Life (In years)
Developed technology	$5,200	$ (2,271)	$ (326)	$2,603	2.0
Customer relationships	1,300	(497)	(88)	715	2.5
Trade name	60	(60)	—	—	—
	$6,560	$ (2,828)	$ (414)	$3,318	

	December 31, 2014				
	Cost	Accumulated Amortization	Foreign Currency Translation Adjustment	Net	Remaining Useful Life (In years)
Developed technology	$5,200	$ (1,118)	$ (191)	$3,891	2.7
Customer relationships	1,300	(244)	(48)	1,008	3.2
Trade name	60	(45)	(2)	13	0.2
	$6,560	$ (1,407)	$ (241)	$4,912	

Amortization expense of purchased intangible assets for the three months ended September 30, 2015 and 2014 was $0.4 million and $0.5 million, respectively, and $1.4 million and $1.0 million for the nine months ended September 30, 2015 and 2014, respectively.

Estimated future amortization expense as of September 30, 2015 is as follows (in thousands):

Remainder of 2015	$406
2016	1,610
2017	1,239
2018	63
	$3,318

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 IPO 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.

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 $2.0 million and $1.7 million for the three months ended September 30, 2015 and 2014, respectively, and $5.4 million and $5.2 million for the nine months ended September 30, 2015 and 2014, respectively.

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 contain 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 consolidated financial statements as a result of these service-level agreements.

Note 8. Common Stock and Stockholders’ Equity

Common Stock

Upon the completion of our IPO, we increased the number of shares authorized for issuance from 125 million to 400 million with a par value of $0.01 per share. As of September 30, 2015 and December 31, 2014, there were 89.1 million and 76.1 million shares of common stock issued and 88.5 million and 75.5 million shares outstanding, respectively. Included within the number of shares issued and outstanding were 0.3 million and 0.6 million shares of common stock subject to repurchase, as of September 30, 2015 and December 31, 2014, respectively.

Preferred Stock

As of September 30, 2015 and December 31, 2014, 10 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

Our board of directors adopted the Employee Stock Purchase Plan, or ESPP, in February 2014, which became effective in May 2014 upon the effectiveness of the registration statement related to our IPO. Under the 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. No shares of common stock were purchased under the ESPP during the three months ended September 30, 2015. For the nine months ended September 30, 2015, 0.6 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 0.8 million shares on January 1, 2015. As of September 30, 2015, 3.4 million shares of common stock were available for issuance under the ESPP.

Stock Option and Grant 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, 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 3.8 million shares on January 1, 2015. As of September 30, 2015, we had 6.0 million shares of common stock available for future grants under the 2014 Plan.

The following table summarizes our stock option and RSU award activities for the nine months ended September 30, 2015 (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 (In years)	Aggregate Intrinsic Value	Outstanding RSUs	Weighted Average Grant Date Fair Value
Outstanding — January 1, 2015	7,560	12,043	$ 7.39	8.29	$ 204,467	3,064	$ 13.69
Increase in authorized shares	3,779						
Stock options granted	(2,009)	2,009	24.25				
RSUs granted	(3,775)					3,775	22.83
Stock options exercised		(2,308)	2.50				
RSUs vested						(1,290)	16.20
Unvested shares repurchased	2						
Stock options forfeited or canceled	67	(67)	4.36				
RSUs forfeited or cancelled	332					(332)	18.75
Outstanding — September 30, 2015	5,956	11,677	$ 11.28	$ 8.12	$ 98,481	5,217	$ 19.36

Aggregate intrinsic value represents the difference between our closing stock price of its 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, 2015 was $19.71.

As of September 30, 2015, we had a total of $145.8 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 3.1 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, 2015 and December 31, 2014, there were 0.3 million and 0.6 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 $1.3 million and $2.1 million, respectively.

Note 9. Net Loss Per Share

We compute net loss per share of common stock in conformity with the two-class method required for participating securities. We considered all series of the redeemable convertible preferred stock to be participating securities as the holders of the preferred stock were entitled to receive a non-cumulative dividend on a pari passu basis in the event that a dividend is paid on common stock. We also consider shares of common stock issued upon the early exercise of stock options subject to repurchase to be participating securities, because holders of such shares have non-forfeitable dividend rights in the event a dividend is paid on common stock. The holders of all series of the redeemable convertible preferred stock and the holders of shares of common stock acquired upon early exercise of stock options do not have a contractual obligation to share in our losses. As such, our net losses for the three and nine months ended September 30, 2015 and 2014 were not allocated to these participating securities. Upon the closing of the IPO in May 2014, all shares of our then-outstanding redeemable convertible preferred stock automatically converted into our common stock.

Basic net loss per share attributable to common stockholders is computed by dividing the net loss attributable to common stockholders by the weighted-average number of shares of common stock outstanding during the period, less the weighted-average unvested common stock subject to repurchase. Diluted net loss per share is computed by giving effect to all potential shares of common stock, including common stock issuable upon conversion of the redeemable convertible preferred stock, outstanding share-based awards, and outstanding warrants, to the extent dilutive. Basic and diluted net loss per share was 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		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Net loss	$(18,924)	$(17,919)	$(59,575)	$(49,922)
Less: Accretion of redeemable convertible preferred stock	—	—	—	(18)
Net loss attributable to common stockholders	$(18,924)	$(17,919)	$(59,575)	$(49,940)
Basic shares:				
Weighted-average shares used to compute basic net loss per share	87,777	71,732	83,536	46,751
Diluted shares:				
Weighted-average shares used to compute diluted net loss per share	87,777	71,732	83,536	46,751
Net loss per share attributable to common stockholders:				
Basic and diluted	$(0.22)	$(0.25)	$(0.71)	$(1.07)

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,	
	2015	2014
Shares subject to outstanding common stock options and employee stock purchase plan	12,067	14,521
Restricted stock units	5,217	2,944
	17,284	17,465

Note 10. Income Taxes

The effective tax rates for the three and nine months ended September 30, 2015 and 2014 were less than 2%. The effective tax rate differs 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. There were no material changes to the unrecognized tax benefits during the three and nine months ended September 30, 2015 and 2014.

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 areas, as determined based on the billing address of our customers (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
United States	$31,388	$19,031	$81,094	$50,774
EMEA	15,397	9,704	41,434	24,565
Other	8,876	5,175	23,594	13,169
Total	$55,661	$33,910	$146,122	$88,508

Long-Lived Assets

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

	As of September 30, 2015	As of December 31, 2014
United States	$ 25,223	$ 22,817
EMEA	10,304	4,373
Other	3,031	1,095
Total	$ 38,558	$ 28,286

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

Note 12. Subsequent Event

On October 13, 2015, we completed the acquisition of We Are Cloud SAS, or WAC, the maker of BIME Analytics software. We acquired 100 percent of the outstanding shares of WAC in exchange for purchase consideration of $45.0 million in cash, subject to 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 to be released 12 months following the closing of the acquisition. We have also entered into retention arrangements pursuant to which we have issued restricted stock unit awards for an aggregate of approximately 0.5 million shares of our common stock, subject to vesting based on continued employment. The acquisition will be accounted for as a business combination. We are in the process of evaluating the impact of the business combination on our consolidated financial statements.

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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, 2014, filed with the SEC on February 17, 2015. 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 pricing based on functionality, the type and, for our customer service platform, the amount of product support we offer and service-level guarantees.

Our largest source of qualified sales leads is free trials of our customer service platform commenced by prospects, many of which come from organic search, customer referrals, and other unpaid sources. 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. We have field sales and marketing teams primarily responsible for lead discovery, qualification, and account management for larger organizations. Many of our existing customers to date have been small to medium sized organizations that make purchasing decisions with limited interaction with our sales or other personnel; as we continue to focus on and become more dependent on sales to larger organizations and increase our investment in paid sources of qualified leads, we expect paid sources of qualified leads to become a greater percentage of our total sources of qualified leads and our sales cycles to lengthen and become less predictable.

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 expect to continue to sell our analytics software on a standalone basis.

For the three months ended September 30, 2015 and 2014, our revenue was $55.7 million and $33.9 million, respectively, representing a 64% growth rate. For the nine months ended September 30, 2015 and 2014, our revenue was $146.1 million and $88.5 million, respectively, representing a 65% growth rate. For the three months ended September 30, 2015 and 2014 we derived $24.3 million, or 44% and $14.9 million, or 44%, respectively, of our revenue from customers located outside of the United States. For the nine months ended September 30, 2015 and 2014 we derived $65.0 million, or 44% and $37.7 million, or 43%, 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, 2015 and 2014, we generated net losses of $18.9 million and $17.9 million, respectively. For the nine months ended September 30, 2015 and 2014, we generated net losses of $59.6 million and $49.9 million, respectively. We intend to invest aggressively to drive continued growth and market leadership.

The growth of our business and our future success depends 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 enterprise 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 expand our operations and headcount in the near term. The expected addition of new personnel and the investments that we anticipate will be necessary to manage our anticipated growth, including investments in additional capacity in data centers, 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 experiencing any direct benefit and will make it difficult to determine if we are allocating our resources efficiently.

We have focused on rapidly growing our business and plan to continue to invest for long-term growth. We expect to continue to invest in additional data center capacity and personnel to support our growth. The amount and timing of these investments will vary based on our estimates of projected growth. We also expect to continue to grow our customer support organization including expanding our product support and professional services teams. While we have moved significant portions of the hosting for our core platform to self-managed colocation data centers, improvements to our gross margin from such move have been partially offset by other hosting expenses, primarily related to the support of our platform infrastructure. Over time, we anticipate that we will continue to gain economies of scale by utilizing capacity within our self-managed colocation data centers, efficient use of other hosting resources, and reducing the need for direct incremental personnel costs resulting from growth in our number of customers. 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, and facilities to support our platform architecture, increased share-based compensation expenses, as well as the amortization of costs associated with capitalized internal-use software and purchased intangible assets.

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 enterprise customer base. We also expect 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 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 users, and we refer to each such user as an “agent”, 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 had approximately 64,300 paid customer accounts as of September 30, 2015, including approximately 32,700 paid customer accounts on our customer service platform and approximately 31,600 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.

Prior to December 31, 2014, we measured the number of customer accounts on our customer service platform, defined as the number of accounts on our customer service platform, exclusive of free trials or other free services, but including our low cost Starter plan, as of the end of specified periods as identified by a unique account identifier. We believe that including the number of paid customer accounts for both our customer service platform and our live chat software in the number of paid customer accounts, while eliminating our Starter plan from this metric, provides an operating metric that reflects the customer accounts that have the most impact on our operating results.

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. 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, and results in upgrades to higher-priced subscription plans. 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. We assess our performance in this area by measuring 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 service platform, and upgrades in subscription plan, as offset by churn, contraction in authorized agents associated with a paid customer account on our customer service platform, and downgrades in subscription plans. We do not currently incorporate operating metrics associated with our live chat 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. 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 United States generally accepted accounting principles, or 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 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 is used to determine our base revenue. Giving effect to this consolidation results in our dollar-based net expansion rate being calculated across approximately 29,900 customers, as compared to the approximately 32,700 total paid customer accounts as of September 30, 2015. 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 and paid customer accounts associated with reseller and other similar channel arrangements.

Beginning with the quarter ended December 31, 2014, we adjusted our calculation of dollar-based net expansion rate to exclude customer accounts on the low cost Starter plan for our customer service platform. In prior periods, we presented a dollar-based net expansion rate, or the historic dollar-based net expansion rate, which included customer accounts on our low-cost Starter subscription plan for our customer service platform. We calculated the historic dollar-based net expansion rate in the same manner as our current calculation of the dollar-based net expansion rate, with the exception that the customer base used in the determination of retained revenue net of contraction and churn and base revenue included the customer accounts on our Starter subscription plan while our current calculation of dollar-based net expansion rate excludes these accounts. While relatively insignificant, we believe that the exclusion of subscriptions to our Starter plan from our calculation of net dollar expansion provides a more useful measure of the effectiveness of resources we deploy to expand our relationships with existing customers.

Our dollar-based net expansion rate was 125% as of September 30, 2015. We expect our dollar-based net expansion rate to decline over time as our aggregate monthly recurring revenue grows.

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 software. Each subscription may have multiple authorized agents, ranging 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 that vary in pricing based on functionality and, for our customer service platform, the type and amount of product support, and service-level commitments. Certain arrangements provide for unlimited usage for a fixed fee or 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 frequency. Due to our mixed contract lengths and billing frequencies, the annualized value of the arrangements we enter into with our customers may not be fully reflected in deferred revenue at any single point in time. Accordingly, we do not believe that the change in deferred revenue for any period is an accurate indicator of future revenue for a given period of time.

We derive an immaterial amount of revenue from implementation, voice, 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 and our product support organizations, depreciation, hosting, and other expenses associated with our data centers, amortization expense associated with capitalized internal-use software, payment processing fees, third party license fees, amortization expense associated with purchased 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.

Currently, we primarily 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. Our live chat software was originally hosted in a managed hosting facility in Florida and in January 2015, we migrated all accounts to our self-managed colocation facility in Ireland. In addition, we utilize third-party managed hosting facilities located in North America, Europe, and Asia to support our platform infrastructure and for certain research and development purposes. We intend to increase capacity in self-managed colocation data center and/or with third-party managed hosting services over time to support our growth.

We intend to continue to invest additional resources in our platform infrastructure and our product support organizations. As we continue to invest in technology innovation, we expect to have increased capitalized internal-use software costs and related amortization. We expect our investment in technology to not only expand the capability of our customer service platform, live chat software, and analytics software but also 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. We expect third- party license fees for technology that is incorporated in certain of our subscription plans to remain significant over time as we increase the number of customers using such subscription plans and take steps necessary to secure long term access to such technology.

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, and facilities to support our platform architecture, increased share-based compensation expenses, as well as the amortization of costs associated with capitalized internal-use software and purchased intangible assets.

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 of these products and services. We expect that, in the future, research and development expenses will increase in absolute dollars, but will fluctuate as a percentage of our revenue depending on fluctuations in revenue and the timing, extent and nature of our research and development expenses. In particular, these expenses are sensitive to the impact of share-based compensation which may cause these expenses to fluctuate from period to period.

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.

We focus our sales and marketing efforts on generating awareness of our company, creating sales leads, 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 direct sales employees, developing our field sales and 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. In particular, these expenses are sensitive to the impact of share-based compensation which may cause these expenses to fluctuate from period to period.

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, and tax related services fees, insurance costs, board of directors’ compensation and costs of achieving and maintaining compliance with Section 404 of the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, executing significant transactions, including 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. In particular, these expenses are sensitive to the impact of share-based compensation which may cause these expenses to fluctuate from period to period.

Other Expense, Net

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

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,	
	2015	2014	2015	2014
Revenue	$55,661	$33,910	$146,122	$88,508
Cost of revenue [(1)]	17,039	11,684	47,491	32,410
Gross profit	38,622	22,226	98,631	56,098
Operating expenses [(1)]:				
Research and development	16,031	9,550	43,517	25,227
Sales and marketing	29,079	21,548	79,725	56,174
General and administrative	12,319	8,940	33,982	23,639
Total operating expenses	57,429	40,038	157,224	105,040
Operating loss	(18,807)	(17,812)	(58,593)	(48,942)
Other income (expense), net	145	(343)	(428	