Zendesk, Inc.
Form 10-Q
May 04, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2018
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 001-36456

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, CA	94103
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (415) 418-7506

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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No x
As of April 30, 2018, there were 104,553,831 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 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 products, and our ability to optimize the pricing for such products;
- the evolution of technology affecting our products, 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 introduce and market new products and to integrate such products into our infrastructure;
- 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 service the interest on our convertible notes and repay such notes, if required;
- 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)

	March 31, 2018 (Unaudited)	December 31, 2017 * As adjusted
Assets		
Current assets:		
Cash and cash equivalents	$609,229	$109,370
Marketable securities	128,751	137,576
Accounts receivable, net of allowance for doubtful accounts of $1,445 and $1,252 as of March 31, 2018 and December 31, 2017, respectively	52,738	57,096
Deferred costs	17,010	15,771
Prepaid expenses and other current assets	29,412	24,165
Total current assets	837,140	343,978
Marketable securities, noncurrent	121,754	97,447
Property and equipment, net	61,000	59,157
Deferred costs, noncurrent	16,851	15,395
Goodwill and intangible assets, net	66,316	67,034
Other assets	9,462	8,359
Total assets	$1,112,523	$591,370
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$6,586	$5,307
Accrued liabilities	37,633	21,876
Accrued compensation and related benefits	33,142	29,017
Deferred revenue	183,936	173,147
Total current liabilities	261,297	229,347
Convertible senior notes, net	439,953	—
Deferred revenue, noncurrent	1,334	1,213
Other liabilities	9,286	6,626
Total liabilities	711,870	237,186
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock	—	—
Common stock	1,042	1,031
Additional paid-in capital	830,741	753,568
Accumulated other comprehensive loss	(3,762)	(2,372)
Accumulated deficit	(427,368)	(398,043)
Total stockholders' equity	400,653	354,184
Total liabilities and stockholders' equity	$1,112,523	$591,370

* See Note 1 for a summary of adjustments.

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 March 31,	
	2018	2017 *As adjusted
Revenue	$129,791	$93,888
Cost of revenue (1)	39,056	28,107
Gross profit	90,735	65,781
Operating expenses (1):		
Research and development	37,085	26,456
Sales and marketing	65,058	46,269
General and administrative	22,207	18,317
Total operating expenses	124,350	91,042
Operating loss	(33,615)	(25,261)
Other income, net	1,000	218
Loss before provision for (benefit from) income taxes	(32,615)	(25,043)
Provision for (benefit from) income taxes	(3,290)	38
Net loss	$(29,325)	$(25,081)
Net loss per share, basic and diluted	$(0.28)	$(0.26)
Weighted-average shares used to compute net loss per share, basic and diluted	103,692	97,475

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

	Three Months Ended March 31,	
	2018	2017 * As adjusted
Cost of revenue	$3,098	$ 2,104
Research and development	10,231	6,914
Sales and marketing	8,007	5,524
General and administrative	5,652	4,562

* See Note 1 for a summary of adjustments.

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 March 31,	
	2018	2017 * As adjusted
Net loss	$(29,325)	$(25,081)
Other comprehensive gain (loss), before tax:		
Net unrealized gain (loss) on available-for-sale investments	(636)	119
Foreign currency translation gain (loss)	(12)	576
Net unrealized gain (loss) on derivative instruments	(742)	1,526
Other comprehensive gain (loss), before tax	(1,390)	2,221
Tax effect	—	(816)
Other comprehensive gain (loss), net of tax	(1,390)	1,405
Comprehensive loss	$(30,715)	$(23,676)

* See Note 1 for a summary of adjustments.

See Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2018	2017 * As adjusted
Cash flows from operating activities		
Net loss	$(29,325)	$(25,081)
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation and amortization	9,865	7,923
Share-based compensation	26,988	19,104
Amortization of deferred costs	4,510	3,179
Amortization of debt discount and issuance costs	720	—
Other	250	697
Changes in operating assets and liabilities:		
Accounts receivable	3,691	(2,316)
Prepaid expenses and other current assets	(3,364)	(380)
Deferred costs	(7,043)	(4,102)
Other assets and liabilities	(12,027)	(332)
Accounts payable	1,052	1,958
Accrued liabilities	10,986	2,524
Accrued compensation and related benefits	(971)	(2,596)
Deferred revenue	10,910	6,704
Net cash provided by operating activities	16,242	7,282
Cash flows from investing activities		
Purchases of property and equipment	(6,808)	(4,791)
Internal-use software development costs	(2,344)	(1,852)
Purchases of marketable securities	(78,321)	(40,758)
Proceeds from maturities of marketable securities	55,263	31,654
Proceeds from sales of marketable securities	6,982	8,602
Net cash used in investing activities	(25,228)	(7,145)
Cash flows from financing activities		
Proceeds from issuance of convertible senior notes, net of issuance costs paid of $12,937	562,063	—
Purchase of capped call related to convertible senior notes	(63,940)	—
Proceeds from exercises of employee stock options	6,193	11,689
Proceeds from employee stock purchase plan	5,096	3,844
Taxes paid related to net share settlement of share-based awards	(734)	(154)
Net cash provided by financing activities	508,678	15,379
Effect of exchange rate changes on cash, cash equivalents and restricted cash	(35)	198
Net increase in cash, cash equivalents and restricted cash	499,657	15,714
Cash, cash equivalents and restricted cash at beginning of period	110,888	95,062
Cash, cash equivalents and restricted cash at end of period	$610,545	$110,776
Reconciliation of cash, cash equivalents and restricted cash to condensed consolidated balance sheets		
Cash and cash equivalents	$609,229	$109,258

Restricted cash included in prepaid expenses and other current assets	682	1,075
Restricted cash included in other assets	634	443
Total cash, cash equivalents and restricted cash	$610,545	$110,776
Supplemental cash flow data		
Cash paid for income taxes and interest	$918	$196
Non-cash investing and financing activities		
Balance of property and equipment in accounts payable and accrued expenses	$3,504	$1,460
Property and equipment acquired through tenant improvement allowances	$1,370	$—
Share-based compensation capitalized in internal-use software development costs	$850	$694
Estimated convertible senior notes offering costs incurred but not yet paid	$850	$—
Vesting of early exercised stock options	$—	$115

*See Note 1 for a summary of adjustments.

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.

We are a software development company that provides software as a service, or SaaS, products that are intended to help organizations and their customers build better relationships. With our origins in customer service, we have evolved our offerings over time to a family of products that work together to help organizations understand their customers, improve communications, and engage where and when it's needed most. Our product family is built upon a modern architecture that enables us and our customers to rapidly innovate, adapt our technology in novel ways, and easily integrate with other products and applications.

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, 2017, filed with the SEC on February 22, 2018. 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, except as described below.

Effective January 1, 2018, we adopted the requirements of Accounting Standards Update, or ASU 2014-09, "Revenue from Contracts with Customers" regarding Accounting Standards Codification, or ASC, Topic 606 and ASU 2016-18, "Statement of Cash Flows, Restricted Cash," as discussed below. All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standards, as indicated by "as adjusted."

The unaudited consolidated balance sheet as of December 31, 2017 included herein was derived from the audited financial statements as of that date, giving effect to the adoption of ASC 606, as discussed below. The unaudited condensed consolidated financial statements reflect all normal recurring adjustments necessary to present fairly our financial position, results of operations, 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, 2018.

Use of Estimates

The preparation of our 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 as well as unrecognized tax benefits, the useful lives of acquired intangible assets and property and equipment, the capitalization and estimated useful life of capitalized costs to obtain customer contracts and capitalized internal-use software, variable consideration related to revenue recognition, 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.

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Concentrations of Risk

As of March 31, 2018, 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 months ended March 31, 2018 or 2017.

Recently Issued Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board, or FASB, issued ASU 2016-02, regarding ASC Topic 842 “Leases,” including subsequent amendments. This new guidance requires lessees to recognize most leases on their balance sheets as right-of-use assets with corresponding lease liabilities 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 in the process of identifying the population of potential lease arrangements and evaluating these arrangements in the context of the new guidance. While we continue to evaluate the effect of adoption on our consolidated financial statements, we expect the adoption will result in the recognition of right-of-use assets and lease liabilities that were not previously recognized, which will increase total assets and liabilities on our consolidated balance sheet.

In August 2017, the FASB issued ASU 2017-12, regarding ASC Topic 815 “Derivatives and Hedging.” This amendment simplifies various aspects of hedge accounting, including measurement and presentation of hedge ineffectiveness and certain documentation and assessment requirements. The amendment also makes more hedging strategies eligible for hedge accounting. The 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 February 2018, the FASB issued ASU 2018-02, “Income Statement - Reporting Comprehensive Income,” which provides for the reclassification of the effect of remeasuring deferred tax balances related to items within accumulated other comprehensive income to retained earnings resulting from the Tax Cuts and Jobs Act, or Tax Act. The 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.

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued new revenue guidance under ASU 2014-09 that provides principles for recognizing revenue when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for the promised goods or services provided to customers. ASC 606 and ASC 340-40 also require the deferral of incremental costs of obtaining contracts with customers and subsequent amortization of those costs over the period of anticipated benefit. Collectively, we refer to this guidance as “ASC 606.” We adopted ASC 606 on January 1, 2018, utilizing the full retrospective method of transition. The adoption resulted in changes to our accounting policies for revenue recognition and incremental costs to acquire contracts, as described below. We applied ASC 606 using the following practical expedients:

- consideration allocated to the remaining performance obligations and an explanation of when we expect to recognize that amount as revenue is not disclosed for comparative periods prior to the adoption date;
- completed contracts that included variable consideration utilize the final transaction price rather than an estimation of variable consideration for comparative periods prior to the adoption date; and
- costs of obtaining contracts with customers are expensed when the amortization period would have been one year or less.

The effect of adopting ASC 606 on our 2017 and 2016 revenues was not material. The primary effect relates to the deferral of sales commissions and other incremental costs to acquire contracts, which we historically expensed as incurred. The impact of adoption is summarized in the tables below. Under ASC 606, all incremental costs to acquire contracts are capitalized and amortized on a straight-line basis over the anticipated period of benefit, which we have determined to be three years.

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

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period. We adopted this standard in the first quarter of 2018. The adoption did not have an effect on our consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows - Restricted Cash," which requires entities to show the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. We adopted this standard in the first quarter of 2018 on a retrospective basis, resulting in an immaterial change to our previously reported statements of cash flows for the three months ended March 31, 2017, which is summarized in the table below.

In January 2017, the FASB issued ASU 2017-01, "Business Combinations - Clarifying the Definition of a Business," which clarifies the definition of a business when evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. We adopted this standard in the first quarter of 2018. The adoption did not have an effect on our consolidated financial statements.

In March 2018, the FASB issued ASU 2018-05, which amends ASC Topic 740 "Income Taxes" to conform with SEC Staff Accounting Bulletin 118, issued in December 2017. The guidance was issued to address the application of GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Cuts and Jobs Act. The standard is effective upon issuance. Additional work is necessary for a more detailed analysis of our deferred tax assets and liabilities and our historical foreign earnings as well as potential correlative adjustments. We are continuing our analysis and expect to finalize our assessment by the fourth quarter of 2018.

We adjusted our condensed consolidated financial statements from amounts previously reported due to the adoption of ASC 606 and ASU 2016-18. Select unaudited condensed consolidated balance sheet line items, which reflect the adoption of ASC 606 are as follows (in thousands):

	December 31, 2017		
	As Previously Reported	Adjustments	As Adjusted
Assets			
Deferred costs	$—	$ 15,771	$15,771
Deferred costs, noncurrent	—	15,395	15,395
Liabilities and stockholders' equity			
Deferred revenue	$174,524	$ (1,377)	$173,147
Accumulated deficit	$(430,586)	$ 32,543	$(398,043)

Select unaudited condensed consolidated statement of operations line items, which reflect the adoption of ASC 606 are as follows (in thousands):

	Three Months Ended March 31, 2017		
	As Previously Reported	Adjustments	As Adjusted
Revenue	$93,007	$ 881	$93,888
Operating expenses:			
Sales and marketing	47,301	(1,032)	46,269
Operating loss	(27,174)	1,913	(25,261)
Net loss	$(26,994)	$ 1,913	$(25,081)
Net loss per share, basic and diluted	$(0.28)	$ 0.02	$(0.26)

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Select unaudited condensed consolidated statement of cash flows line items, which reflect the adoption of ASC 606 and ASU 2016-18 are as follows (in thousands):

	Three Months Ended March 31, 2017		
	As Previously Reported	Adjustments	As Adjusted
Cash flow from operating activities			
Net loss	$(26,994)	$ 1,913	$(25,081)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Share-based compensation	19,213	(109)	19,104
Amortization of deferred costs	—	3,179	3,179
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(513)	133	(380)
Deferred costs	—	(4,102)	(4,102)
Deferred revenue	7,585	(881)	6,704
Net cash provided by operating activities	7,149	133	7,282
Net increase in cash, cash equivalents and restricted cash	15,581	133	15,714
Cash, cash equivalents and restricted cash at beginning of period	93,677	1,385	95,062
Cash, cash equivalents and restricted cash at end of period	$109,258	$ 1,518	$110,776

We have also updated our significant accounting policies in connection with the adoption of ASC 606:

Revenue Recognition

We generate substantially all of our revenue from subscription services, which are comprised of subscription fees from customer accounts on Zendesk Support and, to a lesser extent, Chat, Talk and Guide. In addition, we generate revenue by providing additional features to certain of our subscription plans for a fee that is incremental to the base subscription rate for such plans. Subscription service arrangements are generally non-cancelable and do not provide for refunds to customers in the event of cancellations or any other right of return. We record revenue net of sales or excise taxes.

We derive an immaterial amount of revenue from implementation and training services, for which we recognize revenue upon completion. We also derive an immaterial amount of revenue from Talk credits, for which we recognize revenue based on usage.

Revenues are recognized when control of these services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services.

We determine revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations in the contract
- Determination of the transaction price
- Allocation of the transaction price to the performance obligations in the contract
- Recognition of revenue when, or as, the performance obligation is satisfied

Subscription revenue is recognized on a ratable basis over the contractual subscription term of the arrangement beginning on the date that our service is made available to the customer. Payments received in advance of services being rendered are recorded as deferred revenue.

In limited circumstances, certain customers have arrangements that provide for a maximum number of users over the subscription term, with usage measured monthly. Incremental fees are incurred when the maximum number of users is

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exceeded. In determining the transaction price for these arrangements, we evaluate the expected usage pattern to estimate any incremental fees that we are entitled to throughout the subscription term and recognize revenue ratably over the subscription term. In making these assessments, we constrain our estimates based on factors that could lead to a probable reversal of revenue.

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

Costs to Obtain Customer Contracts

Sales commissions and related expenses are considered incremental and recoverable costs of acquiring customer contracts. These costs are capitalized and amortized on a straight-line basis over the anticipated period of benefit, which we have estimated to be three years. We determined the period of benefit by taking into consideration the length of our customer contracts, our technology lifecycle, and other factors. Amortization expense is recorded in sales and marketing expense within our consolidated statement of operations.

Deferred Revenue

We invoice customers for subscriptions to our products in monthly, quarterly, or annual installments. Deferred revenue consists primarily of customer billings made in advance of performance obligations being satisfied and revenue being recognized. The term between invoicing and when payment is due is not significant and we do not provide financing arrangements to customers. Deferred revenue associated with performance obligations that are anticipated to be satisfied, and thus revenue recognized, during the succeeding 12-month period is recorded as current deferred revenue and the remaining portion is recorded as noncurrent deferred revenue. Deferred revenue associated with implementation, Talk usage, and training services was immaterial as of December 31, 2017 and March 31, 2018.

We invoice customers based on billing schedules established in our contracts. Accounts receivable are recorded when the right to consideration becomes unconditional.

Note 2. Business Combination

On April 27, 2017, we completed the acquisition of Outbound Solutions, Inc., or Outbound, a provider of software that enables companies to deliver intelligent, behavior-based messages across multiple channels. We acquired Outbound for purchase consideration of $16.6 million in cash.

The total purchase consideration 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 growth from the expansion of the scope of and market opportunity for our products. Goodwill is not 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.

Net tangible assets acquired	$96
Net deferred tax liability recognized	(492)
Identifiable intangible assets:	
Developed technology	3,200
Customer relationships	410
Goodwill	13,350
Total purchase price	$16,564

The developed technology and customer relationship intangible assets were assigned useful lives of 6.5 and 3.5 years, respectively.

From the date of the acquisition, the results of operations of Outbound have been included in and are immaterial to our consolidated financial statements. Pro forma revenue and results of operations have not been presented because the historical results of Outbound are not material to our consolidated financial statements in any period presented.

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Note 3. Financial Instruments

Investments

The following tables present information about our financial assets measured at fair value on a recurring basis based on the three-tier fair value hierarchy (in thousands):

	Fair Value Measurement at March 31, 2018		
	Level 1	Level 2	Total
Description			
Money market funds	$374,729	$—	$374,729
Corporate bonds	—	170,795	170,795
Commercial paper	—	33,495	33,495
Asset-backed securities	—	31,533	31,533
U.S. treasury securities	—	17,789	17,789
Agency securities	—	14,914	14,914
Total	$374,729	$268,526	$643,255
Included in cash and cash equivalents			$392,750
Included in marketable securities			$250,505

	Fair Value Measurement at December 31, 2017		
	Level 1	Level 2	Total
Description			
Corporate bonds	$—	$149,069	$149,069
Money market funds	32,832	—	32,832
U.S. treasury securities	—	28,382	28,382
Asset-backed securities	—	27,738	27,738
Commercial paper	—	19,622	19,622
Agency securities	—	14,911	14,911
Total	$32,832	$239,722	$272,554
Included in cash and cash equivalents			$37,531
Included in marketable securities			$235,023

As of March 31, 2018 and December 31, 2017, there were no securities within Level 3 of the fair value hierarchy. There were no transfers between fair value measurement levels during the three months ended March 31, 2018. Gross unrealized gains and losses for cash equivalents and marketable securities as of March 31, 2018 and December 31, 2017 were not material. Unrealized losses for securities that have been in an unrealized loss position for more than 12 months as of March 31, 2018 and December 31, 2017 were not material.

The following table classifies our marketable securities by contractual maturity (in thousands):

	March 31, 2018	December 31, 2017
Due in one year or less	$128,751	$137,576
Due after one year	121,754	97,447
Total	$250,505	$235,023

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

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Derivative Instruments and Hedging

Our foreign currency exposures typically arise from expenditures associated with foreign operations and sales in foreign currencies of our products. To mitigate the effect 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 March 31, 2018, the balance of accumulated other comprehensive loss included an unrecognized net gain of $0.2 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 a net gain of $0.4 million into earnings over the next 12 months associated with our cash flow hedges.

The following tables present information about our derivative instruments on our consolidated balance sheets (in thousands):

	March 31, 2018			
	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	$2,716	Accrued liabilities	$1,945
Total		$2,716		$1,945

	December 31, 2017			
	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	$2,359	Accrued liabilities	$1,220
Total		$2,359		$1,220

Our foreign currency forward contracts had a total notional value of $174.2 million and $139.7 million as of March 31, 2018 and December 31, 2017, respectively. We have a master netting arrangement 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. As of March 31, 2018 and December 31, 2017, there was no cash collateral posted with counterparties.

The following table presents information about our derivative instruments on our condensed consolidated statements of operations (in thousands):

		Three Months Ended March 31, 2018		Three Months Ended March 31, 2017	
Hedging Instrument	Location of Gain (Loss) Reclassified into Earnings	Gain Recognized in AOCI	Gain Reclassified from AOCI into Earnings	Gain Recognized in AOCI	Loss Reclassified from AOCI into Earnings
Foreign currency forward contracts	Revenue, cost of revenue, operating expenses	$319	$ 1,061	$993	$ (533)

Total	$319	$ 1,061	$993	$ (533)

All derivatives have been designated as hedging instruments. Amounts recognized in earnings related to excluded time value and hedge ineffectiveness for the three months ended March 31, 2018 and 2017 were not material.

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Convertible Senior Notes

As of March 31, 2018, the fair value of our convertible senior notes was $587.2 million. The fair value was determined based on the quoted price of the convertible senior notes in an inactive market on the last trading day of the reporting period and has been classified as Level 2 in the fair value hierarchy.

Note 4. Costs to Obtain Customer Contracts

The balances of deferred costs to obtain customer contracts were $33.9 million and $31.2 million as of March 31, 2018 and December 31, 2017, respectively. Amortization expense for these deferred costs was $4.5 million and $3.2 million for the three months ended March 31, 2018 and 2017, respectively. There was no impairment loss related to these deferred costs for the periods presented.

Note 5. Property and Equipment

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

	March 31, 2018	December 31, 2017
Hosting equipment	$36,410	$37,222
Capitalized internal-use software	33,103	31,593
Leasehold improvements	29,066	28,113
Computer equipment and licensed software and patents	17,955	16,316
Furniture and fixtures	9,902	9,581
Construction in progress	16,531	11,220
Total	142,967	134,045
Less: accumulated depreciation and amortization	(81,967)	(74,888)
Property and equipment, net	$61,000	$59,157

Depreciation expense was $6.3 million and $4.8 million for the three months ended March 31, 2018 and 2017, respectively.

Amortization expense of capitalized internal-use software was $1.5 million and $2.1 million for the three months ended March 31, 2018 and 2017, respectively. We recorded an impairment loss of $1.8 million to construction in progress during the three months ended March 31, 2018, which was included within research and development expenses on our consolidated statement of operations. The carrying value of capitalized internal-use software at March 31, 2018 and December 31, 2017 was $17.6 million and $17.7 million, respectively, including $8.7 million of construction in progress for both periods.

Note 6. Goodwill and Acquired Intangible Assets

The balance of goodwill as of March 31, 2018 was $59.1 million and there were no changes in the carrying amount of goodwill for the three months ended March 31, 2018.

Acquired intangible assets subject to amortization consist of the following (in thousands):

	As of March 31, 2018			
	Cost	Accumulated Amortization	Net	Weighted Average Remaining Useful Life
				(In years)
Developed technology	$17,200	$ (10,540)	$6,660	3.5
Customer relationships	2,210	(1,685)	525	2.3
	$19,410	$ (12,225)	$7,185	

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	As of December 31, 2017				
	Cost	Accumulated Amortization	Foreign Currency Translation Adjustments	Net	Weighted Average Remaining Useful Life
					(In years)
Developed technology	$17,200	$ (9,835)	$ (93)	$7,272	3.7
Customer relationships	2,210	(1,549)	(30)	631	2.4
	$19,410	$ (11,384)	$ (123)	$7,903	

Amortization expense of acquired intangible assets was $0.7 million and $0.9 million for the three months ended March 31, 2018 and 2017, respectively.

Estimated future amortization expense as of March 31, 2018 is as follows (in thousands):

Remainder of 2018	$2,015
2019	2,674
2020	1,102
2021	492
2022	492
2023	410
	$7,185

Note 7. 0.25% Convertible Senior Notes and Capped Call

In March 2018, we issued $500.0 million aggregate principal amount of 0.25% convertible senior notes due March 15, 2023 in a private offering and an additional $75.0 million aggregate principal amount of such notes pursuant to the exercise in full of the over-allotment options of the initial purchasers, collectively the “Notes.” The Notes are unsecured obligations and bear interest at a fixed rate of 0.25% per annum, payable semi-annually in arrears on March 15 and September 15 of each year, commencing on September 15, 2018. The total net proceeds from the offering, after deducting initial purchase discounts and estimated debt issuance costs, are approximately $561.2 million.

Each $1,000 principal amount of the Notes will initially be convertible into 15.8554 shares of our common stock, the “Conversion Option,” which is equivalent to an initial conversion price of approximately $63.07 per share, subject to adjustment upon the occurrence of specified events. The Notes will be convertible at the option of the holders at any time prior to the close of business on the business day immediately preceding December 15, 2022, only under the following circumstances: (1) during any calendar quarter commencing after the calendar quarter ending on June 30, 2018 (and only during such calendar quarter), if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day; (2) during the five business day period after any five consecutive trading day period, the “Measurement Period,” in which the trading price per $1,000 principal amount of notes for each trading day of the Measurement Period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate on each such trading day; or (3) upon the occurrence of specified corporate events (as set forth in the indenture). On or after December 15, 2022 until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert their Notes at any time, regardless of the foregoing circumstances. Upon conversion, we will pay or deliver, as the case may be, cash, shares of our common stock or a combination of cash and shares of our common stock, at our election. If certain specified fundamental changes occur (as set forth in the indenture) prior to the maturity date, holders of the Notes may require us to repurchase for cash all or any portion of their notes at a repurchase price equal to 100% of the principal amount of the Notes to be repurchased, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date. In addition, if specific corporate events occur prior to the applicable maturity date, we will increase the conversion rate for a holder who elects to convert their notes in connection with such a corporate event in certain circumstances. It is our current intent and policy to settle conversions through combination settlement with a specified dollar amount of $1,000 per $1,000 principal amount of Notes. During the three months ended March 31, 2018, the conditions allowing holders of the Notes to convert have not been met. The Notes are therefore not convertible during the three months ended March 31, 2018 and are classified as long-term debt.

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In accounting for the transaction, the Notes were separated into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar debt instrument that does not have an associated convertible feature. The carrying amount of the equity component representing the Conversion Option was $125.0 million and was determined by deducting the fair value of the liability component from the par value of the Notes. The equity component was recorded in additional paid-in capital and is not remeasured as long as it continues to meet the conditions for equity classification. The excess of the principal amount of the liability component over its carrying amount, the “Debt Discount,” is amortized to interest expense over the contractual term of the Notes at an effective interest rate of 5.26%.

In accounting for the debt issuance costs of $13.8 million related to the Notes, we allocated the total amount incurred to the liability and equity components of the Notes based on their relative values. Issuance costs attributable to the liability component were $10.8 million and will be amortized to interest expense using the effective interest method over the contractual term of the Notes. Issuance costs attributable to the equity component were netted with the equity component in additional paid-in capital.

The net carrying amount of the liability component of the Notes is as follows (in thousands):

	March 31, 2018	December 31, 2017
Principal	$575,000	$ —
Unamortized Debt Discount	(124,305)	—
Unamortized issuance costs	(10,742)	—
Net carrying amount	$439,953	$ —

The net carrying amount of the equity component of the Notes is as follows (in thousands):

	March 31, 2018	December 31, 2017
Debt Discount for Conversion Option	$124,976	$ —
Issuance costs	(2,997)	—
Net carrying amount	$121,979	$ —

Interest expense related to the Notes is as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Contractual interest expense	$ 44	$ —
Amortization of Debt Discount	671	—
Amortization of issuance costs	49	