

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

☒ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended September 30, 2019

OR

☐ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Commission File Number: 001-35580



(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

20-2056195
(I.R.S. Employer
Identification Number)

2225 Lawson Lane
Santa Clara, California 95054
(Address of principal executive offices and zip code)

(408) 501-8550
(Registrant's telephone number, including area code)

(Former name, former address and formal fiscal year, if changed since last report.)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol	Name of each exchange on which registered
Common stock, par value \$0.001 per share	NOW	The New York Stock Exchange

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes ☒ No ☐

Indicate by check mark whether the Registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit such files). Yes ☒ No ☐

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

Large Accelerated Filer	<input checked="" type="checkbox"/>	Accelerated Filer	<input type="checkbox"/>
Non-Accelerated Filer	<input type="checkbox"/>	Smaller Reporting Company	<input type="checkbox"/>
		Emerging Growth Company	<input type="checkbox"/>

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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 Act). Yes ☐ No ☒

As of September 30, 2019, there were approximately 188.6 million shares of the Registrant's Common Stock outstanding.

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PART I

ITEM 1. FINANCIAL STATEMENTS

SERVICENOW, INC. CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands) (unaudited)

	September 30, 2019	December 31, 2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 622,925	\$ 566,204
Short-term investments	848,148	931,718
Accounts receivable, net	539,416	574,810
Current portion of deferred commissions	158,241	139,890
Prepaid expenses and other current assets	128,483	132,071
Total current assets	2,297,213	2,344,693
Deferred commissions, less current portion	293,086	282,490
Long-term investments	1,001,513	581,856
Property and equipment, net ⁽¹⁾	400,858	347,216
Operating lease right-of-use assets ⁽¹⁾	405,424	—
Intangible assets, net	112,947	100,582
Goodwill	153,902	148,845
Other assets	91,865	73,458
Total assets	\$ 4,756,808	\$ 3,879,140
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 61,906	\$ 30,733
Accrued expenses and other current liabilities ⁽¹⁾	319,792	330,246
Current portion of deferred revenue	1,761,532	1,651,594
Current portion of operating lease liabilities ⁽¹⁾	49,331	—
Total current liabilities	2,192,561	2,012,573
Deferred revenue, less current portion	41,286	38,597
Operating lease liabilities, less current portion ⁽¹⁾	388,483	—
Convertible senior notes, net	686,516	661,707
Other long-term liabilities ⁽¹⁾	18,489	55,064
Total liabilities	3,327,335	2,767,941
Stockholders' equity:		
Common stock	189	180
Additional paid-in capital	2,360,621	2,093,834
Accumulated other comprehensive income (loss)	19,631	(4,035)
Accumulated deficit ⁽¹⁾	(950,968)	(978,780)
Total stockholders' equity	1,429,473	1,111,199
Total liabilities and stockholders' equity	\$ 4,756,808	\$ 3,879,140

(1) We adopted Topic 842 using the modified retrospective method as of January 1, 2019 and elected the transition option that allows us not to restate the comparative periods in our condensed consolidated financial statements in the year of adoption. See Note 2 for further details.

See accompanying notes to condensed consolidated financial statements

SERVICENOW, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands, except share and per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Revenues:				
Subscription	\$ 834,910	\$ 626,567	\$ 2,355,885	\$ 1,755,174
Professional services and other	50,923	46,530	152,778	138,201
Total revenues	885,833	673,097	2,508,663	1,893,375
Cost of revenues ⁽¹⁾ :				
Subscription	139,330	106,821	401,398	303,918
Professional services and other	61,463	51,037	183,794	150,578
Total cost of revenues	200,793	157,858	585,192	454,496
Gross profit	685,040	515,239	1,923,471	1,438,879
Operating expenses ⁽¹⁾ :				
Sales and marketing	362,975	289,323	1,118,279	883,893
Research and development	190,099	135,655	546,041	380,839
General and administrative	75,642	80,693	245,540	216,851
Total operating expenses	628,716	505,671	1,909,860	1,481,583
Income (loss) from operations	56,324	9,568	13,611	(42,704)
Interest expense	(8,371)	(11,233)	(24,808)	(43,795)
Interest income and other income (expense), net	12,817	8,895	44,196	45,520
Income (loss) before income taxes	60,770	7,230	32,999	(40,979)
Provision for (benefit from) income taxes	20,172	(1,175)	5,025	(7,260)
Net income (loss)	\$ 40,598	\$ 8,405	\$ 27,974	\$ (33,719)
Net income (loss) per share - basic	\$ 0.22	\$ 0.05	\$ 0.15	\$ (0.19)
Net income (loss) per share - diluted	\$ 0.21	\$ 0.04	\$ 0.14	\$ (0.19)
Weighted-average shares used to compute net income (loss) per share - basic	188,074,303	178,719,694	185,676,049	177,198,179
Weighted-average shares used to compute net income (loss) per share - diluted	197,878,215	192,190,899	196,738,774	177,198,179
Other comprehensive income (loss):				
Foreign currency translation adjustments	\$ 5,507	\$ 1,655	\$ 14,732	\$ 212
Unrealized gain (loss) on investments, net of tax	582	922	8,934	(163)
Other comprehensive income, net of tax	6,089	2,577	23,666	49
Comprehensive income (loss)	\$ 46,687	\$ 10,982	\$ 51,640	\$ (33,670)

(1) Includes stock-based compensation as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Cost of revenues:				
Subscription	\$ 18,880	\$ 12,775	\$ 54,019	\$ 36,604
Professional services and other	10,867	8,407	31,749	24,310
Sales and marketing	68,712	60,132	200,071	169,283
Research and development	50,636	35,527	144,259	97,905
General and administrative	13,839	27,567	62,046	73,207

See accompanying notes to condensed consolidated financial statements

SERVICENOW, INC.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands, except share data)
(unaudited)

	Three Months Ended September 30, 2019						Three Months Ended September 30, 2018					
	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount					Shares	Amount				
Balance at beginning of period	187,461,809	\$ 188	\$2,238,782	\$ (991,566)	\$ 13,542	\$1,260,946	177,945,946	\$ 178	\$1,889,727	\$ (994,200)	\$ (3,995)	\$ 891,710
Common stock issued under employee stock plans	1,097,392	1	41,926	—	—	41,927	1,359,393	1	39,021	—	—	39,022
Taxes paid related to net share settlement of equity awards	—	—	(83,172)	—	—	(83,172)	—	—	(66,694)	—	—	(66,694)
Stock-based compensation	—	—	163,085	—	—	163,085	—	—	145,631	—	—	145,631
Settlement of 2018 Notes conversion feature	—	—	—	—	—	—	—	—	(81,318)	—	—	(81,318)
Benefit from exercise of 2018 Note Hedges	—	—	—	—	—	—	—	—	80,851	—	—	80,851
Other comprehensive income, net of tax	—	—	—	—	6,089	6,089	—	—	—	—	2,577	2,577
Net income	—	—	—	40,598	—	40,598	—	—	—	8,405	—	8,405
Balance at end of period	<u>188,559,201</u>	<u>\$ 189</u>	<u>\$2,360,621</u>	<u>\$ (950,968)</u>	<u>\$ 19,631</u>	<u>\$1,429,473</u>	<u>179,305,339</u>	<u>\$ 179</u>	<u>\$2,007,218</u>	<u>\$ (985,795)</u>	<u>\$ (1,418)</u>	<u>\$1,020,184</u>
	Nine Months Ended September 30, 2019						Nine Months Ended September 30, 2018					
	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount					Shares	Amount				
Balance at beginning of period	180,175,355	\$ 180	\$2,093,834	\$ (978,780)	\$ (4,035)	\$ 1,111,199	174,275,864	\$ 174	\$1,731,367	\$ (958,564)	\$ 5,767	\$ 778,744
Impact of the adoption of new accounting pronouncements	—	—	—	(162)	—	(162)	—	—	—	6,488	(7,234)	(746)
Common stock issued under employee stock plans	4,100,652	4	105,232	—	—	105,236	5,029,475	5	100,437	—	—	100,442
Taxes paid related to net share settlement of equity awards	—	—	(330,792)	—	—	(330,792)	—	—	(221,267)	—	—	(221,267)
Stock-based compensation	—	—	492,352	—	—	492,352	—	—	403,152	—	—	403,152
Settlement of 2018 Notes conversion feature	—	—	—	—	—	—	—	—	(554,472)	—	—	(554,472)
Benefit from exercise of 2018 Note Hedges	—	—	—	—	—	—	—	—	548,001	—	—	548,001
Settlement of 2018 Warrants	4,283,194	5	(5)	—	—	—	—	—	—	—	—	—
Other comprehensive income, net of tax	—	—	—	—	23,666	23,666	—	—	—	—	49	49
Net income (loss)	—	—	—	27,974	—	27,974	—	—	—	(33,719)	—	(33,719)
Balance at end of period	<u>188,559,201</u>	<u>\$ 189</u>	<u>\$2,360,621</u>	<u>\$ (950,968)</u>	<u>\$ 19,631</u>	<u>\$1,429,473</u>	<u>179,305,339</u>	<u>\$ 179</u>	<u>\$2,007,218</u>	<u>\$ (985,795)</u>	<u>\$ (1,418)</u>	<u>\$1,020,184</u>

See accompanying notes to condensed consolidated financial statements

SERVICENOW, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2019	2018
Cash flows from operating activities:		
Net income (loss)	\$ 27,974	\$ (33,719)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	179,783	106,492
Amortization of deferred commissions	122,226	107,367
Amortization of debt discount and issuance costs	24,808	43,795
Stock-based compensation	492,144	401,309
Deferred income taxes	(2,842)	(32,297)
Gain on marketable equity securities	—	(19,257)
Repayments of convertible senior notes attributable to debt discount	—	(101,633)
Other	(4,621)	4,502
Changes in operating assets and liabilities, net of effect of business combinations:		
Accounts receivable	28,331	7,454
Deferred commissions	(158,309)	(152,521)
Prepaid expenses and other assets	(25,569)	1,519
Accounts payable	30,088	5,058
Deferred revenue	135,455	174,058
Accrued expenses and other liabilities	(34,707)	9,350
Net cash provided by operating activities	814,761	521,477
Cash flows from investing activities:		
Purchases of property and equipment	(185,889)	(136,349)
Business combinations, net of cash and restricted cash acquired	—	(24,940)
Purchases of other intangibles	(37,360)	(13,600)
Purchases of investments	(1,255,691)	(826,998)
Sales of investments	31,046	39,975
Maturities of investments	900,407	861,629
Realized gains on derivatives not designated as hedging instruments, net	21,742	—
Net cash used in investing activities	(525,745)	(100,283)
Cash flows from financing activities:		
Repayments of convertible senior notes attributable to principal	—	(311,520)
Proceeds from employee stock plans	105,227	100,437
Taxes paid related to net share settlement of equity awards	(330,802)	(221,268)
Payments on financing obligations	—	(756)
Net cash used in financing activities	(225,575)	(433,107)
Foreign currency effect on cash, cash equivalents and restricted cash	(6,439)	(9,593)
Net increase (decrease) in cash, cash equivalents and restricted cash	57,002	(21,506)
Cash, cash equivalents and restricted cash at beginning of period	568,538	727,829
Cash, cash equivalents and restricted cash at end of period	\$ 625,540	\$ 706,323
Cash, cash equivalents and restricted cash at end of period:		
Cash and cash equivalents	\$ 622,925	\$ 703,629
Restricted cash included in prepaid expenses and other current assets	2,615	2,694
Total cash, cash equivalents and restricted cash shown in the condensed consolidated statements of cash flows	\$ 625,540	\$ 706,323
Supplemental disclosures of other cash flow information:		
Income taxes paid, net of refunds	\$ 15,856	\$ 14,936
Non-cash investing and financing activities:		
Settlement of 2018 Notes conversion feature	\$ —	\$ 554,472
Benefit from exercise of 2018 Note Hedges	—	548,001
Property and equipment included in accounts payable and accrued expenses	26,566	25,018

See accompanying notes to condensed consolidated financial statements

SERVICENOW, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Unless the context requires otherwise, references in this report to “ServiceNow,” the “Company,” “we,” “us,” and “our” refer to ServiceNow, Inc. and its consolidated subsidiaries.

(1) Description of the Business

ServiceNow, the company that makes work, work better for people, is a leading provider of enterprise cloud computing services that define, structure, manage and automate digital workflows for global enterprises. We deliver digital workflows that help our customers create great experiences and unlock productivity. Our Now Platform enables enterprise-wide experiences and productivity by simplifying and streamlining processes across systems, functions and departments. Our product portfolio focuses on delivering better information technology (IT), employee and customer workflows, and enabling our customers to build any workflow application that makes sense for their business.

(2) Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements and condensed footnotes have been prepared in accordance with the applicable rules and regulations of the Securities and Exchange Commission (the SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements due to the permitted exclusion of certain disclosures for interim reporting. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary under GAAP for fair statement of results for the interim periods presented have been included. The results of operations for the three and nine months ended September 30, 2019 are not necessarily indicative of the results to be expected for the year ending December 31, 2019 or for other interim periods or future years. The condensed consolidated balance sheet as of December 31, 2018 is derived from audited financial statements; however, it does not include all of the information and footnotes required by GAAP for complete financial statements. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the SEC on February 27, 2019.

Prior Period Reclassification

Certain reclassifications of prior period amounts pertaining to the reclassification of revenues from IT Operations Management (ITOM) products to digital workflow products have been made in Note 18 to conform to the current period presentation. These reclassifications did not result in a restatement of prior period financial statements.

Principles of Consolidation

The condensed consolidated financial statements have been prepared in conformity with GAAP, and include our accounts and the accounts of our wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated upon consolidation.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, as well as reported amounts of revenues and expenses during the reporting period. Such management estimates and assumptions include, but are not limited to, evaluating the terms and conditions included within our customer contracts as well as determining stand-alone selling price (SSP) for each distinct performance obligation included in customer contracts with multiple performance obligations, the period of benefit for deferred commissions, purchase price allocation for business combinations, stock-based compensation expenses, the useful life and recoverability of our property and equipment, goodwill and identifiable intangible assets, whether an arrangement is or contains a lease, the discount rate used for operating leases, fair value of convertible notes, income taxes, and legal contingencies. Actual results could differ from those estimates.

Segments

We define the term “chief operating decision maker” to be our Chief Executive Officer. Our chief operating decision maker allocates resources and assesses financial performance based upon discrete financial information at the consolidated level. Accordingly, we have determined that we operate as a single operating and reportable segment.

Concentration of Credit Risk and Significant Customers

Financial instruments potentially exposing us to credit risk consist primarily of cash, cash equivalents, derivative contracts, investments and accounts receivable. We hold cash at financial institutions that management believes are high credit, quality financial institutions and invest in securities with a minimum rating of BBB by Standard & Poor’s, Baa2 by Moody’s, or BBB by Fitch to minimize our credit risks. Our derivative contracts expose us to credit risk to the extent that the counterparties may be unable to meet the terms of the arrangement. We mitigate this credit risk by transacting with major financial institutions with high credit ratings and entering into master netting arrangements, which permit net settlement of transactions with the same counterparty. While the contract or notional amount is often used to express the volume of foreign currency derivative contracts, the amounts potentially subject to credit risk are generally limited to the amounts, if any, by which the counterparties’ obligations under the agreements exceed the obligations of the Company to the counterparties. We are not required to pledge, and are not entitled to receive, cash collateral related to these derivative instruments. We are also exposed to credit risk under the convertible note hedge transactions that may result from counterparties’ non-performance.

Credit risk arising from accounts receivable is mitigated to a certain extent due to our large number of customers and their dispersion across various industries and geographies. As of September 30, 2019, we had one customer that represented approximately 17% of our accounts receivable balance. As of December 31, 2018, there were no customers that represented more than 10% of our accounts receivable balance. There were no customers that individually exceeded 10% of our total revenues in any of the periods presented. For purposes of assessing concentration of credit risk and significant customers, a group of customers under common control or customers that are affiliates of each other are regarded as a single customer.

Updated Significant Accounting Policies

Leases

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, “Leases (Topic 842),” which requires lessees to generally recognize on the balance sheet operating and financing lease liabilities and corresponding right-of-use assets, and to recognize on the income statement the expenses in a manner similar to prior practice. We adopted Topic 842 using the modified retrospective method as of January 1, 2019 and elected the transition option that allows us not to restate the comparative periods in our financial statements in the year of adoption. We also elected the package of transition expedients available for expired or existing contracts, which allowed us to carryforward our historical assessment of (1) whether contracts are or contain leases, (2) lease classification and (3) initial direct costs.

We determine if an arrangement is or contains a lease at inception by evaluating various factors, including whether a vendor’s right to substitute an identified asset is substantive. Lease classification is determined at the lease commencement date, on which the leased assets are made available for our use. Operating leases are included in “Operating lease right-of-use assets”, “Current portion of operating lease liabilities”, and “Operating lease liabilities, less current portion” in our condensed consolidated balance sheets. We did not have any material financing leases in any of the periods presented.

Right-of-use assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make payments arising from the lease. Operating lease right-of-use assets and liabilities are recognized at the lease commencement date based on the present value of lease payments over the lease term. The difference between the total right-of-use assets and total lease liabilities recorded as of January 1, 2019 is primarily due to the derecognition of deferred rent liabilities that were included in “Accrued expenses and other current liabilities” and “Other long-term liabilities”, respectively, in our condensed consolidated balance sheet as of December 31, 2018. Lease payments consist primarily of the fixed payments under the arrangement, less any lease incentives such as rent holidays. We use an estimate of our incremental borrowing rate (IBR) based on the information available at the lease commencement date in determining the present value of lease payments, unless the implicit rate is readily determinable. In determining the appropriate IBR, we consider information including, but not limited to, our credit rating, the lease term, and the currency in which the arrangement is denominated. For leases which commenced prior to our adoption of Topic 842, we used the IBR on January 1, 2019. Our lease terms may include the sole option for us to either renew or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

For our office facility leases, we elected to account for lease and non-lease components as a single lease component. For other arrangements, lease and non-lease components are generally accounted for separately. Additionally, we do not record leases on the balance sheet that, at the lease commencement date, have a lease term of 12 months or less.

Derivative financial instruments and hedging activities

We use derivative financial instruments to manage foreign currency risks. These derivative contracts consist of forward contracts entered into with various counterparties and are not designated as hedging instruments under applicable accounting guidance. As such, all changes in the fair value of these derivative contracts are recorded in “Interest income and other income (expense), net” on the condensed consolidated statements of comprehensive income (loss), and are intended to offset the foreign currency gains or losses associated with the underlying monetary assets and liabilities. Realized gains (losses) from settlement of the derivative assets and liabilities not designated as hedging instruments are classified as investing activities in the condensed consolidated statement of cash flows.

Accounting Pronouncement Adopted in 2019

Leases

As described in the “Leases” section above, we adopted Topic 842 using the modified retrospective method as of January 1, 2019 with an immaterial amount of cumulative effect adjustment recorded to our accumulated deficit as of January 1, 2019. As this standard was adopted on a modified prospective basis as of January 1, 2019, the adoption of this standard did not impact our previously reported financial statements for periods ended on or prior to December 31, 2018. Upon adoption, we recorded operating lease right-of-use assets of approximately \$334.7 million and corresponding operating lease liabilities of \$362.7 million on our condensed consolidated balance sheets.

Accounting Pronouncements Adopted in 2018

For details on our adoption of ASU 2014-09, “Revenue from Contracts with Customers (Topic 606),” ASU 2016-01, “Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,” ASU 2016-16, “Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory” and other accounting standards adopted in 2018, refer to Note 2, Summary of Significant Accounting Policies, of the notes to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the SEC on February 27, 2019.

New Accounting Pronouncements Pending Adoption

Cloud computing arrangements implementation costs

In August 2018, the FASB issued ASU 2018-15, “Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract,” which aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The new standard requires capitalized costs to be amortized on a straight-line basis generally over the term of the arrangement, and the financial statement presentation for these capitalized costs would be the same as that of the fees related to the hosting arrangements. This new standard is effective for our interim and annual periods beginning January 1, 2020 and earlier adoption is permitted. This standard could be applied either retrospectively or prospectively to all implementation costs incurred after the date of adoption. We will adopt this standard on a prospective basis as of January 1, 2020 and the impact of our adoption of this standard on our condensed consolidated financial statements will largely depend on the magnitude of implementation costs incurred in our cloud computing arrangements beginning January 1, 2020.

Credit losses

In June 2016, the FASB issued ASU 2016-13, “Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,” which requires a financial asset measured at amortized cost basis to be presented at the net amount expected to be collected, with further clarifications made more recently. For trade receivables, loans, and other financial instruments, we will be required to use a forward-looking expected loss model rather than the incurred loss model for recognizing credit losses which reflects losses that are probable. Credit losses relating to available-for-sale debt securities are required to be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. This new standard is effective for our interim and annual periods beginning January 1, 2020. We are currently evaluating the impact of the adoption of this standard on our condensed consolidated financial statements, which will largely depend on the composition and credit quality of our investment portfolio and trade receivables as well as the economic condition at the time of adoption.

(3) Investments

Marketable Debt Securities

The following is a summary of our available-for-sale investment securities recorded within short-term and long-term investments and those securities classified within cash and cash equivalents on the condensed consolidated balance sheets (in thousands):

	September 30, 2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
Commercial paper	\$ 108,568	\$ 113	\$ (22)	\$ 108,659
Corporate notes and bonds	1,574,066	7,662	(276)	1,581,452
Certificates of deposit	30,493	50	—	30,543
U.S. government and agency securities	128,867	189	(49)	129,007
Total available-for-sale securities	<u>\$ 1,841,994</u>	<u>\$ 8,014</u>	<u>\$ (347)</u>	<u>\$ 1,849,661</u>

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
Commercial paper	\$ 108,061	\$ —	\$ —	\$ 108,061
Corporate notes and bonds	1,233,589	343	(4,218)	1,229,714
Certificates of deposit	73,584	1	—	73,585
U.S. government and agency securities	102,549	23	(358)	102,214
Total available-for-sale securities	<u>\$ 1,517,783</u>	<u>\$ 367</u>	<u>\$ (4,576)</u>	<u>\$ 1,513,574</u>

As of September 30, 2019, the contractual maturities of our investment securities, excluding securities classified within cash and cash equivalents on the condensed consolidated balance sheet, did not exceed 36 months. The fair values of available-for-sale investment securities, by remaining contractual maturity, are as follows (in thousands):

	September 30, 2019
Due within 1 year	\$ 848,148
Due in 1 year through 5 years	1,001,513
Total	<u>\$ 1,849,661</u>

The following table shows the fair values and the gross unrealized losses of these securities, classified by the length of time that the securities have been in a continuous unrealized loss position, and aggregated by investment types, excluding those securities classified within cash and cash equivalents on the condensed consolidated balance sheets (in thousands):

	September 30, 2019					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Commercial paper	\$ 17,826	\$ (22)	\$ —	\$ —	\$ 17,826	\$ (22)
Corporate notes and bonds	249,623	(230)	55,236	(46)	304,859	(276)
U.S. government and agency securities	36,425	(48)	2,999	(1)	39,424	(49)
Total	<u>\$ 303,874</u>	<u>\$ (300)</u>	<u>\$ 58,235</u>	<u>\$ (47)</u>	<u>\$ 362,109</u>	<u>\$ (347)</u>

	December 31, 2018					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate notes and bonds	\$ 714,605	\$ (2,603)	\$ 294,956	\$ (1,615)	\$ 1,009,561	\$ (4,218)
Certificates of deposit	1,000	—	—	—	1,000	—
U.S. government and agency securities	11,756	(5)	61,457	(353)	73,213	(358)
Total	<u>\$ 727,361</u>	<u>\$ (2,608)</u>	<u>\$ 356,413</u>	<u>\$ (1,968)</u>	<u>\$ 1,083,774</u>	<u>\$ (4,576)</u>

As of September 30, 2019, we had a total of 111 available-for-sale securities, excluding those securities classified within cash and cash equivalents on the condensed consolidated balance sheet in an unrealized loss position. There were no impairments considered “other-than-temporary” as it is more likely than not we will hold the securities until maturity or a recovery of the cost basis.

Marketable Equity Securities

During the nine months ended September 30, 2018, we recognized \$19.3 million of unrealized gains through net income that related to the changes in the fair value of these securities during the nine months ended September 30, 2018. As of each of September 30, 2019 and December 31, 2018, we had no marketable equity securities on our condensed consolidated balance sheet.

Strategic Investments

As of September 30, 2019 and December 31, 2018, the total amount of equity investments in privately-held companies included in other assets on our condensed consolidated balance sheets was \$21.4 million and \$14.6 million, respectively. These non-marketable equity investments are recorded at fair value only if an impairment or observable price adjustment is recognized in the current period. We classify these assets as Level 3 within the fair value hierarchy only if an impairment or observable price adjustment is recognized on these non-marketable equity securities during the period as they are based on observable transaction price at the transaction date and other unobservable inputs such as volatility.

(4) Fair Value Measurements

The following table presents our fair value hierarchy for our assets measured at fair value on a recurring basis as of September 30, 2019 (in thousands):

	Level 1	Level 2	Total
Cash equivalents:			
Money market funds	\$ 292,716	\$ —	\$ 292,716
Commercial paper	—	104,698	104,698
Corporate notes and bonds	—	34,603	34,603
Marketable securities:			
Commercial paper	—	108,659	108,659
Corporate notes and bonds	—	1,581,452	1,581,452
Certificates of deposit	—	30,543	30,543
U.S. government and agency securities	—	129,007	129,007
Total	\$ 292,716	\$ 1,988,962	\$ 2,281,678

The following table presents our fair value hierarchy for our assets measured at fair value on a recurring basis as of December 31, 2018 (in thousands):

	Level 1	Level 2	Total
Cash equivalents:			
Money market funds	\$ 229,047	\$ —	\$ 229,047
Commercial paper	—	16,961	16,961
Certificates of deposit	—	2,465	2,465
Marketable securities:			
Commercial paper	—	108,061	108,061
Corporate notes and bonds	—	1,229,714	1,229,714
Certificates of deposit	—	73,585	73,585
U.S. government and agency securities	—	102,214	102,214
Total	\$ 229,047	\$ 1,533,000	\$ 1,762,047

We determine the fair value of our security holdings based on pricing from our service providers and market prices from industry-standard independent data providers. Such market prices may be quoted prices in active markets for identical assets (Level 1 inputs) or pricing determined using inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs), such as yield curve, volatility factors, credit spreads, default rates, loss severity, current market and contractual prices for the underlying instruments or debt, broker and dealer quotes, as well as other relevant economic measures.

Our equity investments in privately-held companies are not included in the table above and are discussed in Note 3. See Note 8 for the fair value measurement of our derivative contracts and Note 11 for the fair value measurement of our convertible senior notes, which are also not included in the table above.

(5) Business Combinations

During the nine months ended September 30, 2018, we completed acquisitions of two privately-held companies, Parlo, Inc. and VendorHawk, Inc., for an aggregate of approximately \$25.1 million in cash. In allocating the aggregate purchase price based on the estimated fair values, we recorded a total of \$18.1 million of goodwill, \$9.0 million of developed technology intangible assets (to be amortized over estimated useful lives of five years) and \$2.2 million of deferred tax liabilities. The excess of purchase consideration over the fair value of net tangible and identifiable assets acquired was recorded as goodwill. We believe the goodwill balance associated with these business combinations represents the synergies expected from expanded market opportunities when integrating the acquired developed technologies with our offerings. Goodwill arising from these business combinations is not deductible for income tax purposes.

The results of operations of these business combinations have been included in our condensed consolidated financial statements from their respective dates of purchase. These business combinations did not have a material impact on our condensed consolidated financial statements, and therefore historical and pro forma disclosures have not been presented.

(6) Goodwill and Intangible Assets

Goodwill balances are presented below (in thousands):

	Carrying Amount
Balance as of December 31, 2018	\$ 148,845
Foreign currency translation adjustments	5,057
Balance as of September 30, 2019	<u>\$ 153,902</u>

Intangible assets consist of the following (in thousands):

	September 30, 2019	December 31, 2018
Developed technology	\$ 139,134	\$ 114,395
Patents	67,730	57,180
Other	282	650
Intangible assets, gross	207,146	172,225
Less: accumulated amortization	(94,199)	(71,643)
Intangible assets, net	<u>\$ 112,947</u>	<u>\$ 100,582</u>

During the nine months ended September 30, 2019, we acquired \$37.4 million of intangible assets, comprising primarily \$26.5 million of developed technology and \$10.6 million in patents. The weighted-average useful lives for the developed technology and patents acquired during the nine months ended September 30, 2019 was approximately five and six years, respectively.

During the nine months ended September 30, 2018, apart from the business combinations described in Note 5, we also acquired \$6.9 million of intangible assets in patents. The weighted-average useful life for the patents acquired during the nine months ended September 30, 2018 was approximately eight years.

Amortization expense for intangible assets for the three months ended September 30, 2019 and 2018 was approximately \$9.0 million and \$6.4 million, respectively, and for the nine months ended September 30, 2019 and 2018 was approximately \$24.1 million and \$18.2 million, respectively.

The following table presents the estimated future amortization expense related to intangible assets held at September 30, 2019 (in thousands):

Years Ending December 31,	
Remainder of 2019	\$ 9,008
2020	26,538
2021	24,380
2022	20,519
2023	14,752
Thereafter	17,750
Total future amortization expense	<u>\$ 112,947</u>

(7) Property and Equipment

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

	September 30, 2019	December 31, 2018
Computer equipment	\$ 601,789	\$ 493,536
Computer software	60,759	58,303
Leasehold and other improvements	94,823	74,721
Furniture and fixtures	50,899	42,551
Building ⁽¹⁾	—	6,551
Construction in progress ⁽¹⁾	21,059	10,167
Property and equipment, gross	829,329	685,829
Less: Accumulated depreciation	(428,471)	(338,613)
Property and equipment, net	\$ 400,858	\$ 347,216

(1) We adopted Topic 842 using the modified retrospective method as of January 1, 2019 and derecognized \$10.6 million in building and construction in progress assets that we were previously deemed to own under the prior lease accounting standards. These assets are recognized under our operating lease right-of-use assets under Topic 842 as of September 30, 2019.

Construction in progress consists primarily of leasehold and other improvements and in-process software development costs. Depreciation expense for the three months ended September 30, 2019 and 2018 was \$42.1 million and \$31.5 million, respectively, and for the nine months ended September 30, 2019 and 2018 was approximately \$119.4 million and \$88.3 million, respectively.

(8) Derivative Contracts

As of September 30, 2019 and December 31, 2018, we had foreign currency forward contracts with total notional values of \$219.3 million and \$872.8 million, respectively, which are not designated as hedge instruments. 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. The fair values of these outstanding derivative contracts were as follows (in thousands):

	Condensed Consolidated Balance Sheet Location	September 30, 2019	December 31, 2018
<i>Derivative Assets:</i>			
Foreign currency derivative contracts	Prepaid expenses and other current assets	\$ 3,217	\$ 22,831
<i>Derivative Liabilities:</i>			
Foreign currency derivative contracts	Accrued expenses and other current liabilities	\$ 1,196	\$ 2,441

(9) Deferred Revenue and Performance Obligations

Revenues recognized during the three months ended September 30, 2019 from amounts included in deferred revenue as of June 30, 2019 were \$0.7 billion. Revenues recognized during the three months ended September 30, 2018 from amounts included in deferred revenue as of June 30, 2018 were \$0.5 billion.

Revenues recognized during the nine months ended September 30, 2019 from amounts included in deferred revenue as of December 31, 2018 were \$1.4 billion. Revenues recognized during the nine months ended September 30, 2018 from amounts included in deferred revenue as of December 31, 2017 were \$1.0 billion.

Remaining Performance Obligations

Transaction price allocated to remaining performance obligations (RPO) represents contracted revenue that has not yet been recognized, which includes deferred revenue and non-cancelable amounts that will be invoiced and recognized as revenues in future periods. RPO excludes contracts that are billed in arrears, such as certain time and materials contracts, as we apply the “right to invoice” practical expedient under relevant accounting guidance.

As of September 30, 2019, the total non-cancelable RPO under our contracts with customers was approximately \$5.6 billion and we expect to recognize revenues on approximately 51% of these RPO over the following 12 months, with the balance to be recognized thereafter.

(10) Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consist of the following (in thousands):

	September 30, 2019	December 31, 2018
Accrued payroll	\$ 158,185	\$ 158,006
Taxes payable	24,565	35,122
Other employee related liabilities	48,770	60,889
Other	88,272	76,229
Total accrued expenses and other current liabilities	<u>\$ 319,792</u>	<u>\$ 330,246</u>

(11) Convertible Senior Notes

In May and June 2017, we issued an aggregate of \$782.5 million of 0% convertible senior notes (the 2022 Notes), which are due June 1, 2022 (Maturity Date) unless earlier converted or repurchased in accordance with their terms. The 2022 Notes do not bear interest, and we cannot redeem the 2022 Notes prior to maturity. In November 2013, we issued \$575.0 million of 0% convertible senior notes (the 2018 Notes, and together with the 2022 Notes, the Notes), which were earlier converted prior to, or settled on November 1, 2018, in accordance with their terms.

The 2022 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries.

Upon conversion of the 2022 Notes, we may choose to 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 upon settlement. We settled the principal amount of our 2018 Notes with cash and currently intend to settle the principal amount of the 2022 Notes with cash.

	Convertible Date	Initial Conversion Price per Share	Initial Conversion Rate per \$1,000 Par Value	Initial Number of Shares
2022 Notes	February 1, 2022	\$ 134.75	7.42 shares	5,806,936
2018 Notes	July 1, 2018	\$ 73.88	13.54 shares	7,783,023

Conversion of the 2022 Notes prior to the Convertible Date. At any time prior to the close of business on the business day immediately preceding February 1, 2022 (Convertible Date), holders of the 2022 Notes may convert their Notes at their option, only if one of the following conditions are met:

- during any calendar quarter (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 the 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 (in each case, the Conversion Condition); or
- during the five-business day period after any five-consecutive trading day period, or the measurement period, in which the trading price per \$1,000 principal amount of the 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
- upon the occurrence of specified corporate events.

Conversion of the 2022 Notes on or after the Convertible Date. On or after the Convertible Date, a holder may convert all or any portion of its Notes at any time prior to the close of business on the second scheduled trading day immediately preceding the Maturity Date, regardless of the foregoing conditions, and such conversions will settle upon the Maturity Date. Upon settlement, 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.

The conversion price of the 2022 Notes will be subject to adjustment in some events. Holders of the 2022 Notes who convert their 2022 Notes in connection with certain corporate events that constitute a “make-whole fundamental change” are, under certain circumstances, entitled to an increase in the conversion rate. Additionally, in the event of a corporate event that constitutes a “fundamental change,” holders of the 2022 Notes may require us to purchase with cash all or a portion of the 2022 Notes upon the occurrence of a fundamental change, at a purchase price equal to 100% of the principal amount of the 2022 Notes plus any accrued and unpaid special interest, if any.

In accounting for the issuance of the 2022 Notes and the related transaction costs, we separated the 2022 Notes into liability and equity components. The 2022 Notes consisted of the following (in thousands):

	September 30, 2019	December 31, 2018
Liability component:		
Principal:		
2022 Notes	\$ 782,500	\$ 782,500
Less: debt issuance cost and debt discount, net of amortization		
2022 Notes	(95,984)	(120,793)
Net carrying amount	<u>\$ 686,516</u>	<u>\$ 661,707</u>
		2022 Notes
Equity component recorded at issuance:		
Note		\$ 162,039
Issuance cost		(2,148)
Net amount recorded in equity		<u>\$ 159,891</u>

The Conversion Condition for the 2022 Notes was met for the quarters ended June 30, 2018, September 30, 2018, March 31, 2019, June 30, 2019, and September 30, 2019. Therefore, our 2022 Notes became convertible at the holders’ option beginning on July 1, 2018 and continue to be convertible through December 31, 2019, with the exception of the quarter ended March 31, 2019 because the Conversion Condition for the 2022 Notes was not met for the quarter ended December 31, 2018. Based on conversion requests we have received during the third quarter of 2019, we expect to settle in cash an immaterial principal amount of the 2022 Notes during the fourth quarter of 2019.

We consider the fair value of the 2022 Notes at September 30, 2019 to be a Level 2 measurement. The estimated fair value of the 2022 Notes at September 30, 2019 and December 31, 2018 based on the closing trading price per \$100 of the Notes was as follows (in thousands):

	September 30, 2019	December 31, 2018
2022 Notes	\$ 1,502,893	\$ 1,105,281

As of September 30, 2019, the remaining life of the 2022 Notes is 32 months, and the 2018 Notes were no longer outstanding. The following table sets forth total interest expense recognized related to the Notes (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Amortization of debt issuance cost				
2022 Notes	\$ 404	\$ 385	\$ 1,196	\$ 1,141
2018 Notes	—	175	—	1,082
Amortization of debt discount				
2022 Notes	7,967	7,585	23,612	22,479
2018 Notes	—	3,088	—	19,093
Total	\$ 8,371	\$ 11,233	\$ 24,808	\$ 43,795
Effective interest rate of the liability component				
2022 Notes		4.75%		
2018 Notes		6.50%		

Note Hedges

To minimize the impact of potential economic dilution upon conversion of the Notes, we entered into convertible note hedge transactions (the 2022 Note Hedge and 2018 Note Hedge, respectively, and collectively, the Note Hedges) with certain investment banks, with respect to our common stock concurrently with the issuance of the 2022 Notes and 2018 Notes. The 2018 Note Hedge offset the dilution and cash payments in excess of the principal amount of the converted 2018 Notes and expired upon the maturity date of the 2018 Notes, which was November 1, 2018.

	Purchase	Initial Shares	Shares as of September 30, 2019
	(in thousands)		
2022 Note Hedge	\$ 128,017	5,806,936	5,806,936
2018 Note Hedge	\$ 135,815	7,783,023	—

The 2022 Note Hedge covers shares of our common stock at a strike price per share that corresponds to the initial conversion price of the 2022 Notes, subject to adjustment, and are exercisable upon conversion of the 2022 Notes. If exercised, we may elect to receive cash, shares of our common stock, or a combination of cash and shares. The 2022 Note Hedge will expire upon the maturity of the 2022 Notes. The 2022 Note Hedge is intended to reduce the potential economic dilution upon conversion of the 2022 Notes in the event that the fair value per share of our common stock at the time of exercise is greater than the conversion price of the 2022 Notes. The 2022 Note Hedge is a separate transaction and is not part of the terms of the 2022 Notes. Holders of the 2022 Notes will not have any rights with respect to the 2022 Note Hedge. The 2022 Note Hedge does not impact earnings per share, as it was entered into to offset any dilution from the 2022 Notes.

Warrants

	Proceeds (in thousands)	Initial Shares	Strike Price	First Expiration Date	Shares as of September 30, 2019
2022 Warrants	\$ 54,071	5,806,936	\$ 203.40	September 1, 2022	5,806,936
2018 Warrants	\$ 84,525	7,783,023	\$ 107.46	February 1, 2019	—

Separately, we entered into warrant transactions with certain investment banks, whereby we sold warrants to acquire, subject to adjustment, the number of shares of our common stock shown in the table above (the 2022 Warrants and 2018 Warrants, respectively, and collectively, the Warrants). If the average market value per share of our common stock for the reporting period, as measured under the Warrants, exceeds the strike price of the respective Warrants, such Warrants would have a dilutive effect on our earnings per share to the extent we report net income. According to the terms of each of the Warrants, the 2018 Warrants were automatically exercised and the 2022 Warrants will be automatically exercised over a 60 trading day period beginning on the first expiration date of the respective Warrants as set forth above. The Warrants are separate transactions and are not remeasured through earnings each reporting period. The Warrants are not part of the Notes or Note Hedges.

As the 2022 Warrants will be net share settled, the total number of shares of our common stock we will issue depends on the daily volume-weighted average stock prices over a 60 trading day period beginning on the first expiration date of the 2022 Warrants, which will be September 1, 2022. We issued approximately 4.3 million shares of our common stock upon the automatic exercise of the 2018 Warrants during the nine months ended September 30, 2019. The 2018 Warrants were no longer outstanding as of the second quarter of 2019. We expect to issue additional shares of our common stock in the second half of 2022 upon the automatic exercise of the 2022 Warrants. The 2022 Warrants could have a dilutive effect to the extent that the daily volume-weighted average stock prices over a 60 trading day period beginning on September 1, 2022 exceeds the strike price of the 2022 Warrants. Based on the volume-weighted average stock price on September 30, 2019, the total number of shares of our common stock to be issued upon the automatic exercise of the 2022 Warrants would be approximately 1.1 million. The actual number of shares of our common stock issuable upon the automatic exercise of the 2022 Warrants, if any, is unknown at this time.

(12) Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income (loss), net of tax, consist of the following (in thousands):

	September 30, 2019	December 31, 2018
Foreign currency translation adjustment	\$ 15,076	\$ 344
Net unrealized gain (loss) on investments, net of tax	4,555	(4,379)
Accumulated other comprehensive income (loss)	<u>\$ 19,631</u>	<u>\$ (4,035)</u>

Reclassification adjustments out of accumulated other comprehensive income (loss) into net loss were immaterial for all periods presented.

(13) Stockholders' Equity***Common Stock***

We are authorized to issue 600.0 million shares of common stock as of September 30, 2019. Holders of our common stock are not entitled to receive dividends unless declared by our board of directors. As of September 30, 2019, we had 188.6 million shares of common stock outstanding and had reserved shares of common stock for future issuance as follows:

	September 30, 2019
Stock plans:	
Options outstanding	1,274,874
RSUs ⁽¹⁾	9,792,023
Shares of common stock available for future grants:	
2012 Equity Incentive Plan ⁽²⁾	29,361,934
2012 Employee Stock Purchase Plan ⁽²⁾	10,196,414
Total shares of common stock reserved for future issuance	50,625,245

(1) Represents the number of shares issuable upon settlement of outstanding restricted stock units (RSUs) and performance RSUs, assuming 100% of the target number of shares for performance RSUs, as discussed under the section entitled "RSUs" in Note 14.

(2) Refer to Note 14 for a description of these plans.

During the nine months ended September 30, 2019 and 2018, we issued a total of 4.1 million shares and 5.0 million shares, respectively, from stock option exercises, vesting of RSUs, net of employee payroll taxes, and purchases from the employee stock purchase plan (ESPP). In addition, as described in Note 11, we issued approximately 4.3 million shares of our common stock upon the automatic exercise of the 2018 Warrants during the nine months ended September 30, 2019.

(14) Equity Awards

We currently have two equity incentive plans, our 2005 Stock Option Plan (the 2005 Plan) and our 2012 Equity Incentive Plan (the 2012 Plan). Our 2005 Plan was terminated in connection with our initial public offering in 2012 but continues to govern the terms of outstanding stock options that were granted prior to the termination of the 2005 Plan. We no longer grant equity awards pursuant to our 2005 Plan.

Our 2012 Plan provides for the grant of incentive stock options, nonqualified stock options, stock appreciation rights, RSUs, performance-based stock awards and other forms of equity compensation (collectively, equity awards). In addition, the 2012 Plan provides for the grant of performance cash awards. Incentive stock options may be granted only to employees. All other equity awards may be granted to employees, including officers, as well as directors and consultants. The share reserve may increase to the extent outstanding stock options under the 2005 Plan expire or terminate unexercised. Prior to January 2019, the share reserve also automatically increased on January 1 of each year, by up to 5% of the total number of shares of common stock outstanding on December 31 of the preceding year as determined by our board of directors. Our board of directors elected not to increase the number of shares of common stock reserved for issuance under the 2012 Plan pursuant to the provision described in the preceding sentence for the year ending December 31, 2019. In January 2019, our Board of Directors amended the 2012 Plan to remove the automatic increase provision. Therefore, for the remaining term of the 2012 Plan, the share reserve will not be increased without stockholder approval.

Our 2012 Employee Stock Purchase Plan (the 2012 ESPP) authorizes the issuance of shares of common stock pursuant to purchase rights granted to our employees. The price at which common stock is purchased under the 2012 ESPP is equal to 85% of the fair market value of our common stock on the first or last day of the offering period, whichever is lower. Offering periods are six months long and begin on February 1 and August 1 of each year. The number of shares of common stock reserved for issuance automatically increases on January 1 of each year until January 1, 2022, by up to 1% of the total number of shares of common stock outstanding on December 31 of the preceding year as determined by our board of directors. Our board of directors elected not to increase the number of shares of common stock reserved for issuance under the 2012 ESPP pursuant to the provision described in the preceding sentence for the year ending December 31, 2019.

Stock Options

Stock options are exercisable at a price equal to the market value of the underlying shares of common stock on the date of the grant as determined by our board of directors or, for those stock options issued subsequent to our initial public offering, the closing price of our common stock as reported on the New York Stock Exchange on the date of grant. Stock options granted under our 2005 Plan and the 2012 Plan to new employees generally vest 25% one year from the date the requisite service period begins and continue to vest monthly for each month of continued employment over the remaining three years. Options granted generally are exercisable for a period of up to ten years contingent on each holder's continuous status as a service provider.

A summary of stock option activity for the nine months ended September 30, 2019 was as follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2018	1,810,580	\$ 46.55		
Exercised	(231,558)	21.69		\$ 46,348
Outstanding at March 31, 2019	1,579,022	50.19		
Exercised	(209,298)	48.77		\$ 45,982
Outstanding at June 30, 2019	1,369,724	50.41		
Exercised	(94,850)	44.77		\$ 21,104
Outstanding at September 30, 2019	1,274,874	\$ 50.83	4.9	\$ 258,821
Vested and expected to vest as of September 30, 2019	1,101,397	\$ 45.27	4.5	\$ 229,732
Vested and exercisable as of September 30, 2019	960,050	\$ 39.76	4.1	\$ 205,542

Aggregate intrinsic value represents the difference between the estimated fair value of our common stock and the exercise price of outstanding, in-the-money options. The total fair value of stock options vested during the nine months ended September 30, 2019 was \$5.9 million.

As of September 30, 2019, total unrecognized compensation cost, adjusted for estimated forfeitures, related to unvested stock options was approximately \$4.2 million. The weighted-average remaining vesting period of unvested stock options at September 30, 2019 was 1.7 years.

RSUs

A summary of RSU activity for the nine months ended September 30, 2019 was as follows:

	Number of Shares	Weighted Average Grant Date Fair Value (Per Share)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2018	10,201,660	\$ 121.84	
Granted	4,257,565	233.78	
Vested	(1,939,925)	117.30	\$ 445,764
Forfeited	(357,319)	121.26	
Outstanding at March 31, 2019	12,161,981	160.28	
Granted	315,421	257.88	
Vested	(1,310,296)	126.88	\$ 354,773
Forfeited	(250,147)	148.46	
Outstanding at June 30, 2019	10,916,959	167.41	
Granted	336,040	271.73	
Vested	(1,123,407)	132.26	\$ 291,068
Forfeited	(337,569)	162.08	
Outstanding at September 30, 2019	9,792,023	\$ 175.21	\$ 2,485,705

RSUs outstanding as of September 30, 2019 were comprised of 9.1 million RSUs with only a service condition and 0.7 million RSUs with both a service condition and a performance condition. RSUs granted with only service vesting criteria under the 2012 Plan to employees generally vest over a four-year period.

Performance-based RSUs (PRSUs) with both service and performance-based vesting criteria are considered as eligible to vest when approved by the compensation committee of our board of directors in January of the year following the grant. The ultimate number of shares eligible to vest for PRSUs range from 0% to 180% of the target number of shares depending on achievement relative to the performance metric over the applicable period. The eligible shares subject to PRSUs granted during the nine months ended September 30, 2019 will vest 33% in February 2020 and continue to vest quarterly for the remaining two subsequent years, contingent on each holder's continuous status as a service provider on the applicable vesting dates. The number of PRSUs granted shown in the table above reflects the shares that could be eligible to vest at 100% of target for PRSUs and includes adjustments for over or under achievement for PRSUs granted in the prior year. We recognized \$53.7 million and \$65.7 million of stock-based compensation expense, net of actual and estimated forfeitures, associated with PRSUs on a graded vesting basis during the nine months ended September 30, 2019 and 2018, respectively.

As of September 30, 2019, total unrecognized compensation cost, adjusted for estimated forfeitures, related to unvested RSUs was approximately \$1.3 billion and the weighted-average remaining vesting period was 2.9 years.

(15) Net Income (Loss) Per Share

Basic net income (loss) per share attributable to common stockholders is computed by dividing net income (loss) attributable to common stockholders by the weighted-average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) attributable to common stockholders by the weighted-average number of shares of common stock outstanding during the period, adjusted for the effects of dilutive shares of common stock, which are comprised of outstanding stock options, RSUs, ESPP obligations, the Notes and the Warrants. Stock awards with performance conditions are included in dilutive shares to the extent the performance condition is met. The dilutive potential shares of common stock are computed using the treasury stock method or the as-if converted method, as applicable. The effects of outstanding stock options, RSUs, ESPP obligations, Notes and Warrants are excluded from the computation of diluted net income (loss) per share in periods in which the effect would be antidilutive.

The following tables present the calculation of basic and diluted net income (loss) per share attributable to common stockholders (in thousands, except share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Numerator:				
Net income (loss)	\$ 40,598	\$ 8,405	\$ 27,974	\$ (33,719)
Denominator:				
Weighted-average shares outstanding - basic	188,074,303	178,719,694	185,676,049	177,198,179
Weighted-average effect of potentially dilutive securities:				
Common stock options	1,049,480	1,438,359	1,152,844	—
RSUs	4,363,056	5,477,421	4,964,120	—
ESPP obligations	—	2,093	—	—
In-the-money portion of 2018 Notes	—	1,523,555	—	—
2018 Warrants	—	3,360,525	1,125,841	—
In-the-money portion of 2022 Notes	2,928,795	1,669,252	2,701,072	—
2022 Warrants	1,462,581	—	1,118,848	—
Weighted-average shares outstanding - diluted	197,878,215	192,190,899	196,738,774	177,198,179
Net income (loss) per share - basic	\$ 0.22	\$ 0.05	\$ 0.15	\$ (0.19)
Net income (loss) per share - diluted	\$ 0.21	\$ 0.04	\$ 0.14	\$ (0.19)

Potentially dilutive securities that are not included in the calculation of diluted net income (loss) per share because doing so would be antidilutive are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Common stock options	—	—	—	1,905,320
RSUs	455,086	790,822	747,604	10,993,646
ESPP obligations	273,219	—	273,219	317,940
2018 Notes	—	—	—	2,190,631
2018 Warrants	—	—	—	7,783,023
2022 Notes	—	—	—	5,806,933
2022 Warrants	—	5,806,933	—	5,806,933
Total potentially dilutive securities	728,305	6,597,755	1,020,823	34,804,426

(16) Income Taxes

We compute our provision for income taxes by applying the estimated annual effective tax rate to year-to-date income from recurring operations and adjust the provision for discrete tax items recorded in the period.

Our income tax provision was \$20.2 million and \$5.0 million for the three and nine months ended September 30, 2019, respectively. The income tax provision was attributable to the mix of earnings and losses in countries with differing statutory tax rates and valuation allowances in certain countries.

Our income tax benefit was \$1.2 million and \$7.3 million for the three and nine months ended September 30, 2018, respectively. For the three months ended September 30, 2018, the income tax benefit was primarily attributable to excess tax benefits of stock-based compensation and loss from domestic operations. For the nine months ended September 30, 2018, the income tax benefit was primarily attributable to the one-time indirect effect of Topic 606 on income taxes associated with intercompany adjustments offset by our loss from operations.

We maintain a full valuation allowance against our U.S. and certain foreign deferred tax assets as of September 30, 2019. We regularly assess the need for a valuation allowance against our deferred tax assets. In making that assessment, we consider both positive and negative evidence related to the likelihood of realization of the deferred tax assets to determine, based on the weight of available evidence, whether it is more likely than not that some or all of the deferred tax assets will not be realized. Due to cumulative losses over recent years and based on all available evidence, we have determined that it is more likely than not that our U.S. and certain foreign deferred tax assets will not be realized as of September 30, 2019. Due to our international expansion and improvements in the operating results of our Irish subsidiary over the past three years, we believe a reasonable possibility exists that within the next several months sufficient positive evidence may become available to reach a conclusion that the valuation allowance against the net deferred tax assets of our Irish subsidiary will no longer be needed. The deferred tax assets of our Irish subsidiary were created primarily as a result of the difference between the tax basis in our Irish subsidiary and the cost reported in our consolidated financial statements resulting from the transfer of intangible assets to our Irish subsidiary as part of our foreign restructuring in 2018. Based on foreign exchange rates as of September 30, 2019, a release of the Irish valuation allowance would result in the recognition of certain deferred tax assets and an income tax benefit of approximately \$550 to \$600 million for the period in which such release is recorded.

We are subject to taxation in the United States and foreign jurisdictions. As of September 30, 2019, our tax years 2004 to 2018 remain subject to examination in most jurisdictions.

There are differing interpretations of tax laws and regulations, and as a result, disputes may arise with tax authorities involving issues of the timing and amount of deductions and allocations of income among various tax jurisdictions. We periodically evaluate our exposures associated with our tax filing positions. We believe that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations, and we do not anticipate a significant impact to our gross unrecognized tax benefits within the next 12 months related to these years. Although the timing of the resolution, settlement, and closure of any audit is highly uncertain, it is reasonably possible that the balance of gross unrecognized tax benefits could significantly change in the next 12 months. However, given the number of years that remain subject to examination, we are unable to estimate the full range of possible adjustments to the balance of gross unrecognized tax benefits.

(17) Commitments and Contingencies

Operating Leases

For some of our offices and data centers, we have entered into non-cancelable operating lease agreements with various expiration dates through 2035. Certain lease agreements include options to renew or terminate the lease, which are not reasonably certain to be exercised and therefore are not factored into our determination of lease payments.

Total operating lease costs were \$16.6 million and \$47.2 million, excluding short-term lease costs, variable lease costs and sublease income each of which were immaterial, for the three and nine months ended September 30, 2019, respectively. Total lease expenses recognized prior to our adoption of Topic 842 was \$11.7 million and \$34.5 million for the three and nine months ended September 30, 2018, respectively.

For the nine months ended September 30, 2019, cash paid for amounts included in the measurement of operating lease liabilities was \$31.7 million and operating lease liabilities arising from obtaining operating right-of-use assets totaled \$106.0 million.

As of September 30, 2019, the weighted-average remaining lease term is 9.9 years, and the weighted-average discount rate is 3.7%.

Maturities of operating lease liabilities as of September 30, 2019 are presented in the table below (in thousands):

Years Ending December 31,

Remainder of 2019	\$	16,242
2020		65,380
2021		64,257
2022		61,138
2023		56,499
Thereafter		272,519
Total operating lease payments		536,035
Less: imputed interest		(98,221)
Present value of operating lease liabilities	\$	437,814

In addition to the amounts above, as of September 30, 2019, we have operating leases, primarily for offices, that have not yet commenced with undiscounted cash flows of \$412.5 million. These operating leases will commence between 2019 and 2022 with lease terms of 3 to 15 years.

Future minimum commitments under our non-cancelable operating leases as of December 31, 2018 are presented in the table below (in thousands):

Years Ending December 31,

2019	\$	55,435
2020		60,996
2021		63,348
2022		67,707
2023		72,491
Thereafter		578,874
Total	\$	898,851

Other Contractual Commitments

Other contractual commitments consist of data center and IT operations and sales and marketing activities. There were no material contractual obligations that were entered into during the nine months ended September 30, 2019 that were outside the ordinary course of business.

In addition to the amounts above, the repayment of our 2022 Notes with an aggregate principal amount of \$782.5 million is due on June 1, 2022. Refer to Note 11 for further information regarding our Notes.

In addition to the obligations in the table above, approximately \$5.0 million of unrecognized tax benefits have been recorded as liabilities as of September 30, 2019.

Letters of Credit

As of September 30, 2019, we had letters of credit in the aggregate amount of \$22.7 million, primarily in connection with our customer contracts and operating leases.

Legal Proceedings

From time to time, we are party to litigation and other legal proceedings in the ordinary course of business. While the results of any litigation or other legal proceedings are uncertain, management does not believe the ultimate resolution of any pending legal matters is likely to have a material adverse effect on our financial position, results of operations or cash flows, except for those matters for which we have recorded a loss contingency. We accrue for loss contingencies when it is both probable that we will incur the loss and when we can reasonably estimate the amount of the loss or range of loss.

Generally, our subscription agreements require us to defend our customers for third-party intellectual property infringement and other claims. Any adverse determination related to intellectual property claims or other litigation could prevent us from offering our services and adversely affect our financial condition and results of operations.

(18) Information about Geographic Areas and Products

Revenues by geographic area, based on the location of our users, were as follows for the periods presented (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
North America ⁽¹⁾	\$ 590,058	\$ 451,457	\$ 1,660,403	\$ 1,252,189
EMEA ⁽²⁾	213,355	161,688	619,793	474,758
Asia Pacific and other	82,420	59,952	228,467	166,428
Total revenues	\$ 885,833	\$ 673,097	\$ 2,508,663	\$ 1,893,375

Property and equipment, net by geographic area were as follows (in thousands):

	September 30, 2019	December 31, 2018
North America ⁽³⁾	\$ 239,511	\$ 227,471
EMEA ⁽²⁾	88,869	82,526
Asia Pacific and other	72,478	37,219
Property and equipment, net	\$ 400,858	\$ 347,216

(1) Revenues attributed to the United States were approximately 94% of North America revenues for each of the three and nine months ended September 30, 2019 and 2018.

(2) Europe, the Middle East and Africa

(3) Property and equipment, net attributed to the United States were approximately 76% of property and equipment, net attributable to North America as of both September 30, 2019 and December 31, 2018.

Subscription revenues consist of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Digital workflow products ⁽¹⁾	\$ 721,161	\$ 548,328	\$ 2,034,872	\$ 1,533,998
ITOM products ⁽¹⁾	113,749	78,239	321,013	221,176
Total subscription revenues	\$ 834,910	\$ 626,567	\$ 2,355,885	\$ 1,755,174

(1) As we have expanded the scope of IntegrationHub (formerly included within our ITOM offering) beyond ITOM to align more closely with our broader platform offering, revenues associated with IntegrationHub have been reclassified from ITOM products to platform, which is part of our digital workflow products. Revenues reclassified from ITOM product revenues to digital workflow products revenues were \$15.3 million and \$43.7 million for the three and nine months ended September 30, 2018, respectively.

Our digital workflow products include our platform, IT service management, IT business management, customer service management, HR service delivery, security operations, IT asset management, field service management, and governance, risk and compliance, and are generally priced on a per user basis. Our ITOM products are generally priced on a per node (physical or virtual server) basis. In previously issued financial statements, we referred to digital workflow products as “service management products.”

(19) Subsequent Events

During the three months ended December 31, 2019, we entered into an asset purchase agreement to acquire certain intellectual property assets and research and development talent from a privately-held company for approximately \$35.0 million in cash. This transaction is expected to close during the same quarter. Our accounting and analysis of this transaction is pending completion.

On October 22, 2019, we announced that John J. Donahoe will resign from his position as our President and Chief Executive Officer, effective on or before December 31, 2019. Mr. Donahoe will continue to serve as a member of our board of directors until his current term expires at the annual meeting of shareholders in 2020. On October 22, 2019, we also announced that William R. McDermott will become our President and Chief Executive Officer and a member of the board of directors, each to become effective on or before January 1, 2020.

ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition, results of operations and cash flows should be read in conjunction with the (1) unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q, and (2) the audited consolidated financial statements and notes thereto and management’s discussion and analysis of financial condition and results of operations for the year ended December 31, 2018 included in the Annual Report on Form 10-K dated as of, and filed with the Securities and Exchange Commission (the SEC), on February 27, 2019 (File No. 001-35580). This Quarterly Report on Form 10-Q contains “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These statements are often identified by the use of words such as “may,” “will,” “expect,” “believe,” “anticipate,” “intend,” “could,” “estimate,” or “continue,” and similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified herein, and those discussed in the section titled “Risk Factors,” set forth in Part II, Item 1A of this Quarterly Report on Form 10-Q and in our other SEC filings. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Investors and others should note that we announce material financial information to our investors using our investor relations website (<https://www.servicenow.com/company/investor-relations.html>), SEC filings, press releases, public conference calls and webcasts. We use these channels, as well as social media, to communicate with our investors and the public about our company, our services and other issues. It is possible that the information we post on social media could be deemed to be material information. Therefore, we encourage investors, the media, and others interested in our company to review the information we post on the social media channels listed on our investor relations website.

Our billings and free cash flow measures included in the sections entitled “—Key Business Metrics—Billings,” and “—Key Business Metrics—Free Cash Flow” are not in accordance with U.S. Generally Accepted Accounting Principles (GAAP). These non-GAAP financial measures are not intended to be considered in isolation or as a substitute for, or superior to, financial information prepared and presented in accordance with GAAP. These measures may be different from non-GAAP financial measures used by other companies, limiting their usefulness for comparison purposes. We encourage investors to carefully consider our results under GAAP, as well as our supplemental non-GAAP results, to more fully understand our business.

Overview

ServiceNow, the company that makes work, work better for people, is a leading provider of enterprise cloud computing services that define, structure, manage and automate digital workflows for global enterprises. We deliver digital workflows that help our customers create great experiences and unlock productivity. We typically deliver our software via the Internet as a service, through an easy-to-use, consumer product-like interface, which means it can be easily configured and rapidly deployed. In a minority of cases, customers deploy our software internally or contract with a third party to host the software to support their unique regulatory or security requirements.

We generally offer our services on an annual subscription fee basis, which includes access to the ordered subscription service and related support, including updates to the subscription service during the subscription term. Pricing for our subscription services is based on a number of factors, including duration of subscription term, volume, mix of products purchased, and discounts. We generate sales through our direct sales team and, to a lesser extent, indirectly through resale partners and third-party referrals. We also generate revenues from professional services and for training of customer and partner personnel. We are shifting the focus of our professional services organization from implementation services to strategic advisory and consulting services to accelerate platform adoption and drive customer outcomes. We generally bill our customers annually in advance for subscription services and monthly in arrears for our professional services as the work is performed.

A majority of our revenues come from large global enterprise customers. We continue to invest in the development of our services, infrastructure and sales and marketing to drive long-term growth. We increased our overall employee headcount to 9,929 as of September 30, 2019 from 7,661 as of September 30, 2018.

Key Business Metrics

Number of customers with ACV greater than \$1 million. We count the total number of customers with annualized contract value (ACV) greater than \$1 million as of the end of the period. We had 809 and 612 customers with ACV greater than \$1 million as of September 30, 2019 and 2018, respectively. For purposes of customer count, a customer is defined as an entity that has a unique Dunn & Bradstreet Global Ultimate (GULT) Data Universal Numbering System (DUNS) number and an active subscription contract as of the measurement date. The DUNS number is a global standard for business identification and tracking. We make exceptions for holding companies, government entities and other organizations for which the GULT, in our judgment, does not accurately represent the ServiceNow customer. For example, while all U.S. government agencies roll up to “Government of the United States” under the GULT, we count each government agency that we contract with as a separate customer. Our customer count is subject to adjustments for acquisitions, spin-offs and other market activity; accordingly, we restate previously disclosed number of customers with ACV greater than \$1 million calculations to allow for comparability. ACV is calculated based on the foreign exchange rate in effect at the time the contract was signed. Foreign exchange rate fluctuations could cause some variability in the number of customers with ACV greater than \$1 million.

Total backlog. Total backlog consists of unbilled backlog, deferred revenue and customer deposits. Unbilled backlog is an operational measure representing future unearned revenue amounts believed to be firm that are to be invoiced under our existing agreements and are not included in the deferred revenue or customer deposits on our condensed consolidated balance sheets. We believe total backlog is a useful measure of customer adoption of our services.

As of September 30, 2019, our total backlog was \$5.8 billion, of which \$4.0 billion was unbilled backlog and \$1.8 billion was deferred revenue and customer deposits. Of this total backlog, we expect to recognize approximately 51% in revenues over the 12 months following September 30, 2019, with the balance to be recognized thereafter. As of December 31, 2018, our total backlog was \$5.1 billion, of which \$3.4 billion was unbilled backlog and \$1.7 billion was deferred revenue and customer deposits.

We expect total backlog to fluctuate due to a number of factors, including the timing, duration and size of customer contracts, the mix of cloud and self-hosted offerings and foreign exchange rate fluctuations.

Billings. We define billings, a non-GAAP financial measure, as GAAP revenues recognized plus the change in total GAAP unbilled receivables, deferred revenue and customer deposits as presented on the condensed consolidated statements of cash flows. A calculation of billings is provided below:

	Three Months Ended September 30,			% Change	Nine Months Ended September 30,			% Change
	2019	2018			2019	2018		
	(dollars in thousands)				(dollars in thousands)			
Billings:								
Total revenues	\$ 885,833	\$ 673,097		32%	\$ 2,508,663	\$ 1,893,375		32%
Change in total deferred revenue, unbilled receivables and customer deposits ⁽¹⁾	29,382	47,444		(38%)	135,098	182,418		(26%)
Total billings	<u>\$ 915,215</u>	<u>\$ 720,541</u>		27%	<u>\$ 2,643,761</u>	<u>\$ 2,075,793</u>		27%

(1) As presented on or derived from our condensed consolidated statements of cash flows.

Billings consists of amounts invoiced for subscription contracts with existing customers, renewal contracts, expansion contracts, contracts with new customers, and contracts for professional services and training. Factors that may cause our billings results to vary from period to period include the following:

- **Billings duration.** While we typically bill customers annually for our subscription services. Customers sometimes request, and we accommodate, billings with durations less than or greater than the typical 12-month term.
- **Contract start date.** From time to time, we enter into contracts with a contract start date in the future, and we exclude these amounts from billings as these amounts are not included in our consolidated balance sheets, unless such amounts have been paid as of the balance sheet date.

- *Foreign currency exchange rates.* While a majority of our billings have historically been in U.S. Dollars, an increasing percentage of our billings in recent periods has been in foreign currencies, particularly the Euro and British Pound Sterling. To facilitate greater year-over-year comparability in our billings results, we disclose the impact that foreign currency rate fluctuations and fluctuations in billings duration had on our billings. The impact of foreign currency rate fluctuations is calculated by translating the current period results for entities reporting in currencies other than U.S. Dollars into U.S. Dollars at the exchange rates in effect during the prior period presented, rather than the actual exchange rates in effect during the current period. The impact of fluctuations in billings duration is calculated by replacing the portion of multi-year billings in excess of 12 months during the current period with the portion of multi-year billings in excess of 12 months during the prior period presented. Notwithstanding the adjustments described above, the comparability of billings results from period to period remains subject to the impact of variations in the dollar value of contracts with future start dates and the timing of contract renewals, for which no adjustments have been presented.

Foreign currency rate fluctuations had an unfavorable impact of \$13.0 million on billings for the three months ended September 30, 2019 and an unfavorable impact of \$55.1 million on billings for the nine months ended September 30, 2019, respectively. Changes in billings duration had a favorable impact of \$7.3 million and an unfavorable impact of \$5.0 million for the three and nine months ended September 30, 2019, respectively.

- *Timing of contract renewals.* While customers typically renew their contracts at the end of the contract term, from time to time customers may do so either before or after the scheduled expiration date. For example, in cases where we are successful in selling additional products or services to an existing customer, a customer may decide to renew its existing contract early to ensure that all its contracts expire on the same date. In other cases, prolonged negotiations or other factors may result in a contract not being renewed until after it has expired.
- *Seasonality.* We have historically experienced seasonality in terms of when we enter into customer agreements for our services. We sign a significantly higher percentage of agreements with new customers, as well as renewal agreements with existing customers, in the fourth quarter of each year. The increase in customer agreements for the fourth quarter is primarily a result of the terms of our commission plans which incentivize our direct sales force to meet their annual quotas by December 31 and large enterprise account buying patterns typical in the software industry, which are driven primarily by the expiration of annual authorized budgeted expenditures. Furthermore, we usually sign a significant portion of these agreements during the last month, and often the last two weeks, of each quarter. This seasonality in the timing of entering into customer contracts is sometimes not immediately apparent in our billings, due to the fact that we typically exclude cloud-offering contracts with a future start date from our billings, unless such amounts have been paid as of the balance sheet date. Similarly, this seasonality is reflected to a much lesser extent, and sometimes is not immediately apparent in our revenues, due to the fact that we recognize subscription revenues from our cloud offering contracts over the term of the subscription agreement, which is generally 12 to 36 months. Although these seasonal factors are common in the technology industry, historical patterns should not be considered a reliable indicator of our future sales activity or performance.

While we believe billings is a useful leading indicator regarding the performance of our business, due to the factors described above, an increase or decrease in new or renewed subscriptions in a reporting period may not have an immediate impact on billings for that reporting period.

Free cash flow. We define free cash flow, a non-GAAP financial measure, as GAAP net cash provided by operating activities reduced by purchases of property and equipment. Purchases of property and equipment are otherwise included in cash used in investing activities under GAAP. We believe information regarding free cash flow provides useful information to investors because it is an indicator of the strength and performance of our business operations. However, our calculation of free cash flow may not be comparable to similar measures used by other companies. A calculation of free cash flow is provided below:

	Nine Months Ended September 30,		
	2019	2018	% Change
	(dollars in thousands)		
Free cash flow:			
Net cash provided by operating activities	\$ 814,761	\$ 521,477	56%
Purchases of property and equipment	(185,889)	(136,349)	36%
Free cash flow ⁽¹⁾	\$ 628,872	\$ 385,128	63%

(1) Free cash flow for the nine months ended September 30, 2018 includes the effect of \$101.6 million relating to the repayments of convertible senior notes attributable to debt discount.

Renewal rate. We calculate our renewal rate by subtracting our attrition rate from 100%. Our attrition rate for a period is equal to the ACV from customers lost during the period, divided by the sum of (i) the total ACV from all customers that renewed during the period, excluding changes in price or users, and (ii) the total ACV from all customers lost during the period. Accordingly, our renewal rate is calculated based on ACV and is not based on the number of customers that have renewed. Further, our renewal rate does not reflect increased or decreased purchases from our customers to the extent such customers are not lost customers. A lost customer is a customer that did not renew an expiring contract and that, in our judgment, will not be renewed. Typically, a customer that reduces its subscription upon renewal is not considered a lost customer. However, in instances where the subscription decrease represents the majority of the customer's ACV, we may deem the renewal as a lost customer. For our renewal rate calculation, we define a customer as an entity with a separate production instance of our service and an active subscription contract as of the measurement date, instead of an entity with a unique GULT or DUNS number. We adjust our renewal rate for acquisitions, consolidations and other customer events that cause the merging of two or more accounts occurring at the time of renewal. Previously disclosed renewal rates may be restated to reflect such adjustments to allow for comparability. Our renewal rate was 99% and 97% for the three months ended September 30, 2019 and 2018, respectively, and 98% for each of the nine months ended September 30, 2019 and 2018. As our renewal rate is impacted by the timing of renewals, which could occur in advance of, or subsequent to the original contract end date, period-to-period comparison of renewal rates may not be meaningful.

Average contract term. We calculate the average contract term for new customers, expansion contracts and renewals based on the term of those contracts entered into during the period weighted by their ACV. Revised mapping of customers in the current period may result in revised new customer, expansion and renewal contract terms for previous periods, due to adjustments for acquisitions, spin-offs, improved subsidiary mapping, consolidations and updates to customer DUNS numbers. Previously disclosed average contract terms may be restated to reflect such adjustments to allow for comparability. The average new customer contract term was 35 months and 32 months for the three months ended September 30, 2019 and 2018, respectively, and 36 months for each of the nine months ended September 30, 2019 and 2018. The average expansion contract term was 26 months and 24 months for the three months ended September 30, 2019 and 2018, respectively, and 27 months and 25 months for the nine months ended September 30, 2019 and 2018, respectively. The average renewal contract term was 22 months and 25 months for the three months ended September 30, 2019 and 2018, respectively, and 24 months and 27 months for the nine months ended September 30, 2019 and 2018, respectively.

Components of Results of Operations

Revenues

Subscription revenues. Subscription revenues are primarily comprised of fees that give customers access to the ordered subscription service for both self-hosted offerings and cloud-based subscription offerings, and related support and updates, if any, to the subscription service during the subscription term. For our cloud-based offerings, we recognize revenue ratably over the subscription term. For self-hosted offerings, a substantial portion of the sales price is recognized upon delivery of the software, which may cause greater variability in our subscription revenues and subscription gross margin. Pricing includes multiple instances, hosting and support services, data backup and disaster recovery services, as well as future updates, when and if available, offered during the subscription term. We typically invoice our customers for subscription fees in annual increments upon execution of the initial contract or subsequent renewal. Our contracts are generally non-cancelable during the subscription term, though a customer can terminate for breach if we materially fail to perform.

Professional services and other revenues. Professional services revenues consist of fees associated with professional services. Our arrangements for professional services are primarily on a time-and-materials basis. We generally invoice our professional services monthly in arrears based on actual hours and expenses incurred, and revenues are recognized as services are delivered. Some of our professional services arrangements are on a fixed fee or subscription basis, under which we recognize revenues over the contract term. Other revenues primarily consist of fees from customer training delivered on-site or through publicly available classes. Typical payment terms require our customers to pay us within 30 days of invoice.

We generate sales directly through our sales team and, to a lesser extent, indirectly through resale partners. We also offer a portfolio of professional and other services, both directly and through our network of partners. Revenues from our direct sales organization represented 81% and 82% of our total revenues for the three months ended September 30, 2019 and 2018, respectively, and 82% and 84% for the nine months ended September 30, 2019 and 2018, respectively. For purposes of calculating revenues from our direct sales organization, revenues from systems integrators and managed services providers are included as part of the direct sales organization.

Allocation of Overhead Costs

Overhead costs associated with office facilities, IT and certain depreciation related to infrastructure that is not dedicated for customer use or research and development use are allocated to cost of revenues and operating expenses based on headcount.

Cost of Revenues

Cost of subscription revenues. Cost of subscription revenues consists primarily of expenses related to hosting our services and providing support to our customers. These expenses are comprised of data center capacity costs, which include colocation costs associated with our data centers as well as interconnectivity between data centers, depreciation related to our infrastructure hardware equipment dedicated for customer use, amortization of intangible assets, expenses associated with software, IT services and support dedicated for customer use, personnel-related costs directly associated with data center operations and customer support, including salaries, benefits, bonuses and stock-based compensation and allocated overhead.

Cost of professional services and other revenues. Cost of professional services and other revenues consists primarily of personnel-related costs directly associated with our professional services and training departments, including salaries, benefits, bonuses and stock-based compensation, the costs of contracted third-party partners, travel expenses and allocated overhead.

Professional services are performed directly by our services team, as well as by contracted third-party partners. Fees paid by us to third-party partners are primarily recognized as cost of revenues as the professional services are delivered. Cost of revenues associated with our professional services engagements contracted with third-party partners as a percentage of professional services and other revenues was 15% for each of the three and nine months ended September 30, 2019, and 16% and 18% for the three and nine months ended September 30, 2018, respectively.

Sales and Marketing

Sales and marketing expenses consist primarily of personnel-related expenses directly associated with our sales and marketing staff, including salaries, benefits, bonuses and stock-based compensation. Sales and marketing expenses also include the amortization of commissions paid to our sales employees, including related payroll taxes and fringe benefits. In addition, sales and marketing expenses include expenses offset by proceeds related to our annual Knowledge user conference (Knowledge), other marketing program expenses, which include events other than Knowledge, and costs associated with purchasing advertising and marketing data, software and subscription services dedicated for sales and marketing use and allocated overhead.

Research and Development

Research and development expenses consist primarily of personnel-related expenses directly associated with our research and development staff, including salaries, benefits, bonuses and stock-based compensation and allocated overhead. Research and development expenses also include data center capacity costs, costs associated with outside services contracted for research and development purposes, amortization of intangible assets and depreciation of infrastructure hardware equipment that is used solely for research and development purposes.

General and Administrative

General and administrative expenses consist primarily of personnel-related expenses for our executive, finance, legal, human resources, facilities and administrative personnel, including salaries, benefits, bonuses and stock-based compensation, external legal, accounting and other professional services fees, other corporate expenses, amortization of intangible assets and allocated overhead.

Provision for Income Taxes

Provision for income taxes consists of federal, state and foreign income taxes. Due to cumulative losses, we maintain a valuation allowance against our U.S. and certain foreign deferred tax assets as of September 30, 2019. We consider all available evidence, both positive and negative, including but not limited to earnings history, projected future outcomes, industry and market trends and the nature of each of the deferred tax assets in assessing the extent to which a valuation allowance should be applied against our U.S. and foreign deferred tax assets.

Results of Operations

To enhance comparability, the following table sets forth our results of operations for the periods presented. The period-to-period comparison of financial results is not necessarily indicative of future results.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
(dollars in thousands)				
Revenues:				
Subscription	\$ 834,910	\$ 626,567	\$ 2,355,885	\$ 1,755,174
Professional services and other	50,923	46,530	152,778	138,201
Total revenues	885,833	673,097	2,508,663	1,893,375
Cost of revenues ⁽¹⁾ :				
Subscription	139,330	106,821	401,398	303,918
Professional services and other	61,463	51,037	183,794	150,578
Total cost of revenues	200,793	157,858	585,192	454,496
Gross profit	685,040	515,239	1,923,471	1,438,879
Operating expenses ⁽¹⁾ :				
Sales and marketing	362,975	289,323	1,118,279	883,893
Research and development	190,099	135,655	546,041	380,839
General and administrative	75,642	80,693	245,540	216,851
Total operating expenses	628,716	505,671	1,909,860	1,481,583
Income (loss) from operations	56,324	9,568	13,611	(42,704)
Interest expense	(8,371)	(11,233)	(24,808)	(43,795)
Interest income and other income (expense), net	12,817	8,895	44,196	45,520
Income (loss) before income taxes	60,770	7,230	32,999	(40,979)
Provision for (benefit from) income taxes	20,172	(1,175)	5,025	(7,260)
Net income (loss)	\$ 40,598	\$ 8,405	\$ 27,974	\$ (33,719)

(1) Stock-based compensation included in the statements of operations above was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
(dollars in thousands)				
Cost of revenues:				
Subscription	\$ 18,880	\$ 12,775	\$ 54,019	\$ 36,604
Professional services and other	10,867	8,407	31,749	24,310
Sales and marketing	68,712	60,132	200,071	169,283
Research and development	50,636	35,527	144,259	97,905
General and administrative	13,839	27,567	62,046	73,207
Total stock-based compensation	\$ 162,934	\$ 144,408	\$ 492,144	\$ 401,309

The following table sets forth our results of operations as a percentage of total revenues for the periods presented.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Revenues:				
Subscription	94%	93%	94%	93%
Professional services and other	6	7	6	7
Total revenues	100	100	100	100
Cost of revenues ⁽¹⁾ :				
Subscription	16	16	16	16
Professional services and other	7	7	7	8
Total cost of revenues	23	23	23	24
Gross profit	77	77	77	76
Operating expenses ⁽¹⁾ :				
Sales and marketing	41	43	45	47
Research and development	21	20	22	20
General and administrative	9	13	9	11
Total operating expenses	71	76	76	78
Income (loss) from operations	6	1	1	(2)
Interest expense	(1)	(2)	(1)	(2)
Interest income and other income (expense), net	1	2	1	2
Income (loss) before income taxes	6	1	1	(2)
Provision for (benefit from) income taxes	1	0	0	0
Net income (loss)	5%	1%	1%	(2%)

(1) Stock-based compensation included in the statements of operations above as a percentage of revenues was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Cost of revenues:				
Subscription	2%	2%	2%	2%
Professional services and other	1	1	1	1
Sales and marketing	8	9	8	9
Research and development	5	5	6	5
General and administrative	2	4	3	4
Total stock-based compensation	18%	21%	20%	21%

Comparison of the Three Months Ended September 30, 2019 and 2018

Revenues

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Revenues:			
Subscription	\$ 834,910	\$ 626,567	33%
Professional services and other	50,923	46,530	9%
Total revenues	<u>\$ 885,833</u>	<u>\$ 673,097</u>	32%
Percentage of revenues:			
Subscription	94%	93%	
Professional services and other	6%	7%	
Total	<u>100%</u>	<u>100%</u>	

Subscription revenues increased \$208.3 million during the three months ended September 30, 2019 compared to the same period in the prior year, driven by increased purchases by existing customers and an increase in our customer count. Included in subscription revenues is \$35.0 million and \$33.2 million of revenues recognized upfront from the delivery of software associated with self-hosted offerings during the three months ended September 30, 2019 and 2018, respectively. We expect subscription revenues to grow in absolute dollars and as a percentage of total revenues for the year ending December 31, 2019 compared to the year ended December 31, 2018 as we continue to add new customers and existing customers increase their usage of our products. Our expectations for revenues, cost of revenues and operating expenses for the remainder of 2019 are based on foreign exchange rates as of September 30, 2019.

Subscription revenues consist of the following:

	Three Months Ended September 30,		
	2019	2018	% Change
	(dollars in thousands)		
Digital workflow products ⁽¹⁾	\$ 721,161	\$ 548,328	32%
ITOM products ⁽¹⁾	113,749	78,239	45%
Total subscription revenues	\$ 834,910	\$ 626,567	33%

(1) As we have expanded the scope of IntegrationHub (formerly included within our ITOM offering) beyond ITOM to align more closely with our broader platform offering, revenues associated with IntegrationHub have been reclassified from ITOM products to platform, which is part of our digital workflow products. Revenues reclassified from ITOM product revenues to digital workflow products revenues was \$15.3 million for the three months ended September 30, 2018.

Our digital workflow products include our platform, IT service management, IT business management, customer service management, HR service delivery, security operations, IT asset management, field service management, and governance, risk and compliance, and are generally priced on a per user basis. Our ITOM products are generally priced on a per node (physical or virtual server) basis. In previously issued financial statements, we referred to digital workflow products as “service management products.”

Professional services and other revenues increased \$4.4 million during the three months ended September 30, 2019 compared to the same period in the prior year. We expect professional services and other revenues to grow in absolute dollar terms, but decline as a percentage of total revenues for the year ending December 31, 2019 compared to the year ended December 31, 2018 as we are increasingly focused on deploying our internal professional services organization as a strategic resource to accelerate platform adoption and drive customer outcomes, and relying on our partner ecosystem to contract directly with customers for service delivery.

Cost of Revenues and Gross Profit Percentage

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Cost of revenues:			
Subscription	\$ 139,330	\$ 106,821	30%
Professional services and other	61,463	51,037	20%
Total cost of revenues	\$ 200,793	\$ 157,858	27%
Gross profit (loss) percentage:			
Subscription	83%	83%	
Professional services and other	(21%)	(10%)	
Total gross profit percentage	77%	77%	
Gross profit	\$ 685,040	\$ 515,239	
Headcount (at period end)			
Subscription	1,365	1,121	22%
Professional services and other	759	641	18%
Total headcount	2,124	1,762	21%

Cost of subscription revenues increased \$32.5 million during the three months ended September 30, 2019 compared to the same period in the prior year due to increased headcount, which resulted in an increase of \$8.3 million in personnel-related costs excluding stock-based compensation, an increase of \$6.1 million in stock-based compensation and an increase of \$2.5 million in overhead expenses. Depreciation expense increased \$9.6 million due to purchases of infrastructure hardware equipment for our data centers and expenses associated with software, IT services and technical support increased \$3.0 million. In addition, data center capacity costs increased \$2.1 million due to the addition of new data centers and the expansion of existing data centers.

Our subscription gross profit percentage was 83% for each of the three months ended September 30, 2019 and 2018. The increase in revenues recognized upfront from the delivery of software associated with self-hosted offerings contributed to approximately one percentage point improvement in our subscription gross profit percentage for each of the three months ended September 30, 2019 and 2018. We expect our cost of subscription revenues to increase in absolute dollar terms for the year ending December 31, 2019 compared to the year ended December 31, 2018 as we provide subscription services to more customers and increase usage within our customer instances, but we expect such increase to be at a slower rate than the increase in our subscription revenues, leading to a slight increase in our subscription gross profit percentage for the year ending December 31, 2019 as we continue to leverage the investments we have made in our existing data center infrastructure. To the extent future acquisitions are consummated, our cost of subscription revenues may increase due to additional non-cash charges associated with the amortization of intangible assets acquired.

Cost of professional services and other revenues increased \$10.4 million during the three months ended September 30, 2019 as compared to the same period in the prior year, primarily due to increased headcount resulting in an increase of \$5.9 million in personnel-related costs excluding stock-based compensation and an increase of \$2.5 million in stock-based compensation.

Our professional services and other gross loss percentage increased to 21% for the three months ended September 30, 2019, from 10% for the three months ended September 30, 2018, primarily due to stock-based compensation and other personnel-related costs increasing at a higher rate than professional services and other revenues as we invest in specialized resources to support our newer products and transform our internal professional services organization from an implementation resource to a strategic advisory resource to accelerate platform adoption and drive customer outcomes. As a result of this transformation, we expect a gross loss for professional services and other revenues for the year ending December 31, 2019.

Sales and Marketing

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Sales and marketing	\$ 362,975	\$ 289,323	25%
Percentage of revenues	41%	43%	
Headcount (at period end)	3,683	2,890	27%

Sales and marketing expenses increased \$73.7 million during the three months ended September 30, 2019 compared to the same period in the prior year, primarily due to increased headcount resulting in an increase of \$48.2 million in personnel-related costs excluding stock-based compensation and commissions, an increase of \$8.6 million in stock-based compensation and an increase of \$8.6 million in overhead expenses. Amortization expenses associated with commissions and third-party referral fees, including their related payroll taxes and fringe benefits, amounted to 5% and 7% of subscription revenues for the three months ended September 30, 2019 and 2018, respectively. Other sales and marketing program expenses, which include events other than Knowledge, and costs associated with purchasing advertising and market data, increased \$9.7 million during the three months ended September 30, 2019 compared to the same period in the prior year. Outside services costs increased \$4.6 million during the three months ended September 30, 2019 compared to the same period in the prior year. Loss from write-off of property and equipment decreased \$4.6 million during the three months ended September 30, 2019 compared to the same period in the prior year primarily due to a write off of internal-use and subscription software in the third quarter of 2018.

We expect sales and marketing expenses to increase in absolute dollar terms for the year ending December 31, 2019 compared to the year ended December 31, 2018, as we continue to expand our direct sales force, increase our marketing activities, grow our international operations and build brand awareness, but decrease as a percentage of total revenues.

Research and Development

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Research and development	\$ 190,099	\$ 135,655	40%
Percentage of revenues	21%	20%	
Headcount (at period end)	2,747	1,860	48%

Research and development expenses increased \$54.4 million during the three months ended September 30, 2019 compared to the same period in the prior year, primarily due to increased headcount, which resulted in an increase of \$29.7 million in personnel-related costs excluding stock-based compensation, an increase of \$15.1 million in stock-based compensation and an increase of \$8.4 million in overhead expenses.

We expect research and development expenses to increase in absolute dollar terms and as a percentage of total revenues for the year ending December 31, 2019 compared to the year ended December 31, 2018 as we continue to improve the existing functionality of our services, develop new applications to fill market needs and enhance our core platform.

General and Administrative

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
General and administrative	\$ 75,642	\$ 80,693	(6%)
Percentage of revenues	9%	13%	
Headcount (at period end)	1,375	1,149	20%

General and administrative expenses decreased \$5.1 million during the three months ended September 30, 2019 compared to the same period in the prior year due to a reduction in stock-based compensation of \$13.7 million primarily attributable to the expected forfeiture of certain awards by our Chief Executive Officer, partially offset by an increase of \$8.0 million in personnel-related costs excluding stock-based compensation due to increased headcount.

We expect general and administrative expenses to increase in absolute dollar terms for the year ending December 31, 2019 compared to the year ended December 31, 2018 as we continue to hire new employees, but decrease as a percentage of total revenues.

Stock-based Compensation

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Cost of revenues:			
Subscription	\$ 18,880	\$ 12,775	48%
Professional services and other	10,867	8,407	29%
Sales and marketing	68,712	60,132	14%
Research and development	50,636	35,527	43%
General and administrative	13,839	27,567	(50%)
Total stock-based compensation	\$ 162,934	\$ 144,408	13%
Percentage of revenues	18%	21%	

Stock-based compensation increased \$18.5 million during the three months ended September 30, 2019 compared to the same period in the prior year, primarily due to additional grants to current and new employees and increased weighted-average grant date fair value of stock awards.

Stock-based compensation is inherently difficult to forecast due to fluctuations in our stock price. Based upon our stock price as of September 30, 2019, we expect stock-based compensation to continue to increase in absolute dollar terms for the year ending December 31, 2019 compared to the year ended December 31, 2018 as we continue to issue stock-based awards to our employees, but decrease as a percentage of total revenues.

Foreign Currency Exchange

Our international operations have provided and will continue to provide a significant portion of our total revenues. Revenues outside North America represented 33% of total revenues for each of the three months ended September 30, 2019 and 2018. Because we primarily transact in foreign currencies for sales outside of the United States, the general strengthening of the U.S. Dollar relative to other major foreign currencies (primarily the Euro and British Pound Sterling) from the three months ended September 30, 2018 to the three months ended September 30, 2019 had an unfavorable impact on our revenues. For entities reporting in currencies other than the U.S. Dollar, if we had translated our results for the three months ended September 30, 2019 at the exchange rates in effect for the three months ended September 30, 2018 rather than the actual exchange rates in effect during the period, our reported subscription revenues would have been \$12.7 million higher. The impact from the foreign currency movements from the three months ended September 30, 2018 to the three months ended September 30, 2019 was not material for professional services and other revenues.

In addition, because we primarily transact in foreign currencies for cost of revenues and operating expenses outside of the United States, the general strengthening of the U.S. Dollar relative to other major foreign currencies (primarily the Euro and British Pound Sterling) from the three months ended September 30, 2018 to the three months ended September 30, 2019 had a favorable impact on our cost of revenues and sales and marketing expenses. For entities reporting in currencies other than the U.S. Dollar, if we had translated our results for the three months ended September 30, 2019 at the exchange rates in effect for the three months ended September 30, 2018 rather than the actual exchange rates in effect during the period, our reported cost of revenues and sales and marketing expenses would have been \$2.5 million and \$3.8 million higher, respectively. The impact from the foreign currency movements from the three months ended September 30, 2018 to the three months ended September 30, 2019 is not material to research and development expenses and general and administrative expenses.

Interest Expense

	Three Months Ended September 30,		% Change
	2019	2018	
	(dollars in thousands)		
Interest expense	\$ (8,371)	\$ (11,233)	(25%)
Percentage of revenues	(1%)	(2%)	

Interest expense decreased \$2.9 million during the three months ended September 30, 2019 compared to the same period in the prior year, primarily due to the decrease in the aggregate amount of convertible debt and associated amortization expense of debt discount and issuance costs related to the repayment of the 2018 Notes that occurred in 2018. For the year ending December 31, 2019, we expect to incur approximately \$33.3 million in amortization expense of debt discount and issuance costs related to the 2022 Notes.

Interest Income and Other Income (Expense), net

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Interest income	\$ 14,562	\$ 8,587	70%
Foreign currency exchange (loss) gain, net of derivative contracts	(1,951)	527	NM
Loss on early note conversions	—	(190)	(100%)
Other	206	(29)	NM
Interest and other income (expense), net	\$ 12,817	\$ 8,895	44%
Percentage of revenues	1%	2%	

NM - Not meaningful.

Interest income and other income (expense), net increased \$3.9 million during the three months ended September 30, 2019 compared to the same period in the prior year, primarily driven by an increase of \$6.0 million in interest income due to higher cash and investment balances and higher yields on our invested balances for the three months ended September 30, 2019, partially offset by a foreign currency exchange loss, net of derivative contracts of \$2.0 million during the three months ended September 30, 2019 compared to a foreign currency exchange gain, net of derivative contracts of \$0.5 million during the three months ended September 30, 2018.

In order to manage certain exposures to currency fluctuations, we enter into foreign currency derivative contracts with maturities of 12 months or less to hedge a portion of our net outstanding monetary assets and liabilities. These hedging contracts may reduce, but cannot entirely eliminate, the impact of adverse currency exchange rate movements.

Provision for (Benefit from) Income Taxes

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Income before income taxes	\$ 60,770	\$ 7,230	741%
Provision for (benefit from) income taxes	20,172	(1,175)	NM
Effective tax rate	33%	(16%)	

NM - Not meaningful.

Our income tax provision was \$20.2 million for the three months ended September 30, 2019. The income tax provision was attributable to the mix of earnings and losses in countries with differing statutory tax rates and valuation allowances in certain countries.

Our income tax benefit was \$1.2 million for the three months ended September 30, 2018. The income tax benefit was primarily attributable to excess tax benefits of stock-based compensation and loss from domestic operations.

We continue to maintain a full valuation allowance on our U.S. federal and state deferred tax assets and certain foreign deferred tax assets, and the significant components of the tax expense recorded are current cash taxes payable in various jurisdictions. The cash tax expenses are impacted by each jurisdiction's individual tax rates, laws on timing of recognition of income and deductions, and availability of net operating losses and tax credits. Given the full valuation allowance, sensitivity of current cash taxes to local rules and our foreign structuring, we expect that our effective tax rate could fluctuate significantly on a quarterly basis and could be adversely affected to the extent earnings are lower than anticipated in countries that have lower statutory rates and higher than anticipated in countries that have higher statutory rates. Due to our international expansion and improvements in the operating results of our Irish subsidiary over the past three years, we believe a reasonable possibility exists that within the next several months, sufficient positive evidence may become available to reach a conclusion that the valuation allowance against the net deferred tax assets of our Irish subsidiary will no longer be needed. The deferred tax assets of our Irish subsidiary were created primarily as a result of the difference between the tax basis in our Irish subsidiary and the cost reported in our consolidated financial statements resulting from the transfer of intangible assets to our Irish subsidiary as part of our foreign restructuring in 2018. Based on foreign exchange rates as of September 30, 2019, a release of the Irish valuation allowance would result in the recognition of certain deferred tax assets and an income tax benefit of approximately \$550 to \$600 million for the period in which such release is recorded.

Net Income

	Three Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Net income	\$ 40,598	\$ 8,405	383%
Percentage of revenues	5%	1%	

Our net income increased \$32.2 million for the three months ended September 30, 2019 compared to the same period in the prior year as growth in our revenues exceeded our expenses. We expect a GAAP net income for the year ending December 31, 2019; however, GAAP net income or loss for the year ending December 31, 2019 will depend in part on a number of factors, including income taxes, non-cash charges associated with equity awards, which vary depending on the grant date stock price and actual attainment for our PRSUs, business combinations and other benefits or expenses which are not known at this time.

Comparison of the Nine Months Ended September 30, 2019 and 2018

Revenues

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Revenues:			
Subscription	\$ 2,355,885	\$ 1,755,174	34%
Professional services and other	152,778	138,201	11%
Total revenues	<u>\$ 2,508,663</u>	<u>\$ 1,893,375</u>	32%
Percentage of revenues:			
Subscription	94%	93%	
Professional services and other	6%	7%	
Total	<u>100%</u>	<u>100%</u>	

Subscription revenues increased \$600.7 million during the nine months ended September 30, 2019 compared to the same period in the prior year, driven by increased purchases by existing customers and an increase in our customer count. Included in subscription revenues are \$118.5 million and \$89.3 million of revenues recognized upfront from the delivery of software associated with self-hosted offerings during the nine months ended September 30, 2019 and 2018, respectively.

Subscription revenues consist of the following:

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Digital workflow products ⁽¹⁾	\$ 2,034,872	\$ 1,533,998	33%
ITOM products ⁽¹⁾	321,013	221,176	45%
Total subscription revenues	\$ 2,355,885	\$ 1,755,174	34%

(1) As we have expanded the scope of IntegrationHub (formerly included within our ITOM offering) beyond ITOM to align more closely with our broader platform offering, revenues associated with IntegrationHub have been reclassified from ITOM products to platform, which is part of our digital workflow products. Revenues reclassified from ITOM product revenues to digital workflow products revenues was \$43.7 million for the nine months ended September 30, 2018.

Our digital workflow products include our platform, IT service management, IT business management, customer service management, HR service delivery, security operations, IT asset management, field service management, and governance, risk and compliance, and are generally priced on a per user basis. Our ITOM products are generally priced on a per node (physical or virtual server) basis. In previously issued financial statements, we referred to digital workflow products as “service management products.”

Professional services and other revenues increased \$14.6 million during the nine months ended September 30, 2019 compared to the same period in the prior year, due to an increase in services provided to our growing customer base.

Cost of Revenues and Gross Profit Percentage

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Cost of revenues:			
Subscription	\$ 401,398	\$ 303,918	32%
Professional services and other	183,794	150,578	22%
Total cost of revenues	\$ 585,192	\$ 454,496	29%
Gross profit (loss) percentage:			
Subscription	83%	83%	
Professional services and other	(20%)	(9%)	
Total gross profit percentage	77%	76%	
Gross profit	\$ 1,923,471	\$ 1,438,879	
Headcount (at period end)			
Subscription	1,365	1,121	22%
Professional services and other	759	641	18%
Total headcount	2,124	1,762	21%

Cost of subscription revenues increased \$97.5 million during the nine months ended September 30, 2019, compared to the same period in the prior year, primarily due to increased headcount resulting in an increase of \$23.3 million in personnel-related costs excluding stock-based compensation, an increase of \$17.4 million in stock-based compensation and an increase of \$8.2 million in overhead expenses. Depreciation expense increased \$27.9 million primarily due to purchases of infrastructure hardware equipment for our data centers and expenses associated with software, IT services and technical support increased \$10.6 million. In addition, data center capacity costs increased \$6.2 million due to the addition of new data centers and the expansion of existing data centers and amortization of intangibles increased \$2.7 million as a result of acquisitions.

Our subscription gross profit percentage was 83% for each of the nine months ended September 30, 2019 and 2018. The increase in revenues recognized upfront from the delivery of software associated with self-hosted offerings contributed to approximately one percentage point improvement in our subscription gross profit percentage for each of the nine months ended September 30, 2019 and 2018.

Cost of professional services and other revenues increased \$33.2 million during the nine months ended September 30, 2019 as compared to the same period in the prior year, primarily due to increased headcount resulting in an increase of \$20.1 million in personnel-related costs excluding stock-based compensation, an increase of \$7.4 million in stock-based compensation and an increase of \$4.1 million in overhead expenses.

Our professional services and other gross loss percentage increased to 20% during the nine months ended September 30, 2019, from 9% for the nine months ended September 30, 2018, primarily due to stock-based compensation and other personnel-related costs increasing at a higher rate than professional services and other revenues as we invest in specialized resources to support our newer products and transform our internal professional services organization from an implementation resource to a strategic advisory resource.

Sales and Marketing

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Sales and marketing	\$ 1,118,279	\$ 883,893	27%
Percentage of revenues	45%	47%	
Headcount (at period end)	3,683	2,890	27%

Sales and marketing expenses increased \$234.4 million during the nine months ended September 30, 2019 compared to the same period in the prior year, primarily due to increased headcount that resulted in an increase of \$116.2 million in personnel-related costs excluding stock-based compensation and commissions, an increase of \$30.8 million in stock-based compensation and an increase of \$27.8 million in overhead expenses. Expenses associated with commissions and third-party referral fees increased \$15.7 million for the nine months ended September 30, 2019 compared to the same period in the prior year, due to an increase in new customer, expansion and renewal contracts. Amortization expenses associated with commissions and third-party referral fees, including their related payroll taxes and fringe benefits amounted to 5% and 6% of subscription revenues for the nine months ended September 30, 2019 and 2018, respectively. Expenses related to our annual Knowledge user conference, net of proceeds increased \$1.7 million due to a 13% year-over-year increase in registrations. Other sales and marketing program expenses, which include events other than Knowledge, and costs associated with purchasing advertising and market data, increased \$34.8 million for the nine months ended September 30, 2019 compared to the same period in the prior year. Outside services costs increased \$7.8 million, and IT costs increased \$5.0 million during the nine months ended September 30, 2019 compared to the same period in the prior year, primarily due to an increase in contractors and subscription software to support our sales and marketing functions. Loss from write-off of property and equipment decreased \$4.6 million during the nine months ended September 30, 2019 compared to the same period in the prior year primarily due to write off of internal-use and subscription software in the third quarter of 2018.

Research and Development

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Research and development	\$ 546,041	\$ 380,839	43%
Percentage of revenues	22%	20%	
Headcount (at period end)	2,747	1,860	48%

Research and development expenses increased \$165.2 million during the nine months ended September 30, 2019 compared to the same period in the prior year, primarily due to increased headcount, which resulted in an increase of \$86.2 million in personnel-related costs excluding stock-based compensation, an increase of \$46.4 million in stock-based compensation and an increase of \$24.9 million in overhead expenses. Increased data center capacity costs and depreciation of infrastructure hardware equipment that is used solely for research and development purposes also contributed to an increase of \$3.1 million and additional expenses related to software and IT services and technical support contributed to an increase of \$2.0 million during the nine months ended September 30, 2019 compared to the same period in the prior year.

General and Administrative

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
General and administrative	\$ 245,540	\$ 216,851	13%
Percentage of revenues	9%	11%	
Headcount (at period end)	1,375	1,149	20%

General and administrative expenses increased \$28.7 million during the nine months ended September 30, 2019 compared to the same period in the prior year, primarily due to increased headcount, which resulted in an increase of \$28.3 million in personnel-related costs excluding stock-based compensation and an increase of \$3.6 million in overhead expenses. Outside services costs increased \$7.5 million during the nine months ended September 30, 2019 compared to the same period in the prior year, primarily due to an increase in contractors and professional fees to support our administrative function. The increase in general and administrative expenses was partially offset by a reduction in stock-based compensation of \$11.2 million, primarily attributable to the expected forfeiture of certain awards by our Chief Executive Officer,

Stock-based Compensation

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Cost of revenues:			
Subscription	\$ 54,019	\$ 36,604	48%
Professional services and other	31,749	24,310	31%
Sales and marketing	200,071	169,283	18%
Research and development	144,259	97,905	47%
General and administrative	62,046	73,207	(15%)
Total stock-based compensation	\$ 492,144	\$ 401,309	23%
Percentage of revenues	20%	21%	

Stock-based compensation increased \$90.8 million during the nine months ended September 30, 2019, compared to the same period in the prior year, primarily due to additional grants to current and new employees and increased weighted-average grant date fair value of stock awards.

Foreign Currency Exchange

Our international operations have provided and will continue to provide a significant portion of our total revenues. Revenues outside North America represented 34% of total revenues for each of the nine months ended September 30, 2019 and 2018. Because we primarily transact in foreign currencies for sales outside of the United States, the general strengthening of the U.S. Dollar relative to other major foreign currencies (primarily the Euro and British Pound Sterling) from the nine months ended September 30, 2018 to the nine months ended September 30, 2019 had an unfavorable impact on our revenues. For entities reporting in currencies other than the U.S. Dollar, if we had translated our results for the nine months ended September 30, 2019 at the exchange rates for the nine months ended September 30, 2018 rather than the actual exchange rates in effect during the period, our subscription revenues would have been \$49.7 million higher and our reported professional services and other revenues would have been \$4.1 million higher.

In addition, because we primarily transact in foreign currencies for cost of revenues and operating expenses outside of the United States, the general strengthening of the U.S. Dollar relative to other major foreign currencies (primarily the Euro and British Pound Sterling) from the nine months ended September 30, 2018 to the nine months ended September 30, 2019 had a favorable impact on our cost of revenues, sales and marketing expenses and research and development expenses. For entities reporting in currencies other than the U.S. Dollar, if we had translated our results for the nine months ended September 30, 2019 at the exchange rates in effect for the nine months ended September 30, 2018 rather than the actual exchange rates in effect during the period, our reported cost of revenues, sales and marketing expenses and research and development expenses would have been \$10.8 million, \$16.8 million and \$2.6 million higher, respectively. The impact from the foreign currency movements from the nine months ended September 30, 2018 to the nine months ended September 30, 2019 is not material to general and administrative expenses.

Interest Expense

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Interest expense	\$ (24,808)	\$ (43,795)	(43%)
Percentage of revenues	(1%)	(2%)	

Interest expense decreased \$19.0 million during the nine months ended September 30, 2019, compared to the same period in the prior year, due to the repayment of the 2018 Notes that occurred in 2018.

Interest Income and Other Income (Expense), net

	Nine Months Ended September 30,		
	2019	2018	% Change
	(dollars in thousands)		
Interest income	\$ 41,495	\$ 24,288	71%
Foreign currency exchange (loss) gain, net of derivative contracts	(637)	6,304	NM
Gain on marketable equity securities	—	19,257	(100%)
Loss on early note conversions	—	(4,067)	(100%)
Other	3,338	(262)	NM
Interest and other income (expense), net	\$ 44,196	\$ 45,520	(3%)
Percentage of revenues	1%	2%	

NM - Not meaningful.

Interest income and other income (expense), net decreased \$1.3 million during the nine months ended September 30, 2019, compared to the same period in the prior year, primarily due to a decrease of \$19.3 million in realized gains relating to changes in the market value of our marketable equity securities held and sold in the prior year. In addition, we incurred a foreign currency exchange loss, net of derivative contracts of \$0.6 million during the nine months ended September 30, 2019 compared to a foreign currency exchange gain, net of derivative contracts of \$6.3 million during the nine months ended September 30, 2018.

The decrease in interest income and other income (expense), net was offset by an increase in interest income of \$17.2 million due to higher cash and investment balances and higher yields on our invested balances for the nine months ended September 30, 2019 compared to the same period in the prior year, an increase of \$2.1 million in other due to an unrealized gain on non-marketable securities relating to observable price changes during the three months ended June 30, 2019, and the absence of a \$4.1 million loss recorded on early note conversions in the prior year.

Provision for (Benefit from) Income Taxes

	Nine Months Ended September 30,		
	2019	2018	% Change
(dollars in thousands)			
Income (loss) before income taxes	\$ 32,999	\$ (40,979)	NM
Provision for (benefit from) income taxes	5,025	(7,260)	NM
Effective tax rate	15%	18%	

NM - Not meaningful.

Our income tax provision was \$5.0 million for the nine months ended September 30, 2019. The income tax provision was attributable to the mix of earnings and losses in countries with differing statutory tax rates and valuation allowances in certain countries.

Our income tax benefit was \$7.3 million for the nine months ended September 30, 2018. The income tax benefit was primarily attributable to the one-time indirect effect of Topic 606 on income taxes associated with intercompany adjustments offset by our loss from operations.

Net Income (Loss)

	Nine Months Ended September 30,		
	2019	2018	% Change
	(dollars in thousands)		
Net income (loss)	\$ 27,974	\$ (33,719)	NM
Percentage of revenues	1%	(2%)	

NM - Not meaningful.

Net loss decreased \$61.7 million for the nine months ended September 30, 2019, compared to the same period in the prior year as growth in our revenues exceeded our expenses.

Liquidity and Capital Resources

Our principal sources of liquidity are our cash and cash equivalents, investments, and cash generated from operations. As of September 30, 2019, we had \$1.5 billion in cash and cash equivalents and short-term investments, of which \$0.2 billion represented cash held by foreign subsidiaries and \$0.2 billion is denominated in currencies other than U.S. Dollar. In addition, we had \$1.0 billion in long-term investments that provide additional capital resources. We do not anticipate that we will need funds generated from foreign operations to fund our domestic operations.

In May and June 2017, we issued the 2022 Notes with an aggregate principal amount of \$782.5 million. In connection with the issuance of the 2022 Notes, we entered into the 2022 Note Hedge transactions and 2022 Warrant transactions with certain financial institutions. The price of our common stock was greater than or equal to 130% of the conversion price of the 2022 Notes for at least 20 trading days during the 30 consecutive trading days ending on the last trading day of the quarters ended June 30, 2018, September 30, 2018, March 31, 2019, June 30, 2019, and September 30, 2019. Therefore, our 2022 Notes became convertible at the holders' option beginning on July 1, 2018 and continue to be convertible through December 31, 2019, with the exception of the quarter ended March 31, 2019 because the Conversion Condition for the 2022 Notes was not met for the quarter ended December 31, 2018. The impact of the 2022 Notes on our liquidity will depend on the settlement method we elect. We currently intend to settle the principal amount of any converted 2022 Notes in cash. Based on conversion requests we have received during the third quarter of 2019, we expect to settle in cash an immaterial principal amount of the 2022 Notes during the fourth quarter of 2019.

During the nine months ended September 30, 2019, we issued approximately 4.3 million shares of our common stock upon the automatic exercise of the 2018 Warrants. The 2018 Warrants were no longer outstanding as of the second quarter of 2019. We expect to issue additional shares of our common stock in the second half of 2022 upon the automatic exercise of the 2022 Warrants. As the 2022 Warrants will be net share settled, there will be no impact on our liquidity. The total number of shares of our common stock we will issue depends on the daily volume-weighted average stock prices over a 60 trading day period beginning on the first expiration date of the 2022 Warrants, which will be September 1, 2022. Refer to Note 11 in the notes to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for additional information.

We anticipate our current cash and cash equivalents balance and cash generated from operations will be sufficient to meet our liquidity needs, including the repayment of our 2022 Notes, expansion of data centers, lease obligations, expenditures related to the growth of our headcount and the acquisition of property and equipment, intangibles, and investments in office facilities, to accommodate our growth for at least the next 12 months. Whether these resources are adequate to meet our liquidity needs beyond that period will depend on our growth, operating results, cash utilized for acquisitions and/or debt retirements if any are consummated, and the capital expenditures required to meet possible increased demand for our services. If we require additional capital resources to grow our business at any time in the future, we may seek to finance our operations from the current funds available or seek additional equity or debt financing.

	Nine Months Ended September 30,	
	2019	2018
	(dollars in thousands)	
Net cash provided by operating activities	\$ 814,761	\$ 521,477
Net cash used in investing activities	(525,745)	(100,283)
Net cash used in financing activities	(225,575)	(433,107)
Net increase (decrease) in cash, cash equivalents and restricted cash, net of foreign currency effect	57,002	(21,506)

Operating Activities

Cash provided by operating activities mainly consists of our net income (loss) adjusted for repayments of convertible senior notes attributable to debt discount, certain non-cash items, including depreciation and amortization, amortization of deferred commissions, amortization of issuance cost and debt discount, stock-based compensation and changes in operating assets and liabilities during the year.

Net cash provided by operating activities was \$814.8 million for the nine months ended September 30, 2019 compared to \$521.5 million for the nine months ended September 30, 2018. The increase in operating cash flow was primarily due to the repayment of convertible senior notes attributable to debt discount that was made during the nine months ended September 30, 2018 and a decrease in net loss adjusted for non-cash items to reconcile net income (loss) to net cash provided by operations, offset by the unfavorable impact on operating cash flow from changes in operating assets and liabilities.

Investing Activities

Net cash used in investing activities for the nine months ended September 30, 2019 was \$525.7 million compared to \$100.3 million for the nine months ended September 30, 2018. The increase in cash used in investing activities was mainly due to a \$398.8 million increase in net purchases of investments, a \$23.8 million increase in purchases of other intangibles and a \$49.5 million increase in capital expenditures, offset by a \$24.9 million reduction in cash outflow for business combinations and a \$21.7 million increase in realized gains on derivatives not designated as hedging instruments, net.

Financing Activities

Net cash used in financing activities was \$225.6 million for the nine months ended September 30, 2019 compared to \$433.1 million for the nine months ended September 30, 2018. The decrease in cash used in financing activities is primarily due to repayments of the 2018 Notes attributable to principal of \$311.5 million during the nine months ended September 30, 2018, offset by additional financing cash outflow during the nine months ended September 30, 2019 due to a \$109.5 million increase in taxes paid related to net share settlement of equity awards.

Contractual Obligations and Commitments

Except as set forth in Note 17, Commitments and Contingencies, of the notes to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q, there have been no material changes outside the ordinary course of business in the contractual obligations and commitments disclosed in our Annual Report on 10-K for the year ended December 31, 2018.

Off-Balance Sheet Arrangements

During all periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in those types of relationships.

Critical Accounting Policies and Significant Judgments and Estimates

There have been no changes to our critical accounting policies and estimates as described in our Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the SEC on February 27, 2019.

New Accounting Pronouncements Pending Adoption

The impact of recently issued accounting standards is set forth in Note 2, Summary of Significant Accounting Policies, of the notes to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in our market risk as compared to the disclosures in Part II, Item 7A in our Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the SEC on February 27, 2019.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Regulations under the Exchange Act require public companies, including our company, to maintain “disclosure controls and procedures,” which are defined in Rule 13a-15(e) and Rule 15d-15(e) to mean a company’s controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including our principal executive officer and principal financial officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required or necessary disclosures. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Our Chief Executive Officer has concluded, based on the evaluation of the effectiveness of the disclosure controls and procedures by our management as of the end of the quarter covered by this Quarterly Report on Form 10-Q, that our disclosure controls and procedures were effective at the reasonable assurance level for this purpose.

Changes in Internal Control Over Financial Reporting

Regulations under the Exchange Act require public companies, including our company, to evaluate any change in our “internal control over financial reporting” as such term is defined in Rule 13a-15(f) and Rule 15d-15(f) of the Exchange Act. Under the supervision and with the participation of our management, including our Chief Executive Officer, we conducted an evaluation of any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recently completed fiscal quarter. Based on that evaluation, our Chief Executive Officer did not identify any change in our internal control over financial reporting during the quarter covered by this Quarterly Report on Form 10-Q that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

As previously disclosed on Current Reports on Form 8-K filed with the SEC on May 2, 2019 and July 24, 2019, Michael Scarpelli resigned as Chief Financial Officer effective August 15, 2019. We do not believe that the resignation has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. We are in the process of conducting our search for Mr. Scarpelli’s successor. Our Chief Executive Officer has signed the required certifications as both the Principal Executive Officer and Principal Financial Officer for our most recently completed fiscal quarter.

PART II

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are party to litigation and other legal proceedings in the ordinary course of business. While the results of any litigation or other legal proceedings are uncertain, we are not presently a party to any legal proceedings that, if determined adversely to us, would individually or taken together have a material adverse effect on our business, financial position, results of operations or cash flows.

ITEM 1A. RISK FACTORS

Investing in our securities involves a high degree of risk. You should consider carefully the risks and uncertainties described below, together with all of the other information in this Quarterly Report on Form 10-Q, including our condensed consolidated financial statements and related notes, before making an investment decision. We have identified the following risks and uncertainties that may have a material adverse effect on our business, financial condition, results of operations and future prospects. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment.

Risks Related to Our Business and Industry

The markets in which we participate are intensely competitive, and if we do not compete effectively, our business and operating results will be adversely affected.

The markets for our enterprise cloud solutions are rapidly evolving and highly competitive, with relatively low barriers to entry. As the market for digital workflow products matures and new technologies and competitors enter the market, we expect competition to intensify. Our current competitors include:

- large, well-established, enterprise application software vendors;
- solutions developed in-house by our potential customers or using integrations with other tools;
- large integrated systems vendors;
- infrastructure-as-a-service and platform-as-a-service providers;
- established and emerging cloud vendors; and
- vendors of products and services for development operations.

Many prospective customers have invested substantial personnel and financial resources to implement and integrate their current enterprise software into their businesses and therefore may be reluctant or unwilling to migrate away from their current solution to our enterprise cloud solutions. Many of our competitors and potential competitors are larger, have greater name recognition, longer operating histories, more established customer relationships, larger marketing budgets and greater resources than we do. Further, other potential competitors not currently offering competitive products may expand their services to compete with our services or we may shift our products and services to compete with current and future competitors in adjacent markets. Acquisitions, integrations and consolidation by and among other companies in our industry may allow potential competitors to offer integrated or bundled products, enhanced functionality, or other advantages, which may impact our competitive position. We have expanded the breadth of our services to include offerings in the markets for IT operations management, customer service management, security operations management, HR service delivery and use of our platform by developers of custom applications. As a result, we expect increasing competition from platform vendors and from application development vendors focused on these other markets. Our competitors may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards, customer requirements and buying practices. In addition, some of our competitors offer their products or services at a lower price, which has resulted in pricing pressures. Larger competitors with more diverse product and service offerings may reduce the price of products or subscriptions that compete with ours or may bundle them with other products and subscriptions. We expect that smaller competitors and new entrants may accelerate pricing pressures, including in the IT service management market, which is our more mature offering and from which we derive the substantial majority of our revenues. For all of these reasons, we may not be able to compete successfully, and competition could result in reduced sales, reduced margins, losses or the failure of our solutions to achieve or maintain market acceptance, any of which could harm our business.

If we do not accurately predict, prepare for, and respond promptly to rapidly evolving technological, market and customer developments, our competitive position and business prospects may be harmed.

The markets in which we compete continue to evolve rapidly, and the pace of innovation will continue to accelerate, as public and private cloud solutions and infrastructure, massively scalable databases, mobile, workflow, consumer product-like user experiences, social, collaboration, machine learning, artificial intelligence, Internet-connected devices, high velocity robotic automation, security, cryptography, internal software development operations, application and service awareness, and other digital technologies increasingly become the basis for customer purchases. At the same time, our customers and prospective customers are either facing their own competitive imperatives to adopt digital technologies, or have been built on fully-digital, modern, dynamic IT technologies, resulting in the ongoing disruption of almost every sector of the global economy. Acquisitions, integrations and consolidation by and among companies in our industry may further accelerate changes in the markets in which we participate. Accordingly, to compete effectively in our rapidly changing markets, we must: identify and innovate in the right emerging technologies among the many in which we could make investments knowing that we cannot make substantial investments in all of them; accurately predict our customers' changing business needs, priorities and adoption practices, including their technology infrastructures and buying and budgetary practices; successfully deliver new platform and database technologies and products that scale to meet these needs and priorities; efficiently integrate with other technologies within our customers' digital environments; profitably market and sell products to companies in markets where our sales and marketing teams have less experience, including to fully-digital companies built on modern, dynamic IT technologies that have historically not been strong buyers of IT service management and IT operations management products like ours; and effectively deliver, either directly or through our ecosystem of partners, the business process planning, IT systems architecture planning, and product implementation services that our customers require to be successful. If we fail to meet any of these requirements, our competitive position, strategic relevance and business prospects may be harmed.

Global economic conditions may harm our industry, business and results of operations.

We operate globally and as a result our business and revenues are impacted by global macroeconomic conditions. Global financial developments seemingly unrelated to us or the software industry may harm us. From time to time, the United States and other key international economies have been impacted by geopolitical and economic instability, high levels of credit defaults globally, international trade disputes, falling demand for a variety of goods and services, high levels of persistent unemployment and wage and income stagnation in some geographic markets, restricted credit, poor liquidity, reduced corporate profitability, volatility in credit, equity and foreign exchange markets, bankruptcies, international trade agreements, trade restrictions and overall uncertainty with respect to the economy. These conditions can arise suddenly and affect the rate of information technology spending and could adversely affect our customers' ability or willingness to purchase our services, delay prospective customers' purchasing decisions, reduce the value or duration of their subscriptions, or affect renewal rates, all of which could harm our operating results. In 2019, for example, the growth rate in the economy of the EU, China, or the US, tariffs or trade relations between the US and China or other countries, political uncertainty in the Middle East and other geopolitical events could directly or indirectly affect our business. Additionally, in connection with the June 2016 referendum by British voters to exit the EU (Brexit), the United Kingdom (the UK) and the EU announced in March 2018 an agreement in principle to transitional provisions under which E.U. law would remain in force in the UK until the end of December 2020, which has been subsequently replaced by a new agreement in principle in October 2019, but this new arrangement still remains subject to the successful ratification of the final withdrawal agreement by the parties' respective legislative bodies. There is substantial uncertainty surrounding Brexit and it may still occur without a withdrawal agreement and associated transition period in place (hard Brexit). A hard Brexit would likely cause serious disruptions of E.U. financial services leading to global economic consequences and increased regulatory and legal complexities, including potentially divergent national laws and regulations between the UK and the EU. Brexit or hard Brexit may also cause disruptions to, or create uncertainty surrounding our business, including by affecting our relationship with our existing and future customers, suppliers and employees and resulting in increased costs or operational challenges.

In addition, the effects, if any, of global financial conditions on our business can be difficult to distinguish from the effects on our business from product, pricing, and other developments in the markets specific to our products and our relative competitive strength. If we make incorrect judgments about our business for this reason our business and results of operations could be adversely affected.

If we or our third-party service providers suffer a cyber-security event, we may lose customers and incur significant liabilities, any of which would harm our business and operating results.

Our operations involve the storage, transmission and processing of our customers' confidential, proprietary and sensitive data, including personally identifiable information, protected health information, financial information and, in some cases, government information. While we have security measures in place designed to protect customer information and prevent data loss, these measures may be breached as a result of employee error or third-party actions, including unintentional events or deliberate attacks by cyber criminals, and result in someone obtaining unauthorized access to our customers' data or our data, including our intellectual property and other confidential business information. In addition, third parties have attempted and may continue to attempt to fraudulently induce employees, contractors, or users to disclose information to gain access to our data or our customers' data, and we may be the target of email scams that attempt to acquire personal information or company assets. Additionally, because we do not control our third-party service providers, or the processing of data by our third-party service providers, we cannot ensure the integrity or security of measures they take to protect customer information and prevent data loss. Moreover, computer malware, viruses and hacking, phishing and denial of service attacks by third parties have become more prevalent in our industry, and have occurred on our and our third-party service providers' systems in the past and may occur on these systems in the future. Because techniques used to sabotage or obtain unauthorized access to systems change frequently and generally are not recognized until successfully launched against a target, we have been and may continue to be unable to anticipate these techniques or to implement adequate preventative measures. We devote significant financial and personnel resources to implement and maintain security measures; however, as cyber-security threats develop, evolve, and grow more complex over time, it may be necessary to make significant further investments to protect data and infrastructure. A security breach suffered by us or our third-party service providers, an attack against our service availability or unauthorized access or loss of data could result in a disruption to our service, litigation, the triggering of service availability, indemnification and other contractual obligations, regulatory investigations, government fines and penalties, reputational damage, loss of sales and customers, mitigation and remediation expenses and other significant costs and liabilities. In addition, we may incur significant costs and operational consequences of investigating, remediating, eliminating and putting in place additional tools and devices designed to prevent actual or perceived security incidents, as well as the costs to comply with any notification obligations resulting from any security incidents. We also cannot be certain that our existing insurance coverage will continue to be available on acceptable terms or will be available in sufficient amounts to cover the potentially significant losses that may result from a security incident or breach or that the insurer will not deny coverage as to any future claim.

Further, in most instances, our customers administer access to the data held in their particular instance for their own employees and service providers. We offer tools and support for what we believe are best practices to maintain security utilizing our services, but customers are not required to utilize those tools or follow our suggested practices. As a result, or for other reasons, a customer may suffer a cyber-security event on its own systems, unrelated to our own, and as a result of that event, a malicious actor could obtain access to the customer's information held on our platform. Even if such a breach is unrelated to our own security programs or practices, that breach could result in our incurring significant economic and operational costs in investigating, remediating, eliminating and putting in place additional tools and devices to further protect our customers from their own vulnerabilities, and could also result in reputational harm to us.

As our business grows, we expect our revenue growth rate to continue to decline.

We have experienced significant revenue growth in prior periods; however, our longer-term, revenue growth rate is declining, and we expect that it will continue to decline into the foreseeable future. We also expect our costs to increase in future periods as we continue to invest in our capacity to support anticipated growth. These investments may not result in increased revenues or growth in our business. You should not rely on our revenue for any prior quarterly or annual periods as any indication of our future revenue growth. If we are unable to maintain consistent revenue or revenue growth, our stock price could be volatile.

We may continue to incur losses in accordance with U.S. Generally Accepted Accounting Principles (GAAP) during future periods.

Although we have recently reported quarterly results that were profitable on a GAAP basis in certain prior quarters, we have incurred net losses in all fiscal years since our inception. Even if our revenues continue to increase, we may incur losses in accordance with GAAP during future periods due to increased costs such as non-cash charges associated with equity awards, business combinations and other expenses. Additionally, we may encounter unforeseen operating expenses, difficulties, complications, delays and other unforeseen or unpredictable factors that may result in increased costs. Furthermore, it is difficult to predict the size and growth rate of our market, customer demand for our products, customer adoption and renewal rates, and the entry of competitive products or the success of existing competitive products. As a result of these and other factors, we may not maintain profitability in the future, and our gross margins and ability to generate cash flow from operations may be negatively impacted. If we fail to increase our revenues sufficiently to keep pace with our growing investments and other expenses, our business, operating results and growth prospects will be adversely affected.

Delays in the release of, or actual or perceived defects in, new or updated products may slow the adoption of our most recent technologies, reduce our ability to efficiently provide our services, decrease customer satisfaction, increase our vulnerability to cyber attacks, and adversely impact sales of additional products to our customers.

We must successfully continue to release new products and updates to existing products. The success of any release depends on a number of factors, including our ability to manage the risks associated with quality or other defects or deficiencies, delays in the timing of releases or the adoption of releases by customers, and other complications that may arise during the early stages of introduction. If releases are delayed or if customers perceive that our releases contain bugs or other defects or are otherwise difficult to implement, customer adoption of our new products or updates may be adversely impacted, customer satisfaction may decrease, our ability to efficiently provide our services may be reduced, and our growth prospects may be harmed.

Various factors, including our customers' business, integration, migration and security requirements, or errors by us, our partners, or our customers, may cause implementations of our products to be delayed, inefficient or otherwise unsuccessful.

Our business depends upon the successful implementation of our products by our customers. Increasingly, we, as well as our customers, rely on our network of partners to deliver implementation services, and there may not be enough qualified implementation partners available to meet customer demand. Further, various factors, including our customers' business, integration, migration and security requirements, or errors by us, our partners, or our customers, may cause implementations to be delayed, inefficient or otherwise unsuccessful. For example, changes in the functional requirements of our customers, delays in timeline, or deviation from recommended best practices may occur during the course of an implementation project. As a result of these and other risks, we or our customers may incur significant implementation costs in connection with the purchase, implementation and enablement of our products. Some customer implementations may take longer than planned or fail to meet our customers' expectations, which may delay our ability to sell additional products or result in customers canceling or failing to renew their subscriptions before our products have been fully implemented. Unsuccessful, lengthy, or costly customer implementation and integration projects could result in claims from customers, harm to our reputation, and opportunities for competitors to displace our products, each of which could have an adverse effect on our business and operating results.

Disruptions or defects in our services could damage our customers' businesses, subject us to substantial liability and harm our reputation and financial results.

From time to time, we experience defects in our services, and new defects may be detected in the future. For example, we provide regular updates to our services, which frequently contain undetected defects when first introduced or released. Defects may also be introduced by our use of third-party software, including open source software. Disruptions may result from errors we make in delivering, configuring or hosting our services, or designing, installing, expanding or maintaining our cloud infrastructure. Disruptions in service can also result from incidents that are outside of our control, including denial of service attacks. We currently serve our customers primarily using equipment managed by us and co-located in third-party data center facilities operated by several different providers located around the world and plan to serve certain of our customers using data center facilities operated by public cloud service providers. These centers are vulnerable to damage or interruption from earthquakes, hurricanes, floods, fires, power loss and similar events. They may also be subject to break-ins, sabotage, intentional acts of vandalism and similar misconduct, equipment failure and adverse events caused by operator error or negligence. Despite precautions taken at these facilities, problems at these facilities could result in lengthy interruptions in our services and the loss of customer data. In addition, our customers may use our services in ways that cause disruptions in service for other customers. Our customers use our services to manage important aspects of their own businesses, and our reputation and business will be adversely affected if our customers and potential customers believe our services are unreliable. Disruptions or defects in our services may reduce our revenues, cause us to issue credits or pay penalties, subject us to claims and litigation, cause our customers to delay payment or terminate or fail to renew their subscriptions, and adversely affect our ability to attract new customers. The occurrence of payment delays, or service credit, warranty, termination for material breach or other claims against us, could result in an increase in our bad debt expense, an increase in collection cycles for accounts receivable, an increase to our service level credit accruals or other increased expenses or risks of litigation. We may not have insurance sufficient to compensate us for the potentially significant losses that may result from claims arising from disruptions in our services.

Our operating results may vary significantly from period to period, and if we fail to meet the financial performance expectations of investors or securities analysts, the price of our common stock could decline substantially.

Our operating results may vary significantly from period to period as a result of various factors, some of which are beyond our control. For any quarterly or annual period, there is a risk that our financial performance will not meet the financial guidance we have previously given for that period, or that we may otherwise fail to meet the financial performance expectations of the securities analysts who issue reports on our company and our common stock price, or of investors in our common stock. There is also a risk that we may issue forward-looking financial guidance for a quarterly or annual period that fails to meet the expectations of such securities analysts or investors. If any of the foregoing occurs, for any reason either within or outside of our control, the price of our common stock could decline substantially and investors in our common stock could incur substantial losses. Some of the important factors that may cause our revenues, operating results and cash flows to vary widely, or cause our forward-looking financial guidance to fall below the expectations of such securities analysts or investors, include:

- our ability to attract new customers, retain and increase sales to existing customers, and satisfy our customers' requirements;
- changes in our mix of products and services, including changes in our mix of cloud and self-hosted offerings;
- changes in foreign currency exchange rates and our ability to effectively hedge our foreign currency exposure;
- the rate of expansion and productivity of our sales force;
- the number of new employees added;
- the cost, timing and management effort for our development of new products and services;
- general economic conditions that may adversely affect either our customers' ability or willingness to purchase additional subscriptions, delay a prospective customer's purchasing decision, reduce the value of new subscription contracts or adversely affect renewal rates;
- the amount and timing of operating costs and capital expenditures related to the operation and expansion of our business;
- seasonality in terms of when we enter into customer agreements for our services;
- the length and complexity of the sales cycle for our services, especially for sales to larger enterprises, government and regulated organizations;
- changes in the size and complexity of our customer relationships;
- changes to our management, sales and account management teams;
- changes in our pricing policies, whether initiated by us or as a result of competition;
- significant security breaches, technical difficulties or interruptions of our services;
- new solutions, products or changes in pricing policies introduced by our competitors;
- changes in effective tax rates;
- changes in the average contract term of our customer agreements, changes in timing of renewals and changes in billings duration;

- changes in our renewal rates and expansion within our existing customers;
- the timing of customer payments and payment defaults by customers;
- extraordinary expenses such as litigation costs or damages, including settlement payments;
- the costs associated with acquiring new businesses and technologies and the follow-on costs of integration, including the tax effects of acquisitions;
- the impact of new accounting pronouncements;
- changes in laws or regulations impacting the delivery of our services;
- our ability to comply with privacy laws and regulations, including the General Data Protection Regulation (the GDPR) and the California Consumer Privacy Act (the CCPA);
- significant litigation or regulatory actions relating to claims of intellectual property infringement, violation of privacy laws, employment matters or any other significant matter;
- the amount and timing of equity awards and the related financial statement expenses; and
- our ability to accurately estimate the total addressable market for our products and services.

Changes in our effective tax rate could impact our financial results.

We are subject to income taxes in the United States and various foreign jurisdictions. We believe that our provision for income taxes is reasonable, but the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods in which such outcome is determined. Our effective tax rate could be adversely affected by changes in the mix of earnings and losses in countries with differing statutory tax rates, certain non-deductible expenses, the valuation of deferred tax assets and liabilities and the effects of acquisitions. Increases in our effective tax rate would reduce our profitability or in some cases increase our losses.

Additionally, our future effective tax rate could be impacted by changes in accounting principles or changes in U.S. federal, state or international tax laws or tax rulings. The U.S. enacted significant tax reform under the Tax Cuts and Jobs Act of 2017 (the Tax Act). The U.S. Department of Treasury has broad authority to issue regulations and interpretative guidance that may significantly impact how we will apply the law, which could affect our results of operations in the period issued. Many countries and organizations such as the Organization for Economic Cooperation and Development are actively considering changes to existing tax laws or have proposed or enacted new laws that could increase our tax obligations in countries where we do business or cause us to change the way we operate our business. Recent global tax developments applicable to multinational businesses and increased scrutiny under tax examinations could have a material impact on our business and negatively affect our financial results. Any changes in federal, state or international tax laws or tax rulings may increase our worldwide effective tax rate and harm our financial position and results of operations.

In addition, we may be subject to income tax audits by tax jurisdictions throughout the world, many of which have not established clear guidance on the tax treatment of cloud computing companies. Although we believe our income tax liabilities are reasonably estimated and accounted for in accordance with applicable laws and principles, an adverse resolution of one or more uncertain tax positions in any period could have a material impact on our results of operations for that period.

Foreign currency exchange rate fluctuations could harm our financial results.

We conduct significant transactions, including revenue transactions and intercompany transactions, in currencies other than the U.S. Dollar or the functional operating currency of the transactional entities. In addition, our international subsidiaries maintain significant net assets that are denominated in currencies other than the functional operating currencies of these entities. Accordingly, changes in the value of currencies relative to the U.S. Dollar may impact our consolidated revenues and operating results due to transactional and translational remeasurement that is reflected in our earnings. It is particularly difficult to forecast any impact from exchange rate movements, so there is risk that unanticipated currency fluctuations could adversely affect our financial results or cause our results to differ from investor expectations or our own guidance in any future periods. In addition, the announcement of Brexit adversely impacted global markets, including currencies, and resulted in a decline in the value of the British pound, as compared to the U.S. Dollar and other currencies. Volatility in exchange rates and global financial markets is expected to continue due to a number of factors, including uncertainty surrounding Brexit or hard Brexit and the recent political and economic uncertainty globally.

In 2018, we began using derivative instruments, such as foreign currency forwards, to hedge certain exposures to fluctuations in foreign currency exchange rates. These hedging contracts may reduce, but cannot entirely eliminate, the impact of adverse currency exchange rate movements. Further, unanticipated changes in currency exchange rates may result in poorer overall financial performance than if we had not engaged in any such hedging transactions. Moreover, for a number of reasons, including our limited experience with these hedging contracts, we may not seek or be able to establish a perfect correlation between such hedging instruments and the exposures being hedged. Any such imperfect correlation may prevent us from achieving the intended hedge, and could and expose us to a greater overall risk of loss than had we not undertaken the hedging strategy.

Lawsuits against us by third-parties that allege we infringe their intellectual property rights could harm our business and operating results.

There is considerable patent and other intellectual property development activity in our industry. Many companies in our industry, including our competitors and other third parties, as well as non-practicing entities, own large numbers of patents, copyrights, trademarks and trade secrets, which they may use to assert claims of patent infringement, misappropriation or other violations of intellectual property rights against us.

Moreover, the patent portfolios of most of our competitors are larger than ours. This disparity may increase the risk that our competitors may sue us for patent infringement and may limit our ability to counterclaim for patent infringement or settle through patent cross-licenses. From time to time, our competitors or other third parties, including patent holding companies seeking to monetize patents they have purchased or otherwise obtained, may claim that we are infringing upon their intellectual property rights. For example, we recorded charges for aggregate legal settlements of \$270.0 million in our consolidated statement of comprehensive loss during the year ended December 31, 2016. The charges covered the fulfillment by us of all financial obligations under settlement agreements with BMC and HPE, with no remaining financial obligations to BMC or HPE under either settlement.

In any intellectual property litigation, regardless of the scope or merits of the claims at issue, we may incur substantial attorney's fees and other litigation expenses and, if the claims are successfully asserted against us and we are found to be infringing upon the intellectual property rights of others, we could be required to: pay substantial damages and/or make substantial ongoing royalty payments; cease offering our products and services; modify our products and services; comply with other unfavorable terms, including settlement terms; and indemnify our customers and business partners and obtain costly licenses on their behalf and refund fees or other payments previously paid to us. Further, upon expiration of the term of any third-party agreements that allow us to use their intellectual property, we may be unable to renew such agreements on favorable terms, if at all, in which case we may face intellectual property litigation. The mere existence of any lawsuit, or any interim or final outcomes, and the course of its conduct and the public statements related to it (or absence of such statements) by the courts, press, analysts and litigants, could be unsettling to our customers and prospective customers and could cause an adverse impact to our customer satisfaction and related renewal rates and cause us to lose potential sales, and could also be unsettling to investors or prospective investors in our common stock and could cause a substantial decline in the price of our common stock. Accordingly, any claim or litigation against us could be costly, time-consuming and divert the attention of our management and key personnel from our business operations and harm our financial condition and operating results.

Our intellectual property protections may not provide us with a competitive advantage, and defending our intellectual property may result in substantial expenses that harm our operating results.

Our success depends to a significant degree on our ability to protect our proprietary technology and our brand under a combination of patent and other intellectual property laws of the United States and other jurisdictions. Though we seek patent protection for our technology, we may not be successful in obtaining patent protection, and any patents acquired in the future may not provide us with competitive advantages, or may be successfully challenged by third parties. Furthermore, legal standards relating to the validity, enforceability and scope of protection of intellectual property rights are uncertain. Any of our intellectual property rights may be challenged by others or invalidated through administrative process or litigation. Effective patent, trademark, copyright and trade secret protection may not be available to us in every country in which our services are available. The laws of some foreign countries may not be as protective of intellectual property rights as those in the United States, and mechanisms for enforcement of intellectual property rights may be inadequate. We may be required to spend significant resources to monitor and protect our intellectual property rights. We have initiated, and in the future may initiate, claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us, divert the efforts of our technical and management personnel and may result in counterclaims with respect to infringement of intellectual property rights by us. If we are unable to prevent third parties from infringing upon or misappropriating our intellectual property, or are required to incur substantial expenses in defending our intellectual property rights, our business and operating results may be adversely affected.

If we are unsuccessful in increasing our penetration of international markets or managing the risks associated with foreign markets, our business and operating results will be adversely affected.

Sales outside of North America represented approximately 33% of total revenues for each of the three months ended September 30, 2019 and 2018 and 34% of total revenues for each of the nine months ended September 30, 2019 and 2018. Our business and future prospects depend on increasing our international sales as a percentage of our total revenues, and the failure to grow internationally will harm our business. Additionally, operating in international markets requires significant investment and management attention and will subject us to regulatory, political and economic risks that are different from those in the United States. We have made, and will continue to make, substantial investments in data centers and cloud computing infrastructure, sales, marketing, personnel and facilities as we enter and expand in new geographic markets. When we make these investments, it is typically unclear whether, and when, sales in the new market will justify our investments, and we may significantly underestimate the level of investment and time required to be successful, or whether we will be successful. Our rate of acquisition of new large enterprise customers, a factor effecting our growth, has generally been lower in Africa, Asia, Eastern Europe, South America and other markets in which we are less established and where there may be increased operational and intellectual property risks, as compared to North America, Australia and areas within Western Europe. An increasing proportion of the large enterprises that are not yet our customers are located in emerging markets where we are less established. We have experienced, and may continue to experience, difficulties in some of our investments in geographic expansion, including in hiring qualified sales management personnel, penetrating the target market, and/or managing foreign operations in such locales.

Risks inherent with international sales include without limitation:

- compliance with multiple, conflicting and changing governmental laws and regulations, including employment, tax, competition, privacy and data protection laws and regulations, including the GDPR;
- compliance by us and our business partners with international bribery and anti-corruption laws, including the UK Bribery Act and the Foreign Corrupt Practices Act;
- the risk that illegal or unethical activities of our local employees or business partners will be attributed to or result in liability to us or damage to reputation;
- longer and potentially more complex sales cycles;
- longer accounts receivable payment cycles and other collection difficulties;
- tax treatment of revenues from international sources and changes to tax codes, including being subject to foreign tax laws and being liable for paying withholding, income or other taxes in foreign jurisdictions;
- different pricing and distribution environments;
- foreign currency fluctuations, which may cause transactional and translational remeasurement losses;
- potential changes in international trade policies, tariffs, agreements and practices, including the adoption and expansion of formal or informal trade restrictions or regulatory frameworks or business practices favoring local competitors;
- potential threatening state-sponsored actions, including cybersecurity threats, directed at local data centers, customers or end-users;
- local business practices and cultural norms that may favor local competitors; and
- localization of our services, including translation into foreign languages and associated expenses.

If we are unable to manage these risks, if our required investments in these international markets are greater than anticipated, or if we are unsuccessful in increasing sales in emerging markets, our revenue growth rate, business and operating results will be adversely affected.

We do business with federal, state and local governments, government agencies, and heavily regulated organizations in the U.S. and in foreign jurisdictions; as a result we face risks related to the procurement process, budget decisions driven by statutory and regulatory determinations, termination of contracts, and compliance with government contracting requirements.

We provide products and services to the U.S. government by leveraging our partner ecosystem and to a number of state and local governments and heavily-regulated organizations both through our partners and directly, and we have made, and may continue to make, significant investments to support future sales opportunities in the federal, state and local government sectors. A substantial majority of our sales to date to government entities have been made indirectly through our distribution and reseller partners. Doing business with government entities presents a variety of risks. Among other risks, the procurement process for governments and their agencies is highly competitive and can be time-consuming, requiring us to incur significant up-front time and expense, such as engaging lobbyists, which subjects us to additional compliance risks and costs, without any assurance that we (or a third-party reseller) will win a contract. Beyond this, demand for our products and services may be impacted by public sector budgetary cycles and funding availability; funding in any given fiscal cycle may be reduced or delayed, including in connection with an extended federal government shutdown, which could adversely impact demand for our products and services. In addition, public sector and heavily-regulated customers may have contractual, statutory or regulatory rights to terminate current contracts with us or our third-party distributors or resellers for convenience or due to a default, though such risk may be assumed by such third-party distributor or reseller. If a contract is terminated for convenience, we may only be able to collect fees for products or services delivered prior to termination and settlement expenses. If a contract is terminated due to a default, we may be liable for excess costs incurred by the customer for procuring alternative products or services or be precluded from doing further business with government entities. Further, entities providing services to governments are required to comply with a variety of complex laws, regulations, and contractual provisions relating to the formation, administration, or performance of government contracts that give public sector customers substantial rights and remedies, many of which are not typically found in commercial contracts. These may include rights with respect to price protection, the accuracy of information provided to the government, contractor compliance with supplier diversity policies, and other terms that are particular to government contracts, such as termination rights. These rules may apply to us and/or third parties through whom we resell our products and services and whose practices we may not control, where such parties' non-compliance could impose repercussions with respect to contractual and customer satisfaction issues. Federal, state, and local governments routinely investigate and audit contractors for compliance with these requirements. If, as a result of an audit or review, it is determined that we have failed to comply with these requirements, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, cost associated with the triggering of price reduction clauses, fines, and suspensions or debarment from future government business, and we may suffer harm to our reputation.

Our customers also include a number of non-U.S. governments. Similar procurement, budgetary, contract, and audit risks that apply in the context of U.S. government contracting also apply to our doing business with these entities, particularly in certain emerging markets where our customer base is less established. In addition, compliance with complex regulations and contracting provisions in a variety of jurisdictions can be expensive and consume significant management resources. In certain jurisdictions, our ability to win business may be constrained by political and other factors unrelated to our competitive position in the market. Additionally, many of our current and prospective customers, such as those in the financial services and health care industries, are highly regulated and may be required to comply with more stringent regulations in connection with subscribing to and implementing our services. Each of these difficulties could materially adversely affect our business and results of operations.

If we fail to comply with anti-corruption laws, including the FCPA and similar laws associated with our activities outside of the United States, as well as general trade regulations, including but not limited to economic sanctions and embargoes, we could be subject to penalties, our business could be materially adversely affected and we could be subject to civil and/or criminal sanctions.

We are subject to the U.S. Foreign Corrupt Practices Act of 1977, as amended (the FCPA), the U.S. domestic bribery statute contained in 18 U.S.C. §201, the UK Bribery Act, and possibly other anti-bribery laws in countries in which we conduct activities. We face significant risks if we fail to comply with the FCPA and other anti-corruption laws that prohibit companies and their employees and third-party intermediaries from promising, authorizing, offering, or providing, directly or indirectly, improper payments or benefits to foreign government officials, political parties, and private-sector recipients for the purpose of obtaining or retaining business, directing business to any person, or securing any advantage. In addition, we use various third parties to sell our solution and conduct our business abroad. We or our third-party intermediaries may have direct or indirect interactions with officials and employees of government agencies or state-owned or affiliated entities and we can be held liable for the corrupt or other illegal activities of these third-party intermediaries, our employees, representatives, contractors, partners, and agents, even if we do not explicitly authorize such activities. We have implemented and continue to update an anti-corruption compliance program but cannot assure you that all of our employees and agents, as well as those companies to which we outsource certain of our business operations, will not take actions in violation of our policies and applicable law, for which we may be ultimately held responsible.

As we continue to expand our business internationally, we will inevitably do more business with large enterprises and the public sector in countries that are perceived to have heightened levels of public sector corruption. Increased business in countries perceived to have heightened levels of corruption could subject us and our officers and directors to increased scrutiny and increased liability from our business operations.

In addition, we are subject to compliance with general trade regulations relating to doing business outside the United States, including certain restrictions on conducting trade in certain restricted countries or with certain entities or individuals.

Any violation of the FCPA, other applicable anti-corruption laws general trade regulations by our own employees or our third-party intermediaries, could result in regulatory investigations, whistleblower complaints, adverse media coverage and/or severe criminal or civil sanctions, which could have a materially adverse effect on our reputation, business, operating results, and prospects. In addition, responding to any enforcement action may result in a significant diversion of management's attention and resources and significant defense costs.

If we lose key employees or are unable to attract and retain the employees we need, our business and operating results will be adversely affected.

Our success depends largely upon the continued services of our management team, including our Chief Executive Officer, and many key individual contributors. From time to time in the ordinary course of business, there may be changes in our management team resulting from the hiring or departure of executives. For example, on October 22, 2019, we announced that our President and Chief Executive Officer, John Donahoe, will be resigning from this position on or before December 31, 2019, and that William McDermott will take the position of President and Chief Executive Officer on or before January 1, 2020. Our Chief Financial Officer, Michael Scarpelli, left the Company in August 2019, and we are in the process of conducting our search for Mr. Scarpelli's successor. While we seek to manage these transitions carefully, including by establishing strong processes and procedures and succession planning, such changes may result in a loss of institutional knowledge and cause disruptions to our business.

In the technology industry, there is substantial and continuous competition for engineers with high levels of experience in designing, developing and managing software and Internet-related solutions, as well as competition for sales executives and operations personnel. We may not be successful in attracting and retaining qualified personnel. We may also experience increased compensation costs that may not be offset by either improved productivity or higher sales. We have from time to time experienced, and we may continue to experience, difficulty in hiring and retaining highly skilled employees with appropriate qualifications, and may not be able to fill positions in desired geographic areas or at all. In particular, competition for experienced software and cloud computing infrastructure engineers in the San Francisco Bay area, San Diego, Seattle, London, Amsterdam and Hyderabad, our primary operating locations, is intense. Our employees, including our executive officers, are employed by us on an "at-will" basis, which means they may terminate their employment with us at any time. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be adversely affected.

Privacy laws and concerns, evolving regulation of cloud computing, cross-border data transfer restrictions, other foreign and domestic regulations and standards related to personal data and the Internet may adversely affect our business.

National and local governments or agencies have in the past adopted, and may in the future adopt, laws and regulations affecting data privacy, the use of the Internet as a commercial medium, and data sovereignty requirements concerning the location of data centers that store and process data. Changing laws, regulations and standards applying to the collection, transfer, processing, storage or use of personal data could affect our customers' ability to use and share data, potentially restricting our ability to store, process and share data with our customers in connection with providing our services, and in some cases, could impact our ability to offer our services in certain locations or our customers' ability to deploy our services globally. For example, in 2016 the EU adopted the GDPR, which took effect on May 25, 2018 and established new requirements applicable to the handling of personal data. In the United Kingdom, a Data Protection Bill that substantially implements the GDPR also became law in May 2018. Further, laws such as the EU's proposed e-Privacy Regulation are increasingly aimed at the use of personal information for marketing purposes, the tracking of individuals' online activities and the "right to be forgotten," requiring a company to delete certain information about individuals upon their request in certain circumstances. Although we do not believe Brexit will require us to alter our operations in any material way to comply with privacy regulations in the EU and the UK, Brexit may cause uncertainty for our customers. In addition, in June 2018 the CCPA was signed into law, which takes effect in January 2020 and broadly defines personal information and provides California consumers increased privacy rights and protections. The CCPA will, among other things, afford such consumers new abilities to opt-out of certain sales of personal information. Legislators have amended the CCPA to, among other things, move the enforcement date of the law to the earlier of when the California Attorney General issues regulations or July 1, 2020. The law may also be amended further before its enforcement date, and it remains unclear what, if any, additional modifications will be made to this legislation or how it will be interpreted. In addition, other nations and U.S. states have discussed, and may pass, future legislation similar to the GDPR and/or the CCPA.

The costs of compliance with, and other burdens imposed by, the GDPR, the e-Privacy Regulation, the CCPA and other privacy laws, regulations and standards may cause us to incur substantial operational costs or require us to modify our data handling practices and/or policies, may limit the use and adoption of our services and reduce overall demand for our services. In addition, non-compliance could result in proceedings or investigations against us by governmental entities or others, significant fines, or reputational harm and may otherwise adversely impact our business, financial condition and operating results. For example, the GDPR imposes significant new obligations and compliance with these obligations depends in part on how particular regulators interpret and apply them. If we fail to comply with the GDPR or if regulators assert that we have failed to comply with the GDPR, we may be subject to fines of up to 4% of our worldwide annual revenue.

In addition to government activity, privacy advocacy groups and other technology and industry groups have established or may establish various new, additional or different self-regulatory standards that may place additional burdens on us. Our customers may expect us to meet voluntary certifications or adhere to other standards established by third parties. If we are unable to maintain these certifications or meet these standards, it could reduce demand for our applications and adversely affect our business.

Because we generally recognize revenues from our subscription service over the subscription term, a decrease in new subscriptions or renewals during a reporting period may not be immediately reflected in our operating results for that period.

We generally recognize revenues from customers ratably over the terms of their subscriptions. Net new ACV from new subscriptions, expansion contracts and renewals entered into during a period can generally be expected to generate revenue for the duration of the subscription term. As a result, most of the revenues we report in each period are derived from the recognition of deferred revenues relating to subscriptions entered into during previous periods. Consequently, a decrease in new or renewed subscriptions in any single reporting period will have a limited impact on our revenues for that period. In addition, our ability to adjust our cost structure in the event of a decrease in new or renewed subscriptions may be limited.

Further, a decline in new subscriptions or renewals in a given period may not be fully reflected in our revenues for that period, but will negatively affect our revenues in future periods. Accordingly, the effect of significant downturns in sales and market acceptance of our services, and changes in our rate of renewals, may not be fully reflected in our results of operations until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenues through additional sales in any period, as revenues from new customers are generally recognized over the applicable subscription term. Additionally, due to the complexity of certain of our customer contracts, the actual revenue recognition treatment required under Topic 606 depends on contract-specific terms and may result in greater variability in revenues from period to period.

In addition, a decrease in new subscriptions or renewals in a reporting period may not have an immediate impact on billings for that period due to factors that may offset the decrease, such as an increase in billings duration, the dollar value of contracts with future start dates, or the dollar value of collections in the current period related to contracts with future start dates.

We rely on our network of partners for a portion of our revenues, and if these partners fail to perform, our ability to sell and distribute our products may be limited, and our operating results may be harmed.

A portion of our revenues is generated by sales through our network of partners, including distributors and resellers. In addition, we increasingly rely on our partners to provide professional services, including customer implementations. While we provide our partners with training and programs, including accreditations and certifications, these programs may not be effective or utilized consistently. In addition, new partners may require extensive training and may take significant time and resources to achieve productivity. Our partners may subject us to lawsuits, potential liability, and reputational harm if, for example, any of our partners misrepresent the functionality of our platform or products to customers, fail to perform services to our customers' expectations, or violate laws or our corporate policies. In addition, our partners may utilize our platform to develop products and services that could potentially compete with products and services that we offer currently or in the future. Concerns over competitive matters or intellectual property ownership could constrain these partnerships. If we fail to effectively manage and grow our network of partners, or properly monitor the quality and efficacy of their service delivery, our ability to sell our products and efficiently provide our services may be impacted, and our operating results may be harmed.

As we acquire or invest in companies and technologies, we may not realize the expected business or financial benefits and the acquisitions and investments may divert our management's attention and result in additional dilution to our stockholders.

We have acquired or invested in companies and technologies in the past as part of our business strategy and may continue to evaluate (and from time to time, execute) potential strategic transactions, including acquisitions of, or investments in, businesses, technologies, services, products and other assets in the future. We also may enter into relationships with other businesses to expand our service offerings, functionality or our ability to provide services in international locations, which could involve preferred or exclusive licenses, additional channels of distribution, discount pricing or investments in other companies. Although we conduct a reasonably extensive due diligence with each of the entities with which we engage for a potential strategic transaction, our due diligence efforts may not reveal every material concern that may exist either with respect to the target entity or our assumptions surrounding the resulting combination. Acquisitions and investments involve numerous risks, including:

- assimilating or integrating the businesses, technologies, products, personnel or operations of the acquired companies;
- failing to achieve the expected benefits of the acquisition or investment;
- potential loss of key employees of the acquired company;
- inability to maintain relationships with customers and partners of the acquired business;
- unanticipated expenses related to acquired technology and its integration into our existing technology;
- potential adverse tax consequences;
- inability to generate sufficient revenue to offset acquisition or investment costs;
- disruption to our business and diversion of management attention and other resources;
- potential financial and credit risks associated with acquired customers;
- dependence on acquired technologies or licenses for which alternatives may not be available to us without significant cost or complexity;
- in the case of foreign acquisitions, the challenges associated with integrating operations across different cultures and languages and any currency and regulatory risks associated with specific countries; and
- potential unknown liabilities associated with the acquired businesses.

In addition, we may have to pay cash, incur debt, or issue equity or equity-linked securities to pay for any future acquisitions, each of which could adversely affect our financial condition or the market price of our common stock. Furthermore, if we finance acquisitions by issuing equity or convertible or other debt securities or loans, our existing stockholders may be diluted, or we could face constraints related to the terms of and repayment obligation related to the incurrence of indebtedness that could affect the market price of our common stock. The occurrence of any of these risks could harm our business, operating results and financial condition.

Our use of open source software could harm our ability to sell our services and subject us to possible litigation.

Our products incorporate software licensed to us by third-party authors under open source licenses, and we expect to continue to incorporate open source software into other services in the future. We attempt to monitor our use of open source software in an effort to avoid subjecting our services to adverse licensing conditions. However, there can be no assurance that our efforts have been or will be successful. There is little or no legal precedent governing the interpretation of the terms of open source licenses, and therefore the potential impact of these terms on our business is uncertain and enforcement of these terms may result in unanticipated obligations regarding our services and technologies. For example, depending on which open source license governs open source software included within our services or technologies, we may be subjected to conditions requiring us to offer our services to users at no cost; make available the source code for modifications and derivative works based upon, incorporating or using the open source software; and license such modifications or derivative works under the terms of the particular open source license. Moreover, if an author or other third party that distributes such open source software were to allege that we had not complied with the conditions of one or more of these licenses, we could be required to incur significant legal costs defending ourselves against such allegations, be subject to significant damages or be enjoined from the distribution of our services.

If we are unable to maintain effective internal control over financial reporting, the accuracy and timeliness of our financial reporting may be adversely affected.

The Sarbanes-Oxley Act requires us, among other things, to assess and report on the effectiveness of our internal control over financial reporting annually and the reasonable assurance level of our disclosure controls and procedures quarterly. In addition, our independent registered public accounting firm is required to audit the effectiveness of our internal control over financial reporting pursuant to Section 404(b) of the Sarbanes-Oxley Act annually. Our independent registered public accounting firm may issue a report that is adverse in the event it is not satisfied with the level at which our controls are documented, designed or operating. Moreover, our testing, or the subsequent testing by our independent registered public accounting firm, may reveal material weaknesses or significant deficiencies. If material weaknesses are identified or we are not able to comply with the requirements of Section 404 in a timely manner, our reported financial results could be materially misstated or could subsequently require restatement, we could receive an adverse opinion regarding our internal control over financial reporting from our independent registered public accounting firm, we could be subject to investigations or sanctions by regulatory authorities and we could incur substantial expenses. We may not be able to effectively implement system and process changes required for new standards on a timely basis. Any delays or failure to update our systems and processes could also lead to a material weakness or significant deficiency.

Natural disasters and other events beyond our control could harm our business.

Natural disasters or other catastrophic events may cause damage or disruption to our operations, international commerce and the global economy, and thus could have a negative effect on us. Our business operations are subject to interruption by natural disasters, flooding, fire, power shortages, pandemics, terrorism, political unrest, telecommunications failure, vandalism, cyber-attacks, geopolitical instability, war, the effects of climate change (such as drought, wildfires, increased storm severity and sea level rise) and other events beyond our control. Although we maintain crisis management and disaster response plans, such events could make it difficult or impossible for us to deliver our services to our customers, could decrease demand for our services, and could cause us to incur substantial expense. Our insurance may not be sufficient to cover losses or additional expense that we may sustain in connection with any natural disaster. The majority of our research and development activities, corporate offices, information technology systems, and other critical business operations are located near major seismic faults in California and Washington. Customer data could be lost, significant recovery time could be required to resume operations and our financial condition and operating results could be adversely affected in the event of a major natural disaster or catastrophic event.

Risks Related to Our Convertible Senior Notes

We may not have the ability to raise the funds necessary to settle conversions of our convertible senior notes due 2022 (the 2022 Notes) in cash or to repurchase the 2022 Notes upon a fundamental change, and our future debt may contain limitations on our ability to pay cash upon conversion or repurchase of the 2022 Notes.

Holders of the 2022 Notes have the right to require us to repurchase all or a portion of their 2022 Notes upon the occurrence of a fundamental change (as defined in the indenture for the 2022 Notes) at a repurchase price equal to 100% of the principal amount of the 2022 Notes to be repurchased, plus accrued and unpaid special interest, if any. In addition, if a make-whole fundamental change (as defined in the indenture for the 2022 Notes) occurs prior to the maturity date of the 2022 Notes, we will in some cases be required to increase the conversion rate for a holder that elects to convert its 2022 Notes in connection with such make-whole fundamental change. Upon conversion of the 2022 Notes, unless we elect to deliver solely shares of our common stock to settle such conversion (other than paying cash in lieu of delivering any fractional shares), we will be required to make cash payments in respect of the 2022 Notes being converted. However, we may not have enough available cash or be able to obtain financing at the time we are required to make repurchases of the 2022 Notes surrendered therefor or pay cash with respect to the 2022 Notes being converted.

We and our subsidiaries may incur substantial additional debt in the future, subject to the restrictions contained in our future debt instruments, some of which may be secured debt. We are not restricted under the terms of the indenture governing the 2022 Notes from incurring additional debt, securing existing or future debt, recapitalizing our debt or taking a number of other actions that could have the effect of diminishing our ability to make payments on the 2022 Notes when due. Furthermore, the indenture for the 2022 Notes prohibits us from engaging in certain mergers or acquisitions unless, among other things, the surviving entity assumes our obligations under the 2022 Notes and the indenture. These and other provisions in the indenture could deter or prevent a third party from acquiring us even when the acquisition may be favorable to holders of the 2022 Notes.

In addition, our ability to repurchase or to pay cash upon conversion of the 2022 Notes may be limited by law, regulatory authority or agreements governing our future indebtedness. Our failure to repurchase the 2022 Notes at a time when the repurchase is required by the indenture or to pay cash upon conversion of the 2022 Notes as required by the indenture would constitute a default. A default under the indenture or the fundamental change itself could also lead to a default under agreements governing our future indebtedness. Moreover, the occurrence of a fundamental change under the indenture could constitute an event of default under any such agreements. If the payment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness and repurchase the 2022 Notes, or to pay cash upon conversion of the 2022 Notes.

The conditional conversion feature of the 2022 Notes may adversely affect our financial condition and operating results.

Prior to the business day immediately preceding February 1, 2022, the holders of the 2022 Notes may elect to convert their notes during any calendar quarter (and only during such calendar quarter) if the last reported sale price of our common stock for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to \$175.18 (the Conversion Condition). The Conversion Condition for the 2022 Notes was met for the quarters ended June 30, 2018, September 30, 2018, March 31, 2019, June 30, 2019, and September 30, 2019. Therefore, our 2022 Notes became convertible at the holders' option beginning on July 1, 2018 and continue to be convertible through December 31, 2019, with the exception of the quarter ended March 31, 2019 because the Conversion Condition for the 2022 Notes was not met for the quarter ended December 31, 2018. Based on conversion requests we have received during the third quarter of 2019, we expect to settle in cash an immaterial principal amount of the 2022 Notes during the fourth quarter of 2019. If more holders elect to convert their 2022 Notes in future periods, unless we elect to satisfy our conversion obligation by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share), we may settle all or a portion of our conversion obligation in cash, which could adversely affect our liquidity and result in a material adverse effect on our financial position, results of operations and cash flows. In addition, to the extent we receive conversion requests, we may also record a loss on early conversions of the 2022 Notes converted by note holders based on the difference between the fair market value allocated to the liability component on the settlement date and the net carrying amount of the liability component and unamortized debt issuance on the settlement date.

The convertible note hedge and warrant transactions may affect the value of the 2022 Notes and our common stock.

In connection with the sale of the 2022 Notes, we entered into convertible note hedge (the 2022 Note Hedge) transactions with certain financial institutions (option counterparties). We also entered into warrant transactions with the option counterparties pursuant to which we sold warrants for the purchase of our common stock (the 2022 Warrants and 2018 Warrants, respectively). The 2022 Note Hedge is expected generally to reduce the potential dilution upon any conversion of the 2022 Notes and/or offset any cash payments we are required to make in excess of the principal amount of converted 2022 Notes, as the case may be. The 2018 Warrants had a dilutive effect as the market price per share of our common stock exceeded the exercise price of the 2018 Warrants, which was \$107.46. We issued approximately 4.3 million shares of our common stock upon the automatic exercise of the 2018 Warrants during the nine months ended September 30, 2019, resulting in immediate and substantial dilution to our existing stockholders. The 2018 Warrants were no longer outstanding as of the second quarter of 2019. Additionally, the 2022 Warrant transactions could separately have a dilutive effect to the extent that the market price per share of our common stock exceeds the exercise price of the 2022 Warrants, which is \$203.40. As the 2022 Warrants will be net share settled, the total number of shares of our common stock we will issue depends on the daily volume-weighted average stock prices over a 60 trading day period beginning on the first expiration date of the 2022 Warrants, which will be September 1, 2022. We expect to issue additional shares of our common stock in the second half of 2022 upon the automatic exercise of the 2022 Warrants. Based on the volume-weighted average stock price on September 30, 2019, the total number of shares of our common stock to be issued upon the automatic exercise of the 2022 Warrants would be approximately 1.1 million. The actual number of shares of our common stock issuable upon the automatic exercise of the 2022 Warrants, if any, is unknown at this time. Refer to Note 11 in the notes to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for additional information.

The option counterparties and/or their respective affiliates may modify their hedge positions by entering into or unwinding various derivatives with respect to our common stock and/or purchasing or selling our common stock in secondary market transactions prior to the maturity of the 2022 Notes (and are likely to do so during any observation period related to a conversion of the 2022 Notes, or following any repurchase of the 2022 Notes by us on any fundamental change repurchase date (as defined in the indenture for the 2022 Notes) or otherwise). This activity could also cause or avoid an increase or a decrease in the market price of our common stock or the 2022 Notes, which could affect note holders' ability to convert the 2022 Notes and, to the extent the activity occurs during any observation period related to a conversion of the 2022 Notes, it could affect the amount and value of the consideration that note holders will receive upon conversion of the 2022 Notes.

The potential effect, if any, of these transactions and activities on the market price of our common stock or the 2022 Notes will depend in part on market conditions and cannot be ascertained at this time. Any of these activities could adversely affect the value of our common stock and the value of the 2022 Notes (and as a result, the value of the consideration, the amount of cash and/or the number of shares, if any, that note holders would receive upon the conversion of any 2022 Notes) and, under certain circumstances, the ability of the note holders to convert the 2022 Notes.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the price of the 2022 Notes or our common stock. In addition, we do not make any representation that the option counterparties will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

We are subject to counterparty risk with respect to the 2022 Note Hedge.

The option counterparties are financial institutions, and we will be subject to the risk that any or all of them may default under the 2022 Note Hedge. Our exposure to the credit risk of the option counterparties will not be secured by any collateral. Recent global economic conditions have resulted in the actual or perceived failure or financial difficulties of many financial institutions. If an option counterparty becomes subject to insolvency proceedings, we will become an unsecured creditor in those proceedings, with a claim equal to our exposure at that time under our transactions with that option counterparty. Our exposure will depend on many factors but, generally, an increase in our exposure will be correlated to an increase in the market price and in the volatility of our common stock. In addition, upon a default by an option counterparty, we may suffer adverse tax consequences and more dilution than we currently anticipate with respect to our common stock. We can provide no assurances as to the financial stability or viability of the option counterparties.

Risks Related to Ownership of Our Common Stock

The market price of our common stock has historically been and is likely to continue to be volatile and could subject us to litigation.

The trading price of our common stock has been, and is likely to continue to be, volatile and could be subject to wide fluctuations in response to various factors, some of which are beyond our control. In addition, the trading prices of the securities of technology companies in general have been highly volatile, and the volatility in market price and trading volume of securities is often unrelated or disproportionate to the financial performance of the companies issuing the securities. Factors affecting the market price of our common stock, some of which are beyond our control, include:

- changes in the estimates of our operating results or changes in recommendations by securities analysts that elect to follow our common stock;
- announcements of new products, services or technologies, new applications or enhancements to services, strategic alliances, acquisitions, or other significant events by us or by our competitors;
- fluctuations in the valuation of companies perceived by investors to be comparable to us, such as high-growth or cloud companies;
- changes to our management team;
- trading activity by directors, executive officers and significant stockholders, or the perception in the market that the holders of a large number of shares intend to sell their shares;
- the size of our market float;
- the volume of trading in our common stock, including sales upon exercise of outstanding options or vesting of equity awards or sales and purchases of any common stock issued upon conversion of the 2022 Notes or in connection with the 2022 Note Hedge and 2022 Warrant transactions relating to the 2022 Notes;
- the economy as a whole, market conditions in our industry, and the industries of our customers; and
- overall performance of the equity markets.

Following periods of volatility in the market price of a company's securities, securities class action litigation has often been brought against that company. Securities litigation could result in substantial costs and divert our management's attention and resources from our business. This could have a material adverse effect on our business, operating results, and financial condition.

We do not intend to pay dividends on our common stock, so any returns will be limited to changes in the value of our common stock.

We have never declared or paid any cash dividends on our common stock. We currently anticipate that we will retain future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. In addition, our ability to pay cash dividends on our common stock may be prohibited or limited by the terms of any future debt financing arrangement. Any return to stockholders will therefore be limited to the increase, if any, of our stock price.

Provisions in our charter documents, Delaware law or our 2022 Notes might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the market price of our common stock.

Our restated certificate of incorporation and restated bylaws contain provisions that could depress the market price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions among other things:

- establish a classified board of directors so that not all members of our board are elected at one time;
- permit the board of directors to establish the number of directors;
- provide that directors may only be removed “for cause” and only with the approval of 66 2/3% of our stockholders;
- require super-majority voting to amend some provisions in our restated certificate of incorporation and restated bylaws;
- authorize the issuance of “blank check” preferred stock that our board could use to implement a stockholder rights plan;
- eliminate the ability of our stockholders to call special meetings of stockholders;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- provide that the board of directors is expressly authorized to make, alter or repeal our restated bylaws; and
- establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at annual stockholder meetings (though our restated bylaws have implemented stockholder proxy access).

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company. Section 203 imposes certain restrictions on merger, business combinations and other transactions between us and holders of 15% or more of our common stock.

Further, the fundamental change provisions of our 2022 Notes may delay or prevent a change in control of our company, because those provisions allow note holders to require us to repurchase such notes upon the occurrence of a fundamental change.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS
EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description of Document</u>	<u>Incorporated by Reference</u>			<u>Filed</u>
		<u>Form</u>	<u>File No.</u>	<u>Exhibit</u>	<u>Herewith</u>
31.1	Certification of Periodic Report under Section 302 of the Sarbanes-Oxley Act of 2002				X
31.2	Certification of Periodic Report under Section 302 of the Sarbanes-Oxley Act of 2002				X
32.1**	Certifications Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X
101.INS	Inline XBRL Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.				X
101.SCH	Inline XBRL Taxonomy Extension Schema Document.				X
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document.				X
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document.				X
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document.				X
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document.				X
104	Cover Page Interactive Data File (formatted as inline XBRL and contained in Exhibit 101)				X

* The certifications on Exhibit 32 hereto are deemed not “filed” for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, or otherwise subject to the liability of that Section. Such certifications will not be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act.

SIGNATURES

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

SERVICENOW, INC.

Date: October 24, 2019

By: /s/ John J. Donahoe

John J. Donahoe

President and Chief Executive Officer

(On behalf of the Registrant)

Date: October 24, 2019

By: /s/ Fay Sien Goon

Fay Sien Goon

Chief Accounting Officer

(As Principal Accounting Officer)

**CERTIFICATION OF PERIODIC REPORT UNDER SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

I, John J. Donahoe, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ServiceNow, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 24, 2019

/s/ John J. Donahoe

John J. Donahoe

President and Chief Executive Officer

(Principal Executive Officer and Principal Financial Officer)

**CERTIFICATION OF PERIODIC REPORT UNDER SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

I, John J. Donahoe, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ServiceNow, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 24, 2019

/s/ John J. Donahoe

John J. Donahoe

President and Chief Executive Officer

(Principal Executive Officer and Principal Financial Officer)

**CERTIFICATIONS PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

I, John J. Donahoe, President and Chief Executive Officer of ServiceNow, Inc. (the “Company”), do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- the Quarterly Report on Form 10-Q of the Company for the period ended September 30, 2019 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company for the periods presented therein.

Date: October 24, 2019

/s/ John J. Donahoe

John J. Donahoe

President and Chief Executive Officer

(Principal Executive Officer and Principal Financial Officer)

A signed original of this written statement required by Section 906 has been provided to ServiceNow, Inc. and will be retained by it and furnished to the Securities and Exchange Commission or its staff upon request.