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ServiceNow, Inc.

Form 10-Q

November 06, 2017

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

× Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2017

OR

· Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 001-35580

SERVICENow, INC.

(Exact name of registrant as specified in its charter)

Delaware 20-2056195

(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

ServiceNow, Inc.
2225 Lawson Lane
Santa Clara, California 95054
(408) 501-8550

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

Emerging growth company ☐

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

As of September 30, 2017, there were approximately 172.7 million shares of the Registrant's Common Stock outstanding.

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Table of Contents**PART I****ITEM 1. FINANCIAL STATEMENTS****SERVICENOW, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

(unaudited)

	September 30, 2017	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,104,871	\$ 401,238
Short-term investments	567,026	498,124
Accounts receivable, net	291,903	322,757
Current portion of deferred commissions	96,811	76,780
Prepaid expenses and other current assets	66,881	43,636
Total current assets	2,127,492	1,342,535
Deferred commissions, less current portion	69,041	61,990
Long-term investments	424,858	262,658
Property and equipment, net	231,304	181,620
Intangible assets, net	68,970	65,854
Goodwill	108,097	82,534
Other assets	39,753	36,576
Total assets	\$ 3,069,515	\$ 2,033,767
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 20,752	\$ 38,080
Accrued expenses and other current liabilities	177,553	171,636
Current portion of deferred revenue	1,082,346	861,782
Total current liabilities	1,280,651	1,071,498
Deferred revenue, less current portion	42,298	33,319
Convertible senior notes, net	1,156,629	507,812
Other long-term liabilities	38,546	34,177
Total liabilities	2,518,124	1,646,806
Stockholders' equity:		
Common stock	173	167
Additional paid-in capital	1,670,339	1,405,317
Accumulated other comprehensive loss	(408)	(21,133)
Accumulated deficit	(1,118,713)	(997,390)
Total stockholders' equity	551,391	386,961
Total liabilities and stockholders' equity	\$ 3,069,515	\$ 2,033,767

See accompanying notes to condensed consolidated financial statements

Table of Contents**SERVICENOW, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

(in thousands, except share and per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenues:				
Subscription	\$455,421	\$ 318,934	\$1,242,563	\$877,035
Professional services and other	42,749	38,722	144,093	127,812
Total revenues	498,170	357,656	1,386,656	1,004,847
Cost of revenues ⁽¹⁾ :				
Subscription	81,878	61,566	228,046	170,707
Professional services and other	45,402	41,271	137,366	123,039
Total cost of revenues	127,280	102,837	365,412	293,746
Gross profit	370,890	254,819	1,021,244	711,101
Operating expenses ⁽¹⁾ :				
Sales and marketing	227,015	166,491	686,325	511,607
Research and development	98,465	75,018	272,959	211,306
General and administrative	52,465	40,085	150,242	117,393
Legal settlements	—	—	—	270,000
Total operating expenses	377,945	281,594	1,109,526	1,110,306
Loss from operations	(7,055)	(26,775)	(88,282)	(399,205)
Interest expense	(16,566)	(8,389)	(36,581)	(24,746)
Interest income and other income (expense), net	853	1,783	739	4,745
Loss before income taxes	(22,768)	(33,381)	(124,124)	(419,206)
Provision for (benefit from) income taxes	1,420	2,877	(2,801)	9
Net loss	\$(24,188)	\$(36,258)	\$(121,323)	\$(419,215)
Net loss per share - basic and diluted	\$(0.14)	\$(0.22)	\$(0.71)	\$(2.56)
Weighted-average shares used to compute net loss per share - basic and diluted	171,883,190	165,378,836	170,359,717	163,767,329
Other comprehensive income (loss):				
Foreign currency translation adjustments	\$3,389	\$ 203	\$15,482	\$(1,106)
Unrealized gain (loss) on investments, net of tax	(2,864)	(615)	5,243	1,523
Other comprehensive income (loss), net of tax	525	(412)	20,725	417
Comprehensive loss	\$(23,663)	\$(36,670)	\$(100,598)	\$(418,798)

(1) Includes stock-based compensation as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Cost of revenues:				
Subscription	\$8,980	\$7,140	\$25,860	\$20,698
Professional services and other	7,056	7,150	21,622	20,045
Sales and marketing	43,962	31,898	124,650	95,757
Research and development	23,092	21,376	67,624	62,956
General and administrative	17,352	13,523	48,695	35,004

See accompanying notes to condensed consolidated financial statements

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Table of Contents**SERVICENOW, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2017	2016
Cash flows from operating activities:		
Net loss	\$(121,323)	\$(419,215)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	81,808	59,716
Amortization of premiums on investments	2,508	3,745
Amortization of deferred commissions	80,251	57,742
Amortization of debt discount and issuance costs	36,581	24,746
Stock-based compensation	288,451	234,460
Deferred income tax	(6,055)	(5,095)
Other	(4,062)	(857)
Changes in operating assets and liabilities, net of effect of business combinations:		
Accounts receivable	42,341	(15,761)
Deferred commissions	(102,348)	(79,190)
Prepaid expenses and other assets	(26,866)	(11,733)
Accounts payable	(11,088)	(8,625)
Deferred revenue	193,594	151,019
Accrued expenses and other liabilities	4,247	36,282
Net cash provided by operating activities	458,039	27,234
Cash flows from investing activities:		
Purchases of property and equipment	(115,856)	(84,112)
Business combinations, net of cash acquired	(26,537)	(34,297)
Purchases of other intangibles	(6,170)	(10,750)
Purchases of investments	(641,666)	(434,397)
Purchases of strategic investments	(4,000)	—
Sales of investments	77,968	266,288
Maturities of investments	350,597	218,452
Restricted cash	(739)	(322)
Net cash used in investing activities	(366,403)	(79,138)
Cash flows from financing activities:		
Net proceeds from borrowings on convertible senior notes	772,127	—
Proceeds from issuance of warrants	54,071	—
Purchases of convertible note hedges	(128,017)	—
Repurchases and retirement of common stock	(55,000)	—
Proceeds from employee stock plans	76,748	55,063
Taxes paid related to net share settlement of equity awards	(131,130)	(88,567)
Payments on financing obligations	(2,681)	(1,361)
Net cash provided by (used in) financing activities	586,118	(34,865)
Foreign currency effect on cash and cash equivalents	25,879	(469)
Net increase (decrease) in cash and cash equivalents	703,633	(87,238)
Cash and cash equivalents at beginning of period	401,238	412,305
Cash and cash equivalents at end of period	\$1,104,871	\$325,067
Non-cash investing and financing activities:		

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Property and equipment included in accounts payable and accrued expenses	\$9,321	\$9,691
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See accompanying notes to condensed consolidated financial statements

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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 is a leading provider of enterprise cloud computing solutions that define, structure, manage and automate services for global enterprises. Our mission is to help our customers improve service levels and reduce costs while scaling and automating their businesses. 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, we deploy our software on-premises at a customer data center to support a customer's unique regulatory or security requirements.

(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 (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. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary 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, 2017 are not necessarily indicative of the results to be expected for the year ending December 31, 2017 or for other interim periods or future years. The condensed consolidated balance sheet as of December 31, 2016 is derived from audited financial statements as of that date; 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, 2016, which was filed with the SEC on February 28, 2017.

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.

Prior Period Reclassification

Certain reclassifications of prior period amounts have been made in our condensed consolidated statements of cash flow and Note 16 to conform to the current period presentation.

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 condensed 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, the best estimate of selling price of the deliverables included in multiple elements revenue arrangements, the fair value of assets acquired and liabilities assumed for business combinations, stock-based compensation expenses, the assessment of the useful life and recoverability of our property and equipment, goodwill and identifiable intangible assets, future taxable income and legal contingencies. Actual results could differ from those estimates.

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New Accounting Pronouncements Pending Adoption

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-09, "Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting," which provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. This new standard is effective for our interim and annual periods beginning January 1, 2018, and early adoption is permitted. We do not anticipate that the adoption of this standard will have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, "Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20)—Premium Amortization on Purchased Callable Debt Securities," which shortens the amortization period for certain callable debt securities held at a premium to require such premiums to be amortized to the earliest call date unless applicable guidance related to certain pools of securities is applied to consider estimated prepayments. This new standard is effective for our interim and annual periods beginning January 1, 2019, and early adoption is permitted. We do not anticipate that the adoption of this standard will have a material impact on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, "Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," which eliminates Step 2 from the goodwill impairment test. This standard requires an entity to perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. In addition, this new standard eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment. This new standard is effective for our interim and annual periods beginning January 1, 2020, and early adoption is permitted. We do not anticipate that the adoption of this standard will have a material impact on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business," which clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. This new standard is required to be applied on a prospective basis, effective for our interim and annual periods beginning January 1, 2018, and early adoption is permitted. The actual impact upon adoption of this new standard will depend upon the nature of our future acquisitions, if any.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)," which requires that amounts generally described as restricted cash or restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. This new standard is effective for our interim and annual periods beginning January 1, 2018, and early adoption is permitted. We do not anticipate that the adoption of this standard will have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory," which includes a revision of the accounting for the income tax consequences of intra-entity transfers of assets other than inventory to reduce the complexity in accounting standards. This new standard is effective for our interim and annual periods beginning January 1, 2018, and early adoption is permitted. The new standard is required to be applied on a modified retrospective basis through a cumulative effect adjustment directly to retained earnings as of the beginning of the period of adoption. While we believe the current impact upon the adoption of this standard on our consolidated financial statements will be immaterial, the actual impact will largely depend on future intra-entity asset transfers, if any.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments," which provides guidance on eight specific cash flow issues. Among these issues, this standard requires, at the settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowings, the portion of the cash payment attributable to the accreted interest related to the debt discount to be classified as cash flows for operating activities, and the portion of the cash payments attributable to the principal to be classified as cash outflows for financing activities. This new standard is effective for our interim and annual periods beginning January 1, 2018, and early adoption is permitted. We currently expect to settle \$575.0 million relating to the principal amount of our 0% convertible senior notes due November 1, 2018 in cash upon maturity. At that time, we expect to classify approximately \$155.3 million of debt discount attributable to the difference between the 0% coupon interest rate and the 6.5% effective interest rate as an operating cash outflow in our consolidated statements of cash flows. The remaining \$419.7 million will be presented as a financing cash outflow in our consolidated statements of cash flows.

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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. Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. 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 consolidated financial statements.

In February 2016, the FASB issued 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 current practice. This new standard, including related amendments recently issued by the FASB, is effective for our interim and annual periods beginning January 1, 2019, and early adoption is permitted. While we are currently evaluating the impact of the adoption of this standard on our consolidated financial statements, we currently anticipate that the adoption of this standard will have a material impact on our consolidated balance sheets given that we had operating lease commitments of approximately \$352 million as of September 30, 2017. However, we do not anticipate that the adoption of this standard will have a material impact on our consolidated statements of comprehensive loss since the expense recognition under this new standard will be similar to current practice.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," which addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments, and requires equity securities to be measured at fair value with changes in fair value recognized through net income. This new standard allows a measurement alternative for equity investments that do not have readily determinable fair values to be measured at cost, less any impairment, plus or minus adjustments resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. This new standard is effective for our interim and annual periods beginning January 1, 2018, and will be adopted by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption, with prospective adoption of the amendments related to equity securities without readily determinable fair values existing as of the date of adoption. While we are currently evaluating the impact of the adoption of this standard on our consolidated financial statements, we preliminarily expect the adoption of this standard to impact our strategic investments and our marketable equity securities, and plan to elect the measurement alternative for equity investments that do not have readily determinable fair values.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." Under this new standard, revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the entity expects to receive in exchange for those goods or services. In addition, this standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The FASB has recently issued several amendments to the standard, including clarification on accounting for licenses of intellectual property and identifying performance obligations. This new standard is effective for our interim and annual periods beginning January 1, 2018.

The Topic 606 guidance permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method) or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (modified retrospective method). We currently anticipate adopting the standard using the full retrospective method to restate each prior reporting period presented.

Given the scope of work required to implement the recognition and disclosure requirements under the Topic 606 standard, we began our assessment process in 2014 and have since made significant progress, including the identification and on-going implementation of necessary changes to our policies, processes, systems and controls.

We do not expect the Topic 606 standard to have a material impact on the timing of revenue recognition related to our cloud-based subscription offerings. However, we expect this new standard to have a material impact on the timing of revenue and expense recognition for our contracts related to on-premises offerings, in which we grant customers the right to deploy our software on the customer's own servers, without significant penalty. Under this new standard, the requirement to have vendor specific objective evidence (VSOE) for undelivered elements is eliminated. As such, we may be required to recognize as revenue a portion of the sales price upon delivery of the software, compared to the current practice of recognizing the entire sales price ratably over an estimated subscription period due to the lack of VSOE. To the extent the amounts recognized as revenue have not been billed, the accrued revenue will be recorded as unbilled receivables on our consolidated balance sheets. We currently believe our total revenues reported for the year ended December 31, 2016 would have increased by approximately \$10 to \$15 million on a pro forma basis if the new standard had been applied for the entire 2016 fiscal year starting on January 1, 2016.

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In addition, we expect the Topic 606 standard to change the way we account for commissions paid on both our on-premises offerings and our cloud-based subscription offerings. Our current practice is to defer only direct and incremental commission costs to obtain a contract and amortize those costs over the contract term for both our on-premises offerings and our cloud-based subscription offerings. Under this new standard, we will defer all incremental commission costs to obtain customer contracts, including indirect costs that are not tied to a specific contract, for both our on-premises offerings and our cloud-based subscription offerings. Commissions allocated to the software element of our on-premises offerings, which are delivered up front, will be expensed immediately under this new standard, while commissions allocated to the support element of our on-premises offerings as well as commissions paid on our cloud-based subscription offerings, which are delivered over time, will be amortized over an expected period of benefit, which we have determined to be approximately five years. As a result, we currently expect the deferred commissions asset to increase and the related amortization expense in each reporting period to decrease under this new standard. The aggregate impact resulting from changes in the way we account for commission expense for both our cloud-based subscription offerings and our on-premises offerings would have reduced our sales and marketing expenses by approximately \$20 to \$25 million on a pro forma basis for the year ended December 31, 2016 if the new standard had been applied for the entire 2016 fiscal year starting on January 1, 2016.

We are continuing to evaluate the impact of the adoption of this standard on our consolidated financial statements, including the tax effects related to the revenue and commission adjustments discussed above and the increased disclosure requirements on our footnotes. Our preliminary assessments are subject to change.

(3) Investments***Marketable Securities***

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

September 30, 2017				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
Commercial paper	\$52,596	\$ —	\$ —	\$52,596
Corporate notes and bonds	775,622	126	(1,064)	774,684
Certificates of deposit	38,288	—	—	38,288
U.S. government agency securities	108,587	—	(209)	108,378
Marketable equity securities	10,000	7,938	—	17,938
Total available-for-sale securities	\$985,093	\$ 8,064	\$(1,273)	\$991,884

December 31, 2016				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
Commercial paper	\$56,839	\$ —	\$ —	\$56,839
Corporate notes and bonds	628,054	91	(1,590)	626,555
Certificates of deposit	35,355	—	—	35,355
U.S. government agency securities	42,088	7	(62)	42,033
Total available-for-sale securities	\$762,336	\$ 98	\$(1,652)	\$760,782

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As of September 30, 2017, the contractual maturities of our available-for-sale investment securities, excluding marketable equity securities and those securities classified within cash and cash equivalents on the condensed consolidated balance sheets, did not exceed 24 months. The fair values of these securities, by remaining contractual maturity, are as follows (in thousands):

	September 30, 2017
Due in 1 year or less	\$549,088
Due in 1 to 2 years	424,858
Total	\$973,946

The following table shows the fair values and the gross unrealized losses of our available-for-sale investment 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, 2017					
	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	\$499,576	\$(822)	\$114,109	\$(242)	\$613,685	\$(1,064)
U.S. government agency securities	91,901	(185)	8,977	(24)	100,878	(209)
Total	\$591,477	\$(1,007)	\$123,086	\$(266)	\$714,563	\$(1,273)

	December 31, 2016					
	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	\$492,503	\$(1,530)	\$47,940	\$(60)	\$540,443	\$(1,590)
U.S. government agency securities	30,033	(62)	—	—	30,033	(62)
Total	\$522,536	\$(1,592)	\$47,940	\$(60)	\$570,476	\$(1,652)

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.

Strategic Investments

Our strategic investments consist of debt and non-marketable equity investments in privately-held companies. Debt investments in privately-held companies are classified as available-for-sale and are recorded at their estimated fair value with changes in fair value recorded through accumulated other comprehensive income, while non-marketable equity securities are recorded at cost. We have not recorded any impairment charges for any of our investments in privately-held companies. The total amount of debt and equity investments in privately-held companies included in other assets on the condensed consolidated balance sheets was \$5.0 million and \$11.0 million as of September 30, 2017 and December 31, 2016, respectively. During the nine months ended September 30, 2017, we reclassified \$10.0 million of non-marketable equity securities (at cost) to short-term investments on our condensed consolidated balance sheets due to an initial public offering by the investee, and recorded an unrealized gain of \$7.9 million within other comprehensive income in our consolidated statements of comprehensive loss. During the nine months ended September 30, 2017, we also acquired an additional \$4.0 million in strategic investments. The fair value of our debt investments in privately-held companies included within our strategic investments is \$1.5 million and \$0.5 million as

of September 30, 2017 and December 31, 2016, respectively. These investments are recorded at fair value using significant unobservable inputs or data in an inactive market and the valuation requires our judgment due to the absence of quoted prices in active markets and inherent lack of liquidity and are categorized accordingly as Level 3 in the fair value hierarchy.

Table of Contents**(4) Fair Value Measurements**

The following table presents our fair value hierarchy for our assets measured at fair value on a recurring basis at September 30, 2017 (in thousands):

	Level 1	Level 2	Total
Cash equivalents:			
Money market funds	\$196,998	\$—	\$196,998
Commercial paper	—	12,478	12,478
Certificates of deposit	—	2,948	2,948
U.S. government agency securities	—	551,772	551,772
Short-term investments:			
Commercial paper	—	52,596	52,596
Corporate notes and bonds	—	449,379	449,379
Certificates of deposit	—	18,755	18,755
U.S. government agency securities	—	28,358	28,358
Marketable equity securities	17,938	—	17,938
Long-term investments:			
Corporate notes and bonds	—	325,305	325,305
Certificates of deposit	—	19,533	19,533
U.S. government agency securities	—	80,020	80,020
Total	\$214,936	\$1,541,144	\$1,756,080

The following table presents our fair value hierarchy for our assets measured at fair value on a recurring basis at December 31, 2016 (in thousands):

	Level 1	Level 2	Total
Cash equivalents:			
Money market funds	\$165,627	\$—	\$165,627
Short-term investments:			
Commercial paper	—	56,839	56,839
Corporate notes and bonds	—	388,429	388,429
Certificates of deposit	—	35,355	35,355
U.S. government agency securities	—	17,501	17,501
Long-term investments:			
Corporate notes and bonds	—	238,125	238,125
U.S. government agency securities	—	24,533	24,533
Total	\$165,627	\$760,782	\$926,409

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.

See Note 3 for the fair value measurement of our debt investments in privately-held companies and Note 9 for the fair value measurement of our convertible senior notes.

Table of Contents**(5) Business Combinations****2017 Business Combinations*****DxContinuum***

On January 20, 2017, we completed the acquisition of a privately-held company, DxContinuum, Inc. (DxContinuum), by acquiring all issued and outstanding common shares of DxContinuum for approximately \$15.0 million in an all-cash transaction to enhance the predictive capabilities of our solutions.

The following table summarizes the allocation of the purchase price to the fair value of the tangible and intangible assets acquired and liabilities assumed as of the acquisition date:

	Purchase Price Allocation (in thousands)	Useful Life (in years)
Net tangible assets acquired	\$37	
Intangible assets:		
Developed technology	6,400	5
Goodwill	11,159	
Net deferred tax liabilities ⁽¹⁾	(2,561)	
Total purchase price	\$15,035	

(1) Deferred tax liabilities, net primarily relates to purchased identifiable intangible assets and is shown net of deferred tax assets.

The excess of purchase consideration over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. We believe the goodwill represents the synergies expected from expanded market opportunities when integrating DxContinuum technologies with our offerings. The goodwill balance is not deductible for income tax purposes.

Other 2017 Business Combinations

In addition to the DxContinuum acquisition during the nine months ended September 30, 2017, we also completed the acquisition of privately-held companies Qlue, Inc. and Digital Telepathy, Inc. (Telepathy) for approximately \$11.6 million in cash, and have included the results of operations of these companies in our condensed consolidated financial statements from their respective dates of purchase. In allocating the aggregate purchase price based on the estimated fair value, we recorded \$9.1 million of goodwill, \$3.5 million of developed technology intangible assets (to be amortized over estimated useful life of five years) and \$1.1 million of deferred tax liabilities. Amounts allocated to the remaining acquired tangible assets and assumed liabilities were not material. \$4.1 million of the goodwill balance associated with these business combinations is deductible for income tax purposes. We are obligated to make cash payments of up to \$5.0 million in connection with the acquisition of Telepathy, contingent upon the continued employment by us of certain former employees of Telepathy on specified future dates. We determined that this additional consideration was not part of the purchase price and will be recognized as post-acquisition expense over the related requisite service period.

Aggregate acquisition-related costs associated with all 2017 business combinations of \$1.5 million for the nine months ended September 30, 2017 are included in general and administrative expenses in our condensed consolidated statements of comprehensive loss.

Table of Contents**2016 Business Combinations*****BrightPoint Security***

On June 3, 2016, we completed the acquisition of a privately-held company, BrightPoint Security, Inc. (BrightPoint), by acquiring all issued and outstanding common shares of BrightPoint for approximately \$19.6 million in an all-cash transaction in order to expand our Security Operations solutions. The following table summarizes the allocation of the purchase price to the fair value of the tangible and intangible assets acquired and liabilities assumed as of the acquisition date:

	Purchase Price Allocation (in thousands)	Useful Life (in years)
Intangible assets:		
Developed technology	\$8,100	6
Customer contracts and related relationships	500	1.5
Goodwill	15,258	
Net tangible liabilities acquired	(1,339)	
Net deferred tax liabilities ⁽¹⁾	(2,890)	
Total purchase price	\$19,629	

(1) Deferred tax liabilities, net primarily relates to purchased identifiable intangible assets and is shown net of deferred tax assets.

ITapp

On April 8, 2016, we completed the acquisition of a privately-held company, ITapp Inc. (ITapp), by acquiring all issued and outstanding common shares of ITapp for approximately \$14.5 million in an all-cash transaction in order to expand our IT Operations Management solutions. The following table summarizes the allocation of the purchase price to the fair value of the tangible and intangible assets acquired and liabilities assumed as of the acquisition date:

	Purchase Price Allocation (in thousands)	Useful Life (in years)
Net tangible assets acquired	\$140	
Intangible assets:		
Developed technology	4,700	5
Customer contracts and related relationships	200	1.5
Goodwill	11,437	
Net deferred tax liabilities ⁽¹⁾	(2,015)	
Total purchase price	\$14,462	

(1) Deferred tax liabilities, net primarily relates to purchased identifiable intangible assets and is shown net of deferred tax assets.

For both of the 2016 business combinations, the excess of purchase consideration over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. We believe the goodwill represents the synergies expected from expanded market opportunities when integrating the acquired technologies with our offerings. The goodwill balance for both business combinations is not deductible for income tax purposes. Aggregate acquisition-related costs of \$1.0 million are included in general and administrative expenses in our condensed consolidated statements of comprehensive loss.

Table of Contents**Unaudited Pro Forma Financial Information**

The results of operations of our 2017 and 2016 business combinations have been included in our condensed consolidated financial statements from their respective dates of purchase. The following pro forma consolidated financial information combines the results of operations from us and all the companies that we acquired since January 1, 2016 for the three and nine months ended September 30, 2017 and 2016, as if these acquisitions had occurred on January 1, 2016 (in thousands, except share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenues	\$499,529	\$359,362	\$1,390,582	\$1,010,374
Net loss	\$(24,152)	\$(37,134)	\$(120,882)	\$(426,883)
Weighted-average shares used to compute net loss per share - basic and diluted	171,883,190	165,378,836	170,359,717	163,767,329
Net loss per share - basic and diluted	\$(0.14)	\$(0.22)	\$(0.71)	\$(2.61)

The pro forma results as presented above are based on estimates and assumptions, which we believe are reasonable. They are not necessarily indicative of our condensed consolidated results of operations in future periods or the results that actually would have been realized had we been a combined company during the periods presented. The pro forma results include adjustments primarily related to amortization of acquired intangible assets and acquisition-related costs.

(6) Goodwill and Intangible Assets

Goodwill balances are presented below (in thousands):

	Carrying Amount
Balance as of December 31, 2016	\$82,534
Goodwill acquired	20,281
Foreign currency translation adjustments	5,282
Balance as of September 30, 2017	\$108,097

Intangible assets consist of the following (in thousands):

	September 30, 2017		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	\$91,527	\$(44,069)	\$47,458
Patents	23,780	(2,532)	21,248
Other	1,775	(1,511)	264
Total intangible assets	\$117,082	\$(48,112)	\$68,970

During the nine months ended September 30, 2017, we acquired patents with a weighted average useful life of 10 years for an aggregate purchase price of \$6.2 million.

December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization
		Net Carrying Amount

Developed technology	\$ 79,206	\$(30,858)	\$ 48,348
Patents	17,610	(867)	16,743
Other	1,775	(1,012)	763
Total intangible assets	\$ 98,591	\$(32,737)	\$ 65,854

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Amortization expense for intangible assets for the three months ended September 30, 2017 and 2016 was approximately \$4.8 million and \$4.3 million, respectively, and for the nine months ended September 30, 2017 and 2016 was approximately \$14.3 million and \$10.9 million, respectively.

The following table presents the estimated future amortization expense related to intangible assets held at September 30, 2017 (in thousands):

Years
Ending
December
31,
~~2017~~, 2017
~~2018~~, 2018
~~2019~~, 2019
~~2020~~, 2020
~~2021~~, 2021
Thereafter
Total
future
amortization
expense
\$ 68,970

(7) Property and Equipment

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

	September 30, 2017	December 31, 2016
Computer equipment	\$ 303,336	\$ 222,648
Computer software	41,200	32,132
Leasehold improvements	48,000	37,095
Furniture and fixtures	36,283	31,574
Building	6,978	6,379
Construction in progress	7,044	2,535
	442,841	332,363
Less: Accumulated depreciation	(211,537)	(150,743)
Total property and equipment, net	\$ 231,304	\$ 181,620

Construction in progress consists primarily of leasehold improvements and in-process software development costs. Depreciation expense for the three months ended September 30, 2017 and 2016 was \$24.3 million and \$17.9 million, respectively, and for the nine months ended September 30, 2017 and 2016 was approximately \$66.9 million and \$48.7 million, respectively.

(8) Accrued Expenses and Other Current Liabilities

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

September 30, 2017	December 31, 2016
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Taxes payable	\$18,694	\$19,472
Bonuses and commissions	57,691	67,259
Accrued compensation	41,229	30,816
Other employee related liabilities	27,386	28,812
Other	32,553	25,277
Total accrued expenses and other current liabilities	\$177,553	\$171,636

Table of Contents**(9) Convertible Senior Notes**

During the three months ended June 30, 2017, we issued \$782.5 million of 0% convertible senior notes (the 2022 Notes), due June 1, 2022 unless earlier converted or repurchased in accordance with their terms. In November 2013, we issued \$575.0 million of 0% convertible senior notes (the 2018 Notes, and together with the 2022 Notes, the Notes), due November 1, 2018 unless earlier converted or repurchased in accordance with their terms. The Notes do not bear interest, and we cannot redeem the Notes prior to maturity.

The 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 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. We currently intend to settle the principal amount of the 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

Holders of the Notes may convert their Notes at their option at any time prior to the close of business on the business day immediately preceding February 1, 2022 and July 1, 2018, for the 2022 Notes and 2018 Notes, respectively (each, a Convertible Date), only under the following circumstances:

- 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 applicable conversion price on each applicable trading day; 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 applicable conversion rate on each such trading day; or

• upon the occurrence of specified corporate events.

On or after the applicable 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. Upon conversion, we will pay or deliver, as the case may be, cash, shares of our common stock or a combination of cash and shares of our common stock, at our election. As noted above, we currently intend to settle the principal amount of the Notes with cash.

The conversion price will be subject to adjustment in some events. Holders of the Notes who convert their 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 Notes may require us to purchase with cash all or a portion of the Notes upon the occurrence of a fundamental change, at a purchase price equal to 100% of the principal amount of the

respective Notes plus any accrued and unpaid special interest, if any.

In accounting for the issuance of the Notes, we separated the Notes into liability and equity components. The carrying cost of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the par value of the Notes. The difference between the principal amount of the Notes and the proceeds allocated to the liability component, or the debt discount, is amortized to interest expense using the effective interest method over the term of the respective Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

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In accounting for the transaction costs related to the issuance of the Notes, we allocated the total amount incurred to the liability and equity components based on their relative fair values. Transaction costs attributable to the liability component are being amortized to interest expense over the respective terms of the Notes, and transaction costs attributable to the equity component were netted with the equity component of the Notes in stockholders' equity. The Notes consisted of the following (in thousands):

	September 30, 2017	December 31, 2016
Liability component:		
Principal:		
2022 Notes	\$782,500	\$—
2018 Notes	575,000	575,000
Less: debt issuance cost and debt discount, net of amortization		
2022 Notes	(160,164)	—
2018 Notes	(40,707)	(67,188)
Net carrying amount	\$1,156,629	\$507,812
	2022 Notes	2018 Notes
Equity component recorded at issuance:		
Note	\$162,039	\$155,319
Issuance cost	(2,148)	(3,257)
Net amount recorded in equity	\$159,891	\$152,062

The price of our common stock was greater than or equal to 130% of the conversion price of the 2018 Notes for at least 20 trading days during the 30 consecutive trading days ending on the last trading day of the quarter ended June 30, 2017. Therefore, as of June 30, 2017, the 2018 Notes became convertible at the holders' option beginning on July 1, 2017 and ending September 30, 2017. As of September 30, 2017, the 2018 Notes continue to be convertible at the holders' option for the period beginning October 1, 2017 and ending December 31, 2017. During the quarter ended September 30, 2017, we received requests to convert an aggregate of \$4,000 principal amount of 2018 Notes, which we elected to settle in cash.

As we have the option to settle the principal amount in shares and we are more than 12 months away from the maturity date, we continue to classify the net carrying amount of our 2018 Notes as a long-term liability and the equity component of our 2018 Notes continues to remain in permanent equity. Our 2018 Notes were not convertible as of December 31, 2016. Our 2022 Notes were not convertible as of September 30, 2017.

We consider the fair value of the Notes at September 30, 2017 to be a Level 2 measurement. The estimated fair values of the Notes at September 30, 2017 and December 31, 2016 based on the closing trading price per \$100 of the Notes were as follows (in thousands):

	September 30, 2017	December 31, 2016
2022 Notes	\$842,322	N/A
2018 Notes	\$922,501	\$681,375

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As of September 30, 2017, the remaining life of the 2022 Notes and 2018 Notes are 56 months and 13 months, respectively. 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,	
	2017	2016	2017	2016
Amortization of debt issuance cost				
2022 Notes	\$367	\$—	\$489	\$—
2018 Notes	481	450	1,421	1,327
Amortization of debt discount				
2022 Notes	7,222	—	9,610	—
2018 Notes	8,496	7,939	25,061	23,419
Total	\$16,566	\$8,389	\$36,581	\$24,746
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.

	Purchase (in thousands)	Shares
2022 Note Hedge	\$128,017	5,806,936
2018 Note Hedge	\$135,815	7,783,023

The Note Hedges cover shares of our common stock at a strike price per share that corresponds to the initial conversion price of the respective Notes, subject to adjustment, and are exercisable upon conversion of the Notes. If exercised, we may elect to receive cash, shares of our common stock, or a combination of cash and shares. We have accounted for the aggregate amount of purchase price for the Note Hedges as a reduction to additional paid-in capital. The Note Hedges will expire upon the maturity of the Notes. The Note Hedges are intended to reduce the potential economic dilution upon conversion of the 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 Notes. The Note Hedges are separate transactions and are not part of the terms of the Notes. Holders of the Notes will not have any rights with respect to the Note Hedges. The Note Hedges do not impact earnings per share, as they were entered into to offset any dilution from the Notes.

Warrants

	Proceeds (in thousands)	Shares	Strike Price
2022 Warrants	\$54,071	5,806,936	\$203.40
2018 Warrants	\$84,525	7,783,023	\$107.46

Separately, we entered into warrant transactions (the 2022 Warrants and 2018 Warrants, respectively, and collectively, the Warrants) 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. 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. 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, and have been accounted for as part of additional paid-in capital.

Table of Contents**(10) Accumulated Other Comprehensive Loss**

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

	September 30, 2017	December 31, 2016
Foreign currency translation adjustment	\$(3,795)	\$(19,277)
Net unrealized gain (loss) on investments, net of tax	3,387	(1,856)
Accumulated other comprehensive loss	\$(408)	\$(21,133)

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

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

We were authorized to issue 600,000,000 shares of common stock as of September 30, 2017. Holders of our common stock are not entitled to receive dividends unless declared by our board of directors. As of September 30, 2017, we had 172,706,935 shares of common stock outstanding and had reserved shares of common stock for future issuance as follows:

	September 30, 2017
Stock plans:	
Options outstanding	4,117,639
RSUs	12,306,875
Shares of common stock available for future grants:	
2012 Equity Incentive Plan ⁽¹⁾	25,731,336
2012 Employee Stock Purchase Plan ⁽¹⁾	9,581,944
Total reserved shares of common stock for future issuance	51,737,794

(1) Refer to Note 12 for a description of these plans.

During the nine months ended September 30, 2017 and 2016, we issued a total of 5,816,968 shares and 5,225,336 shares, respectively, from stock option exercises, vesting of restricted stock units (RSUs), net of employee payroll taxes and purchases from the employee stock purchase plan (ESPP). In May 2017, we repurchased and retired 540,806 shares of our common stock for approximately \$55.0 million, or \$101.70 per share from certain purchasers of the 2022 Notes in connection with the 2022 Notes offering. We had no similar repurchases or retirements of common stock during the nine months ended September 30, 2016.

(12) 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. The share reserve also automatically increases on January 1 of each year until January 1, 2022, 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. On January 1, 2017, 8,371,539 shares of common stock were automatically added to the 2012 Plan pursuant to the provision described in the preceding sentence.

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. On January 1, 2017, 1,674,308 shares of common stock were automatically added to the 2012 ESPP pursuant to the provision described in the preceding sentence.

Stock Options

A summary of the stock option activity for the nine months ended September 30, 2017 is as follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2016	5,818,435	\$ 20.57		
Granted	566,720	84.81		
Exercised	(697,446)	15.77		\$51,560
Canceled	(38,334)	71.68		
Outstanding at March 31, 2017	5,649,375	27.26		
Granted	50,000	103.60		
Exercised	(705,807)	8.62		\$62,617
Canceled	(1,174)	57.78		
Outstanding at June 30, 2017	4,992,394	30.65		
Exercised	(843,046)	16.66		\$78,926
Canceled	(31,709)	69.45		
Outstanding at September 30, 2017	4,117,639	\$ 33.22	5.49	\$347,148
Vested and expected to vest as of September 30, 2017	4,080,735	\$ 32.87	5.47	\$345,495
Vested and exercisable as of September 30, 2017	3,040,729	\$ 16.77	4.27	\$306,399

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 weighted-average grant date fair value per share of options granted was \$37.57 for the nine months ended September 30, 2017. The total fair value of stock options vested during the nine months ended September 30, 2017 was \$8.6 million.

Included in the number of options granted during the nine months ended September 30, 2017 are 396,720 options with both service and market-based criteria, which were granted to our President and Chief Executive Officer, who started his employment with us during the second quarter. The fair values of the options granted and the corresponding derived service periods were calculated using a Monte Carlo simulation, which estimates the potential outcome of reaching the market condition based on simulated future stock prices. The stock-based compensation expense associated with these options are recorded on a graded vesting basis.

As of September 30, 2017, total unrecognized compensation cost, adjusted for estimated forfeitures, related to unvested stock options was approximately \$29.7 million. The weighted-average remaining vesting period of unvested stock options at September 30, 2017 was 3.34 years.

RSUs

A summary of RSU activity for the nine months ended September 30, 2017 is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value (Per Share)	Aggregate Intrinsic Value (in thousands)
Non-vested at December 31, 2016	12,222,282	\$63.66	
Granted	4,216,410	88.05	
Vested	(1,801,659)	55.73	\$ 164,367
Forfeited	(507,680)	73.14	
Non-vested at March 31, 2017	14,129,353	71.60	
Granted	763,940	97.79	
Vested	(1,177,903)	63.84	\$ 115,487
Forfeited	(445,303)	68.78	
Non-vested at June 30, 2017	13,270,087	73.89	
Granted	711,084	111.06	
Vested	(1,274,390)	61.61	\$ 137,021
Forfeited	(399,906)	73.46	
Non-vested at September 30, 2017	12,306,875	\$77.33	\$ 1,446,427

RSUs granted to employees under the 2012 Plan generally vest over a four-year period. As of September 30, 2017, total unrecognized compensation cost, adjusted for estimated forfeitures, related to unvested RSUs was approximately \$698.8 million and the weighted-average remaining vesting period was 2.83 years.

(13) Net Loss Per Share

Basic net loss per share attributable to common stockholders is computed by dividing net loss attributable to common stockholders by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share is computed by dividing net 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 common stock options, RSUs, ESPP obligations, convertible senior notes and warrants. 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 common stock options, RSUs, ESPP obligations, convertible senior notes and warrants are excluded from the computation of diluted net loss per share in periods in which the effect would be antidilutive.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Numerator:				
Net loss	\$(24,188)	\$(36,258)	\$(121,323)	\$(419,215)
Denominator:				
Weighted-average shares outstanding—basic and diluted	171,883,190	165,378,836	170,359,717	163,767,329
Net loss per share—basic and diluted:	\$(0.14)	\$(0.22)	\$(0.71)	\$(2.56)

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

	September 30,	
	2017	2016
Common stock options	4,117,639	6,475,548
Restricted stock units	12,306,875	12,834,324
ESPP obligations	363,951	360,536
2018 convertible senior notes	7,783,023	7,783,023
Warrants related to the issuance of 2018 convertible senior notes	7,783,023	7,783,023
2022 convertible senior notes	5,806,933	—
Warrants related to the issuance of 2022 convertible senior notes	5,806,933	—
Total potentially dilutive securities	43,968,377	35,236,454

(14) Income Taxes

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

Our effective tax rate was (6)% and 2% for the three and nine months ended September 30, 2017, which was lower than the U.S. federal statutory tax rate of 34%. The lower tax rate was primarily attributable to our loss from operations, the foreign tax rate differential, a release of the valuation allowance in connection with acquisitions, excess tax benefits of stock-based compensation and the tax effects of unrealized gains in investment securities.

Our effective tax rate was (9)% and 0% for the three and nine months ended September 30, 2016, which was lower than the U.S. federal statutory tax rate of 34%. The lower tax rate was primarily attributable to our loss from operations, the foreign tax rate differential, a release of the valuation allowance in connection with acquisitions and excess tax benefits of stock-based compensation.

We are subject to taxation in the United States and foreign jurisdictions. As of September 30, 2017, our tax years 2005 to 2016 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.

Table of Contents**(15) Commitments and Contingencies*****Operating Leases and Other Contractual Commitments***

For some of our offices and data centers, we have entered into non-cancelable operating lease agreements with various expiration dates. Future minimum payments under our non-cancelable operating leases and other contractual commitments outstanding as of September 30, 2017 are presented in the table below (in thousands):

	Leases, net of Sublease Income	Purchase Obligations ⁽¹⁾	Other	Total
Years Ending December 31,				
Remainder of 2017	\$ 10,235	\$ 9,988	\$ 141	\$ 20,364
2018	44,460	35,984	565	81,009
2019	45,906	16,599	565	63,070
2020	45,688	7,845	565	54,098
2021	44,204	5,605	565	50,374
Thereafter	161,530	2,144	1,605	165,279
Total	\$352,023	\$ 78,165	\$ 4,006	\$434,194

Consists of future minimum payments under non-cancelable purchase commitments primarily related to data center and IT operations and sales and marketing activities. Not included in the table above are certain purchase commitments related to our future annual Knowledge user conferences and other customer or

⁽¹⁾ sales conferences. If we were to cancel these contractual commitments as of September 30, 2017, we would have been obligated to pay cancellation penalties of approximately \$22.9 million in aggregate, of which \$9.8 million is related to our Knowledge user conference in May 2018.

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, and the repayment of our 2018 Notes with an aggregate principal amount of \$575.0 million is due on November 1, 2018. Refer to Note 9 for further information regarding our Notes.

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.

On February 6, 2014, Hewlett-Packard Company (Hewlett-Packard) filed a lawsuit against us in the U.S. District Court for the Northern District of California. The lawsuit alleged patent infringement and sought damages and an injunction. On or about November 1, 2015, Hewlett Packard Enterprise Company (HPE) separated from Hewlett-Packard as an independent company, Hewlett-Packard assigned to HPE all right, title, and interest in the eight Hewlett-Packard patents in the lawsuit, and HPE was substituted as plaintiff in the litigation. On March 4, 2016, we entered into a confidential settlement agreement resolving the lawsuit with HPE (HPE Settlement). As a result, on March 9, 2016, the lawsuit was dismissed.

BMC Software, Inc. (BMC) filed lawsuits against us in the U.S. District Court for the Eastern District of Texas on

September 23, 2014 and February 12, 2016, and in the Dusseldorf (Germany) Regional Court, Patent Division, on March 2, 2016. Each of the lawsuits alleged patent infringement and sought damages and an injunction. On April 8, 2016, we entered into a confidential settlement agreement resolving all the lawsuits with BMC (BMC Settlement). As a result, the second Texas lawsuit was dismissed on April 14, 2016, and each of the initial Texas lawsuit and the German lawsuit was dismissed on April 25, 2016.

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These settlements are considered multiple element arrangements for accounting purposes. We evaluated the accounting treatment of these settlements by identifying each element of the arrangements, which included amongst other elements, a release of past infringement claims and a covenant not to sue for a specified term of years. The primary benefit we received from the arrangements was the settlement and termination of all existing litigation, the avoidance of future litigation expenses and the avoidance of future management and customer disruptions. We determined that none of the elements of the settlement agreements have identifiable future benefits that would be capitalized as an asset. Accordingly, we recorded charges for aggregate legal settlements of \$270.0 million in our condensed consolidated statement of comprehensive loss during the nine months ended September 30, 2016. The charge covers the fulfillment by us of all financial obligations under both the BMC Settlement and HPE Settlement with no remaining financial obligations under either settlement.

(16) 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,	
	2017	2016	2017	2016
North America ⁽¹⁾	\$ 329,582	\$ 239,585	\$ 937,426	\$ 684,111
EMEA ⁽²⁾	127,518	90,399	340,054	246,745
Asia Pacific and other	41,070	27,672	109,176	73,991
Total revenues	\$ 498,170	\$ 357,656	\$ 1,386,656	\$ 1,004,847

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

	September 30, 2017	December 31, 2016
North America ⁽³⁾	\$ 160,813	\$ 132,671
EMEA ⁽²⁾	50,692	37,449
Asia Pacific and other	19,799	11,500
Total property and equipment, net	\$ 231,304	\$ 181,620

(1) Revenues attributed to the United States were approximately 94% of North America revenues for the three and nine months ended September 30, 2017 and approximately 95% of North America revenues for the three and nine months ended September 30, 2016.

(2) Europe, the Middle East and Africa

(3) Property and equipment, net attributed to the United States were approximately 88% and 92% of property and equipment, net attributable to North America as of September 30, 2017 and December 31, 2016, respectively.

Subscription revenues consist of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Service Management solutions	\$ 399,795	\$ 290,005	\$ 1,097,177	\$ 799,278
IT Operations Management solutions	55,626	28,929	145,386	77,757
Total subscription revenues	\$ 455,421	\$ 318,934	\$ 1,242,563	\$ 877,035

Our Service Management solutions include ServiceNow Platform, IT Service Management, IT Business Management, Customer Service Management, Human Resources Management and Security Operations Management, which have similar features and functions, and are generally priced on a per user basis. Our IT Operations Management solutions, which improve visibility, availability and agility of enterprise services, are generally priced on a per node basis.

(17) Subsequent Event

On October 31, 2017, we acquired for cash all of the outstanding stock of SkyGiraffe Inc., a mobile platform company, for total purchase consideration of approximately \$32 million. Our accounting and analysis of this transaction is pending completion.

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

The following discussion and analysis of our financial condition, 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, 2016 included in the Annual Report on Form 10-K dated as of, and filed with the Securities and Exchange Commission, or the SEC, on February 28, 2017 (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, or 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.

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 believe investors should consider these non-GAAP financial measures in evaluating our results as they are indicative of our ongoing performance and reflect how management evaluates our operational results and trends.

Overview

ServiceNow is a leading provider of enterprise cloud computing solutions that define, structure, manage and automate services for global enterprises. Our mission is to help our customers improve service levels and reduce costs while scaling and automating their businesses. 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, we deploy our software on-premises at a customer data center to support a customer’s 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 subscribed service during the subscription term. We provide a scaled pricing model based on the duration of the subscription term, and we frequently extend discounts to our customers based on the number of users. 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 for implementation and configuration services and for training of customer and partner personnel. 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 5,895 as of September 30, 2017 from 4,501 as of September 30, 2016.

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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 436 and 308 customers with ACV greater than \$1 million as of September 30, 2017 and 2016, respectively. For purposes of customer count, a customer is defined as an entity with 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. Previously disclosed number of customers with ACV greater than \$1 million as well as our average contract term calculations are restated 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.

G2K customer count. The Global 2000 (G2K) customer count is defined as the total number of G2K companies in our customer base as of the end of the period. The Forbes Global 2000 is an annual ranking of the top 2,000 public companies in the world by Forbes magazine. The ranking is based on a mix of four metrics: sales, profit, assets, and market value. The Forbes Global 2000 is updated annually in the second quarter of the calendar year. Current and prior period G2K customer counts are based on the most recent list for comparability purposes. We adjust the G2K count for acquisitions, spin-offs and other market activity to ensure the G2K customer count is accurately captured. For example, we add a G2K customer when a G2K company that is not our customer acquires a company in our existing customer base that is not a G2K company. When we enter into a contract with a G2K parent company, or any of its related subsidiaries, or any combination of entities within a G2K company, we count only one G2K customer. We do not count further penetration into entities within a given G2K as a new customer in the G2K customer count. Our G2K customer count also excludes customers that have only purchased our Express product offering, which is our entry-level IT service management solution. Our G2K customer count was 815 and 707 as of September 30, 2017 and 2016, respectively.

Average ACV per G2K customer. We calculate average ACV for our G2K customers by taking aggregate ACV from G2K customers as of the end of the period divided by the total number of G2K customers as of the end of the period. ACV is calculated based on the foreign exchange rate in effect at the time the contract was entered into, and as a result, foreign currency rate fluctuations could cause variability in the average ACV per G2K customer. Our average ACV per G2K customer was approximately \$1.2 million and \$1.0 million as of September 30, 2017 and 2016, respectively.

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 total ACV from all customers that renewed during the period, excluding changes in price or users, and 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. 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. Our renewal rate was 97% and 99% for the three months ended September 30, 2017 and 2016, respectively, and 97% and 98% for the nine months ended September 30, 2017 and 2016, respectively. 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.

Billings. We define billings, a non-GAAP financial measure, as revenues recognized plus the change in total deferred revenue as presented on the condensed consolidated statements of cash flows. The change in total deferred revenue as presented on the condensed consolidated statements of cash flows represents the change in deferred revenues in local currencies translated into U.S. dollars using an average foreign currency exchange rate, and aligns actual billings with the exchange rates in effect at the time of the billings. We believe billings is a useful leading indicator regarding the performance of our business.

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A calculation of billings is provided below:

	Three Months Ended September 30, 2017			% Change	Nine Months Ended September 30, 2017			% Change
	2016				2016			
	(dollars in thousands)				(dollars in thousands)			
Billings:								
Total revenues	\$498,170	\$357,656	39 %		\$1,386,656	\$1,004,847	38 %	
Change in deferred revenue from the condensed consolidated statements of cash flows	47,932	46,620	3 %		193,594	151,019	28 %	
Total billings	\$546,102	\$404,276	35 %		\$1,580,250	\$1,155,866	37 %	

Billings consists of amounts invoiced for subscription contracts with existing customers, renewals, upsells and new customers, and contracts for professional services, training, and our Knowledge and other customer forum events. 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 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 condensed 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.

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 upselling additional products or services, 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.

Accordingly, while we believe billings is a useful leading indicator regarding the performance of our business, 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 due to the factors above, which may offset the increase or decrease, as applicable.

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. In our Annual Report on Form 10-K for the year ended December 31, 2016, we calculated the impact of fluctuations in billings duration using a different methodology that applied the weighted average billings duration in effect during the prior period presented rather than the actual weighted average billings duration in effect during the current period. Weighted average billings duration refers to the weighted average billings duration for all our customer contracts commencing during the period, unless such amounts have been paid during the period. To the extent that multi-year billings grow and billings durations lengthen, our current methodology provides more meaningful information on the impact of multi-year billings

fluctuations than our previous weighted average billings duration methodology. This change in methodology did not have a material impact on the amounts previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2016. 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 a favorable impact of \$6.9 million and an unfavorable impact of \$11.4 million on billings for the three and nine months ended September 30, 2017, respectively. Changes in billings duration had an unfavorable impact of \$3.9 million and a favorable impact of \$14.0 million for the three and nine months ended September 30, 2017, respectively.

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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 to 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 contracts with a future start date from our billings. 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 over the term of the license 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.

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. In addition, free cash flow is impacted by the timing of collections and disbursements, including the timing of capital expenditures. We have historically seen higher collections in the quarter ended March 31 due to seasonality in timing of entering into customer contracts in the quarter ended December 31. A calculation of free cash flow is provided below:

	Nine Months Ended September 30,		% Change
	2017	2016	
	(dollars in thousands)		
Free cash flow:			
Net cash provided by operating activities	\$458,039	\$27,234	NM
Purchases of property and equipment	(115,856)	(84,112)	38 %
Free cash flow ⁽¹⁾	\$342,183	\$(56,878)	NM

NM - Not meaningful.

⁽¹⁾ Free cash flow includes the effect of a \$267.5 million payment for legal settlement during the nine months ended September 30, 2016. Refer to Note 15 in the notes to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for further details.

Average contract term. We calculate the average contract term for new customers, upsells and renewals based on the terms of those contracts entered into during the period weighted by their ACV. The average new customer contract term was 26 months and 30 months for the three months ended September 30, 2017 and 2016, respectively, and 30 months and 32 months for the nine months ended September 30, 2017 and 2016, respectively. The average upsell contract term was 22 months and 25 months for the three months ended September 30, 2017 and 2016, respectively, and 25 months for each of the nine months ended September 30, 2017 and 2016. The average renewal contract term was 25 months and 27 months for the three months ended September 30, 2017 and 2016, respectively, and 26 months and 27 months for the nine months ended September 30, 2017 and 2016, 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, related support and upgrades, if any, to the subscription service during the subscription term. Pricing includes multiple instances, hosting and support services, data backup and disaster recovery services, as well as future upgrades, 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.

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Professional services and other revenues. Professional services revenues consist of fees associated with the implementation and configuration of our subscription service. 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. Other revenues primarily include fees from customer training delivered on-site or publicly available classes, attendance and sponsorship fees for our annual Knowledge user conference and other customer forums. 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, through our resale partners. Revenues from our direct sales organization represented 88% of our total revenues for each of the three months ended September 30, 2017 and 2016, and 89% and 88% for the nine months ended September 30, 2017 and 2016, respectively. We make sales to our resale partners at a discount and record those revenues at the discounted price when all revenue recognition criteria are met. From time to time, other third parties provide us referrals for which we pay a referral fee. We include revenues associated with these referrals as part of revenues from our direct sales organization. Referral fees paid to these third parties are between 5% and 15% of the customer's ACV, depending on the level of activity these third parties perform in the sales process. We include these fees in sales and marketing expense.

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 includes facility 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 and 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 associated with the implementation and configuration of our subscription services are performed directly by our services team, as well as by contracted third-party partners. Fees paid 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 19% for each of the three months ended September 30, 2017 and 2016 and 18% for each of the nine months ended September 30, 2017 and 2016.

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, commissions and stock-based compensation. Sales and marketing expenses also include third-party referral fees, expenses related to our annual Knowledge user conference, other marketing program expenses, which include events other than Knowledge, advertising and market data, 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, facility 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.

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Legal Settlements

Legal settlements consist of one-time aggregate charges related to the settlement agreements with Hewlett Packard Enterprise Company (HPE) and BMC Software, Inc. (BMC). Refer to Note 15 in the notes to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for further details of these matters.

Provision for (Benefit from) Income Taxes

Provision for (benefit from) income taxes consists of federal, state and foreign income taxes. Due to cumulative losses, we maintain a valuation allowance against our U.S. deferred tax assets as of September 30, 2017 and December 31, 2016. 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 deferred tax assets.

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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,	
	2017	2016	2017	2016
	(in thousands)		(in thousands)	
Revenues:				
Subscription	\$455,421	\$318,934	\$1,242,563	\$877,035
Professional services and other	42,749	38,722	144,093	127,812
Total revenues	498,170	357,656	1,386,656	1,004,847
Cost of revenues ⁽¹⁾ :				
Subscription	81,878	61,566	228,046	170,707
Professional services and other	45,402	41,271	137,366	123,039
Total cost of revenues	127,280	102,837	365,412	293,746
Gross profit	370,890	254,819	1,021,244	711,101
Operating expenses ⁽¹⁾ :				
Sales and marketing	227,015	166,491	686,325	511,607
Research and development	98,465	75,018	272,959	211,306
General and administrative	52,465	40,085	150,242	117,393
Legal settlements	—	—	—	270,000
Total operating expenses	377,945	281,594	1,109,526	1,110,306
Loss from operations	(7,055)	(26,775)	(88,282)	(399,205)
Interest expense	(16,566)	(8,389)	(36,581)	(24,746)
Interest income and other income (expense), net	853	1,783	739	4,745
Loss before income taxes	(22,768)	(33,381)	(124,124)	(419,206)
Provision for (benefit from) income taxes	1,420	2,877	(2,801)	9
Net loss	\$(24,188)	\$(36,258)	\$(121,323)	\$(419,215)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(in thousands)		(in thousands)	
Cost of revenues:				
Subscription	\$8,980	\$7,140	\$25,860	\$20,698
Professional services and other	7,056	7,150	21,622	20,045
Sales and marketing	43,962	31,898	124,650	95,757
Research and development	23,092	21,376	67,624	62,956
General and administrative	17,352	13,523	48,695	35,004
Total stock-based compensation	\$100,442	\$81,087	\$288,451	\$234,460

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

	Three Months Ended September 30, 2017		2016		Nine Months Ended September 30, 2017		2016	
Revenues:								
Subscription	91	%	89	%	90	%	87	%
Professional services and other	9		11		10		13	
Total revenues	100		100		100		100	
Cost of revenues ⁽¹⁾ :								
Subscription	16		17		17		17	
Professional services and other	10		12		9		12	
Total cost of revenues	26		29		26		29	
Gross profit	74		71		74		71	
Operating expenses ⁽¹⁾ :								
Sales and marketing	46		47		49		51	
Research and development	19		21		19		21	
General and administrative	10		11		12		12	
Legal settlements	—		—		—		27	
Total operating expenses	75		79		80		111	
Loss from operations								