

Starbucks transaction revenue. Under our payment processing agreement with Starbucks, we charge a percentage of the total transaction amount for processing credit and debit card payment transactions for all Starbucks-owned stores in the United States. Under the amended terms of our payment processing agreement, Starbucks can terminate the agreement with 30 days' notice, and, as of October 1, 2015, Starbucks is no longer obligated to use us as their exclusive payment processor. Starbucks has announced that it will transition to another payment processor and will cease using our payment processing services altogether prior to the scheduled expiration of the agreement in the third quarter of 2016, positively affecting our overall gross profit. Starbucks transaction revenue in 2012 includes the initial recognition of the fair value of a warrant issued in our payment processing agreement with Starbucks.

As part of the amendment of our payment processing agreement with Starbucks in August 2015, certain warrants held by Starbucks to purchase shares of our common stock contingent upon achievement of certain performance thresholds were canceled. Additionally, as part of this amendment, we agreed to facilitate the sale of 2,269,830 shares of our Series D preferred stock held by Starbucks to a third party. If the aggregate purchase price in a sale to a third party of the Series D preferred stock is less than \$37 million, then we will pay Starbucks the difference. This obligation terminates upon the expiration of any applicable lock-up period following an initial public offering. In the event that such obligation has not terminated, and the shares have not been sold, by October 30, 2016, we are obligated to repurchase the shares for an aggregate purchase price of \$37 million. This obligation is being accounted for as a derivative instrument initially valued at \$1.5 million and recorded as a reduction to Starbucks transaction revenue. To the extent this obligation remains outstanding, we will measure the fair value of this derivative instrument on a quarterly basis with incremental increases or decreases in its value, if any, recorded as changes to Starbucks transaction revenue in the applicable quarter.

Software and data product revenue. In addition to payments and POS services, we offer our sellers paid software services, including Square Appointments and Square Customer Engagement. Square Capital is our most significant data service and provides merchant cash advances (MCAs) to pre-qualified sellers. In return for these advances, the merchant agrees to repay a fixed future receivable amount. A fixed percentage of the merchant's daily processing volume is withheld as repayment for their advance. Of that repayment, the agreed upon fixed percentage is recognized as revenue, resulting in revenue being recognized ratably as cash is collected. We currently fund a significant majority of the MCAs from arrangements with third parties that commit to purchase the future receivables related to the MCAs. This funding significantly increases the speed with which we can scale Square Capital and allows us to mitigate our balance sheet risk.

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We generate revenue from selling these future receivables to third parties by charging upfront fees when the receivables are sold and charging ongoing servicing fees for servicing these receivables. We fund the remaining MCAs from our balance sheet. In these instances, the difference between the fixed amount of the future receivable and the related MCA is collected over time and recognized as revenue. Revenue for Caviar, our food delivery service, is also included in software and data product revenue and is derived from seller fees, which are a percentage of total food order value, delivery fees, which are fixed per transaction, and service fees paid by the consumer based on total food order value. We expect software and data product revenue to constitute an increasing percentage of our total net revenue.

Hardware revenue. Hardware revenue includes revenue from sales of Square Stand, Square Readers for EMV chip cards and NFC, and third-party peripherals. Third-party peripherals include cash drawers, receipt printers, and barcode scanners, all of which can be integrated with Square Stand to provide a comprehensive POS solution. We began selling Square Readers for EMV chip cards in the second quarter of 2015. As we broaden our hardware offerings and third-party peripherals, and as we migrate new and existing sellers to Square Readers for EMV chip cards and NFC, hardware revenue may increase as a portion of total net revenue.

Cost of Revenue and Gross Margin

Transaction costs. Transaction costs consist primarily of interchange fees set by payment card networks and that are paid to the card-issuing financial institution, assessment fees paid to payment card networks, fees paid to third-party payment processors, and bank settlement fees.

Starbucks transaction costs. Starbucks transaction costs are made up of the same components as our overall transaction costs.