

**Software and data product costs.** Software and data product costs consist primarily of Caviar-related costs, which include payments to third-party couriers for deliveries and the costs of equipment provided to sellers. Cost of revenue for other software and data products consist primarily of the allocated portion of costs related to our third-party data center facilities and depreciation, as well as personnel-related and facilities costs related to customer support. To the extent we are able to increase the proportion of our total net revenue that is derived from sale of these software and data products, we expect our overall gross margin will be positively affected.

**Hardware costs.** Hardware costs consist primarily of product costs associated with Square Stand, Square Readers for EMV chip cards and NFC, and third-party peripherals. Product costs include manufacturing-related overhead and personnel costs, certain royalties, packaging, and fulfillment costs. We currently offer our Square Reader for EMV chip cards and anticipate offering our new Square Reader for EMV chip cards and NFC at a price approximately equal to our costs. For Square Stand, our production costs exceed our revenue. However, we believe that Square Stand is an attractive offering to many of our larger sellers, and, as a result, we intend to continue to offer Square Stand at prices less than our costs. In conjunction with the sale of Square Reader for EMV chip cards and NFC, we will also begin to recognize additional costs related to the design and distribution of those units, although we do not expect the effect of these additional costs on our overall gross margin to be significant.

**Amortization of acquired technology.** These costs consist of amortization related to technologies acquired through acquisitions that have the capability of producing revenue.

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### ***Operating Expenses***

Operating expenses consist of product development, sales and marketing, general and administrative expenses, transaction and advance losses, amortization of acquired customer assets, and impairment of intangible assets. For product development and general and administrative expenses, the largest single component is personnel-related expenses, including salaries and bonuses, employee benefit costs, and share-based compensation. In the case of sales and marketing expenses, a significant portion is related to paid advertising expenses in addition to personnel-related expenses. Operating expenses also include allocated overhead costs for facilities, human resources, and IT.

### ***Product Development***

Product development expenses currently represent the largest component of our operating expenses and consist primarily of personnel-related expenses of our engineering and design personnel, fees and supply costs related to maintenance and capacity expansion at third-party data center facilities, development and tooling costs, and fees for software licenses, consulting, legal, and other services that are directly related to growing and maintaining our portfolio of products and services. Additionally, product development expenses include the depreciation of product-related infrastructure and tools, including data center equipment, internally developed software, and computer equipment. We continue to focus our product development efforts on adding new features and apps, and on enhancing the functionality and ease of use of our offerings. Our ability to realize returns on these investments is substantially dependent upon our ability to successfully address current and emerging requirements of sellers and buyers through the development and introduction of these new products and services. While we expect total product development expenses to increase as we invest further in engineering and design personnel, we also expect our product development expenses to decline as a percentage of total net revenue.

### ***Sales and Marketing***

Sales and marketing expenses consist primarily of three components. First, sales and marketing includes costs incurred to acquire new sellers through various paid advertising channels, including online, mobile, email, direct mail, and direct response TV, all of which are expensed as incurred. Second, sales and marketing expenses include personnel-related expenses of our direct sales, account management, local and product marketing, retail and ecommerce, partnerships, and communications personnel. Third, sales and marketing expenses include the costs associated with the manufacturing and distribution of the Square Reader for magnetic stripe cards, which is offered for free on our website and provided through various marketing events and distribution channels. New sellers who purchase a Square Reader for magnetic stripe cards from one of our retail distribution partners are offered a rebate equal to the price paid. The cost to us of manufacturing and distributing Square Readers for magnetic stripe cards is partially offset by amounts received from retail distribution partners. As our sellers transition to using Square Readers for EMV chip cards and NFC, we expect to distribute relatively fewer Square Readers for magnetic stripe cards, thus reducing that component of our sales and marketing costs. Sales and marketing expenses also include costs associated with Square Cash,