

Pandora Media, Inc.  
Form 10-Q  
October 28, 2014  
Table of Contents

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, 2014

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-35198

Pandora Media, Inc.

(Exact name of registrant as specified in its charter)

Delaware

94-3352630

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

2101 Webster Street, Suite 1650

94612

Oakland, CA

(Zip Code)

(Address of principal executive offices)

(510) 451-4100

(Registrant's telephone number, including area code)

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Edgar Filing: Pandora Media, Inc. - Form 10-Q

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

The number of shares of registrant's common stock outstanding as of October 23, 2014 was: 208,086,733.

---

Table of Contents

Pandora Media, Inc.

FORM 10-Q Quarterly Report

Table of Contents

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	<u>3</u>
<u>Condensed Consolidated Balance Sheets as of December 31, 2013 and September 30, 2014 (unaudited)</u>	<u>4</u>
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2013 (unaudited recast) and 2014 (unaudited)</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Loss for the Three and Nine Months Ended September 30, 2013 (unaudited recast) and 2014 (unaudited)</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 (unaudited recast) and 2014 (unaudited)</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	<u>8</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>18</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>35</u>
<u>Item 4. Controls and Procedures</u>	<u>36</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>37</u>
<u>Item 1A. Risk Factors</u>	<u>37</u>
<u>Item 6. Exhibits</u>	<u>43</u>
<u>Signatures</u>	<u>44</u>

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

Pandora Media, Inc.

Condensed Consolidated Balance Sheets

(In thousands, except share and per share amounts)

(Unaudited)

	As of December 31, 2013	As of September 30, 2014
Assets		
Current assets:		
Cash and cash equivalents	\$245,755	\$148,884
Short-term investments	98,662	167,510
Accounts receivable, net of allowance of \$1,272 at December 31, 2013 and \$1,046 at September 30, 2014	164,023	197,516
Prepaid expenses and other current assets	10,343	11,135
Total current assets	518,783	525,045
Long-term investments	105,686	120,944
Property and equipment, net	35,151	42,292
Other long-term assets	13,715	13,986
Total assets	\$673,335	\$702,267
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$14,413	\$13,001
Accrued liabilities	14,881	14,993
Accrued royalties	66,110	71,509
Deferred revenue	42,650	18,243
Accrued compensation	17,952	31,353
Total current liabilities	156,006	149,099
Other long-term liabilities	9,098	10,814
Total liabilities	165,104	159,913
Stockholders' equity:		
Common stock: 195,395,940 shares issued and outstanding at December 31, 2013 and 207,863,135 at September 30, 2014	20	21
Additional paid-in capital	675,103	752,048
Accumulated deficit	(166,591)	(209,275)
Accumulated other comprehensive loss	(301)	(440)
Total stockholders' equity	508,231	542,354
Total liabilities and stockholders' equity	\$673,335	\$702,267

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents

Pandora Media, Inc.  
Condensed Consolidated Statements of Operations  
(In thousands, except per share amounts)  
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2013	2014	2013	2014
	(recast)		(recast)	
Revenue				
Advertising	\$134,963	\$194,293	\$359,232	\$512,251
Subscription and other	34,340	45,300	78,299	140,551
Total revenue	169,303	239,593	437,531	652,802
Cost of revenue				
Cost of revenue - Content acquisition costs	83,535	111,315	249,186	331,051
Cost of revenue - Other	12,126	15,453	32,749	44,421
Total cost of revenue	95,661	126,768	281,935	375,472
Gross profit	73,642	112,825	155,596	277,330
Operating expenses				
Product development	9,099	13,381	23,661	38,288
Sales and marketing	47,049	72,320	129,465	200,416
General and administrative	21,397	29,143	51,683	81,369
Total operating expenses	77,545	114,844	204,809	320,073
Loss from operations	(3,903)	) (2,019)	) (49,213)	) (42,743)
Other income (expense), net	(173)	) 44	(422)	) 236
Loss before provision for income taxes	(4,076)	) (1,975)	) (49,635)	) (42,507)
Income tax expense	(16)	) (50)	) (45)	) (177)
Net loss	\$(4,092)	) \$(2,025)	) \$(49,680)	) \$(42,684)
Weighted-average common shares outstanding used in computing basic and diluted net loss per share	178,635	206,982	175,407	204,208
Net loss per share, basic and diluted	\$(0.02)	) \$(0.01)	) \$(0.28)	) \$(0.21)

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents

Pandora Media, Inc.  
 Condensed Consolidated Statements of Comprehensive Loss  
 (In thousands)  
 (Unaudited)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2013	2014	2013	2014
	(recast)		(recast)	
Net loss	\$ (4,092	) \$ (2,025	) \$ (49,680	) \$ (42,684
Change in foreign currency translation adjustment	17	(138	) (40	) (122
Change in net unrealized losses on marketable securities	—	(217	) 4	(17
Other comprehensive income (loss)	17	(355	) (36	) (139
Total comprehensive loss	\$ (4,075	) \$ (2,380	) \$ (49,716	) \$ (42,823

The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents

Pandora Media, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine months ended September 30,	
	2013	2014
	(recast)	
Operating activities		
Net loss	\$(49,680	) \$(42,684
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	7,718	11,224
Stock-based compensation	28,826	60,116
Amortization of premium on investments	87	2,106
Amortization of debt issuance costs	192	148
Changes in assets and liabilities		
Accounts receivable	(27,058	) (33,493
Prepaid expenses and other assets	(6,946	) (4,288
Accounts payable and accrued liabilities	14,228	5,807
Accrued royalties	7,903	5,416
Accrued compensation	(2,245	) 12,579
Deferred revenue	13,707	(24,407
Reimbursement of cost of leasehold improvements	1,555	3,161
Net cash used in operating activities	(11,713	) (4,315
Investing activities		
Purchases of property and equipment	(15,391	) (23,194
Purchases of patents	(8,000	) —
Purchases of investments	(24,634	) (273,427
Proceeds from maturities of investments	44,290	186,667
Payments related to acquisition	(400	) —
Net cash used in investing activities	(4,135	) (109,954
Financing activities		
Borrowings under debt arrangements	10,000	—
Repayments of debt	(10,000	) —
Proceeds from follow-on offering, net of issuance costs	379,309	—
Proceeds from exercise of stock options	14,640	15,168
Payment of debt issuance costs in connection with the debt refinancing	(450	) —
Tax withholdings related to net share settlements of restricted stock units	(480	) (1,986
Proceeds from employee stock purchase plan	—	4,388
Net cash provided by financing activities	393,019	17,570
Effect of exchange rate changes on cash and cash equivalents	(28	) (172
Net increase (decrease) in cash and cash equivalents	377,143	(96,871
Cash and cash equivalents at beginning of period	59,939	245,755
Cash and cash equivalents at end of period	\$437,082	\$148,884
Supplemental disclosures of cash flow information		
Cash paid during the period for interest	\$294	\$314
Purchases of property and equipment recorded in accounts payable and accrued liabilities	\$1,711	\$2,550





Table of Contents

The accompanying notes are an integral part of the condensed consolidated financial statements.

7

---

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements

1. Description of Business and Basis of Presentation

Pandora Media, Inc. provides an internet radio service offering a personalized experience for each listener wherever and whenever they want to listen to radio on a wide range of smartphones, tablets, traditional computers and car audio systems, as well as a range of other internet-connected devices. We have pioneered a new form of radio—one that uses intrinsic qualities of music to initially create stations and then adapts playlists in real-time based on the individual feedback of each listener. We offer local and national advertisers an opportunity to deliver targeted messages to our listeners using a combination of audio, display and video advertisements. We also offer a paid subscription service which we call Pandora One. We were incorporated as a California corporation in January 2000 and reincorporated as a Delaware corporation in December 2010.

As used herein, “Pandora,” “we,” “our,” the “Company” and similar terms include Pandora Media, Inc. and its subsidiaries, unless the context indicates otherwise.

Basis of Presentation

The interim unaudited condensed consolidated financial statements and accompanying notes have been prepared in accordance with United States generally accepted accounting principles (“U.S. GAAP”) and include the accounts of Pandora and our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. In the opinion of our management, the interim unaudited condensed consolidated financial statements include all adjustments, which include only normal recurring adjustments, necessary for the fair presentation of our financial position for the periods presented. These interim unaudited condensed consolidated financial statements are not necessarily indicative of the results expected for the full fiscal year or for any subsequent period and should be read in conjunction with the audited consolidated financial statements and related notes included in our Transition Report on Form 10-K for the eleven months ended December 31, 2013.

We changed our fiscal year from the twelve months ending January 31 to the calendar twelve months ending December 31, effective beginning with the year ended December 31, 2013. As a result of this change, our prior fiscal year was an 11-month transition period ended on December 31, 2013. All references herein to a fiscal year refer to the twelve months ended December 31 of such year, and references to the first, second, third and fourth fiscal quarters refer to the three months ended March 31, June 30, September 30 and December 31, respectively. Prior year results have been recast on a calendar quarter basis. Refer to our Transition Report on Form 10-K for the eleven months ended December 31, 2013 for additional information regarding our fiscal year change.

Certain changes in presentation have been made to conform the prior period presentation to current period reporting. Our statements of operations now include the presentation of gross profit, which is calculated as total revenue less cost of revenue. In addition, we have reclassified certain software license fees, facilities-related expenses and depreciation expenses among the general and administrative, cost of revenue — other, sales and marketing and product development lines in our condensed consolidated statements of operations. Furthermore, we have reclassified certain compensation-related amounts from the accrued liabilities line item to the accrued compensation line item of our condensed consolidated balance sheets and our condensed consolidated statements of cash flows.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and the related disclosures at the date of the financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Estimates are used for determining accrued royalties, selling prices for elements sold in multiple-element arrangements, the allowance for doubtful accounts, stock-based compensation, income taxes and the subscription return reserve. To the extent there are material differences between these estimates, judgments, or assumptions and actual results, our financial statements could be affected. In many cases, the accounting treatment of a particular transaction is specifically dictated by U.S. GAAP and does not require management's judgment in its application. There are also areas in which management's judgment in selecting among available alternatives would not produce a materially different result.

2. Summary of Significant Accounting Policies

8

---

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

Other than discussed below, there have been no material changes to our significant accounting policies as compared to those described in our Transition Report on Form 10-K for the eleven months ended December 31, 2013.

Stock-Based Compensation — Restricted Stock Units and Stock Options

Stock-based awards granted to employees, including grants of restricted stock units (“RSUs”) and stock options, are recognized as expense in the statements of operations based on their grant date fair value. We recognize stock-based compensation expense on a straight-line basis over the service period of the award, which is generally four years. We estimate the grant date fair value of RSUs at our stock price. We estimate the grant date fair value of employee stock options using the Black-Scholes valuation model. The determination of the fair value of a stock option is affected by the deemed fair value of the underlying stock price on the grant date, as well as other assumptions including the risk-free interest rate, the estimated volatility of our stock price over the term of the award, the estimated period of time that we expect employees to hold their stock options and the expected dividend rate. Stock-based compensation expense is recorded net of estimated forfeitures for only those stock-based awards that we expect to vest. We estimate the forfeiture rate based on historical forfeitures of equity awards and, as necessary, adjust the rate to reflect changes in facts and circumstances. We revise our estimated forfeiture rate if actual forfeitures differ from our initial estimates.

Stock-Based Compensation — Employee Stock Purchase Plan

In December 2013, our board of directors approved the Employee Stock Purchase Plan (“ESPP”), which was approved by our stockholders at the annual meeting in June 2014. We estimate the fair value of shares to be issued under the ESPP on the first day of the offering period using the Black-Scholes valuation model. The determination of the fair value is affected by our stock price on the first date of the offering period, as well as other assumptions including the risk-free interest rate, the estimated volatility of our stock price over the term of the offering period, the expected term of the offering period and the expected dividend rate. Stock-based compensation expense related to the ESPP is recognized on a straight-line basis over the offering period, net of estimated forfeitures.

Deferred Revenue

Our deferred revenue consists principally of both prepaid but unrecognized subscription revenue and advertising fees received or billed in advance of the delivery or completion of the delivery of services. Deferred revenue is recognized as revenue when the services are provided and all other revenue recognition criteria have been met.

In addition, subscription revenue derived from sales through certain mobile devices may be subject to refund or cancellation terms which may affect the timing or amount of the subscription revenue recognition. When refund rights exist, we recognize revenue when services have been provided and the rights lapse or when we have developed sufficient transaction history to estimate a return reserve.

We were required to defer revenue for certain in application (“in-app”) mobile subscriptions that contained refund rights until the refund rights lapsed or until we developed sufficient operating history to estimate a return reserve. As of December 31, 2013, we had deferred all revenue related to these in-app mobile subscriptions subject to refund rights totaling approximately \$14.2 million, as we did not have sufficient history to estimate a return reserve. Beginning in January 2014, we had sufficient historic transactional information which enabled us to estimate future returns. Accordingly, in January 2014, we began recording revenue related to these in-app mobile subscriptions net of

estimated returns. This change resulted in a one-time increase in subscription revenue in the three months ended March 31, 2014 of approximately \$14.2 million, as the previously deferred revenue was recognized. As of September 30, 2014, the deferred revenue related to the return reserve was not significant.

#### Concentration of Credit Risk

For the three and nine months ended September 30, 2013 and 2014, we had no customers that accounted for more than 10% of our total revenue. As of December 31, 2013 and September 30, 2014, we had no customers that accounted for more than 10% of our total accounts receivable.

#### Recently Issued Accounting Standards

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-9, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-9”). ASU 2014-9 outlines a single comprehensive model for entities to use in accounting for revenue. Under the guidance, revenue is recognized when a company transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The standard is effective for public entities with annual and interim reporting periods beginning after December 15, 2016. Entities have the option of using either a full retrospective or a modified retrospective approach to adopt the guidance. We are currently evaluating implementation methods and the effect that implementation of this standard will have on our consolidated financial statements upon adoption.

In August 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-15, Going Concern (Subtopic 205-40) (“ASU 2014-15”). ASU 2014-15 requires management of all entities to evaluate whether there are conditions and events that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the financial statements are issued (or available to be issued when applicable). The guidance is effective for fiscal years beginning after December 15, 2016 and for interim periods within that fiscal year. We do not expect the adoption of this guidance to have a material effect on our consolidated financial statements.

## 3. Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments consisted of the following:

	As of December 31, 2013 (in thousands)	As of September 30, 2014
Cash and cash equivalents:		
Cash	\$89,176	\$51,004
Money market funds	98,437	91,780
Commercial paper	54,247	6,100
Corporate debt securities	3,895	—
Total cash and cash equivalents	\$245,755	\$148,884
Short-term investments:		
Commercial paper	\$47,526	\$54,643
Corporate debt securities	50,436	112,867
U.S. government and government agency debt securities	700	—
Total short-term investments	\$98,662	\$167,510
Long-term investments:		
Corporate debt securities	\$100,690	\$107,840
U.S. government and government agency debt securities	4,996	13,104
Total long-term investments	\$105,686	\$120,944
Cash, cash equivalents and investments	\$450,103	\$437,338

Our short-term investments have maturities of less than twelve months and are classified as available-for-sale. Our long-term investments have maturities of greater than twelve months and are classified as available-for-sale.

The following tables summarize our available-for-sale securities' adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category as of December 31, 2013 and September 30, 2014.

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

	As of December 31, 2013			
	Adjusted Cost (in thousands)	Unrealized Gains	Unrealized Losses	Fair Value
Money market funds	\$98,437	\$—	\$—	\$98,437
Commercial paper	101,773	—	—	101,773
Corporate debt securities	155,273	6	(258)	) 155,021
U.S. government and government agency debt securities	5,700	—	(4)	) 5,696
Total cash equivalents and marketable securities	\$361,183	\$6	\$(262)	) \$360,927
	As of September 30, 2014			
	Adjusted Cost (in thousands)	Unrealized Gains	Unrealized Losses	Fair Value
Money market funds	\$91,780	\$—	\$—	\$91,780
Commercial paper	60,743	—	—	60,743
Corporate debt securities	220,969	24	(286)	) 220,707
U.S. government and government agency debt securities	13,115	2	(13)	) 13,104
Total cash equivalents and marketable securities	\$386,607	\$26	\$(299)	) \$386,334

The following table presents available-for-sale investments by contractual maturity date as of December 31, 2013 and September 30, 2014.

	As of December 31, 2013	
	Adjusted Cost (in thousands)	Fair Value
Due in one year or less	\$255,278	\$255,241
Due after one year through three years	105,905	105,686
Total	\$361,183	\$360,927
	As of September 30, 2014	
	Adjusted Cost (in thousands)	Fair Value
Due in one year or less	\$265,438	\$265,390
Due after one year through three years	121,169	120,944
Total	\$386,607	\$386,334

Our investment policy requires investments to be investment grade, primarily rated “A1” by Standard & Poor’s or “P1” by Moody’s or better for short-term investments and rated “A” by Standard & Poor’s or “A2” by Moody’s or better for long-term investments, with the objective of minimizing the potential risk of principal loss. In addition, the investment policy limits the amount of credit exposure to any one issuer.



The unrealized losses on our available-for-sale securities as of September 30, 2014 were primarily a result of unfavorable changes in interest rates subsequent to the initial purchase of these securities. As of September 30, 2014, we owned 119 securities that were in an unrealized loss position. We do not intend nor expect to need to sell these securities before recovering the associated unrealized losses. We expect to recover the full carrying value of these securities. As a result, no portion of the unrealized losses at September 30, 2014 is deemed to be other-than-temporary and the unrealized losses are not deemed to be

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

credit losses. No available-for-sale securities have been in an unrealized loss position for twelve months or more. When evaluating the investments for other-than-temporary impairment, we review factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and any changes thereto, and our intent to sell, or whether it is more likely than not we will be required to sell, the investment before recovery of the investment's amortized cost basis. During the three and nine months ended September 30, 2014, we did not recognize any impairment charges.

## 4. Fair Value

We record cash equivalents and short-term investments at fair value. Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. Fair value measurements are required to be disclosed by level within the following fair value hierarchy:

Level 1 — Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2 — Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level 3 — Inputs lack observable market data to corroborate management's estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

When determining fair value, whenever possible we use observable market data and rely on unobservable inputs only when observable market data is not available.

The fair value of these financial assets and liabilities was determined using the following inputs at December 31, 2013 and September 30, 2014:

	As of December 31, 2013		Total
	Fair Value Measurement Using Quoted Prices in Active Markets for Identical Instruments (Level 1) (in thousands)	Significant Other Observable Inputs (Level 2)	
Assets:			
Money market funds	\$98,437	\$—	\$98,437
Commercial paper	—	101,773	101,773
Corporate debt securities	—	155,021	155,021
U.S. government and government agency debt securities	—	5,696	5,696

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Total assets measured at fair value	\$98,437	\$262,490	\$360,927
-------------------------------------	----------	-----------	-----------

12

---

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

	As of September 30, 2014		
	Fair Value Measurement Using		
	Quoted Prices in Significant	Other	Total
	Active Markets	Observable	
	for Identical	Inputs	
	Instruments	(Level 2)	
	(Level 1)		
	(in thousands)		
Assets:			
Money market funds	\$91,780	\$—	\$91,780
Commercial paper	—	60,743	60,743
Corporate debt securities	—	220,707	220,707
U.S. government and government agency debt securities	—	13,104	13,104
Total assets measured at fair value	\$91,780	\$294,554	\$386,334

Our money market funds are classified as Level 1 within the fair value hierarchy because they are valued primarily using quoted market prices. Our other cash equivalents and short-term investments are classified as Level 2 within the fair value hierarchy because they are valued using professional pricing sources for identical or comparable instruments, rather than direct observations of quoted prices in active markets. As of December 31, 2013 and September 30, 2014, we held no Level 3 assets or liabilities.

## 5. Commitments and Contingencies

## Legal Proceedings

We have been in the past, and continue to be, a party to privacy and patent infringement litigation which has consumed, and may continue to consume, financial and managerial resources. We are also from time to time subject to various other legal proceedings and claims arising in the ordinary course of our business. We record a liability when we believe that it is both probable that a loss has been incurred and the amount can be reasonably estimated. Our management periodically evaluates developments that could affect the amount, if any, of liability that we have previously accrued and make adjustments as appropriate. Determining both the likelihood and the estimated amount of a loss requires significant judgment, and management's judgment may be incorrect. We do not believe the ultimate resolution of any pending legal matters is likely to have a material adverse effect on our business, financial position, results of operations or cash flows.

In September 2011, a putative class action lawsuit was filed against Pandora in the United States District Court for the Northern District of California alleging that we violated Michigan's video rental privacy law and consumer protection statute by allowing our listeners' listening history to be visible to the public. Our motion to dismiss the complaint was granted on September 28, 2012, judgment was entered on November 14, 2012. The plaintiff appealed the judgment to the U.S. Court of Appeals for the Ninth Circuit. Briefing of the appeal was completed on August 2, 2013. No date has been set for oral argument.

On September 10, 2012, B.E. Technology, LLC filed suit against Pandora in the United States District Court for the Western District of Tennessee alleging that we infringe a B.E. Technology patent and seeking injunctive relief and monetary damages. We filed our answer on December 31, 2012. Defendants in other suits in which B.E. Technology

is plaintiff have filed inter partes review petitions before the U.S. Patent and Trademark Office challenging the validity of the patent Pandora is alleged to have infringed. The trial court granted Pandora's motion to stay this litigation until the inter partes review has been concluded.

We currently believe that Pandora has substantial and meritorious defenses to the claims in the lawsuits discussed above and intend to vigorously defend our position.

We are also subject to legal proceedings involving musical work royalty rates. On November 5, 2012, we filed a petition in the rate court established by the consent decree between the American Society of Composers, Authors and Publishers ("ASCAP") and the U.S. Department of Justice in the U.S. District Court for the Southern District of New York for the determination of reasonable license fees and terms for the ASCAP consent decree license applicable to the period January 1, 2011 through December 31, 2015. On June 11, 2013 we filed a motion for partial summary judgment seeking a determination

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

that as a matter of law the publishers alleged to have withdrawn certain rights of public performance by digital audio transmission from the scope of grant of rights ASCAP could license on behalf of such publishers subsequent to the date of our request for a license from ASCAP were not valid as to our ASCAP consent decree license. On September 17, 2013, our motion for partial summary judgment was granted, alleviating the need to negotiate direct licenses for such purportedly withdrawn performance rights. A trial to determine the royalty rates we will pay ASCAP concluded in February 2014 and the court issued its opinion in March 2014. On April 14, 2014, ASCAP filed a notice of appeal of the District Court's decision with the Second Circuit Court of Appeals.

On June 13, 2013, Broadcast Music, Inc. ("BMI") filed a petition in the rate court established by the consent decree between BMI and the U.S. Department of Justice in the U.S. District Court for the Southern District of New York for the determination of reasonable fees and terms for the BMI consent decree license applicable to the period January 1, 2013 through December 31, 2014. We filed our response on July 19, 2013. On November 1, 2013, we filed a motion for partial summary judgment seeking a determination that as a matter of law the publishers alleged to have withdrawn certain rights of public performance by digital audio transmission from the scope of grant of rights BMI could license on behalf of such publishers subsequent to the date of our request for a license from BMI were not valid as to our BMI consent decree license. On December 18, 2013, our motion for summary judgment was denied.

On April 17, 2014, UMG Recordings, Inc., Sony Music Entertainment, Capitol Records, LLC, Warner Music Group Corp., and ABKCO Music and Records, Inc. filed suit against Pandora Media Inc. in the Supreme Court of the State of New York. The complaint claims common law copyright infringement and unfair competition arising from allegations that Pandora owes royalties for the public performance of sound recordings recorded prior to February 15, 1972.

On October 2, 2014, Flo & Eddie Inc. filed suit against Pandora Media Inc. in the federal district court for the Central District of California. The complaint alleges misappropriation and conversion in connection with the public performance of sound recordings recorded prior to February 15, 1972.

The outcome of any litigation is inherently uncertain. Based on our current knowledge we believe that the final outcome of the matters discussed above will not likely, individually or in the aggregate, have a material adverse effect on our business, financial position, results of operations or cash flows; however, in light of the uncertainties involved in such matters, there can be no assurance that the outcome of each case or the costs of litigation, regardless of outcome, will not have a material adverse effect on our business. In particular, rate court proceedings could take years to complete, could be very costly and may result in royalty rates that are materially less favorable than rates we currently pay.

Indemnification Agreements, Guarantees and Contingencies

In the ordinary course of business, we are party to certain contractual agreements under which we may provide indemnifications of varying scope, terms and duration to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of breach of such agreements, services to be provided by us or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with directors and certain officers and employees that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors, officers or employees. Such indemnification provisions are accounted for in accordance with guarantor's accounting and disclosure requirements for guarantees, including indirect guarantees of indebtedness of others. To

date, we have not incurred, do not anticipate incurring and therefore have not accrued for, any costs related to such indemnification provisions.

While the outcome of these matters cannot be predicted with certainty, we do not believe that the outcome of any claims under indemnification arrangements will have a material adverse effect on our financial position, results of operations or cash flows.

6. Other Long-Term Assets

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

	As of December 31, 2013	As of September 30, 2014
	(in thousands)	
Other long-term assets:		
Patents, net of amortization	\$7,636	\$7,091
Long-term security deposits	4,736	4,956
Other	1,343	1,939
Total other long-term assets	\$13,715	\$13,986

## Pending Acquisition

In June 2013, we entered into a local marketing agreement to program KXMZ-FM, a Rapid City, South Dakota-area terrestrial radio station. In addition, we entered into an agreement to purchase the assets of KXMZ-FM for a total purchase price of approximately \$0.6 million in cash, subject to certain closing conditions. As of September 30, 2014, we have paid \$0.4 million of the purchase price, which is included in the other long-term assets line item of our balance sheets.

The completion of the KXMZ-FM acquisition is subject to various closing conditions, which include, but are not limited to, regulatory approval by the Federal Communications Commission. Upon completion of these conditions, we expect to account for this acquisition as a business combination.

## 7. Debt Instruments

We are party to a \$60.0 million credit facility with a syndicate of financial institutions, which expires on September 12, 2018. The interest rate on borrowings is either LIBOR plus 2.00% -2.25% or an alternate base rate plus 1.00%-1.25%, both of which are per annum rates based on outstanding borrowings. The amount of borrowings available under the credit facility at any time is based on our monthly accounts receivable balance at such time, and the amounts borrowed are collateralized by our personal property (including such accounts receivable but excluding intellectual property). Under the credit facility, we can request up to \$15.0 million in letters of credit be issued by the financial institutions.

The credit facility contains customary events of default, conditions to borrowing and covenants, including restrictions on our ability to dispose of assets, make acquisitions, incur debt, incur liens and make distributions to stockholders. The credit facility also includes a financial covenant requiring the maintenance of minimum liquidity of at least \$5.0 million. During the continuance of an event of a default, the lenders may accelerate amounts outstanding, terminate the credit facility and foreclose on all collateral.

As of September 30, 2014, we had no borrowings outstanding, \$1.1 million in letters of credit outstanding and \$58.9 million of available borrowing capacity under the credit facility.

## 8. Stock-based Compensation Plans and Awards

## Employee Stock Purchase Plan



In December 2013, our board of directors approved the Employee Stock Purchase Plan (“ESPP”), which was approved by our stockholders at the annual meeting in June 2014. The ESPP allows eligible employees to purchase shares of our common stock through payroll deductions of up to 15% of their eligible compensation, subject to a maximum of \$25,000 per calendar year. Shares reserved for issuance under the ESPP include 4,000,000 shares of common stock. The ESPP provides for six-month offering periods, commencing in February and August of each year. At the end of each offering period employees are able to purchase shares at 85% of the lower of the fair market value of our common stock on the first trading day of the offering period or on the last day of the offering period.

We estimate the fair value of shares to be issued under the ESPP on the first day of the offering period using the Black-Scholes valuation model. The determination of the fair value is affected by our stock price on the first date of the offering period, as well as other assumptions including the risk-free interest rate, the estimated volatility of our stock price over the term

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

of the offering period, the expected term of the offering period and the expected dividend rate. Stock-based compensation expense related to the ESPP is recognized on a straight-line basis over the offering period, net of estimated forfeitures.

The per-share fair value of shares to be granted under the ESPP is determined on the first day of the offering period using the Black-Scholes option pricing model using the following assumptions:

	Three months ended September		Nine months ended September		
	30, 2013	2014	30, 2013	2014	
Expected life (in years)	N/A	0.5	N/A	0.5	
Risk-free interest rate	N/A	0.05 - 0.08%	N/A	0.05 - 0.08%	
Expected volatility	N/A	42	% N/A	42	%
Expected dividend yield	N/A	0	% N/A	0	%

During the three and nine months ended September 30, 2014, we withheld \$1.9 million and \$4.4 million in contributions from employees and recognized \$0.6 million and \$1.5 million of stock-based compensation expense related to the ESPP. In the three and nine months ended September 30, 2014, 149,378 shares of common stock were issued under the ESPP.

## Employee Stock-Based Awards

Our 2011 Equity Incentive Plan (the "2011 Plan") provides for the issuance of stock options, restricted stock units and other stock-based awards to our employees. The 2011 Plan is administered by the compensation committee of our board of directors.

## Stock options

We measure stock-based compensation expenses for stock options at the grant date fair value of the award and recognize expenses on a straight-line basis over the requisite service period, which is generally the vesting period. We estimate the fair value of stock options using the Black-Scholes option-pricing model. During the three months ended September 30, 2013 and 2014, we recorded stock-based compensation expense from stock options of approximately \$3.7 million and \$4.0 million. During the nine months ended September 30, 2013 and 2014, we recorded stock-based compensation expense from stock options of approximately \$8.6 million and \$11.2 million.

The per-share fair value of each stock option was determined on the grant date using the Black-Scholes option pricing model using the following assumptions.

	Three months ended September		Nine months ended September		
	30, 2013	2014	30, 2013	2014	
Expected life (in years)	6.32	6.08	5.99 - 6.32	6.08	
Risk-free interest rate	2.04	% 1.93	% 0.99 - 2.04%	1.71 - 1.93%	
Expected volatility	58	% 58	% 57 - 59%	58 - 59%	
Expected dividend yield	0	% 0	% 0	% 0	%

Restricted stock units

The fair value of the restricted stock units is expensed ratably over the vesting period. RSUs vest annually on a cliff basis over the service period, which is generally four years. During the three months ended September 30, 2013 and 2014, we recorded stock-based compensation expense from RSUs of approximately \$8.5 million and \$17.5 million. During the nine months ended September 30, 2013 and 2014, we recorded stock-based compensation expense from RSUs of approximately \$20.2 million and \$47.4 million.

Stock-based Compensation Expense

Table of Contents

Pandora Media, Inc.

## Notes to Condensed Consolidated Financial Statements - Continued

Stock-based compensation expense related to all employee and non-employee stock-based awards was as follows:

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2013	2014	2013	2014
	(in thousands)		(in thousands)	
	(unaudited)		(unaudited)	
Stock-based compensation expense:				
Cost of revenue - Other	\$540	\$1,063	\$1,435	\$2,976
Product development	2,610	4,402	6,449	12,289
Sales and marketing	5,754	10,442	15,202	28,675
General and administrative	3,260	6,204	5,740	16,176
Total stock-based compensation expense	\$12,164	\$22,111	\$28,826	\$60,116

## 9. Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted-average number of shares of common stock outstanding during the period.

Diluted net loss per share is computed by giving effect to all potential shares of common stock, including stock options and restricted stock units, to the extent dilutive. Basic and diluted net loss per share were the same for the three and nine months ended September 30, 2013 and 2014, as the inclusion of all potential common shares outstanding would have been anti-dilutive.

The following table sets forth the computation of historical basic and diluted net loss per share:

	Three months ended September		Nine months ended September	
	30,		30,	
	2013	2014	2013	2014
	(in thousands except per share amounts)		(in thousands except per share amounts)	
Numerator:				
Net loss	\$(4,092)	\$(2,025)	\$(49,680)	\$(42,684)
Denominator:				
Weighted-average common shares outstanding used in computing basic and diluted net loss per share	178,635	206,982	175,407	204,208
Net loss per share, basic and diluted	\$(0.02)	\$(0.01)	\$(0.28)	\$(0.21)

The following potential common shares outstanding were excluded from the computation of diluted net loss per share because including them would have been anti-dilutive:

	As of September 30,	
	2013	2014
	(in thousands)	
Options to purchase common stock	23,859	11,571

Edgar Filing: Pandora Media, Inc. - Form 10-Q

Restricted stock units	10,340	11,339
Total common stock equivalents	34,199	22,910

17

---

Table of Contents

Pandora Media, Inc.

Notes to Condensed Consolidated Financial Statements - Continued

Notes to Condensed Consolidated Financial Statements - Continued

10. Subsequent Event

Subsequent to September 30, 2014, the Company amended the operating lease agreement for its corporate headquarters in Oakland, California to increase both the leased space and the term of the lease, which previously required monthly lease payments through September 2017. This amendment is expected to result in an additional commitment of approximately \$18.4 million through 2020.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")

You should read the following discussion of our financial condition and results of operations in conjunction with the condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and our Transition Report on Form 10-K for the eleven months ended December 31, 2013 filed with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act").

We changed our fiscal year to the calendar twelve months ending December 31, effective beginning with the year ended December 31, 2013. As a result of this change, our prior fiscal year was an 11-month transition period ended on December 31, 2013. All references herein to a fiscal year refer to the twelve months ended December 31 of such year, and references to the first, second, third and fourth fiscal quarters refer to the three months ended March 31, June 30, September 30 and December 31, respectively. Prior year results have been recast on a calendar quarter basis. Refer to our Transition Report on Form 10-K for the eleven months ended December 31, 2013 for additional information regarding our fiscal year change.

This Quarterly Report on Form 10-Q contains "forward-looking statements" that involve substantial risks and uncertainties. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Exchange Act, including, but not limited to, statements regarding our expectations, beliefs, intentions, strategies, future operations, future financial position, future revenue, projected expenses, plans and objectives of management and economic, competitive and technological trends. In some cases, you can identify forward-looking statements by terms such as "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "project," "will," "would," "should," "could," "can," "predict," "potential," "continue," "objective," or the negative of similar expressions intended to identify forward-looking statements. However, not all forward-looking statements contain these identifying words. These forward-looking statements reflect our current views about future events and involve known risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievement to be materially different from those 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 below, and those discussed in the section titled "Risk Factors" included in this Quarterly Report on Form 10-Q and our Transition Report on Form 10-K for the eleven months ended December 31, 2013. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. We qualify all of our forward-looking statements by these cautionary statements. These and other factors could cause our results to differ materially from those expressed in this Quarterly Report on Form 10-Q.

Some of the industry and market data contained in this Quarterly Report on Form 10-Q are based on independent industry publications, including those generated by Triton Digital Media (“Triton”) or other publicly available information. This information involves a number of assumptions and limitations. Although we believe that each source is reliable as of its respective date, we have not independently verified the accuracy or completeness of this information.

As used herein, “Pandora,” the “Company,” “we,” “our,” and similar terms refer to Pandora Media, Inc., unless the context indicates otherwise.

“Pandora” and other trademarks of ours appearing in this report are our property. This report may contain additional trade names and trademarks of other companies. We do not intend our use or display of other companies’ trade names or trademarks to imply an endorsement or sponsorship of us by such companies, or any relationship with any of these companies.

#### Overview

Pandora is the leader in internet radio in the United States, offering a personalized experience for each of our listeners wherever and whenever they want to listen to radio on a wide range of smartphones, tablets, traditional computers and car

## Table of Contents

audio systems, as well as a range of other internet-connected devices. The majority of our listener hours occur on mobile devices, with the majority of our revenue generated from advertising on these devices. We have pioneered a new form of radio—one that uses intrinsic qualities of music to initially create stations and then adapts playlists in real-time based on the individual feedback of each listener. We offer local and national advertisers an opportunity to deliver targeted messages to our listeners using a combination of audio, display and video advertisements.

As of September 30, 2014, we had more than 250 million registered users, and more than 200 million registered users had accessed Pandora through smartphones and tablets. For the three months ended September 30, 2014, we streamed 4.99 billion hours of radio, and as of September 30, 2014, we had 76.5 million active users during the prior 30 day period. According to an August 2014 report by Triton, we have more than a 70% share of internet radio among the top 20 stations and networks in the United States. Since we launched our free, advertising-supported radio service in 2005 our listeners have created over 7 billion stations.

At the core of our service is our set of proprietary personalization technologies, including the Music Genome Project and our playlist generating algorithms. The Music Genome Project is a database of over 1,000,000 uniquely analyzed songs from over 125,000 artists, spanning over 600 genres and sub-genres, which we develop one song at a time by evaluating and cataloging each song's particular attributes. When a listener enters a single song, artist or genre to start a station, the Pandora service instantly generates a station that plays music we think that listener will enjoy. Based on listener reactions to the songs we stream, we further tailor the station to match the listener's preferences in real time.

We currently provide the Pandora service through two models:

**Free Service.** Our free service is advertising-based and allows listeners access to our music and comedy catalogs and personalized playlist generating system for free across all of our delivery platforms.

**Pandora One.** Pandora One is provided to paying subscribers without any external advertising. Pandora One enables listeners to create more stations, have more daily skips and enjoy higher quality audio on supported devices.

A key element of our strategy is to make the Pandora service available everywhere that there is internet connectivity. To this end, we make the Pandora service available through a variety of distribution channels. In addition to streaming our service to traditional computers, we have developed Pandora mobile device applications or "apps" for smartphones such as iPhone, Android and the Windows Phone and for tablets including the iPad and Android tablets. We distribute those mobile apps free to listeners via app stores. In addition, Pandora is now integrated with more than 1,000 connected devices, including automobiles, automotive aftermarket devices and consumer electronic devices.

## Recent Events

In August 2014, we announced an agreement to partner with Music and Entertainment Rights Licensing Independent Network ("Merlin"), the global rights agency for the independent label sector, whose membership includes over 20,000 independent record labels and distributors worldwide. This partnership was designed to help independent labels and artists increase the audiences they reach. Participating labels, and the artists they represent, can also take advantage of the marketing capabilities of our connected platform, including providing direct access to our metadata to help participating labels make data-driven business decisions. We do not expect this partnership to have a material effect on our financial condition or operating results.

In July 2014, we signed a multi-year agreement with BMG Rights Management US LLC ("BMG") for a U.S. license for BMG's complete Broadcast Music, Inc. ("BMI") and the American Society of Composers, Authors and Publishers ("ASCAP") catalog of musical works. We do not expect this agreement to have a material effect on our consolidated financial condition or operating results.



Effective in March 2014, we implemented a change in the pricing structure for Pandora One under which the \$36 annual subscription option was eliminated. In addition, effective in May 2014, the monthly pricing option for Pandora One was increased to \$4.99 per-month for new subscribers. Existing monthly subscribers who did not lapse maintained the \$3.99 per-month pricing structure, and existing annual subscribers who did not lapse were migrated to the \$3.99 per-month monthly pricing structure.

An important element of our strategy to achieve greater penetration of the local radio advertising market is to have Pandora's audience data presented in a manner consistent with similar data on terrestrial radio stations so that advertisers and

## Table of Contents

advertising agencies can better evaluate the relative value proposition of advertising on Pandora. In February 2014, Triton received Media Rating Council (“MRC”) accreditation for its Webcast Metrics Local (“WCML”) product, which allows agencies and advertisers to evaluate Pandora’s relative audience scale using broadcast metrics in specific advertising markets. Also in February 2014, we completed the WCML publisher audit of our user-declared geographic and demographic listener data. We believe this accreditation validates that our local audience metrics are reliable and effective.

In June 2013, we entered into a local marketing agreement to program KXMZ-FM, a Rapid City, South Dakota-area terrestrial radio station. In addition, we entered into an agreement to purchase the assets of KXMZ-FM for a total purchase price of approximately \$0.6 million in cash, subject to certain closing conditions. These agreements were made in part to allow us to qualify for certain settlement agreements concerning royalties for the public performance of musical works between the Radio Music Licensing Committee (“RMLC”) and ASCAP and BMI. We believe that we qualify for the RMLC royalty rates, which provide us with savings of less than 1% of revenue in cost of revenue - content acquisition costs, compared with the latest contractual rates. As of September 30, 2014, we have paid \$0.4 million of the purchase price, which is included in the other long-term assets line item of our balance sheets. Completion of the KXMZ-FM acquisition is subject to various closing conditions. These include, but are not limited to, regulatory approval by the Federal Communications Commission. Upon completion of these conditions, we expect to account for this transaction as a business combination.

### Factors Affecting our Business Model

As our mobile listenership increases, we face new challenges in optimizing our advertising products for delivery on mobile and other connected device platforms and monetizing inventory generated by listeners using these platforms. The mobile digital advertising market is at an early stage of development, with lower overall spending levels than traditional online advertising markets, and faces technical challenges due to fragmented platforms and a lack of standard audience measurement protocols. As a greater share of our listenership is consumed on mobile devices, our ability to monetize increased mobile streaming may not keep up with our past monetization of streaming to desktop computers and laptops.

In addition, our monetization strategy includes increasing the number of ad campaigns for traditional computer, mobile and other connected device platforms sold to local advertisers, placing us in more direct competition with broadcast radio for advertiser spending, especially for audio advertisements. By contrast, historically our display advertisers have been predominantly national brands. To successfully monetize our growing listener hours, a key strategy is to convince a substantial base of local advertisers of the benefits of advertising on the Pandora service including demonstrating the effectiveness and relevance of our advertising products, and in particular, audio advertising products, across the range of our delivery platforms.

Growth in our active users and distribution platforms has fueled a corresponding growth in listener hours. Our total number of listener hours is a key driver for both revenue generation opportunities and content acquisition costs, which are the largest component of our expenses.

Revenue. Listener hours define the number of opportunities we have to sell advertisements, which we refer to as inventory. Our ability to attract advertisers depends in large part on our ability to offer sufficient inventory within desired demographics. In turn, our ability to generate revenue depends on the extent to which we are able to sell the inventory we have.

Cost of Revenue—Content Acquisition Costs. The number of sound recordings we transmit to users of the Pandora service, as generally reflected by listener hours, drives substantially all of our content acquisition costs, although certain of our licensing agreements require us to pay fees for public performances of musical works based on a

percentage of revenue.

We pay royalties to the copyright owners, or their agents, of each sound recording that we stream and to the copyright owners, or their agents, of the musical work embodied in that sound recording, subject to certain exclusions. Royalties for sound recordings are negotiated with and paid to record labels, rights organizations or to SoundExchange. Royalties for musical works are most often negotiated with and paid to PROs such as ASCAP, BMI and SESAC or directly to publishing companies. Royalties are calculated based on the number of sound recordings streamed, revenue earned or other usage measures.

We stream spoken word comedy content pursuant to a federal statutory license, for which the underlying literary works are not currently entitled to eligibility for licensing by any PRO for the United States. Rather, pursuant to industry-wide custom and practice, this content is performed absent a specific license from any such PRO or the copyright owner of such content. However, we pay royalties to SoundExchange at rates negotiated between representatives of online music services and SoundExchange for the right to stream this spoken word comedy content.

Table of Contents

Given the current royalty structures in effect through 2015 with respect to the public performance of sound recordings in the United States, our content acquisition costs increase with each additional listener hour, regardless of whether we are able to generate more revenue. As such, our ability to achieve and sustain profitability and operating leverage depends on our ability to increase our revenue per hour of streaming through increased advertising revenue across all of our delivery platforms.

In addition, we expect to invest heavily in our operations to support anticipated future growth. One of our key objectives is furthering our market leadership in internet radio, which we believe will strengthen our brand and help us to convince advertisers to allocate spending towards our ad products. As such, a central focus is adding, retaining and engaging listeners to build market share and grow our listener hours. As our business matures, we expect that our revenue growth will exceed the growth in our listener hours. However, we expect to incur annual net losses on a U.S. GAAP basis in the near term because our current strategy is to leverage any improvements in gross profit by investing in broadening distribution channels, developing innovative and scalable advertising products, increasing utilization of advertising inventory and building our sales force. These investments are intended to drive further growth in our business through both increased listener hours and monetization of those hours, and as a result we are targeting gradual improvements in gross profit over time. Our planned reinvestment of any resulting incremental gross profit will continue to depress any growth of bottom line profitability.

## Key Metrics

## Listener Hours

We track listener hours because it is a key indicator of the growth of our business. We calculate listener hours based on the total bytes served for each track that is requested and served from our servers, as measured by our internal analytics systems, whether or not a listener listens to the entire track. To the extent that third-party measurements of listener hours are not calculated using a similar server-based approach, the third-party measurements may differ from our measurements.

The table below sets forth our total listener hours for the three and nine months ended September 30, 2013 and 2014.

	Three months ended September 30,		Nine months ended September 30,	
	2013	2014	2013	2014
	(in billions)		(in billions)	
Listener hours	3.99	4.99	12.16	14.83

## Active Users

We track the number of active users as an additional indicator of the breadth of audience we are reaching at a given time. Active users are defined as the number of distinct registered users, including subscribers, that have requested audio from our servers within the trailing 30 days to the end of the final calendar month of the period. The number of active users may overstate the number of unique individuals who actively use our service within a month as one individual may register for, and use, multiple accounts.

The table below sets forth our total active users as of September 30, 2013 and 2014.

	As of September 30,	
	2013	2014
	(in millions)	
Active users	72.7	76.5

Revenue per Thousand Listener Hours (“RPMs”)

21

---

Table of Contents

We track total RPMs for our service, which includes ad and subscription RPMs, because it is a key indicator of our ability to monetize our listener hours. We focus on total RPMs across all of our delivery platforms. Total RPMs compare advertising and subscription and other revenue in a given period to total listener hours in the period. We calculate total RPMs by dividing the total revenue by the number of thousands of listener hours using the inputs below.

The table below sets forth our users on an advertising and subscription basis as of September 30, 2013 and 2014.

User type	As of September 30,	
	2013	2014
	Users (in millions)	
Ad-based active users	70.1	73.5
Subscribers*	3.1	3.5
Total	73.2	77.0

\* Includes subscribers that have not used our service within the trailing 30 days to the end of the final calendar month of the period.

The table below sets forth our listener hours on an advertising and subscription basis for the three and nine months ended September 30, 2013 and 2014.

User type	Three months ended September 30,		Nine months ended September 30,	
	2013	2014	2013	2014
	Listener hours (in billions)		Listener hours (in billions)	
Ad-based active users	3.41	4.38	10.66	13.01
Subscribers	0.58	0.61	1.50	1.82
Total	3.99	4.99	12.16	14.83

Advertising-based active users (“ad-based active users”) are defined as the number of users, excluding subscribers, that have requested audio from our servers within the trailing 30 days to the end of the final calendar month of the period. Subscribers are defined as the number of distinct users at the end of the period that have subscribed to our service. Inactive subscribers are included as they contribute towards revenue per thousand listener hours (“RPMs”), which are described in further detail below.

#### Advertising Revenue per Thousand Listener Hours (“ad RPMs”)

We track ad RPMs for our free, advertising-supported service because it is a key indicator of our ability to monetize advertising inventory created by our listener hours. We focus on ad RPMs across all of our delivery platforms. We believe ad RPMs to be the central top-line indicator for evaluating the results of our monetization efforts. Ad RPMs are calculated by dividing advertising revenue by the number of thousands of listener hours of our advertising-based service.

#### Subscription and Other Revenue per Thousand Listener Hours (“subscription RPMs”)

We track subscription RPMs because it is a key indicator of the performance of our subscription service. We focus on subscription RPMs across all of our delivery platforms. Subscription RPMs are calculated by dividing subscription and other revenue by the number of thousands of listener hours of our subscription service.

#### Total Revenue per Thousand Listener Hours (“total RPMs”)

We track total RPMs for our service, which includes ad and subscription RPMs, because it is a key indicator of our ability to monetize our listener hours. Total RPMs compare advertising and subscription and other revenue in a given period to total listener hours in the period. We calculate total RPMs by dividing the total revenue by the number of thousands of listener hours.

Table of Contents

## Licensing Costs per Thousand Listener Hours (“LPMs”)

We track LPMs and analyze them in combination with our analysis of RPMs as they provide a key indicator of our profitability. LPMs are relatively fixed licensing costs with scheduled annual rate increases that drive period-over-period changes in LPMs. As such, the margin on our business varies principally with variances in ad RPMs and subscription RPMs.

## Estimated RPMs and LPMs by Platform

We also provide estimates of disaggregated ad RPMs, subscription RPMs, total RPMs and related LPMs for our traditional computer platform as well as our mobile and other connected devices platforms, which we calculate by dividing the estimated revenue and costs generated through the respective platforms by the number of thousands of listener hours of our services delivered through such platforms. While we believe that such disaggregated data provides directional insight for evaluating our efforts to monetize our service, we do not validate such disaggregated data to the level of financial statement reporting. Such data should be seen as indicative only and as management's best estimate. We continue to refine our systems and methodologies used to categorize RPMs and LPMs.

Period-to-period results should not be regarded as precise nor can they be relied upon as indicative of results for future periods. In addition, as our business matures and in response to technological evolutions, we anticipate that the relevant indicators we monitor for evaluating our business may change.

The table below sets forth our RPMs and LPMs, including total, traditional computer and mobile and other connected devices, on an advertising (“ad”), subscription and total basis for the three months ended September 30, 2013 and 2014.

	Three months ended September 30,		2014	
	2013 RPM	LPM*	RPM	LPM*
Advertising:				
Traditional computer	\$58.44	\$19.08	\$64.13	\$20.59
Mobile and other connected devices	35.31	18.85	40.82	20.33
Total advertising	\$39.68	\$18.89	\$44.35	\$20.37
Subscription:				
Traditional computer	\$53.52	\$31.91	\$61.56	\$33.53
Mobile and other connected devices	60.85	33.49	78.11	36.94
Total subscription	\$58.93	\$33.08	\$74.14	\$36.12
Total:				
Total traditional computer	\$57.50	\$21.54	\$63.67	\$22.94
Total mobile and other connected devices	38.75	20.82	44.96	22.18
Total	\$42.49	\$20.97	\$48.00	\$22.30

\* Under the Pureplay Settlement agreement, we pay per-performance rates for the streaming of sound recordings for our Pandora One subscription service that are higher than the per-performance rates for our free, advertising-supported service.

The table below sets forth our RPMs and LPMs, including total, traditional computer and mobile and other connected devices, on an ad and subscription basis for the nine months ended September 30, 2013 and 2014.





Table of Contents

	Nine months ended September 30,		2014	
	2013 RPM	LPM*	RPM	LPM*
<b>Advertising:</b>				
Traditional computer	\$53.67	\$18.91	\$59.64	\$20.76
Mobile and other connected devices	28.96	18.55	35.55	20.38
Total advertising	\$33.70	\$18.62	\$39.37	\$20.44
<b>Subscription:</b>				
Traditional computer	\$49.95	\$31.86	\$60.09	\$33.54
Mobile and other connected devices	52.97	34.51	84.39	36.59
Total subscription	\$52.08	\$33.73	\$77.32	\$35.82
<b>Total:</b>				
Total traditional computer	\$53.01	\$21.21	\$59.59	\$23.09
Total mobile and other connected devices	31.59	20.30	40.82	22.16
Total	\$35.97	\$20.49	\$44.02	\$22.32

\* Under the Pureplay Settlement agreement, we pay per-performance rates for the streaming of sound recordings for our Pandora One subscription service that are higher than the per-performance rates for our free, advertising-supported service.

**Total ad RPMs**

For the three and nine months ended September 30, 2014 compared to 2013, total ad RPMs increased primarily due to an increase in ad RPMs on the mobile and other connected devices platform. Ad RPMs on the mobile and other connected devices platform increased as advertising revenue growth outpaced the growth in advertising listener hours as a result of an increase in the average price per ad sold on that platform, due in part to our shift to local ad sales.

**Total subscription RPMs**

For the three months ended September 30, 2014 compared to 2013, total subscription RPMs increased as the growth in subscription and other revenue outpaced the growth in subscription listener hours on both the traditional computer and the mobile and other connected devices platforms, primarily due to an increase in the average price per subscriber as a result of the increase in the Pandora One pricing structure.

For the nine months ended September 30, 2014 compared to 2013, total subscription RPMs increased as the growth in subscription and other revenue outpaced the growth in subscription listener hours on both the traditional computer and the mobile and other connected devices platforms, primarily due to an increase in the average price per subscriber as a result of the increase in the Pandora One pricing structure. In addition, the changes in subscription RPMs for the nine months ended September 30, 2014 reflect a \$14.2 million increase in subscription revenue in connection with the one-time recognition of the accumulation of deferred revenue related to in-app subscriptions. Refer to "Deferred Revenue" below for further details regarding these in-app subscriptions.

**Total ad LPMs**

Total ad LPMs in the three and nine months ended September 30, 2014 increased compared to the respective prior year periods primarily due to scheduled rate increases for sound recording royalties paid to SoundExchange.

**Total subscription LPMs**



Table of Contents

Total subscription LPMs in the three and nine months ended September 30, 2014 increased compared to the respective prior year periods primarily due to scheduled rate increases for sound recording royalties paid to SoundExchange.

Table of Contents

## Basis of Presentation and Results of Operations

The following table presents our results of operations for the periods indicated as a percentage of total revenue. The period-to-period comparisons of results are not necessarily indicative of results for future periods.

	Three months ended		Nine months ended		
	September 30,		September 30,		
	2013	2014	2013	2014	
Revenue:					
Advertising	80	% 81	% 82	% 78	%
Subscription and other	20	19	18	22	
Total revenue	100	100	100	100	
Cost of revenue:					
Cost of revenue — Content acquisition costs	49	46	57	51	
Cost of revenue — Other(1)	7	6	7	7	
Total cost of revenue	57	53	64	58	
Gross profit	43	47	36	42	
Operating expenses:					
Product development(1)	5	6	5	6	
Sales and marketing(1)	28	30	30	31	
General and administrative(1)	13	12	12	12	
Total operating expenses	46	48	47	49	
Loss from operations	(2	) (1	) (11	) (7	)
Other income (expense), net	—	—	—	—	
Loss before provision for income taxes	(2	) (1	) (11	) (7	)
Provision for income taxes	—	—	—	—	
Net Loss	(2	)% (1	)% (11	)% (7	)%

(1) Includes stock-based compensation as follows:

Cost of revenue - Other	0.3	% 0.4	% 0.3	% 0.5	%
Product development	1.5	1.8	1.5	1.9	
Sales and marketing	3.4	4.4	3.5	4.4	
General and administrative	1.9	2.6	1.3	2.5	

Note: Amounts may not recalculate due to rounding

## Revenue

	Three months ended			Nine months ended		
	September 30,		\$ Change	September 30,		\$ Change
	2013	2014		2013	2014	
	(in thousands)			(in thousands)		
Advertising	\$134,963	\$194,293	\$59,330	\$359,232	\$512,251	\$153,019
Subscription and other	34,340	45,300	10,960	78,299	140,551	62,252
Total revenue	\$169,303	\$239,593	\$70,290	\$437,531	\$652,802	\$215,271

## Advertising revenue



## Table of Contents

We generate advertising revenue primarily from audio, display and video advertising, which is typically sold on a cost-per-thousand impressions, or CPM, basis. Advertising campaigns typically range from one to twelve months, and advertisers generally pay us based on the number of delivered impressions or the satisfaction of other criteria, such as click-throughs. We also have arrangements with advertising agencies under which these agencies sell advertising inventory on our service directly to advertisers. We report revenue under these arrangements net of amounts due to agencies. For the three months ended September 30, 2013 and 2014 and the nine months ended September 30, 2013 and 2014, advertising revenue accounted for 80%, 81%, 82% and 78%, of our total revenue, respectively. We expect that advertising will comprise a substantial majority of revenue for the foreseeable future.

For the three months ended September 30, 2014 compared to 2013, advertising revenue increased \$59.3 million or 44%, primarily due to an approximate 20% increase in the average price per ad sold, due in part to our shift to local ad sales and our focus on monetizing mobile inventory, and an approximate 20% increase in the number of ads sold, primarily due to an increase in advertising listener hours.

For the nine months ended September 30, 2014 compared to 2013, advertising revenue increased \$153.0 million or 43%, primarily due to an approximate 30% increase in the average price per ad sold, due in part to our shift to local ad sales and our focus on monetizing mobile inventory, and an approximate 10% increase in the number of ads sold, primarily due to an increase in advertising listener hours.

### Subscription and other revenue

Subscription and other revenue is generated primarily through the sale of Pandora One, a premium version of the Pandora service, which currently includes advertisement-free access and higher audio quality on the devices that support it. Subscription revenue is recognized on a straight-line basis over the duration of the subscription period. For the three months ended September 30, 2013 and 2014 and the nine months ended September 30, 2013 and 2014, subscription and other revenue accounted for 20%, 19%, 18% and 22% of our total revenue, respectively.

Effective in March 2014, we implemented a change in the pricing structure for Pandora One under which the \$36 annual subscription option was eliminated. In addition, effective in May 2014, the monthly pricing option for Pandora One was increased to \$4.99 per-month for new subscribers. Existing monthly subscribers who did not lapse maintained the \$3.99 per-month pricing structure, and existing annual subscribers who did not lapse were migrated to the \$3.99 per-month monthly pricing structure.

For the three months ended September 30, 2014 compared to 2013, subscription revenue increased \$11.0 million or 32%, primarily due to an approximate 15% increase in the average price per subscription as a result of the change in the Pandora One pricing structure and due to an approximate 10% increase in the number of subscribers.

For the nine months ended September 30, 2014 compared to 2013, subscription revenue increased \$62.3 million or 80%, primarily due to an approximate 30% increase in the average price per subscription as a result of the change in the Pandora One pricing structure and due to an approximate 10% increase in the number of subscribers. The increase in subscription revenue for the nine months ended September 30, 2014 was also due to a \$14.2 million increase in subscription revenue in connection with the one-time recognition of the accumulation of deferred revenue related to in-app subscriptions. Refer to "Deferred Revenue" below for further details regarding these in-app subscriptions.

### Deferred revenue

Our deferred revenue consists principally of both prepaid but unrecognized subscription revenue and advertising fees received or billed in advance of the delivery or completion of the delivery of services. Deferred revenue is recognized as revenue when the services are provided and all other revenue recognition criteria have been met.

In addition, subscription revenue derived from sales through certain mobile devices may be subject to refund or cancellation terms which may affect the timing or amount of the subscription revenue recognition. When refund rights exist, we recognize revenue when services have been provided and the rights lapse or when we have developed sufficient transaction history to estimate a return reserve.

We were required to defer revenue for certain in-app mobile subscriptions that contained refund rights until the refund rights lapsed or until we developed sufficient operating history to estimate a return reserve. As of December 31, 2013, we had deferred all revenue related to these in-app mobile subscriptions subject to refund rights totaling approximately \$14.2 million, as we did not have sufficient transaction history to estimate a return reserve. Beginning in January 2014, we had sufficient



Table of Contents

transaction history that enabled us to estimate future returns. Accordingly, in January 2014, we began recording revenue related to these in-app mobile subscriptions net of estimated returns. This resulted in a one-time increase in subscription revenue in the three months ended March 31, 2014 of approximately \$14.2 million, as the previously deferred revenue was recognized. As of September 30, 2014, the deferred revenue related to the return reserve was not significant.

Deferred revenue in our condensed consolidated balance sheet as of September 30, 2014 decreased as compared to December 31, 2013 in connection with the one-time recognition of the accumulation of deferred revenue related to in-app subscriptions in the three months ended March 31, 2014. In addition, deferred revenue also decreased due to the elimination of the annual pricing option, as we collected less cash upfront under the one-month subscription period as opposed to the twelve-month subscription period under the annual subscription option.

## Costs and Expenses

Cost of revenue consists of cost of revenue — content acquisition costs and cost of revenue — other. Our operating expenses consist of product development, sales and marketing and general and administrative costs. Cost of revenue - content acquisition costs are the most significant component of our costs and expenses, followed by employee-related costs, which include stock-based compensation expenses. We expect to continue to hire additional employees in order to support our anticipated growth and our product development initiatives. In any particular period, the timing of additional hires could materially affect our cost of revenue and operating expenses, both in absolute dollars and as a percentage of revenue. We anticipate that our costs and expenses will increase in the future.

## Cost of revenue - content acquisition costs

	Three months ended September 30,			Nine months ended September 30,		
	2013	2014	\$ Change	2013	2014	\$ Change
Cost of revenue - content acquisition costs	\$83,535	\$111,315	\$27,780	\$249,186	\$331,051	\$81,865

## Content acquisition costs as a percentage of advertising revenue by platform

	Three months ended September 30,			Nine months ended September 30,		
	2013	2014		2013	2014	
Traditional computer	34	% 33		% 36	% 35	%
Mobile and other connected devices	53	% 50		% 64	% 56	%

Cost of revenue—content acquisition costs principally consist of royalties paid for streaming music or other content to our listeners. Royalties are currently calculated using negotiated rates documented in agreements. The majority of our royalties are payable based on a fee per public performance of a sound recording, while in other cases our royalties are payable based on a percentage of our revenue or a formula that involves a combination of per performance and revenue metrics. For royalty arrangements under negotiation, we accrue for estimated royalties based on the available facts and circumstances and adjust these estimates as more information becomes available. The results of any finalized negotiation may be materially different from our estimates.

We estimate our advertising-based content acquisition costs attributable to specific platforms by allocating costs from royalties payable based on a fee per track to the platform for which the track is served and by allocating costs from

royalties based on a percentage of our revenue in accordance with the overall percentage of our revenue estimated to be attributable to such platforms. While we believe that comparing disaggregated content acquisition costs and revenues across our delivery platforms may provide directional insight for evaluating our efforts to monetize the rapid adoption of our service on mobile and other connected devices, we do not validate such disaggregated metrics to the level of financial statement reporting. We continue to refine our systems and methodologies used to categorize such metrics across our delivery platforms and the period-to-period comparisons of results are not necessarily indicative of results for future periods.

For the three months ended September 30, 2014 compared to 2013, content acquisition costs increased \$27.8 million or 33%, primarily due to an approximate 25% increase in listener hours and scheduled royalty rate increases of 8%.  
Content

Table of Contents

acquisition costs as a percentage of total revenue decreased from 49% to 46%, primarily due to an increase in advertising revenue. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our traditional computer platform decreased from 34% to 33%, primarily due to an increase in advertising revenue on the traditional computer platform as a result of an increase in the average price per ad sold, offset by scheduled rate increases. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our mobile and other connected devices platform decreased from 53% to 50%, primarily due an increase in advertising revenue on the mobile and other connected devices platform as a result of an increase in the average price per ad sold and an increase in the number of ads sold, offset by scheduled rate increases.

For the nine months ended September 30, 2014 compared to 2013, content acquisition costs increased \$81.9 million or 33%, primarily due to an approximate 20% increase in listener hours and scheduled royalty rate increases of 8%. Content acquisition costs as a percentage of total revenue decreased from 57% to 51%, primarily due to an increase in advertising revenue and a \$14.2 million increase in subscription revenue in connection with the one-time recognition of the accumulation of deferred revenue related to in-app subscriptions. Refer to “Deferred Revenue” above for further details regarding these in-app subscriptions. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our traditional computer platform decreased from 36% to 35%, primarily due to an increase in advertising revenue on the traditional computer platform as a result of an increase in the average price per ad sold, offset by scheduled rate increases. Estimated content acquisition costs as a percentage of the advertising revenue attributable to our mobile and other connected devices platform decreased from 64% to 56%, primarily due to an increase in advertising revenue on the mobile and other connected devices platform as a result of an increase in the average price per ad sold and an increase in the number of ads sold. The decrease in estimated content acquisition costs as a percentage of the advertising revenue attributable to our mobile and other connected devices platform was also due to the effect of measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, such as adjusting the number of times users can skip songs during a given listening session, as well as optimizing time-based thresholds whereby music will stop playing after a certain length of user inactivity with the service, partially offset by scheduled rate increases.

## Cost of revenue—other

	Three months ended			Nine months ended		
	September 30,		\$ Change	September 30,		\$ Change
	2013	2014		2013	2014	
	(in thousands)					
Cost of revenue — other	\$12,126	\$15,453	\$3,327	\$32,749	\$44,421	\$11,672

Cost of revenue—other consists primarily of hosting and infrastructure costs and other costs of ad sales. Hosting and infrastructure costs consist of content streaming, maintaining our internet radio service, creating and serving advertisements through third-party ad servers and the employee-related costs associated with supporting those functions. Other costs of ad sales include support costs related to music events that are sold as part of advertising arrangements. We make payments to third-party ad servers for the period the advertising impressions or click-through actions are delivered or occur, and accordingly, we record this as a cost of revenue in the related period.

For the three months ended September 30, 2014 compared to 2013, cost of revenue increased \$3.3 million or 27%, primarily due to a \$1.6 million increase in hosting and infrastructure costs driven by an increase in listener hours and a \$1.5 million increase in employee-related costs driven by an approximate 40% increase in headcount.

For the nine months ended September 30, 2014 compared to 2013, cost of revenue increased \$11.7 million or 36%, primarily due to a \$4.3 million increase in employee-related costs and a \$1.6 million increase in facilities and equipment expenses, both of which were driven by an approximate 40% increase in headcount, a \$3.7 million increase

in hosting and infrastructure costs driven by an increase in listener hours and a \$2.1 million increase in other costs of ad sales related to events sold as part of advertising arrangements.

Gross profit

29

---

Table of Contents

	Three months ended			Nine months ended		
	September 30,			September 30,		
	2013	2014	\$ Change	2013	2014	\$ Change
	(in thousands)			(in thousands)		
Total revenue	\$169,303	\$239,593	\$70,290	\$437,531	\$652,802	\$215,271
Total cost of revenue	95,661	126,768	31,107	281,935	375,472	93,537
Gross profit	\$73,642	\$112,825	\$39,183	\$155,596	\$277,330	\$121,734
Gross margin	43	% 47	%	36	% 42	%

For the three months ended September 30, 2014 compared to 2013, gross profit increased by \$39.2 million or 53%, primarily due to an increase in advertising revenue as a result of an increase in the average price per ad sold and an increase in the number of ads sold. Gross margin increased from 43% to 47% as the growth in revenue outpaced the growth in content acquisition costs primarily due to an increase in advertising revenue and the effect of measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, such as adjusting the number of times users can skip songs during a given listening session, as well as optimizing time-based thresholds whereby music will stop playing after a certain length of user inactivity with the service.

For the nine months ended September 30, 2014 compared to 2013, gross profit increased by \$121.7 million or 78%, primarily due to an increase in advertising revenue as a result of an increase in the average price per ad sold and an increase in the number of ads sold. Gross margin increased from 36% to 42% as the growth in revenue outpaced the growth in content acquisition costs primarily due to an increase in advertising revenue and the effect of measures we have adopted to manage the growth of mobile content acquisition costs while minimizing adverse effects on the listener experience, such as adjusting the number of times users can skip songs during a given listening session, as well as optimizing time-based thresholds whereby music will stop playing after a certain length of user inactivity with the service. The increase in gross margin was also due to an increase in subscription and other revenue driven by a \$14.2 million increase in connection with the one-time recognition of the accumulation of deferred revenue related to in-app subscriptions. Refer to “Deferred Revenue” above for further details regarding these in-app subscriptions.

## Product development

	Three months ended			Nine months ended		
	September 30,			September 30,		
	2013	2014	\$ Change	2013	2014	\$ Change
	(in thousands)			(in thousands)		
Product development	\$9,099	\$13,381	\$4,282	\$23,661	\$38,288	\$14,627

Product development consists primarily of employee-related costs, including salaries and benefits related to employees in software engineering, music analysis and product management departments, facilities-related expenses, information technology and costs associated with supporting consumer connected-device manufacturers in implementing our service in their products. We incur product development expenses primarily for improvements to our website and the Pandora app, development of new advertising products and development and enhancement of our personalized station generating system. We have generally expensed product development as incurred. Certain website development and internal use software development costs are capitalized when specific criteria are met. In such cases, the capitalized amounts are amortized over the useful life of the related application once the application is placed in service. We intend to continue making significant investments in developing new products and enhancing the functionality of our existing products.

## Edgar Filing: Pandora Media, Inc. - Form 10-Q

For the three months ended September 30, 2014 compared to 2013, product development expenses increased \$4.3 million or 47%, primarily due to a \$4.0 million increase in employee-related costs driven by an approximate 40% increase in headcount.

For the nine months ended September 30, 2014 compared to 2013, product development expenses increased \$14.6 million or 62%, primarily due to a \$13.4 million increase in employee-related costs and a \$1.1 million increase in facilities and equipment expenses, both of which were driven by an approximate 40% increase in headcount.

Sales and marketing

30

---

Table of Contents

	Three months ended			Nine months ended		
	September 30,			September 30,		
	2013	2014	\$ Change	2013	2014	\$ Change
	(in thousands)			(in thousands)		
Sales and marketing	\$47,049	\$72,320	\$25,271	\$129,465	\$200,416	\$70,951

Sales and marketing consists primarily of employee-related costs, including salaries, commissions and benefits related to employees in sales, sales support and marketing departments. In addition, sales and marketing expenses include transaction processing commissions on subscription purchases on mobile platforms, external sales and marketing expenses such as third-party marketing, branding, advertising and public relations expenses, facilities-related expenses, infrastructure costs and credit card fees. We expect sales and marketing expenses to increase as we hire additional personnel to build out our sales and sales support teams, particularly as we continue to build out our local market sales team.

For the three months ended September 30, 2014 compared to 2013, sales and marketing expenses increased \$25.3 million or 54%, primarily due to a \$16.9 million increase in employee-related costs driven by an approximate 30% increase in headcount, a \$4.2 million increase in marketing expenses, a \$1.9 million increase in transaction processing commissions on subscription purchases on mobile platforms and a \$1.0 million increase in music events.

For the nine months ended September 30, 2014 compared to 2013, sales and marketing expenses increased \$71.0 million or 55%, primarily due to a \$49.0 million increase in employee-related costs and a \$3.5 million increase in facilities and equipment expenses, both of which were driven by an approximate 30% increase in headcount, a \$8.1 million increase in transaction processing commissions on subscription purchases on mobile platforms, a \$7.1 million increase in marketing expenses and a \$1.9 million increase in music events.

## General and administrative

	Three months ended			Nine months ended		
	September 30,			September 30,		
	2013	2014	\$ Change	2013	2014	\$ Change
	(in thousands)			(in thousands)		
General and administrative	\$21,397	\$29,143	\$7,746	\$51,683	\$81,369	\$29,686

General and administrative consists primarily of employee-related costs, including salaries and benefits for finance, accounting, legal, internal information technology and other administrative personnel. In addition, general and administrative expenses include professional services costs for outside legal and accounting services, facilities-related expenses and infrastructure costs. We expect general and administrative expenses to increase in future periods as we continue to invest in corporate infrastructure, including adding personnel and systems to our administrative functions.

For the three months ended September 30, 2014 compared to 2013, general and administrative expenses increased \$7.7 million or 36%, primarily due to a \$6.0 million increase in employee-related costs driven by an approximate 40% increase in headcount.

For the nine months ended September 30, 2014 compared to 2013 general and administrative expenses increased \$29.7 million or 57%, primarily due to a \$19.0 million increase in employee-related costs and a \$2.8 million increase in facilities and equipment expenses, both of which were driven by an approximate 40% increase in headcount, and a \$5.4 million increase in professional services costs primarily due to royalty-related legal matters.

## Income tax benefit (expense)

We have historically been subject to income taxes only in the United States. As we expand our operations outside the United States, we become subject to taxation based on the foreign statutory rates and our effective tax rate could fluctuate accordingly.

Income taxes are computed using the asset and liability method, under which deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted statutory income tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce net deferred tax assets to the amount expected to be realized.



## Table of Contents

### Off-Balance Sheet Arrangements

Our liquidity is not dependent on the use of off-balance sheet financing arrangements and as of September 30, 2014 we had no such arrangements. There has been no material change in our contractual obligations other than in the ordinary course of business since the eleven months ended December 31, 2013.

### Quarterly Trends

Our operating results fluctuate from quarter to quarter as a result of a variety of factors. We expect our operating results to continue to fluctuate in future quarters.

Our results reflect the effects of seasonal trends in listener behavior. During the last three months of each calendar year, we experience higher advertising revenue as a result of greater advertiser demand during the holiday season. We also experience lower advertising revenue in the first three months of the calendar year due to reduced advertiser demand. In addition, we expect to experience increased usage during the last three months of each calendar year during the holiday season, and in the first three months of each calendar year due to increased use of media-streaming devices received as gifts during the holiday season. We believe these seasonal trends have affected, and will continue to affect our operating results, particularly as increases in content acquisition costs from increased usage are not offset by increases in advertising revenue in the first calendar quarter. We believe that our business may become more seasonal in the future and that such seasonal variations in listener behavior may result in fluctuations in our financial results.

In addition, expenditures by advertisers tend to be cyclical and discretionary in nature, reflecting overall economic conditions, the economic prospects of specific advertisers or industries, budgeting constraints and buying patterns and a variety of other factors, many of which are outside our control. As a result of these and other factors, the results of any prior quarterly or annual periods should not be relied upon as indications of our future operating performance.

### Liquidity and Capital Resources

As of September 30, 2014, we had cash, cash equivalents and investments totaling \$437.3 million, which consisted of cash and money market funds held at major financial institutions, commercial paper and investment-grade corporate debt securities.

Our principal uses of cash during the nine months ended September 30, 2014 were funding our operations, as described below, and capital expenditures.

### Sources of Funds

We believe, based on our current operating plan, that our existing cash and cash equivalents and available borrowings under our credit facility will be sufficient to meet our anticipated cash needs for at least the next twelve months.

From time to time, we may explore additional financing sources and means to lower our cost of capital, which could include equity, equity-linked and debt financing. In addition, in connection with any future acquisitions, we may require additional funding which may be provided in the form of additional debt, equity or equity-linked financing or a combination thereof. There can be no assurance that any additional financing will be available to us on acceptable terms.

### Our Indebtedness

We are party to a \$60.0 million credit facility with a syndicate of financial institutions, which expires on September 12, 2018. Refer to Note 8 “Debt Instruments” in the Notes to Condensed Consolidated Financial Statements for further details regarding our credit facility.

#### Capital Expenditures

Consistent with previous periods, future capital expenditures will primarily focus on acquiring additional hosting and general corporate infrastructure. Our access to capital is adequate to meet our anticipated capital expenditures for our current plans.

#### Historical Trends

32

---

Table of Contents

The following table summarizes our cash flow data for the nine months ended September 30, 2013 and 2014.

	Nine months ended September 30,	
	2013	2014
	(in thousands)	
	(unaudited)	
Net cash used in operating activities	\$ (11,713	) \$ (4,315
Net cash used in investing activities	(4,135	) (109,954
Net cash provided by financing activities	393,019	17,570

#### Operating activities

In the nine months ended September 30, 2014, net cash used in operating activities was \$4.3 million and primarily consisted of our net loss of \$42.7 million, which was more than offset by non-cash charges of \$73.6 million, primarily related to \$60.1 million in stock-based compensation charges. Net cash used in operating activities also included a \$24.4 million decrease in deferred revenue from December 31, 2013, primarily due to the one-time recognition of the accumulation of deferred revenue related to in-app subscriptions of \$14.2 million and due to a decrease in deferred revenue as a result of the elimination of the annual subscription option, as we collected less cash upfront under the one-month subscription period as opposed to the twelve-month subscription period under the annual subscription option. Cash used in operating activities decreased \$7.4 million from the nine months ended September 30, 2013 primarily due to a \$7.0 million decrease in our net loss.

#### Investing activities

In the nine months ended September 30, 2014, net cash used in investing activities was \$110.0 million, primarily due to \$273.4 million of purchases of investments and \$23.2 million of capital expenditures for leasehold improvements and server equipment, partially offset by \$186.7 million in maturities of investments.

#### Financing activities

In the nine months ended September 30, 2014, net cash provided by financing activities was \$17.6 million, primarily consisting of \$15.2 million in proceeds from the exercise of stock options.

#### Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of these condensed consolidated financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Our estimates form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimate that are reasonably likely to occur, could materially impact the condensed consolidated financial statements. We believe that our critical accounting policies reflect the

more significant estimates and assumptions used in the preparation of the condensed consolidated financial statements.

Other than those discussed below, there have been no material changes to our critical accounting policies and estimates as compared to those described in our Transition Report on Form 10-K for the eleven months ended December 31, 2013 under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Policies and Estimates.”

Deferred Revenue

33

---

Table of Contents

We were required to defer revenue for certain in-app mobile subscriptions that contained refund rights until the refund rights lapsed or until we developed sufficient operating history to estimate a return reserve. As of December 31, 2013, we had deferred all revenue related to these in-app mobile subscriptions subject to refund rights totaling approximately \$14.2 million, as we did not have sufficient history to estimate a return reserve. Beginning in January 2014, we had sufficient historic transactional information which enabled us to estimate future returns. Accordingly, in January 2014, we began recording revenue related to these in-app mobile subscriptions net of estimated returns. This change resulted in a one-time increase in subscription revenue in the three months ended March 31, 2014 of approximately \$14.2 million, as the previously deferred revenue was recognized. As of September 30, 2014, the deferred revenue related to the return reserve was not significant.

Stock-Based Compensation

Stock-based compensation expenses are classified in the statement of operations based on the department to which the related employee reports. Our stock-based awards are comprised principally of restricted stock units ("RSUs") and stock options. We measure stock-based compensation expense for employees at the grant date fair value of the award, and recognize expense on a straight-line basis over the requisite service period, which is generally the vesting period, net of estimated forfeitures. We estimate the grant date fair value of RSUs at our stock price. We generally estimate the grant date fair value of stock options using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model is affected by our stock price on the date of grant, the expected stock price volatility over the expected term of the award, which is based on projected employee stock option exercise behaviors, the risk-free interest rate for the expected term of the award and expected dividends. Stock-based compensation expense is recorded net of estimated forfeitures in the statement of operations for only those stock-based awards that we expect to vest. We estimate the forfeiture rate based on historical forfeitures of equity awards and adjust the rate to reflect changes in facts and circumstances, if any. We will revise our estimated forfeiture rate if actual forfeitures differ from our initial estimates.

Table of Contents

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Fluctuation Risk

There have been no material changes in our primary market risk exposures or how those exposures are managed from the information disclosed in Part II, Item 7A of our Transition Report on Form 10-K for the eleven months ended December 31, 2013. For further discussion of quantitative and qualitative disclosures about market risk, reference is made to our Transition Report on Form 10-K.

Table of Contents

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Based on their evaluation at the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2014.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The material set forth in Note 5 in the Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q is incorporated herein by reference.

Item 1A. Risk Factors

Investing in our common stock involves a high degree of risk. Before deciding to invest in our common stock, you should carefully consider each of the risk factors described in “Part I - Item 1A. Risk Factors” in our Transition Report on Form 10-K for the eleven months ended December 31, 2013 and all information set forth in this Quarterly Report on Form 10-Q. Those risks and the risks described in this Quarterly Report on Form 10-Q, including in the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” could materially harm our business, financial condition, operating results, cash flow and prospects. If that occurs, the trading price of our common stock could decline, and you may lose all or part of your investment.

There have been no material changes to the Risk Factors described under “Part I - Item 1A. Risk Factors” in our Transition Report on Form 10-K for the eleven months ended December 31, 2013, other than as set forth below. The risk factors below, all of which originally appear in our Transition Report on Form 10-K, have been updated to reflect additional information regarding third party measurement, royalties and litigation, among other things.

Unavailability of, or fluctuations in, third-party measurements of our audience may adversely affect our ability to grow advertising revenue.

Selling ads, locally and nationally, requires that we demonstrate to advertisers that our service has substantial reach and usage. Third-party measurements may not reflect our true listening audience and their underlying methodologies are subject to change at any time. In addition, the methodologies we apply to measure the key metrics that we use to monitor and manage our business may differ from the methodologies used by third-party measurement service providers. For example, we calculate listener hours based on the total bytes served for each track that is requested and served from our servers, as measured by our internal analytics systems, whether or not a listener listens to the entire track. By contrast, certain third-party measurement service providers may calculate and report the number of listener hours using a client-based approach, which measures time elapsed during listening sessions. Measurement technologies for mobile and consumer electronic devices may be even less reliable in quantifying the reach, usage and location of our service, and it is not clear whether such technologies will integrate with our systems or uniformly and comprehensively reflect the reach, usage and location of our service. While we have been working with third-party measurement service providers and certain of their measurements have now earned Media Ratings Council accreditation, some providers have not yet developed uniform measurement systems that comprehensively measure the reach, usage and location of our service. In order to demonstrate to potential advertisers the benefits of our service, we supplement third-party measurement data with our internal research, which may be perceived as less valuable than third-party numbers. If third-party measurement providers report lower metrics than we do, or if there is wide variance among reported metrics, our ability to convince advertisers of the benefits of our service could be adversely affected.

The lack of accurate cross-platform measurements for internet radio and broadcast radio may adversely affect our ability to grow advertising revenue.

We have invested substantial resources to create accurate cross-platform measurements for internet radio and broadcast radio in the major automated media-buying platforms, creating a one-stop shop that enables media buyers to compare internet radio audience reach with terrestrial radio audience reach using traditional broadcast radio metrics.



To achieve this result, we currently rely on third parties such as Triton to quantify the reach and usage of our service and on media buying agencies to provide Internet radio metrics side-by-side with terrestrial radio metrics in media-buying platforms.

We have also partnered with media buying agencies that show internet radio measurements alongside terrestrial metrics in the media buying systems that media buyers use to purchase advertising. Media buying agencies receive measurement metrics from third parties, such as Triton for internet radio and Nielsen for more traditional media like terrestrial radio and television. Media buying agencies may choose not to show, or may be prohibited by third-party measurement services that measure terrestrial radio and other traditional media from showing, internet radio metrics alongside traditional terrestrial metrics. Our ability to realize our long-term potential will be significantly affected by our success in these advertising initiatives, and there is no assurance we will achieve substantial penetration of these advertising markets.

Table of Contents

We operate under and pay royalties pursuant to statutory and third-party licenses for the reproduction and public performance of sound recordings that could change or cease to exist, which would adversely affect our business.

We currently operate under statutory and third-party licenses that may change or cease to exist. We must pay performance rights royalties for the digital audio transmission of sound recordings. Subject to our ongoing compliance with numerous statutory conditions and regulatory requirements for a non-interactive service, we are permitted to operate our radio service under federal statutory licenses that allow the streaming in the U.S. of any sound recording lawfully released to the public. Pandora offers a small number of ancillary services (e.g., "Pandora Premieres") that allows users to more directly engage with a limited amount of content for which we secure rights directly from copyright owners. We are also permitted to make reproductions of sound recordings on computer servers pursuant to these statutory licenses designed to facilitate the making of transmissions. For the eleven months ended December 31, 2013 we incurred SoundExchange related content acquisition costs representing 48% of our total revenue for that period.

There is no guarantee that Congress will not amend the Copyright Act to eliminate the availability of these licenses or that we will continue to be eligible to operate under these statutory licenses. For example, if copyright owners objected, and a court agreed, that we operate an "interactive" streaming service, that we make reproductions of sound recordings not covered by the statutory license, or that the functionality or transmission methods of our service extend beyond what is allowed under the statutory license, we could be subject to significant liability for copyright infringement and, absent making technological changes, lose our eligibility to operate under the statutory license. In that event, we would have to negotiate license agreements with sound recording copyright owners individually, a time-consuming and expensive undertaking that could jeopardize our ability to stream a significant percentage of the music currently in our library and result in royalty costs that are prohibitively expensive.

As described in "Business-Content, Copyrights and Royalties-Sound Recordings" in our Transition Report on Form 10-K, we currently elect to avail ourselves of the Pureplay Settlement, which provides the rates and terms of statutory licenses for the reproduction and public performance of sound recordings for commercial webcasters through 2015, and we intend to continue to avail ourselves of this settlement through 2015. We presently do not know what rates will be available to us commencing January 1, 2016. There can be no assurance that we will be able to reach a new agreement with SoundExchange for rates for commercially reasonable rates. The CRB, which has rate-making authority over us upon expiration of the Pureplay Settlement, has consistently established royalty rates, including those established for the years 2011 through 2015 that would, if paid by us, consume a significantly greater portion of our revenue and negatively impact our ability to achieve and sustain profitability. There can be no assurance that the per performance rates established by the CRB for periods following 2015 will not exceed the rates currently paid by us under the Pureplay Settlement. If we are unable to reach a new agreement for commercially reasonable rates with SoundExchange and the CRB sets performance rates for post-2015 periods that exceed the Pureplay Settlement, our content acquisition costs may significantly increase, which could materially harm our financial condition and inhibit the implementation of our business plans.

Outside the statutory framework, we have entered into a partnership with Music and Entertainment Rights Licensing Independent Network ("Merlin"), the global rights agency for the independent label sector, pursuant to which we directly negotiated performance royalties for sound recordings with Merlin and its members. There is no guarantee that any licenses we directly negotiate would continue to be available to us in the future or that such licenses would be available at the royalty rates initially established.

We depend upon third-party licenses for the right to publicly perform musical works and a change to these licenses could materially increase our content acquisition costs.

Our content costs, in part, are comprised of the royalties we pay for the public performance of musical works embodied in the sound recordings that we stream. As described in “Business—Content, Copyrights and Royalties—Musical Works” in our Transition Report on Form 10-K to secure the rights to publicly perform musical works embodied in sound recordings over the internet, we obtain licenses from or for the benefit of copyright owners and pay royalties to copyright owners or their agents. Copyright owners of musical works are vigilant in protecting their rights and currently are seeking substantial increases in the rates applicable to the public performance of such works. There is no guarantee that the licenses available to us now will continue to be available in the future or that such licenses will be available at the royalty rates associated with the current licenses. If we are unable to secure and maintain rights to publicly perform musical works or if we cannot do so on terms that are acceptable to us, our ability to perform music content to our listeners, and consequently our ability to attract and retain both listeners and advertisers, will be adversely impacted. For the eleven months ended December 31, 2013, we incurred content acquisition costs for the public performance of musical works representing approximately 4% of our total revenue for that period.

Table of Contents

Copyright owners of musical works, typically, songwriters and music publishers, have traditionally relied on intermediaries known as performing rights organizations to negotiate so-called “blanket” licenses with copyright users, collect royalties under such licenses, and distribute them to copyright owners. We have obtained public performance licenses from, and pay license fees to, the three major performing rights organizations in the United States: the American Society of Composers, Authors and Publishers (“ASCAP”), Broadcast Music, Inc. (“BMI”) and SESAC, Inc. (“SESAC”).

We currently operate under interim licenses with each of ASCAP and BMI. ASCAP and BMI each are governed by a consent decree with the United States Department of Justice. The rates we pay ASCAP and BMI can be established by either negotiation or through a rate court proceeding conducted by the United States District Court for the Southern District of New York. We elected to terminate our prior agreements with ASCAP as of December 31, 2010 and with BMI as of December 31, 2012 because, among other things, we believed that the royalty rates sought by ASCAP and BMI were in excess of rates paid by our largest radio competitors, broadcast radio stations and satellite radio. Notwithstanding our termination of these agreements, the musical works administered by each of ASCAP and BMI continued to be licensed to us pursuant to the provisions of their respective consent decrees. In November 2012, we filed a petition requesting that the ASCAP rate court determine reasonable license fees and terms for the ASCAP consent decree license applicable to the period January 1, 2011 through December 31, 2015. In June 2013, BMI filed a petition requesting that the BMI rate court determine reasonable license fees and terms for the BMI consent decree license applicable to the period January 1, 2013 through December 31, 2017. A trial to determine the royalty rates we will pay ASCAP concluded in February 2014 and the court issued its opinion in March 2014, but ASCAP has appealed the decision and such appeal is pending. A trial date has not been set for the BMI rate court proceeding. Each of these proceedings has been, and is expected to continue to be, protracted, expensive and uncertain in outcome. It is likely that trial level outcomes will be appealed and the final resolution may not be known for years. In the event that these matters are resolved adversely to us, our content acquisition costs could increase significantly, which would adversely affect our operating results. Notwithstanding the ASCAP court decision, there is no guarantee that final rates established by mutual agreement or by a rate court determination would establish royalty rates more favorable to us than those we previously paid pursuant our terminated agreements with ASCAP and/or BMI or those that we pay pursuant to our interim arrangements with ASCAP and/or BMI.

We currently operate under an agreement with SESAC, which automatically renews yearly, but is subject to termination by either party in accordance with its terms at the end of each yearly term. The SESAC rate is subject to small annual increases. There is no guarantee that either the license or the associated royalty rate available to us now with respect to SESAC will be available to us in the future.

In certain cases, we have also directly negotiated royalty agreements with publishers. There is no guarantee that any directly negotiated licenses with publishers available to us now will continue to be available in the future or that such licenses will be available at the royalty rates associated with such licenses.

We do not currently pay so-called “mechanical royalties” to music publishers for the reproduction and distribution of musical works embodied in server copies or transitory copies used to make streams audible to our listeners. Although not currently a matter of dispute, if music publishers were to retreat from the publicly stated position of their trade association that non-interactive streaming does not require the payment of a mechanical royalties, and a final judgment were entered by a court requiring that payment, our royalty obligations could increase significantly, which would increase our operating expenses and harm our business and financial conditions. While we would vigorously challenge such mechanical royalties as not required by law, our challenge may be unsuccessful and would in any case involve commitment of substantial time and resources. In addition, we stream spoken word comedy content, for which the underlying literary works are not currently entitled to eligibility for licensing by any performing rights organization in the United States. Rather, pursuant to industry-wide custom and practice, this content is performed absent a specific license from any such performing rights organization or individual rights owners, although royalties

are paid to SoundExchange for the public performance of the sound recordings in which such literary works are embodied. There can be no assurance that this industry custom will not change or that we will not otherwise become subject to additional licensing costs for spoken word comedy content imposed by performing rights organizations or individual copyright owners in the future or be subject to damages for copyright infringement.

Assertions by third parties of violations under state law with respect to the public performance and reproduction of pre-1972 sound recordings could result in significant costs and substantially harm our business and operating results.

As described in “Business—Content, Copyrights and Royalties—Sound Recordings” in our Transition Report on Form 10-K, sound recordings made on or after February 15, 1972 fall within the scope of federal copyright protection. Subject to our ongoing compliance with numerous federal statutory conditions and regulatory requirements for a noninteractive service, we are permitted to operate our radio service under a statutory license that allows the streaming in the U.S. of any such sound

Table of Contents

recording lawfully released to the public and permits us to make reproductions of such sound recordings on computer servers pursuant to a separate statutory license designed to facilitate the making of such transmissions.

By contrast, protection of sound recordings created prior to February 15, 1972 (“pre-1972 sound recordings”) remains governed by a patchwork of state statutory and common laws. Copyright owners of pre-1972 sound recordings have commenced litigation against us, alleging violations of New York and California state statutory and common laws with respect to the unauthorized reproduction and public performance of pre-1972 sound recordings, seeking, among other things, restitution, disgorgement of profits, and punitive damages as well as injunctive relief prohibiting further violation of those copyright owners’ alleged exclusive rights. Litigation has been brought previously against Sirius XM Radio Inc. (“Sirius”) for similar claims, and a federal district court and a state court in California recently ruled against Sirius for violating exclusive public performance rights in California. That same plaintiff has initiated litigation against us, alleging similar violations of exclusive rights under California law. If we are found liable for the violation of the exclusive rights of any pre-1972 sound recording copyright owners, then we could be subject to liability, the amount of which could be significant. If we are required to obtain licenses from individual sound recording copyright owners for the reproduction and public performance of pre-1972 sound recordings, then the time, effort and cost of securing such licenses directly from all owners of sound recording used on our service could be significant and could harm our business and operating results. If we are required to obtain licenses for pre-1972 sound recordings to avoid liability and are unable to secure such licenses, then we may have to remove pre-1972 sound recordings from our service, which could harm our ability to attract and retain users.

Our royalty payments are subject to audits and our royalty calculation methods involve significant estimates.

The royalties that we pay to SoundExchange for the streaming of sound recordings are calculated using a per performance rate. While we believe that the mechanisms we use to track performances are sufficient to ensure that we are accurately reporting and paying royalties, our ability to do so depends in part on our ability to maintain these mechanisms as new devices are introduced and technologies evolve. Any understatement or overstatement of performances could result in our paying lower or higher royalties to SoundExchange than we actually owed, which could in turn affect our financial condition and results of operations. SoundExchange informed us in December 2013 that it intends to audit our payments for the years 2010, 2011, and 2012. In addition, performing rights organizations and musical work copyright owners with whom we have entered into direct licenses have or may have the right to audit our royalty payments, and any such audit could result in disputes over whether we have paid the proper royalties. If such a dispute were to occur, we could be required to pay additional royalties and audit fees. The amounts involved could be material.

Rate court proceedings, the attempted and/or purported withdrawal of certain music publishers or the rights to certain of their works for certain purposes from ASCAP and BMI, and our recent entry into a local marketing agreement to program KXMZ-FM have highlighted uncertainties for the royalty rates that we pay for the public performance of musical works. For example, we could be liable for both increased royalty rates going forward and a potential true-up of royalty payments in excess of any interim royalties paid for the period following December 31, 2010 with respect to ASCAP if ASCAP successfully appeals the rate court’s March 2014 ruling and/or for the period following December 31, 2012 with respect to BMI. We record a liability for public performance royalties based on our best estimate of the amount owed to each organization based on historical rates, third-party evidence and legal developments. For each quarterly period, we evaluate our estimates to assess the adequacy of recorded liabilities. If actual royalty rates differ from estimates, revisions to the estimated royalty liabilities may be required, which could materially affect our results of operations. Any royalty audit could result in disputes over whether we have paid the proper royalties.

Federal, state and industry regulations as well as self-regulation related to privacy and data security concerns pose the threat of lawsuits and other liability, require us to expend significant resources, and may hinder our ability and our

advertisers' ability to deliver relevant advertising.

We collect and utilize demographic and other information, including personally identifiable information, from and about our listeners as they interact with our service. For example, to register for a Pandora account, our listeners must provide the following information: age, gender, zip code and e-mail address. Listeners must also provide their credit card or debit card numbers and other billing information in connection with additional service offerings. We also may collect information from our listeners when they enter information on their profile page, post comments on other listeners' pages, use other community or social networking features that are part of our service, participate in polls or contests or sign up to receive e-mail newsletters. Further, we and third parties use tracking technologies, including "cookies" and related technologies, to help us manage and track our listeners' interactions with our service and deliver relevant advertising. Third parties may, without our knowledge or consent, illegally obtain, transmit or utilize our listeners' personally identifiable information, or data associated with particular users or devices.

Table of Contents

Various federal and state laws and regulations, as well as the laws of foreign jurisdictions in which we may choose to operate, govern the collection, use, retention, sharing and security of the data we receive from and about our listeners. Privacy groups and government bodies have increasingly scrutinized the ways in which companies link personal identities and data associated with particular users or devices with data collected through the internet, and we expect such scrutiny to continue to increase. Alleged violations of laws and regulations relating to privacy and data security, and any relevant claims, may expose us to potential liability and may require us to expend significant resources in responding to and defending such allegations and claims. Claims or allegations that we have violated laws and regulations relating to privacy and data security have resulted and could in the future result in negative publicity and a loss of confidence in us by our listeners and our advertisers, and may subject us to fines by credit card companies and loss of our ability to accept credit and debit card payments.

Existing privacy-related laws and regulations are evolving and subject to potentially differing interpretations, and various federal and state legislative and regulatory bodies, as well as foreign legislative and regulatory bodies, may expand current or enact new laws regarding privacy and data security-related matters. We may find it necessary or desirable to join self-regulatory bodies or other privacy-related organizations that require compliance with their rules pertaining to privacy and data security. We also may be bound by contractual obligations that limit our ability to collect, use, disclose and leverage listener data and to derive economic value from it. New laws, amendments to or re-interpretations of existing laws, rules of self-regulatory bodies, industry standards and contractual obligations, as well as changes in our listeners' expectations and demands regarding privacy and data security, may limit our ability to collect, use and disclose, and to leverage and derive economic value from listener data. We may also be required to expend significant resources to adapt to these changes and to develop new ways to deliver relevant advertising or otherwise provide value to our advertisers. In particular, government regulators have proposed "do not track" mechanisms, and requirements that users affirmatively "opt-in" to certain types of data collection that, if enacted into law or adopted by self-regulatory bodies or as part of industry standards, could significantly hinder our ability to collect and use data relating to listeners. Restrictions on our ability to collect, access and harness listener data, or to use or disclose listener data or any profiles that we develop using such data, would in turn limit our ability to stream personalized music content to our listeners and offer targeted advertising opportunities to our advertising customers, each of which are critical to the success of our business. Such restrictions would also hinder our ability to provide labels and artists with analytics, which is an important tool through which we believe we can foster closer relationships with labels and artists.

We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, self-regulatory bodies, industry standards and contractual obligations. Increased regulation of data utilization and distribution practices, including self-regulation and industry standards, could increase our cost of operation, limit our ability to grow our operations or otherwise adversely affect our business.

We are subject to a number of risks related to credit card and debit card payments we accept.

We accept payments exclusively through credit and debit card transactions. For credit and debit card payments, we pay interchange and other fees, which may increase over time. An increase in those fees would require us to either increase the prices we charge for our products, which could cause us to lose subscribers and subscription revenue, or absorb an increase in our operating expenses, either of which could harm our operating results.

If we or any of our processing vendors have problems with our billing software, or the billing software malfunctions, it could have an adverse effect on our subscriber satisfaction and could cause one or more of the major credit card companies to disallow our continued use of their payment products. In addition, if our billing software fails to work properly and, as a result, we do not automatically charge our subscribers' credit cards on a timely basis or at all, or there are issues with financial insolvency of our third-party vendors or other unanticipated problems or events, we could lose subscription revenue, which would harm our operating results.



We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, which could change or be reinterpreted to make it more difficult for us to comply. We are currently in compliance with the Payment Card Industry, or PCI, Data Security Standard, or PCI DSS, a security standard with which companies that collect, store or transmit certain data regarding credit and debit cards, credit and debit card holders and credit and debit card transactions are required to comply. However, there is no guarantee that we will maintain PCI DSS compliance. Our failure to comply fully with PCI DSS in the future could violate payment card association operating rules, federal and state laws and regulations and the terms of our contracts with payment processors and merchant banks. Such failure to comply fully also could subject us to fines, penalties, damages and civil liability, and could result in the loss of our ability to accept credit and debit card payments. Further, there is no guarantee that PCI DSS compliance will prevent illegal or improper use of our payment systems or the theft, loss, or misuse of data pertaining to credit and debit cards, credit and debit card holders and credit and debit card transactions.

Table of Contents

If we fail to adequately control fraudulent credit card transactions, we may face civil liability, diminished public perception of our security measures and significantly higher credit card-related costs, each of which could adversely affect our business, financial condition and results of operations. If we are unable to maintain our chargeback rate or refund rates at acceptable levels, credit card and debit card companies may increase our transaction fees or terminate their relationships with us. Any increases in our credit card and debit card fees could adversely affect our results of operations, particularly if we elect not to raise our rates for our service to offset the increase. The termination of our ability to process payments on any major credit or debit card would significantly impair our ability to operate our business.

Table of Contents

## Item 6. Exhibits

Exhibit No.	Exhibit Description	Incorporated by Reference			Filing Date	Filed By	Filed Herewith
		Form	File No.	Exhibit			
10.12I	Ninth Amendment to Lease between CIM/Oakland Center 21, LP and Pandora Media, Inc., dated August 15, 2013						X
10.12J	Tenth Amendment to Lease between CIM/Oakland Center 21, LP and Pandora Media, Inc., dated October 1, 2014						X
31.01	Certification of the Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act						X
31.02	Certification of the Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act						X
32.01	Certification of the Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act						X
101	Interactive Data Files Pursuant to Rule 405 of Regulation S-T: (i) Condensed Balance Sheets as of September 30, 2014 and December 31, 2013, (ii) Condensed Statements of Operations for the Three and Nine months ended September 30, 2014 and 2013, (iii) Condensed Statements of Comprehensive Loss for the Three and Nine months Ended September 30, 2014 and 2013, (iv) Condensed Statements of Cash Flows for the Nine months ended September 30, 2014 and 2013 and (v) Notes to Condensed Financial Statements						X

† Indicates management contract or compensatory plan.

43

---

Table of Contents

SIGNATURES

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

PANDORA MEDIA, INC.

Date: October 28, 2014

By: /s/ Michael S. Herring  
Michael S. Herring  
Executive Vice President and Chief  
Financial Officer  
(Duly Authorized Officer and Principal Financial  
and Accounting Officer)