Workday, Inc.
Form 10-Q
September 02, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended July 31, 2016
OR
¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 001-35680

Workday, Inc.
(Exact name of registrant as specified in its charter)

Delaware	20-2480422
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6230 Stoneridge Mall Road
Pleasanton, California 94588
(Address of principal executive offices)
Telephone Number (925) 951-9000
(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 (the "Exchange Act") 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 x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
As of August 31, 2016, there were approximately 200 million shares of the registrant's common stock outstanding.

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Workday, Inc.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
Workday, Inc.
Condensed Consolidated Balance Sheets
(in thousands)
(unaudited)

	July 31, 2016	January 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$405,529	$300,087
Marketable securities	1,662,381	1,669,372
Accounts receivable, net	248,658	293,407
Deferred costs	22,664	21,817
Prepaid expenses and other current assets	90,858	77,625
Total current assets	2,430,090	2,362,308
Property and equipment, net	255,118	214,158
Deferred costs, noncurrent	32,488	30,074
Goodwill and acquisition-related intangible assets, net	68,623	65,816
Other assets	43,485	57,738
Total assets	$2,829,804	$2,730,094
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$17,135	$19,605
Accrued expenses and other current liabilities	58,880	43,122
Accrued compensation	76,693	91,211
Unearned revenue	854,845	768,741
Total current liabilities	1,007,553	922,679
Convertible senior notes, net	520,765	507,476
Unearned revenue, noncurrent	124,269	130,988
Other liabilities	36,371	32,794
Total liabilities	1,688,958	1,593,937
Stockholders' equity:		
Common stock	198	193
Additional paid-in capital	2,444,172	2,247,454
Accumulated other comprehensive income (loss)	(2,588)	799
Accumulated deficit	(1,300,936)	(1,112,289)
Total stockholders' equity	1,140,846	1,136,157
Total liabilities and stockholders' equity	$2,829,804	$2,730,094

See Notes to Condensed Consolidated Financial Statements.

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Workday, Inc.
Condensed Consolidated Statements of Operations
(in thousands, except per share data)
(unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2016	2015	2016	2015
Revenues:				
Subscription services	$306,228	$223,742	$586,231	$424,735
Professional services	71,495	58,954	136,922	108,918
Total revenues	377,723	282,696	723,153	533,653
Costs and expenses[(1)]:				
Costs of subscription services	51,379	35,287	100,579	67,069
Costs of professional services	66,473	56,792	125,900	102,924
Product development	161,886	115,345	303,664	214,680
Sales and marketing	139,177	106,430	266,668	201,325
General and administrative	45,705	36,482	86,888	68,699
Total costs and expenses	464,620	350,336	883,699	654,697
Operating loss	(86,897)	(67,640)	(160,546)	(121,044)
Other expense, net	(21,193)	(3,779)	(27,031)	(11,015)
Loss before provision for (benefit from) income taxes	(108,090)	(71,419)	(187,577)	(132,059)
Provision for (benefit from) income taxes	(65)	(1,998)	1,070	(1,080)
Net loss	$(108,025)	$(69,421)	$(188,647)	$(130,979)
Net loss per share, basic and diluted	$(0.55)	$(0.37)	$(0.96)	$(0.70)
Weighted-average shares used to compute net loss per share, basic and diluted	197,223	189,360	195,887	188,382

(1) Costs and expenses include share-based compensation expenses as follows:

Costs of subscription services	$4,968	$3,173	$9,365	$5,221
Costs of professional services	5,969	5,144	11,262	8,598
Product development	38,314	28,632	71,282	49,443
Sales and marketing	20,844	13,222	39,846	21,587
General and administrative	18,127	14,593	34,702	27,189

See Notes to Condensed Consolidated Financial Statements.

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Workday, Inc.
Condensed Consolidated Statements of Comprehensive Loss
(in thousands)
(unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2016	2015	2016	2015
Net loss	$(108,025)	$(69,421)	$(188,647)	$(130,979)
Other comprehensive income (loss), net of tax:				
Net change in foreign currency translation adjustment	(248)	(227)	433	(200)
Net change in unrealized gains (losses) on available-for-sale investments	382	(192)	934	(337)
Net change in market value of effective foreign currency forward exchange contracts	6,310	1,018	(4,754)	997
Other comprehensive income (loss), net of tax	6,444	599	(3,387)	460
Comprehensive loss	$(101,581)	$(68,822)	$(192,034)	$(130,519)

See Notes to Condensed Consolidated Financial Statements.

Workday, Inc.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2016	2015	2016	2015
Cash flows from operating activities				
Net loss	$(108,025)	$(69,421)	$(188,647)	$(130,979)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation and amortization	26,662	19,888	52,786	38,457
Share-based compensation expenses	88,222	64,764	166,457	112,038
Amortization of deferred costs	6,140	7,735	12,013	12,360
Amortization of debt discount and issuance costs	6,690	6,336	13,289	12,586
Gain on sale of cost method investment	(65)	(3,220)	(65)	(3,220)
Impairment of cost method investment	15,000	—	15,000	—
Other	1,918	(2,119)	1,600	(1,382)
Changes in operating assets and liabilities, net of business combinations:				
Accounts receivable	(55,992)	(27,570)	45,055	32,147
Deferred costs	(10,486)	(7,082)	(15,274)	(10,583)
Prepaid expenses and other assets	(11,902)	(7,806)	(12,678)	(15,476)
Accounts payable	1,542	1,428	(180)	4,180
Accrued expense and other liabilities	(6,517)	2,590	(972)	6,915
Unearned revenue	53,071	29,665	79,340	50,344
Net cash provided by (used in) operating activities	6,258	15,188	167,724	107,387
Cash flows from investing activities				
Purchases of marketable securities	(557,180)	(476,470)	(1,191,136)	(862,045)
Maturities of marketable securities	539,315	429,186	1,164,903	710,593
Sales of available-for-sale securities	28,652	19,524	28,852	29,524
Business combinations, net of cash acquired	(3,670)	(7,961)	(3,670)	(7,961)
Owned real estate projects	(6,788)	—	(25,774)	—
Capital expenditures, excluding owned real estate projects	(26,539)	(25,469)	(61,017)	(53,789)
Purchases of cost method investments	(200)	(15,750)	(300)	(15,750)
Sale of cost method investment	315	3,538	315	3,538
Change in restricted cash	(4,000)	—	(4,000)	—
Other	(684)	—	(296)	—
Net cash provided by (used in) investing activities	(30,779)	(73,402)	(92,123)	(195,890)
Cash flows from financing activities				
Proceeds from issuance of common stock from employee equity plans	25,395	19,172	28,776	22,736
Principal payments on capital lease obligations	—	(1,016)	—	(2,464)
Other	195	362	571	779
Net cash provided by (used in) financing activities	25,590	18,518	29,347	21,051
Effect of exchange rate changes	(144)	(210)	494	(162)
Net increase (decrease) in cash and cash equivalents	925	(39,906)	105,442	(67,614)
Cash and cash equivalents at the beginning of period	404,604	270,484	300,087	298,192
Cash and cash equivalents at the end of period	$405,529	$230,578	$405,529	$230,578
Supplemental cash flow data				

Cash paid for interest	$3,241	$3,211	$3,245	$3,244
Cash paid for taxes	3,566	418	4,147	1,034
Non-cash investing and financing activities:				
Vesting of early exercise stock options	$460	$472	$920	$944
Property and equipment, accrued but not paid	11,426	18,642	11,426	18,642
Non-cash additions to property and equipment	394	323	915	2,183

See Notes to Condensed Consolidated Financial Statements.

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Workday, Inc.
Notes to Condensed Consolidated Financial Statements
Note 1. Overview and Basis of Presentation
Company and Background
Workday provides financial management, human capital management, and analytics applications designed for the world's largest companies, educational institutions, and government agencies. We offer innovative and adaptable technology focused on the consumer Internet experience and cloud delivery model. Our applications are designed for global enterprises to manage complex and dynamic operating environments. We provide our customers highly adaptable, accessible and reliable applications to manage critical business functions that enable them to optimize their financial and human capital resources. We were originally incorporated in March 2005 in Nevada and in June 2012, we reincorporated in Delaware. As used in this report the terms "Workday," "registrant," "we," "us," and "our" mean Workday, Inc. and its subsidiaries unless the context indicates otherwise.
Basis of Presentation
The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (GAAP) and applicable rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. The condensed consolidated financial statements include the results of Workday, Inc. and its wholly-owned subsidiaries. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. In the opinion of our management, the information contained herein reflects all adjustments necessary for a fair presentation of Workday’s results of operations, financial position and cash flows. All such adjustments are of a normal, recurring nature. The results of operations for the quarter ended July 31, 2016 shown in this report are not necessarily indicative of results to be expected for the full year ending January 31, 2017. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended January 31, 2016, filed on March 22, 2016. There have been no changes to our significant accounting policies described in the annual report that have had a material impact on our condensed consolidated financial statements and related notes.
Certain prior period amounts reported in our condensed consolidated financial statements and notes thereto have been reclassified to conform to the current period presentation. The reclassifications were immaterial and had no effect on previously reported operating results or financial position.
Use of Estimates
The preparation of condensed consolidated financial statements in conformity with GAAP requires us to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements, as well as the reported amounts of revenues and expenses during the reporting period. These estimates include, but are not limited to, the determination of the relative selling prices for our services, certain assumptions used in the valuation of equity awards and the fair value of assets acquired and liabilities assumed through business combinations. Actual results could differ from those estimates and such differences could be material to our condensed consolidated financial position and results of operations.
Segment Information
We operate in one operating segment, cloud applications. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker, who is our chief executive officer, in deciding how to allocate resources and assessing performance. Our chief operating decision maker allocates resources and assesses performance based upon discrete financial information at the consolidated level. Since we operate in one operating segment, which is equivalent to our reportable segment, all required financial segment information can be found in the condensed consolidated financial statements.
Recently Issued Accounting Pronouncements
On May 28, 2014, the FASB issued ASU 2014-09 regarding ASC Topic 606, Revenue from Contracts with Customers. The standard provides principles for recognizing revenue for the transfer of promised goods or services to

customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance is effective for our fiscal year beginning February 1, 2018. Early adoption is permitted. We are evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

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On January 5, 2016, the FASB issued ASU 2016-01 regarding ASC Topic 825-10, Recognition and Measurement of Financial Assets and Financial Liabilities. The standard requires entities to carry all investments in equity securities at fair value through net income. The guidance is effective for our fiscal year beginning February 1, 2018. Early adoption is permitted. We are evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

On February 25, 2016, the FASB issued ASU 2016-02, Leases (Topic 842). These amendments require the recognition of lease assets and lease liabilities on the balance sheet by lessees for those leases currently classified as operating leases under ASC 840 “Leases”. The guidance is effective for our fiscal year beginning February 1, 2019. Early adoption is permitted. We are evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

On March 30, 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which simplifies the accounting for share-based payment transactions, including accounting for income taxes, forfeitures, and classification in the statement of cash flows. The guidance is effective for our fiscal year beginning February 1, 2017. Early adoption is permitted. We are evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

Note 2. Marketable Securities

At July 31, 2016, marketable securities consisted of the following (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. agency obligations	$1,024,936	$ 785	$ (38)	$1,025,683
U.S. treasury securities	219,052	209	(1)	219,260
U.S. corporate securities	141,416	41	(29)	141,428
Commercial paper	296,362	—	—	296,362
Money market funds	222,069	—	—	222,069
	$1,903,835	$ 1,035	$ (68)	$1,904,802
Included in cash and cash equivalents	$242,421	$ —	$ —	$242,421
Included in marketable securities	$1,661,414	$ 1,035	$ (68)	$1,662,381

At January 31, 2016, marketable securities consisted of the following (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. agency obligations	$1,018,513	$ 127	$ (405)	$1,018,235
U.S. treasury securities	338,736	70	(141)	338,665
U.S. corporate securities	135,065	36	(18)	135,083
Commercial paper	177,390	—	(1)	177,389
Money market funds	148,961	—	—	148,961
	$1,818,665	$ 233	$ (565)	$1,818,333
Included in cash and cash equivalents	$148,961	$ —	$ —	$148,961
Included in marketable securities	$1,669,704	$ 233	$ (565)	$1,669,372

We do not believe the unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence, which includes our intent to hold these investments to maturity as of July 31, 2016. No marketable securities held as of July 31, 2016 have been in a continuous unrealized loss position for more than 12 months. We classify our marketable securities as available-for-sale at the time of purchase and reevaluate such classification as of each balance sheet date. We may sell these securities at any time for use in current operations or for other purposes, such as consideration for acquisitions, even if they have not yet reached maturity. As a result, we classify our investments, including securities with maturities beyond 12 months as current assets in the accompanying condensed consolidated balance sheets. Marketable securities on the condensed consolidated balance sheets consist of securities with original maturities at the time of purchase greater than three months and the remainder of the securities is reflected in cash and cash equivalents. During the three and six months ended July 31, 2016, we sold $29 million of our marketable securities and the realized gains from the sales are immaterial.

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Note 3. Deferred Costs

Deferred costs consisted of the following (in thousands):

	July 31, 2016	January 31, 2016
Current:		
Deferred professional service costs	$801	$ 895
Deferred sales commissions	21,863	20,922
Total	$22,664	$ 21,817
Noncurrent:		
Deferred professional service costs	$—	$ 360
Deferred sales commissions	32,488	29,714
Total	$32,488	$ 30,074

Note 4. Property and Equipment, Net

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

	July 31, 2016	January 31, 2016
Land	$3,504	$—
Buildings	30,893	4,280
Computers, equipment and software	262,985	230,705
Computers, equipment and software acquired under capital leases	19,979	24,400
Furniture and fixtures	22,856	18,894
Leasehold improvements	102,351	86,282
	442,568	364,561
Less accumulated depreciation and amortization	(187,450)	(150,403)
Property and equipment, net	$255,118	$214,158

During the first quarter of fiscal 2017, we purchased real property located in Pleasanton, California, which includes land together with an office building of approximately 58,000 square feet, at a cost of $15 million, and we started construction of our new customer briefing and development center (development center) in Pleasanton, California, consisting of approximately 410,000 square feet of office space. We have capitalized the construction costs associated with the development center as Buildings in the table above.

Depreciation expense totaled $22 million and $17 million for the three months ended July 31, 2016 and 2015, respectively, and $44 million and $33 million for the six months ended July 31, 2016 and 2015, respectively.

Note 5. Goodwill and Acquisition-related Intangible Assets, Net

Goodwill and acquisition-related intangible assets, net consisted of the following (in thousands):

	July 31, 2016	January 31, 2016
Acquired developed technology	$23,500	$ 20,461
Customer relationship assets	338	338
	23,838	20,799
Less accumulated amortization	(8,034)	(5,308)
Acquisition-related intangible assets, net	15,804	15,491
Goodwill	52,819	50,325
Goodwill and acquisition-related intangible assets, net	$68,623	$ 65,816

In the second quarter of fiscal 2017, we acquired a cloud-based educational video platform company for $5 million, resulting in increases of $3 million and $2 million in acquired developed technology and goodwill, respectively.

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Developed technology from acquisitions is typically amortized over a useful life of three to four years. Goodwill amounts are not amortized, but rather tested for impairment at least annually during the last three months of the fiscal year. As of July 31, 2016, our future estimated amortization expense related to the acquired developed technology is as follows (in thousands):

Fiscal Period:	
2017	$3,043
2018	4,953
2019	4,570
2020	2,921
2021	317
Total	$15,804

Note 6. Other Assets

Other assets consisted of the following (in thousands):

	July 31, 2016	January 31, 2016
Cost method investments	$13,592	$ 28,742
Acquired land leasehold interest, net	9,728	9,781
Technology patents, net	2,559	3,020
Other	17,606	16,195
Total	$43,485	$ 57,738

Amortization expense related to the acquired land leasehold interest and technology patents was less than $0.3 million for each of the three month periods ended July 31, 2016 and 2015, and $0.5 million for each of the six month periods ended July 31, 2016 and 2015.

During the three months ended July 31, 2016, we recorded a $15 million other-than-temporary impairment for one of our cost method investments. The impairment expense is recorded in Other expense, net in the condensed consolidated statements of operations. We test our cost method investments for impairment at least annually, and more frequently upon the occurrence of certain events.

Note 7. Fair Value Measurements

We measure our financial assets and liabilities at fair value at each reporting period using a fair value hierarchy that requires that we maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument’s classification within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Three levels of inputs may be used to measure fair value:

Level 1 — Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 — Unobservable inputs that are supported by little or no market activity.

Financial Assets

We value our marketable securities using quoted prices for identical instruments in active markets when available. If we are unable to value our marketable securities using quoted prices for identical instruments in active markets, we value our investments using independent reports that utilize quoted market prices for comparable instruments. We validate, on a sample basis, the derived prices provided by the independent pricing vendors by comparing their assessment of the fair values of our investments against the fair values of the portfolio balances of another third-party professional’s pricing service. To date, all of our marketable securities can be valued using one of these two methodologies.

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Based on our valuation of our marketable securities, we concluded that they are classified in either Level 1 or Level 2 and we have no financial assets or liabilities measured using Level 3 inputs. The following tables present information about our assets that are measured at fair value on a recurring basis using the above input categories (in thousands):

	Fair Value Measurements as of July 31, 2016		
Description	Level 1	Level 2	Total
U.S. agency obligations	$—	$1,025,683	$1,025,683
U.S. treasury securities	219,260	—	219,260
U.S. corporate securities	—	141,428	141,428
Commercial paper	—	296,362	296,362
Money market funds	222,069	—	222,069
	$441,329	$1,463,473	$1,904,802
Included in cash and cash equivalents			$242,421
Included in marketable securities			$1,662,381

	Fair Value Measurements as of January 31, 2016		
Description	Level 1	Level 2	Total
U.S. agency obligations	$—	$1,018,235	$1,018,235
U.S. treasury securities	338,665	—	338,665
U.S. corporate securities	—	135,083	135,083
Commercial paper	—	177,389	177,389
Money market funds	148,961	—	148,961
	$487,626	$1,330,707	$1,818,333
Included in cash and cash equivalents			$148,961
Included in marketable securities			$1,669,372

Financial Liabilities

The carrying amounts and estimated fair values of financial instruments not recorded at fair value are as follows (in thousands):

	July 31, 2016		January 31, 2016	
	Net Carrying Amount Before Unamortized Debt Issuance Costs	Estimated Fair Value	Net Carrying Amount Before Unamortized Debt Issuance Costs	Estimated Fair Value
0.75% Convertible senior notes	$317,705	$410,732	$310,013	$362,250
1.50% Convertible senior notes	208,479	309,330	203,923	264,063

The difference between the principal amount of the notes, $350 million for the 0.75% convertible senior notes and $250 million for the 1.50% convertible senior notes, and the net carrying amount before unamortized debt issuance costs represents the unamortized debt discount (see Note 8). The estimated fair value of the convertible senior notes, which we have classified as Level 2 financial instruments, was determined based on the quoted bid price of the convertible senior notes in an over-the-counter market on the last trading day of each reporting period.

Based on the closing price of our common stock of $83.34 on July 29, 2016, the if-converted value of the 0.75% convertible senior notes and the if-converted value of the 1.50% convertible senior notes were greater than their respective principal amounts.

Derivative Financial Instruments

We conduct business on a global basis in multiple foreign currencies, subjecting Workday to foreign currency risk. To mitigate this risk, we utilize hedging contracts as described below. We do not enter into any derivatives for trading or speculative purposes.

Our foreign currency contracts are classified within Level 2 because the valuation inputs are based on quoted prices and market observable data of similar instruments in active markets, such as currency spot and forward rates.

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Cash Flow Hedges

We are exposed to foreign currency fluctuations resulting from customer contracts denominated in foreign currencies. We have a hedging program in which we enter into foreign currency forward contracts related to certain customer contracts. We designate these forward contracts as cash flow hedging instruments as the accounting criteria for such designation have been met. The effective portion of the gains or losses resulting from changes in the fair value of these hedges is recorded in Accumulated other comprehensive income (loss) (OCI) on the condensed consolidated balance sheets and will be subsequently reclassified to the related revenue line item in the condensed consolidated statements of operations in the same period that the underlying revenues are earned. The changes in value of these contracts resulting from changes in forward points on our forward contracts are excluded from the assessment of hedge effectiveness and are recorded as incurred in Other expense, net in the condensed consolidated statements of operations.

As of July 31, 2016 and January 31, 2016, we had 122 and 65 outstanding foreign currency forward contracts designated as cash flow hedges with total notional values of $205 million and $133 million, respectively. All contracts have maturities not greater than 15 months. The notional value represents the amount that will be bought or sold upon maturity of the forward contract.

During the three and six months ended July 31, 2016, all cash flow hedges were considered effective.

Foreign Currency Forward Contracts not Designated as Hedges

We also enter into foreign currency forward contracts to hedge a portion of our net outstanding monetary assets and liabilities. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are recorded in Other expense, net in our condensed consolidated statements of operations. These forward contracts are intended to offset the foreign currency gains or losses associated with the underlying monetary assets and liabilities.

As of July 31, 2016 and January 31, 2016, we had 34 and 21 outstanding forward contracts with total notional values of $42 million and $22 million, respectively. All contracts have maturities not greater than 15 months.

The fair values of outstanding derivative instruments were as follows (in thousands):

	Condensed Consolidated Balance Sheets Location	July 31, 2016	January 31, 2016
Derivative Assets:			
Foreign currency forward contracts designated as cash flow hedges	Prepaid expenses and other current assets	$ 2,845	$ 4,695
Foreign currency forward contracts not designated as hedges	Prepaid expenses and other current assets	577	605
Derivative Liabilities:			
Foreign currency forward contracts designated as cash flow hedges	Accrued expenses and other current liabilities	$ 3,897	$ 98
Foreign currency forward contracts not designated as hedges	Accrued expenses and other current liabilities	426	56

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Gains (losses) associated with foreign currency forward contracts designated as cash flow hedges were as follows (in thousands):

	Condensed Consolidated Statement of Operations and Statement of Comprehensive Loss Locations	Three Months Ended July 31, 2016	2015	Six Months Ended July 31, 2016	2015
Gains (losses) recognized in OCI (effective portion)(1)	Net change in market value of effective foreign currency forward exchange contracts	$6,453	$1,018	$(4,501)	$997
Gains (losses) reclassified from OCI into income (effective portion)	Revenues	143	—	253	—
Gains (losses) recognized in income (amount excluded from effectiveness testing and ineffective portion)	Other expense, net	165	20	316	42

(1) Of the total effective portion of foreign currency forward contracts designated as cash flow hedges as of July 31, 2016, net gains of $0.2 million are expected to be reclassified out of Accumulated other comprehensive income (loss) within the next 12 months.

Gains (losses) associated with foreign currency forward contracts not designated as cash flow hedges were as follows (in thousands):

Derivative Type	Condensed Consolidated Statement of Operations Location	Three Months Ended July 31, 2016	2015	Six Months Ended July 31, 2016	2015
Foreign currency forward contracts not designated as hedges	Other expense, net	$1,098	$ 17	$(541)	$ 78

We are subject to master netting agreements with certain counterparties of the foreign exchange contracts, under which we are permitted to net settle transactions of the same currency with a single net amount payable by one party to the other. It is our policy to present the derivatives gross in the condensed consolidated balance sheets. Our foreign currency forward contracts are not subject to any credit contingent features or collateral requirements and we do not believe we are subject to significant counterparty concentration risk given the short-term nature, volume, and size of the derivative contracts outstanding.

As of July 31, 2016, information related to these offsetting arrangements was as follows (in thousands):

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts of Assets Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Cash Collateral Received	Net Assets Exposed
Derivative Assets						
Counterparty A	$ 199	$ —	$ 199	$ (199)	$ —	$ —
Counterparty B	3,223	—	3,223	(3,223)	—	—
Total	$ 3,422	$ —	$ 3,422	$ (3,422)	$ —	$ —

Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed	Net Amounts of Liabilities Presented in the	Gross Amounts Not Offset in the Condensed Consolidated Balance	Net Liabilities Exposed

		Consolidated Balance Sheets	Condensed Consolidated Balance Sheets	Sheets Financial Instruments	Cash Collateral Pledged	
Derivative Liabilities						
Counterparty A	$ 1,947	$ —	$ 1,947	$ (199)	$ —	$ 1,748
Counterparty B	2,376	—	2,376	(3,223)	—	(847)
Total	$ 4,323	$ —	$ 4,323	$ (3,422)	$ —	$ 901

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Note 8. Convertible Senior Notes, Net

Convertible Senior Notes

In June 2013, we issued 0.75% convertible senior notes due July 15, 2018 (2018 Notes) with a principal amount of $350 million. The 2018 Notes are unsecured, unsubordinated obligations, and interest is payable in cash in arrears at a fixed rate of 0.75% on January 15 and July 15 of each year. The 2018 Notes mature on July 15, 2018 unless repurchased or converted in accordance with their terms prior to such date. We cannot redeem the 2018 Notes prior to maturity.

Concurrently, we issued 1.50% convertible senior notes due July 15, 2020 (2020 Notes) with a principal amount of $250 million (together with the 2018 Notes, referred to as the Notes). The 2020 Notes are unsecured, unsubordinated obligations, and interest is payable in cash in arrears at a fixed rate of 1.50% on January 15 and July 15 of each year. The 2020 Notes mature on July 15, 2020 unless repurchased or converted in accordance with their terms prior to such date. We cannot redeem the 2020 Notes prior to maturity.

The terms of the Notes are governed by Indentures by and between us and Wells Fargo Bank, National Association, as Trustee (the Indentures). Upon conversion, holders of the Notes will receive cash, shares of Class A common stock or a combination of cash and shares of Class A common stock, at our election.

For the 2018 Notes, the initial conversion rate is 12.0075 shares of Class A common stock per $1,000 principal amount, which is equal to an initial conversion price of approximately $83.28 per share of Class A common stock, subject to adjustment. Prior to the close of business on March 14, 2018, the conversion is subject to the satisfaction of certain conditions as described below. For the 2020 Notes, the initial conversion rate is 12.2340 shares of Class A common stock per $1,000 principal amount, which is equal to an initial conversion price of approximately $81.74 per share of Class A common stock, subject to adjustment. Prior to the close of business on March 13, 2020, the conversion is subject to the satisfaction of certain conditions, as described below.

Holders of the Notes who convert their Notes in connection with certain corporate events that constitute a make-whole fundamental change (as defined in the Indentures) are, under certain circumstances, entitled to an increase in the conversion rate. Additionally, in the event of a corporate event that constitutes a fundamental change (as defined in the Indentures), holders of the Notes may require us to repurchase all or a portion of their Notes at a price equal to 100% of the principal amount of the Notes, plus any accrued and unpaid interest.

Holders of the Notes may convert all or a portion of their Notes prior to the close of business on March 14, 2018 for the 2018 Notes and March 13, 2020 for the 2020 Notes, in multiples of $1,000 principal amount, only under the following circumstances:

- if the last reported sale price of Class A common stock for at least twenty trading days during a period of thirty consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price of the respective Notes on each applicable trading day;
- during the five business day period after any five consecutive trading day period in which the trading price per $1,000 principal amount of the respective Notes for each day of that five day consecutive trading day period was less than 98% of the product of the last reported sale price of Class A common stock and the conversion rate of the respective Notes on such trading day; or
- upon the occurrence of specified corporate events, as noted in the Indentures.

In accounting for the issuance of the Notes, we separated each of the Notes into liability and equity components. The carrying amounts of the liability components were calculated by measuring the fair value of similar liabilities that do not have associated convertible features. The carrying amount of the equity components representing the conversion option were determined by deducting the fair value of the liability components from the par value of the respective Notes. These differences represent debt discounts that are amortized to interest expense over the respective terms of the Notes. The equity components are not remeasured as long as they continue to meet the conditions for equity classification.

We allocated the total issuance costs incurred to the Notes on a prorated basis using the aggregate principal balances. In accounting for the issuance costs related to the Notes, we allocated the total amount of issuance costs incurred to liability and equity components. Issuance costs attributable to the liability components are being amortized to interest expense over the respective terms of the Notes, and the issuance costs attributable to the equity components were netted against the respective equity components in Additional paid-in capital. For the 2018 Notes, we recorded liability issuance costs of $7 million and equity issuance costs of $2 million. Amortization expense for the liability issuance costs was $0.4 million and $0.7 million for each of the three and six month periods ended July 31, 2016 and 2015. For the 2020 Notes, we recorded liability issuance costs of $5 million and equity issuance costs of $2 million. Amortization expense for the liability issuance costs was $0.2 million and $0.3 million for each of the three and six month periods ended July 31, 2016 and 2015.

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The Notes, net consisted of the following (in thousands):

	July 31, 2016		January 31, 2016	
	2018 Notes	2020 Notes	2018 Notes	2020 Notes
Principal amounts:				
Principal	$350,000	$250,000	$350,000	$250,000
Unamortized debt discount[(1)]	(32,295)	(41,521)	(39,987)	(46,077)
Net carrying amount before unamortized debt issuance costs	317,705	208,479	310,013	203,923
Unamortized debt issuance costs[(1)]	(2,754)	(2,665)	(3,458)	(3,002)
Net carrying amount	$314,951	$205,814	$306,555	$200,921
Carrying amount of the equity component[(2)]	$74,892	$66,007	$74,892	$66,007

(1) Included in the condensed consolidated balance sheets within Convertible senior notes, net and amortized over the remaining lives of the Notes on the straight-line basis as it approximates the effective interest rate method.

(2) Included in the condensed consolidated balance sheets within Additional paid-in capital, net of $2 million and $2 million for the 2018 Notes and 2020 Notes, respectively, in equity issuance costs.

As of July 31, 2016, the remaining life of the 2018 Notes and 2020 Notes is approximately 23 months and 47 months, respectively.

The effective interest rates of the liability components of the 2018 Notes and 2020 Notes are 5.75% and 6.25%, respectively. These interest rates were based on the interest rates of similar liabilities at the time of issuance that did not have associated convertible features. The following table sets forth total interest expense recognized related to the Notes (in thousands):

	Three Months Ended July 31,				Six Months Ended July 31,			
	2016		2015		2016		2015	
	2018 Notes	2020 Notes	2018 Notes	2020 Notes	2018 Notes	2020 Notes	2018 Notes	2020 Notes
Contractual interest expense	$657	$937	$657	$937	$1,313	$1,875	$1,313	$1,875
Interest cost related to amortization of debt issuance costs	352	170	352	169	704	337	704	337
Interest cost related to amortization of the debt discount	3,873	2,295	3,658	2,157	7,692	4,556	7,264	4,281

Notes Hedges

In connection with the issuance of the Notes, we entered into convertible note hedge transactions with respect to our Class A common stock (Purchased Options). The Purchased Options cover, subject to anti-dilution adjustments substantially identical to those in the Notes, approximately 7.3 million shares of our Class A common stock and are exercisable upon conversion of the Notes. The Purchased Options have initial exercise prices that correspond to the initial conversion prices of the 2018 Notes and 2020 Notes, respectively, subject to anti-dilution adjustments substantially similar to those in the Notes. The Purchased Options will expire in 2018 for the 2018 Notes and in 2020 for the 2020 Notes, if not earlier exercised. The Purchased Options are intended to offset potential economic dilution to our Class A common stock upon any conversion of the Notes. The Purchased Options are separate transactions and are not part of the terms of the Notes.

We paid an aggregate amount of $144 million for the Purchased Options, which is included in Additional paid-in capital in the condensed consolidated balance sheets.

Warrants

In connection with the issuance of the Notes, we also entered into warrant transactions to sell warrants (the Warrants) to acquire, subject to anti-dilution adjustments, up to approximately 4.2 million shares in July 2018 and 3.1 million shares in July 2020 of our Class A common stock at an exercise price of $107.96 per share. If the Warrants are not exercised on their exercise dates, they will expire. If the market value per share of our Class A common stock exceeds the applicable exercise price of the Warrants, the Warrants will have a dilutive effect on our earnings per share assuming that we are profitable. The Warrants are separate transactions, and are not part of the terms of the Notes or the Purchased Options.

We received aggregate proceeds of $93 million from the sale of the Warrants, which is recorded in Additional paid-in capital in the condensed consolidated balance sheets.

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Note 9. Commitments and Contingencies

Facility-related Commitments

We have entered into non-cancelable operating lease agreements for certain of our offices and data centers in the U.S. and other countries with various expiration dates. Certain of our office leases are with an affiliate of our Chairman, David Duffield, who is also a significant stockholder (see Note 14). The operating lease agreements generally provide for rental payments on a graduated basis and for options to renew, which could increase future minimum lease payments if exercised. This includes payments for office and data center square footage, as well as data center power capacity for certain data centers. We generally recognize these expenses on a straight-line basis over the period in which we benefit from the lease and we have accrued for rent expense incurred but not paid. Total rent expense was $17 million and $10 million for the three months ended July 31, 2016 and 2015, respectively, and $34 million and $20 million for the six months ended July 31, 2016 and 2015, respectively.

In January 2014, we entered into a 95-year lease for a 6.9-acre parcel of vacant land in Pleasanton, California, under which we paid $2 million for base rent from commencement through December 31, 2020. Annual rent payments of $0.2 million plus increases based on increases in the consumer price index begin on January 1, 2021 and continue through the end of the lease. We started construction of our new development center, consisting of approximately 410,000 square feet of office space, on this property in the first quarter of fiscal 2017.

Legal Matters

We are a party to various legal proceedings and claims which arise in the ordinary course of business. In our opinion, as of July 31, 2016, there was not at least a reasonable possibility that we had incurred a material loss, or a material loss in excess of a recorded accrual, with respect to such loss contingencies.

Note 10. Common Stock and Stockholders' Equity

Common Stock

As of July 31, 2016, there were 122 million shares of Class A common stock and 77 million shares of Class B common stock outstanding. The rights of the holders of Class A common stock and Class B common stock are identical, except with respect to voting and conversion. Each share of Class A common stock is entitled to one vote per share and each share of Class B common stock is entitled to ten votes per share. Each share of Class B common stock can be converted into a share of Class A common stock at any time at the option of the holder.

Employee Equity Plans

Our 2012 Equity Incentive Plan (EIP) serves as the successor to our 2005 Stock Plan (together with the EIP, the Stock Plans). Pursuant to the terms of the EIP, the share reserve increased by 10 million shares on March 31, 2016, and as of July 31, 2016, we had approximately 59 million shares of Class A common stock available for future grants.

We also have a 2012 Employee Stock Purchase Plan (ESPP). Under the ESPP, eligible employees are granted options to purchase shares at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. Options to purchase shares are granted twice yearly on or about June 16 and December 16 and exercisable on or about the succeeding December 15 and June 15, respectively, of each year. Pursuant to the terms of the ESPP, the share reserve increased by 2 million shares on March 31, 2016. As of July 31, 2016, 6 million shares of Class A common stock were available for issuance under the ESPP.

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Stock Options

The Stock Plans provide for the issuance of incentive and nonstatutory options to employees and non-employees. Prior to our initial public offering, we also issued nonstatutory options outside of the Stock Plans. Options issued under the Stock Plans generally are exercisable for periods not to exceed 10 years and generally vest over five years.

A summary of information related to stock option activity during the six months ended July 31, 2016 is as follows:

	Outstanding Stock Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in millions)
Balance as of January 31, 2016	12,862,976	$ 4.21	$ 756
Stock option grants	—	—	
Stock options exercised	(2,056,059)	$ 3.64	
Stock options canceled	(64,539)	$ 9.73	
Balance as of July 31, 2016	10,742,378	$ 4.28	$ 849
Vested and expected to vest as of July 31, 2016	10,710,095	$ 4.27	$ 847
Exercisable as of July 31, 2016	10,095,731	$ 3.93	$ 736

As of July 31, 2016, there was a total of $9 million in unrecognized compensation cost related to unvested stock options which is expected to be recognized over a weighted-average period of approximately 1 year.

Common Stock Subject to Repurchase

The Stock Plans allow for the early exercise of stock options for certain individuals as determined by the board of directors. We have the right to purchase at the original exercise price any unvested (but issued) common shares during the repurchase period following termination of services of an employee. The consideration received for an exercise of an option is considered to be a deposit of the exercise price and the related dollar amount is recorded as a liability. The shares and liabilities are reclassified into equity as the awards vest. We had $2 million and $3 million recorded in liabilities related to early exercises of stock options as of July 31, 2016 and January 31, 2016, respectively.

Restricted Stock Units

The Stock Plans provide for the issuance of restricted stock units ("RSUs") to employees. RSUs generally vest over four years. A summary of information related to RSU activity during the six months ended July 31, 2016 is as follows:

	Number of Shares	Weighted-Average Grant Date Fair Value
Balance as of January 31, 2016	9,211,082	$ 81.48
RSUs granted	5,563,165	$ 74.34
RSUs vested	(2,201,706)	$ 82.04
RSUs forfeited	(327,344)	$ 81.74
Balance as of July 31, 2016	12,245,197	$ 78.13

As of July 31, 2016, there was a total of $850 million in unrecognized compensation cost related to unvested RSUs, which is expected to be recognized over a weighted-average period of approximately 2.9 years.

Restricted Stock Awards

The Stock Plans provide for the issuance of restricted stock awards to employees. Restricted stock awards generally vest over five years. Under the EIP, 0.4 million restricted awards of Class B common stock are outstanding with weighted average grant date fair value of $12.97, all of which are subject to forfeiture as of July 31, 2016. During the six months ended July 31, 2016, 0.1 million shares of restricted stock awards vested with weighted average grant date fair value of $12.67.

As of July 31, 2016, there was a total of $4 million in unrecognized compensation cost related to unvested restricted stock awards, which is expected to be recognized over a weighted-average period of approximately 1.4 years.

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Performance-based Restricted Stock Units

During the first quarter of fiscal 2017, 0.1 million shares of performance-based restricted stock units (PRSUs) were granted to the Chairman of the Board, Chief Executive Officer and certain of Workday's executive management. These PRSU awards include performance conditions and service conditions, and will generally vest over four years if the performance conditions are achieved for the fiscal year ended January 31, 2017. As of July 31, 2016, vesting of the PRSUs was not considered probable. As a result, no additional compensation expense was recognized and all previous expense related to the PRSUs was reversed.

Additionally, during the second quarter of fiscal 2017, 0.3 million shares of PRSUs were granted to all employees other than executive management and include performance conditions related to company-wide goals and service conditions. We expect to grant additional shares related to this program for employees hired in fiscal 2017. These PRSU awards will vest if the performance conditions are achieved for the fiscal year ended January 31, 2017 and if the individual employee continues to provide service through the vesting date of March 15, 2017.

Note 11. Other Expense, Net

Other expense, net consisted of the following (in thousands):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2016	2015	2016	2015
Interest income	$2,897	$998	$5,111	$1,953
Interest expense [(1)]	(7,914)	(7,952)	(15,945)	(15,837)
Gain from sale of cost method investment	65	3,220	65	3,220
Impairment of cost method investment	(15,000)	—	(15,000)	—
Other income (expense)	(1,241)	(45)	(1,262)	(351)
Other expense, net	$(21,193)	$(3,779)	$(27,031)	$(11,015)

(1) Interest expense includes the contractual interest expense related to the 2018 Notes and 2020 Notes and non-cash interest related to amortization of the debt discount and debt issuance costs (see Note 8).

Note 12. Income Taxes

We compute the year-to-date income tax provision by applying the estimated annual effective tax rate to the year-to-date pre-tax income or loss and adjust for discrete tax items in the period. We reported a tax provision of $1 million for the six months ended July 31, 2016 and a tax benefit of $1 million for the six months ended July 31, 2015. The income tax provision of $1 million for the six months ended July 31, 2016 was primarily attributable to $2 million state taxes and income tax expense in profitable foreign jurisdictions and $1 million benefit from the release of valuation allowances which resulted from certain acquired intangible assets from a business acquisition during the current quarter.

The tax benefits of $1 million for the six months ended July 31, 2015 consisted of $2 million provision primarily resulting from income tax expense in profitable foreign jurisdictions and U.S. income tax expense on estimated taxable income before considering the realization of excess benefits from stock based compensation; and $3 million tax benefit from the release of an acquired uncertain tax position including interest and penalties due to the lapse of statute of limitations.

We are subject to income tax audits in the U.S. and foreign jurisdictions. We record liabilities related to uncertain tax positions and believe that we have provided adequate reserves for income tax uncertainties in all open tax years. Due to our history of tax losses, all years remain open to tax audit.

We periodically evaluate the realizability of our net deferred tax assets based on all available evidence, both positive and negative. The realization of net deferred tax assets is dependent on our ability to generate sufficient future taxable income during periods prior to the expiration of tax attributes to fully utilize these assets. As of July 31, 2016, we intend to continue maintaining a full valuation allowance on our deferred tax assets except for certain foreign jurisdictions.

Note 13. Net Loss Per Share

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

Diluted net loss per share is computed by giving effect to all potential shares of common stock, including our outstanding stock options, outstanding warrants, common stock related to unvested early exercised stock options, common stock related to unvested restricted stock awards and convertible senior notes to the extent dilutive, and common stock issuable pursuant to the ESPP. Basic and diluted net loss per share was the same for each period presented, as the inclusion of all potential common shares outstanding would have been anti-dilutive.

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The net loss per share attributable to common stockholders is allocated based on the contractual participation rights of the Class A common shares and Class B common shares as if the loss for the year had been distributed. As the liquidation and dividend rights are identical, the net loss attributable to common stockholders is allocated on a proportionate basis.

We consider shares issued upon the early exercise of options subject to repurchase and unvested restricted stock awards to be participating securities because holders of such shares have non-forfeitable dividend rights in the event of our declaration of a dividend for common shares. In future periods, to the extent we are profitable, we will subtract earnings allocated to these participating securities from net income to determine net income attributable to common stockholders.

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

	Three Months Ended July 31,				Six Months Ended July 31,			
	2016		2015		2016		2015	
	Class A	Class B	Class A	Class B	Class A	Class B	Class A	Class B
Net loss per share, basic and diluted:								
Numerator:								
Allocation of distributed net loss	$(66,079)	$(41,946)	$(40,382)	$(29,039)	$(114,733)	$(73,914)	$(75,376)	$(55,603)
Denominator:								
Weighted-average common shares outstanding	120,642	76,581	110,150	79,210	119,136	76,751	108,411	79,971
Basic and diluted net loss per share	$(0.55)	$(0.55)	$(0.37)	$(0.37)	$(0.96)	$(0.96)	$(0.70)	$(0.70)

The anti-dilutive securities excluded from the weighted-average shares used to calculate the diluted net loss per common share were as follows (in thousands):

	As of July 31,	
	2016	2015
Outstanding common stock options	10,743	14,622
Shares subject to repurchase	363	892
Unvested restricted stock awards, units, and PRSUs	12,993	10,227
Shares related to the convertible senior notes	7,261	7,261
Shares subject to warrants related to the issuance of convertible senior notes	7,261	7,261
Shares issuable pursuant to the ESPP	359	264
	38,980	40,527

Note 14. Related-Party Transactions

We currently lease certain office space from an affiliate of our Chairman, Mr. Duffield, adjacent to our corporate headquarters in Pleasanton, California under various lease agreements. The average term of the agreements is 10 years and the total rent due under the agreements is $8 million for the fiscal year ended January 31, 2017, and $90 million in total. Rent expense under these agreements was $2 million for each of the three month periods ended July 31, 2016 and 2015, respectively, and $4 million and $3 million for the six months ended July 31, 2016 and 2015, respectively.

Note 15. Geographic Information

Revenues

Revenue by geography is generally based on the address of the customer as defined in our master subscription agreement. The following tables set forth revenue by geographic area (in thousands):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2016	2015	2016	2015
United States	$312,148	$237,058	$597,167	$447,339

International	65,575	45,638	125,986	86,314
Total	$377,723	$282,696	$723,153	$533,653

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No single country other than the United States had revenues greater than 10% of total revenues for the three and six months ended July 31, 2016 and 2015. No customer individually accounted for more than 10% of our accounts receivable, net as of July 31, 2016 or January 31, 2016.

Long-Lived Assets

We attribute our long-lived assets, which primarily consist of property and equipment, to a country based on the physical location of the assets. The following table sets forth property and equipment by geographic area (in thousands):

	July 31, 2016	January 31, 2016
United States	$210,564	$ 176,398
Ireland	36,842	29,451
International	7,712	8,309
Total	$255,118	$ 214,158

Note 16. 401(k) Plan

We have a qualified defined contribution plan under Section 401(k) of the Internal Revenue Code covering eligible employees. In the second quarter of fiscal 2017, we began to match a certain portion of employee contributions up to a fixed maximum per employee. We incurred expense for contributions under the defined contribution plan of less than $1 million for each of the three and six month periods ended July 31, 2016.

Note 17. Subsequent Events

On August 5, 2016, we purchased real property located in Pleasanton, California. The real property includes land together with an office building of approximately 209,000 square feet and parking structures. The purchase price was $47 million and was paid for with available cash.

On August 5, 2016, we acquired a leading provider of operational analytics and data discovery tools for approximately $156 million in cash. We are still in the process of preparing the initial accounting of the transaction and will establish a preliminary purchase price allocation with respect to this transaction by the end of the third quarter of fiscal 2017.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements. All statements contained in this report other than statements of historical fact, including statements regarding our future results of operations and financial position, our business strategy and plans, and our objectives for future operations, are forward-looking statements. The words “believe,” “may,” “will,” “estimate,” “continue,” “anticipate,” “intend,” “expect,” “seek,” and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and trends that we believe may affect our financial condition, results of operations, business strategy, short-term and long-term business operations and objectives, and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in the “Risk Factors” section. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the future events and trends discussed in this report may not occur and actual results could differ materially and adversely from those anticipated or implied by the forward-looking statements.

You should not rely upon forward-looking statements as predictions of future events. The events and circumstances reflected in the forward-looking statements may not be achieved or occur. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activities, performance, or achievements. We are under no duty to update any of these forward-looking statements after the date of this report or to conform these statements to actual results or revised expectations.

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

You should read the following discussion of our financial condition and results of operations in conjunction with the condensed consolidated financial statements and notes thereto included elsewhere in this report. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this report, as well as in the section entitled “Risk Factors.”

Overview

Workday provides financial management, human capital management, and analytics applications designed for the world's largest companies, educational institutions, and government agencies. We offer innovative and adaptable technology focused on the consumer Internet experience and cloud delivery model. Our applications are designed for global enterprises to manage complex and dynamic operating environments. We provide our customers highly adaptable, accessible and reliable applications to manage critical business functions that enable them to optimize their financial and human capital resources.

We were founded in 2005 to deliver cloud applications to global enterprises. Our applications are designed around the way people work today – in an environment that is global, collaborative, fast-paced and mobile. Our cycle of frequent updates has facilitated rapid innovation and the introduction of new applications throughout our history. We began offering our Human Capital Management (HCM) application in 2006, and our Financial Management application in 2007. Since then we have continued to invest in innovation and have consistently introduced new services to our customers.

We offer Workday applications to our customers on an enterprise-wide subscription basis, typically with three-year terms and with subscription fees largely based on the size of the customer’s workforce. We generally recognize revenues from subscription fees ratably over the term of the contract. We currently derive a substantial majority of our subscription services revenues from subscriptions to our HCM application. We market our applications through our direct sales force.

We have achieved significant growth in a relatively short period of time. Our diverse customer base includes large, global companies and our direct sales force generally targets organizations with more than 1,000 workers. A substantial amount of our growth comes from new customers. Our current financial focus is on growing our revenues and expanding our customer base. While we are incurring losses today, we strive to invest in a disciplined manner across all of our functional areas to sustain continued near-term revenue growth and support our long-term initiatives. Our operating expenses have increased significantly in absolute dollars in recent periods, primarily due to the significant growth of our employee population. We had approximately 6,000 and approximately 4,500 employees as of July 31, 2016 and 2015, respectively.

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We intend to continue investing for long-term growth. We have invested, and expect to continue to invest, heavily in our application development efforts to deliver additional compelling applications and to address customers' evolving needs. In addition, we plan to continue to expand our ability to sell our applications globally, particularly in Europe and Asia, by investing in product development and customer support to address the business needs of local markets, increasing our sales and marketing organizations, acquiring, building and/or leasing additional office space, and expanding our ecosystem of services partners to support local deployments. We expect to make further significant investments in our data center infrastructure as we plan for future growth. We are also investing in personnel to service our growing customer base. These investments will increase our costs on an absolute basis in the near-term. Many of these investments will occur in advance of experiencing any direct benefit from them and will make it difficult to determine if we are allocating our resources efficiently. We expect our product development, sales and marketing, and general and administrative expenses as a percentage of total revenues to decrease over time as we grow our revenues, and we anticipate that we will gain economies of scale by increasing our customer base without direct incremental development costs and by utilizing more of the capacity of our data centers.

Since inception, we have invested heavily in our professional services organization to help ensure that customers successfully deploy and adopt our applications. Additionally, we continue to expand our professional services partner ecosystem to further support our customers. We believe our investment in professional services, as well as partners building consulting practices around Workday, will drive additional customer subscriptions and continued growth in revenues. Due to our expanding partner ecosystem, we will not be investing in our professional services organization at the same rates as we have in the past, and we expect professional services revenues and the cost of professional services as a percentage of total revenues will continue to decline over time.

Components of Results of Operations

Revenues

We primarily derive our revenues from subscription services fees and professional services fees. Subscription services revenues primarily consist of fees that give our customers access to our cloud applications, which include related customer support. Professional services fees include deployment services, optimization services, and training. Subscription services revenues accounted for 81% of our total revenues during the six months ended July 31, 2016 and represented 97% of our total unearned revenue as of July 31, 2016. Subscription services revenues are driven primarily by the number of customers, the number of workers at each customer, the number of applications subscribed to by each customer, and the price of our applications.

The mix of the applications to which a customer subscribes can affect our financial performance due to price differentials in our applications. Compared to our other offerings, our HCM application has been available for a longer period of time, is more established in the marketplace and has benefited from continued enhancements of the functionality over a longer period of time, all of which help us to improve our pricing for that application. However, new products or services offerings by competitors in the future could impact the mix and pricing of our offerings.

Subscription services fees are generally recognized ratably as revenues over the contract term beginning on the date the application is made available to the customer, which is generally within one week of contract signing. Our subscription contracts typically have a term of three years and are non-cancelable. We generally invoice our customers in advance, in annual installments. Amounts that have been invoiced are initially recorded as unearned revenue. Amounts that have not yet been invoiced represent backlog and are not reflected in our condensed consolidated financial statements.

The majority of our consulting engagements are billed on a time and materials basis, and revenues are typically recognized as the services are performed. We offer a number of training options intended to support our customers in configuring, using and administering our services. In some cases, we supplement our consulting teams by subcontracting resources from our service partners and deploying them on customer engagements. As Workday's professional services organization and the Workday-related consulting practices of our partner firms continue to develop, we expect the partners to increasingly contract directly with our subscription customers. As a result of this trend, and the increase of our subscription services revenues, we expect professional services revenues as a percentage of total revenues to decline over time.

Costs and Expenses

Costs of subscription services revenues. Costs of subscription services revenues consist primarily of employee-related expenses related to hosting our applications and providing customer support, the costs of data center capacity, and depreciation of computer equipment and software.

Costs of professional services revenues. Costs of professional services revenues consist primarily of employee-related expenses associated with these services, the cost of subcontractors and travel.

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Product development. Product development expenses consist primarily of employee-related costs. We continue to focus our product development efforts on adding new features and applications, increasing the functionality and enhancing the ease of use of our cloud applications.

Sales and marketing. Sales and marketing expenses consist primarily of employee-related costs, sales commissions, marketing programs and travel. Marketing programs consist of advertising, events, corporate communications, brand building and product marketing activities. Commissions earned by our sales force that can be associated specifically with a non-cancelable subscription contract are generally deferred and amortized over the same period that revenues are recognized for the related non-cancelable contract.

General and administrative. General and administrative expenses consist of employee-related costs for finance and accounting, legal, human resources and management information systems personnel, legal costs, professional fees and other corporate expenses.

Results of Operations

Revenues

Our total revenues for the three and six months ended July 31, 2016 and 2015 were as follows (in thousands, except percentages):

	Three Months Ended July 31,			Six Months Ended July 31,		
	2016	2015	% Change	2016	2015	% Change
Revenues:						
Subscription services	$306,228	$223,742	37%	$586,231	$424,735	38%
Professional services	71,495	58,954	21%	136,922	108,918	26%
Total revenues	$377,723	$282,696	34%	$723,153	$533,653	36%

Total revenues were $378 million for the three months ended July 31, 2016, compared to $283 million during the prior year period, an increase of $95 million, or 34%. Subscription services revenues were $306 million for the three months ended July 31, 2016, compared to $224 million for the prior year period, an increase of $82 million, or 37%. The increase in subscription services revenues was due primarily to an increased number of customer contracts as compared to the prior year period. Professional services revenues were $71 million for the three months ended July 31, 2016, compared to $59 million for the prior year period, an increase of $13 million, or 21%. The increase in professional services revenues was due primarily to the addition of new customers and a greater number of customers requesting deployment and integration services.

Total revenues were $723 million for the six months ended July 31, 2016, compared to $534 million during the prior year period, an increase of $190 million, or 36%. Subscription services revenues were $586 million for the six months ended July 31, 2016, compared to $425 million for the prior year period, an increase of $161 million, or 38%. The increase in subscription services revenues was due primarily to an increased number of customer contracts as compared to the prior year period. Professional services revenues were $137 million for the six months ended July 31, 2016, compared to $109 million for the prior year period, an increase of $28 million, or 26%. The increase in professional services revenues was due primarily to the addition of new customers and a greater number of customers requesting deployment and integration services.

Operating Expenses

GAAP operating expenses were $465 million for the three months ended July 31, 2016, compared to $350 million for the prior year period, an increase of $115 million, or 33%. The increases were primarily due to an increase of $84 million in employee-related costs driven by higher headcount, $6 million in depreciation and amortization expense and $5 million in service contracts expense to expand data center capacity.

GAAP operating expenses were $884 million for the six months ended July 31, 2016, compared to $655 million for the prior year period, an increase of $229 million, or 35%. The increases were primarily due to an increase of $167 million in employee-related costs driven by higher headcount, $13 million in depreciation and amortization expense and $9 million in service contracts expense to expand data center capacity.

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We use the non-GAAP financial measure of non-GAAP operating expenses to understand and compare operating results across accounting periods, for internal budgeting and forecasting purposes, for short- and long-term operating plans, and to evaluate our financial performance and the ability of operations to generate cash. We believe that non-GAAP operating expenses reflect our ongoing business in a manner that allows for meaningful period-to-period comparisons and analysis of trends in our business, as they exclude expenses that are not reflective of ongoing operating results. We also believe that non-GAAP operating expenses provide useful information to investors and others in understanding and evaluating our operating results and future prospects in the same manner as management and in comparing financial results across accounting periods and to those of peer companies.

Non-GAAP operating expenses are calculated by excluding share-based compensation expenses, and certain other expenses, which consist of employer payroll tax-related items on employee stock transactions and amortization of acquisition-related intangible assets.

Non-GAAP operating expenses were $372 million for the three months ended July 31, 2016, compared to $283 million for the prior year period, an increase of $89 million, or 31%. The increases were primarily due to an increase of $59 million in employee-related costs driven by higher headcount, $5 million in depreciation and amortization expense and $5 million in service contracts expense to expand data center capacity.

Non-GAAP operating expenses were $706 million for the six months ended July 31, 2016, compared to $536 million for the prior year period, an increase of $170 million, or 32%. The increases were primarily due to an increase of $110 million in employee-related costs driven by higher headcount, $11 million in depreciation and amortization expense and $9 million in service contracts expense to expand data center capacity.

Reconciliations of our GAAP to non-GAAP operating expenses were as follows (in thousands):

	Three Months Ended July 31, 2016			
	GAAP Operating Expenses	Share-Based Compensation Expenses(1)	Other Operating Expenses(2)	Non-GAAP Operating Expenses(3)
Costs of subscription services	$51,379	$ (4,968)	$ (133)	$ 46,278
Costs of professional services	66,473	(5,969)	(226)	60,278
Product development	161,886	(38,314)	(2,566)	121,006
Sales and marketing	139,177	(20,844)	(707)	117,626
General and administrative	45,705	(18,127)	(924)	26,654
Total costs and expenses	$464,620	$ (88,222)	$ (4,556)	$ 371,842

	Three Months Ended July 31, 2015			
	GAAP Operating Expenses	Share-Based Compensation Expenses (1)	Other Operating Expenses (2)	Non-GAAP Operating Expenses(3)
Costs of subscription services	$35,287	$ (3,173)	$ (76)	$ 32,038
Costs of professional services	56,792	(5,144)	(170)	51,478
Product development	115,345	(28,632)	(1,068)	85,645
Sales and marketing	106,430	(13,222)	(327)	92,881
General and administrative	36,482	(14,593)	(516)	21,373
Total costs and expenses	$350,336	$ (64,764)	$ (2,157)	$ 283,415

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	Six Months Ended July 31, 2016			
	GAAP Operating Expenses	Share-Based Compensation Expenses(1)	Other Operating Expenses(2)	Non-GAAP Operating Expenses(3)
Costs of subscription services	$100,579	$ (9,365)	$ (452)	$ 90,762
Costs of professional services	125,900	(11,262)	(716)	113,922
Product development	303,664	(71,282)	(6,360)	226,022
Sales and marketing	266,668	(39,846)	(1,797)	225,025
General and administrative	86,888	(34,702)	(1,736)	50,450
Total costs and expenses	$883,699	$ (166,457)	$ (11,061)	$ 706,181

	Six Months Ended July 31, 2015			
	GAAP Operating Expenses	Share-Based Compensation Expenses(1)	Other Operating Expenses(2)	Non-GAAP Operating Expenses(3)
Costs of subscription services	$67,069	$ (5,221)	$ (262)	$ 61,586
Costs of professional services	102,924	(8,598)	(524)	93,802
Product development	214,680	(49,443)	(3,381)	161,856
Sales and marketing	201,325	(21,587)	(958)	178,780
General and administrative	68,699	(27,189)	(1,103)	40,407
Total costs and expenses	$654,697	$ (112,038)	$ (6,228)	$ 536,431

(1) Share-based compensation expenses were $88 million and $65 million for the three months ended July 31, 2016 and 2015, respectively, and $166 million and $112 million for the six months ended July 31, 2016 and 2015, respectively. The increase in share-based compensation expenses was primarily due to grants of RSUs to existing and new employees. During the three and six month periods ended July 31, 2016 and 2015, the realized excess tax benefits related to share-based compensation were immaterial.

(2) Other operating expenses include employer payroll tax-related items on employee stock transactions of $3 million and $2 million for the three months ended July 31, 2016 and 2015, respectively, and $8 million and $6 million for the six months ended July 31, 2016 and 2015, respectively. In addition, other operating expenses included amortization of acquisition-related intangible assets of $1 million and $0.4 million for the three months ended July 31, 2016 and 2015, respectively, and $3 million and $1 million for the six months ended July 31, 2016 and 2015, respectively. Amortization of acquisition-related intangible assets is recorded as part of product development expenses.

(3) See “Non-GAAP Financial Measures” below for further information.

Costs of Subscription Services

GAAP operating expenses in costs of subscription services were $51 million for the three months ended July 31, 2016, compared to $35 million for the prior year period, an increase of $16 million or 46%. The increase was primarily due to increases of $7 million in employee-related costs driven by higher headcount, $4 million in service contracts expense to expand data center capacity, and $2 million in depreciation expense related to our data centers.

GAAP operating expenses in costs of subscription services were $101 million for the six months ended July 31, 2016, compared to $67 million for the prior year period, an increase of $34 million or 51%. The increase was primarily due to increases of $14 million in employee-related costs driven by higher headcount, $8 million in service contracts expense to expand data center capacity, and $6 million in depreciation expense related to our data centers.

Non-GAAP operating expenses in costs of subscription services were $46 million for the three months ended July 31, 2016, compared to $32 million for the prior year period, an increase of $14 million, or 44%. The increase was primarily due to increases of $6 million in employee-related costs driven by higher headcount, $4 million in service contracts expense to expand data center capacity, and $2 million in depreciation expense related to our data centers.

Non-GAAP operating expenses in costs of subscription services were $91 million for the six months ended July 31, 2016, compared to $62 million for the prior year period, an increase of $29 million, or 47%. The increase was primarily due to increases of $10 million in employee-related costs driven by higher headcount, $8 million in service contracts expense to expand data center capacity, and $6 million in depreciation expense related to our data centers. See the table above for a reconciliation of GAAP to non-GAAP operating expenses.

We expect that GAAP and non-GAAP operating expenses in costs of subscription services will continue to increase in absolute dollars as we improve and expand our data center capacity and operations.

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Costs of Professional Services

GAAP operating expenses in costs of professional services were $66 million for the three months ended July 31, 2016, compared to $57 million for the prior year period, an increase of $9 million, or 16%. The increase was primarily due to additional costs of $11 million to staff our deployment and integration engagements.

GAAP operating expenses in costs of professional services were $126 million for the six months ended July 31, 2016, compared to $103 million for the prior year period, an increase of $23 million, or 22%. The increase was primarily due to additional costs of $23 million to staff our deployment and integration engagements.

Non-GAAP operating expenses in costs of professional services were $60 million for the three months ended July 31, 2016, compared to $51 million for the prior year period, an increase of $9 million, or 18%. The increase was primarily due to additional costs of $10 million to staff our deployment and integration engagements.

Non-GAAP operating expenses in costs of professional services were $114 million for the six months ended July 31, 2016, compared to $94 million for the prior year period, an increase of $20 million, or 21%. The increase was primarily due to additional costs of $20 million to staff our deployment and integration engagements.

See the table above for a reconciliation of GAAP to non-GAAP operating expenses.

Due to the increase in demand for our professional services, we have increased both our internal professional services staff as well as third-party supplemental staff. Going forward, we expect GAAP and non-GAAP costs of professional services as a percentage of total revenues to continue to decline as we increasingly rely on third parties to deploy our applications and as the number of our customers continues to grow. For fiscal 2017, we anticipate GAAP and non-GAAP professional services margins to be lower than fiscal 2016 as we invest in building our partnership ecosystem in the education and government sectors, as well as internationally.

Product Development

GAAP operating expenses in product development were $162 million for the three months ended July 31, 2016, compared to $115 million for the prior year period, an increase of $47 million, or 41%. The increase was primarily due to increases of $37 million in employee-related costs driven by higher headcount and $6 million in facility and IT-related expenses.

GAAP operating expenses in product development were $304 million for the six months ended July 31, 2016, compared to $215 million for the prior year period, an increase of $89 million, or 41%. The increase was primarily due to increases of $69 million in employee-related costs driven by higher headcount and $12 million in facility and IT-related expenses.

Non-GAAP operating expenses in product development were $121 million for the three months ended July 31, 2016, compared to $86 million for the prior year period, an increase of $35 million, or 41%. The increase was primarily due to increases of $27 million in employee-related costs driven by higher headcount and $6 million in facility and IT-related expenses.

Non-GAAP operating expenses in product development were $226 million for the six months ended July 31, 2016, compared to $162 million for the prior year period, an increase of $64 million, or 40%. The increase was primarily due to increases of $47 million in employee-related costs driven by higher headcount and $12 million in facility and IT-related expenses.

See the table above for a reconciliation of GAAP to non-GAAP operating expenses.

We expect that GAAP and non-GAAP product development expenses will continue to increase in absolute dollars as we improve and extend our applications and develop new technologies.

Sales and Marketing

GAAP operating expenses in sales and marketing were $139 million for the three months ended July 31, 2016, compared to $106 million for the prior year period, an increase of $33 million, or 31%. The increase was primarily due to increases of $26 million in employee-related costs driven by higher headcount and higher commissionable sales volume, $2 million in facility and IT-related expenses, and $2 million in advertising, marketing and event costs.

GAAP operating expenses in sales and marketing were $267 million for the six months ended July 31, 2016, compared to $201 million for the prior year period, an increase of $66 million, or 33%. The increase was primarily due to increases of $51 million in employee-related costs driven by higher headcount and higher commissionable sales volume, $5 million in facility and IT-related expenses, and $4 million in advertising, marketing and event costs.

Non-GAAP operating expenses in sales and marketing were $118 million for the three months ended July 31, 2016, compared to $93 million for the prior year period, an increase of $25 million, or 27%. The increase was primarily due to increases of $18 million in employee-related costs driven by higher headcount and higher commissionable sales volume, $2 million in facility and IT-related expenses, and $2 million in advertising, marketing and event costs.

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Non-GAAP operating expenses in sales and marketing were $225 million for the six months ended July 31, 2016, compared to $179 million for the prior year period, an increase of $46 million, or 26%. The increase was primarily due to increases of $32 million in employee-related costs driven by higher headcount and higher commissionable sales volume, $5 million in facility and IT-related expenses, and $4 million in advertising, marketing and event costs.

See the table above for a reconciliation of GAAP to non-GAAP operating expenses.

We expect that GAAP and non-GAAP sales and marketing expenses will continue to increase in absolute dollars as we continue to invest in the expansion of our domestic and international selling and marketing activities to build brand awareness and attract new customers.

General and Administrative

GAAP operating expenses in general and administrative were $46 million for the three months ended July 31, 2016, compared to $36 million for the prior year period, an increase of $10 million, or 28%. The increase was primarily due to $7 million in additional employee-related costs driven by higher headcount and $2 million in higher professional fees.

GAAP operating expenses in general and administrative were $87 million for the six months ended July 31, 2016, compared to $69 million for the prior year period, an increase of $18 million, or 26%. The increase was primarily due to $14 million in additional employee-related costs driven by higher headcount and $3 million in higher professional fees.

Non-GAAP operating expenses in general and administrative were $27 million for the three months ended July 31, 2016, compared to $21 million for the prior year period, an increase of $6 million, or 29%. The increase was primarily due to $3 million in employee-related costs driven by higher headcount and $2 million in higher professional fees.

Non-GAAP operating expenses in general and administrative were $50 million for the six months ended July 31, 2016, compared to $40 million for the prior year period, an increase of $10 million, or 25%. The increase was primarily due to $7 million in employee-related costs driven by higher headcount and $3 million in higher professional fees.

See the table above for a reconciliation of GAAP to non-GAAP operating expenses.

We expect GAAP and non-GAAP general and administrative expenses will continue to increase in absolute dollars as we further invest in our infrastructure and support our global expansion.

Operating Margins

GAAP operating margins improved from (24)% for the three months ended July 31, 2015 to (23)% for the three months ended July 31, 2016. The improvements in our GAAP operating margins in the three months ended July 31, 2016 were primarily due to higher subscription services revenues, higher professional services revenues and improvements in operating leverage.

GAAP operating margins improved from (23)% for the six months ended July 31, 2015 to (22)% for the six months ended July 31, 2016. The improvements in our non-GAAP operating margins in the six months ended July 31, 2016 were primarily due to higher subscription services revenues, higher professional services revenues and improvements in operating leverage.

We use non-GAAP operating margins to understand and compare operating results across accounting periods, for internal budgeting and forecasting purposes, for shor