Workday, Inc.
Form 10-Q
December 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 October 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 November 30, 2016, there were approximately 201 million shares of the registrant's common stock outstanding.

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

	October 31, 2016	January 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$386,557	$300,087
Marketable securities	1,527,238	1,669,372
Accounts receivable, net	268,945	293,407
Deferred costs	23,067	21,817
Prepaid expenses and other current assets	88,788	77,625
Total current assets	2,294,595	2,362,308
Property and equipment, net	334,265	214,158
Deferred costs, noncurrent	33,551	30,074
Goodwill and acquisition-related intangible assets, net	212,087	65,816
Other assets	48,071	57,738
Total assets	$2,922,569	$2,730,094
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$28,374	$19,605
Accrued expenses and other current liabilities	66,075	43,122
Accrued compensation	103,206	91,211
Unearned revenue	900,441	768,741
Total current liabilities	1,098,096	922,679
Convertible senior notes, net	527,547	507,476
Unearned revenue, noncurrent	123,179	130,988
Other liabilities	36,288	32,794
Total liabilities	1,785,110	1,593,937
Stockholders' equity:		
Common stock	200	193
Additional paid-in capital	2,549,639	2,247,454
Accumulated other comprehensive income	2,622	799
Accumulated deficit	(1,415,002)	(1,112,289)
Total stockholders' equity	1,137,459	1,136,157
Total liabilities and stockholders' equity	$2,922,569	$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 October 31,		Nine Months Ended October 31,	
	2016	2015	2016	2015
Revenues:				
Subscription services	$335,722	$242,700	$921,953	$667,435
Professional services	73,860	62,566	210,782	171,484
Total revenues	409,582	305,266	1,132,735	838,919
Costs and expenses[(1)]:				
Costs of subscription services	54,645	39,791	155,224	106,860
Costs of professional services	72,240	61,963	198,140	164,887
Product development	185,311	124,020	488,975	338,700
Sales and marketing	149,549	111,658	416,217	312,983
General and administrative	57,721	38,008	144,609	106,707
Total costs and expenses	519,466	375,440	1,403,165	1,030,137
Operating loss	(109,884)	(70,174)	(270,430)	(191,218)
Other expense, net	(3,105)	(6,722)	(30,136)	(17,737)
Loss before provision for (benefit from) income taxes	(112,989)	(76,896)	(300,566)	(208,955)
Provision for (benefit from) income taxes	1,077	915	2,147	(165)
Net loss	$(114,066)	$(77,811)	$(302,713)	$(208,790)
Net loss per share, basic and diluted	$(0.57)	$(0.41)	$(1.54)	$(1.10)
Weighted-average shares used to compute net loss per share, basic and diluted	199,479	190,727	197,093	189,185

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

Costs of subscription services	$5,472	$3,203	$14,837	$8,424
Costs of professional services	7,436	5,424	18,698	14,022
Product development	45,968	29,547	117,250	78,990
Sales and marketing	22,597	15,321	62,443	36,908
General and administrative	24,982	15,164	59,684	42,353

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 October 31,		Nine Months Ended October 31,	
	2016	2015	2016	2015
Net loss	$(114,066)	$(77,811)	$(302,713)	$(208,790)
Other comprehensive income (loss), net of tax:				
Net change in foreign currency translation adjustment	(322)	(318)	111	(518)
Net change in unrealized gains (losses) on available-for-sale investments	(392)	(237)	542	(574)
Net change in market value of effective foreign currency forward exchange contracts	5,924	181	1,170	1,178
Other comprehensive income (loss), net of tax	5,210	(374)	1,823	86
Comprehensive loss	$(108,856)	$(78,185)	$(300,890)	$(208,704)

See Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2016	2015	2016	2015
Cash flows from operating activities				
Net loss	$(114,066)	$(77,811)	$(302,713)	$(208,790)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation and amortization	30,453	22,260	83,239	60,717
Share-based compensation expenses	100,098	68,659	266,555	180,697
Amortization of deferred costs	6,507	5,389	18,520	17,749
Amortization of debt discount and issuance costs	6,782	6,422	20,071	19,008
Gain on sale of cost method investment	—	—	(65)	(3,220)
Impairment of cost method investment	—	—	15,000	—
Other	78	48	1,678	(1,334)
Changes in operating assets and liabilities, net of business combinations:				
Accounts receivable	(20,360)	(14,727)	24,695	17,420
Deferred costs	(7,973)	(8,744)	(23,247)	(19,327)
Prepaid expenses and other assets	(1,425)	(9,522)	(14,103)	(24,998)
Accounts payable	2,260	(3,719)	2,080	461
Accrued expense and other liabilities	30,591	29,785	29,619	36,700
Unearned revenue	38,514	34,719	117,854	85,063
Net cash provided by (used in) operating activities	71,459	52,759	239,183	160,146
Cash flows from investing activities				
Purchases of marketable securities	(380,620)	(623,377)	(1,571,756)	(1,485,422)
Maturities of marketable securities	449,592	551,270	1,614,495	1,261,863
Sales of available-for-sale securities	63,340	69,187	92,192	98,711
Business combinations, net of cash acquired	(144,209)	(23,475)	(147,879)	(31,436)
Owned real estate projects	(59,705)	—	(85,479)	—
Capital expenditures, excluding owned real estate projects	(27,518)	(37,893)	(88,535)	(91,682)
Purchases of cost method investments	—	(700)	(300)	(16,450)
Sale of cost method investment	—	—	315	3,538
Change in restricted cash	3,900	—	(100)	—
Other	—	—	(296)	—
Net cash provided by (used in) investing activities	(95,220)	(64,988)	(187,343)	(260,878)
Cash flows from financing activities				
Proceeds from issuance of common stock from employee equity plans	4,491	2,360	33,267	25,096
Principal payments on capital lease obligations	—	(663)	—	(3,127)
Other	435	246	1,006	1,025
Net cash provided by (used in) financing activities	4,926	1,943	34,273	22,994
Effect of exchange rate changes	(137)	(399)	357	(561)
Net increase (decrease) in cash and cash equivalents	(18,972)	(10,685)	86,470	(78,299)
Cash and cash equivalents at the beginning of period	405,529	230,578	300,087	298,192
Cash and cash equivalents at the end of period	$386,557	$219,893	$386,557	$219,893
Supplemental cash flow data				

Cash paid for interest	$48	$8	$3,293	$3,252
Cash paid for income taxes	655	618	4,802	1,652
Non-cash investing and financing activities:				
Vesting of early exercise stock options	$445	$472	$1,365	$1,416
Property and equipment, accrued but not paid	25,917	17,237	25,917	17,237
Non-cash additions to property and equipment	67	4,308	982	6,491

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 October 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 are in process of assessing the financial statement impact of adoption.

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On January 5, 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10), which 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), which requires 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 (Topic 718), 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 are in the process of assessing the financial statement impact of adoption.

On October 24, 2016, the FASB issued ASU 2016-16, Intra-Entity Transfers of Assets Other Than Inventory (Topic 740), which requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Prior to the issuance of this ASU, existing guidance prohibited the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset had been sold to an outside party. 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.

Note 2. Marketable Securities

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. agency obligations	$972,605	$ 507	$ (101)	$973,011
U.S. treasury securities	192,253	107	(15)	192,345
U.S. corporate securities	187,606	26	(207)	187,425
Commercial paper	261,177	—	—	261,177
Money market funds	162,001	—	—	162,001
	$1,775,642	$ 640	$ (323)	$1,775,959
Included in cash and cash equivalents	$248,721	$ —	$ —	$248,721
Included in marketable securities	$1,526,921	$ 640	$ (323)	$1,527,238

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

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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 October 31, 2016. No marketable securities held as of October 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 are reflected in cash and cash equivalents. During the three and nine months ended October 31, 2016, we sold $63 million and $92 million, respectively, of our marketable securities and the realized gains from the sales are immaterial.

Note 3. Deferred Costs

Deferred costs consisted of the following (in thousands):

	October 31, 2016	January 31, 2016
Current:		
Deferred professional service costs	$ 580	$ 895
Deferred sales commissions	22,487	20,922
Total	$ 23,067	$ 21,817
Noncurrent:		
Deferred professional service costs	$ —	$ 360
Deferred sales commissions	33,551	29,714
Total	$ 33,551	$ 30,074

Note 4. Property and Equipment, Net

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

	October 31, 2016	January 31, 2016
Land	$ 6,592	$ —
Buildings	92,366	4,280
Computers, equipment and software	292,662	230,705
Computers, equipment and software acquired under capital leases	17,958	24,400
Furniture and fixtures	22,937	18,894
Leasehold improvements	107,959	86,282
	540,474	364,561
Less accumulated depreciation and amortization	(206,209)	(150,403)
Property and equipment, net	$ 334,265	$ 214,158

During the third quarter of fiscal 2017, we purchased real property located in Pleasanton, California, which includes land together with an office building of approximately 209,000 square feet and parking structures, for $47 million. 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, for $15 million. Additionally, 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.

Depreciation expense totaled $23 million and $18 million for the three months ended October 31, 2016 and 2015, respectively, and $67 million and $51 million for the nine months ended October 31, 2016 and 2015, respectively.

Note 5. Business Combinations

On August 5, 2016, we acquired a leading provider of operational analytics and data discovery tools for the purpose of enriching the analytics in our products. We have included the financial results of the acquired company in the consolidated financial statements from the date of acquisition. The purchase consideration of this acquisition was

$144 million, net of cash acquired.

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The following table summarizes the estimated fair values of assets acquired and liabilities assumed as of the date of acquisition (in thousands):

Cash and cash equivalents	$3,213
Other tangible assets	3,523
Acquired developed technology	42,000
Customer relationship assets	1,000
Accounts payable and other liabilities	(1,737)
Unearned revenue	(6,000)
Net assets acquired	41,999
Goodwill	105,423
Total purchase consideration	$147,422

The excess of purchase consideration over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. The fair values assigned to tangible and identifiable intangible assets acquired and liabilities assumed are based on management's estimates and assumptions. The preliminary estimated fair values of assets acquired and liabilities assumed, including current income taxes payable and deferred taxes, and identifiable intangible assets may be subject to change as additional information is received and certain tax returns are finalized. We expect to finalize the allocation of purchase consideration as soon as practicable and no later than one year from the acquisition date.

Developed technology represents the estimated fair value of the acquired existing technology. The goodwill balance is not deductible for U.S. income tax purposes.

Additionally, during 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.

Note 6. Goodwill and Acquisition-related Intangible Assets, Net

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

	October 31, 2016	January 31, 2016
Acquired developed technology	$65,500	$20,461
Customer relationship assets	1,338	338
	66,838	20,799
Less accumulated amortization	(12,946)	(5,308)
Acquisition-related intangible assets, net	53,892	15,491
Goodwill	158,195	50,325
Goodwill and acquisition-related intangible assets, net	$212,087	$65,816

Developed technology and customer relationship assets from acquisitions are 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 October 31, 2016, our future estimated amortization expense related to acquired developed technology and customer relationship assets is as follows (in thousands):

Fiscal Period:	
2017	$5,105
2018	19,286
2019	18,904
2020	10,281
2021	316
Total	$53,892

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Note 7. Other Assets

Other assets consisted of the following (in thousands):

	October 31, 2016	January 31, 2016
Cost method investments	$ 14,004	$ 28,742
Acquired land leasehold interest, net	9,702	9,781
Technology patents, net	2,328	3,020
Other	22,037	16,195
Total	$ 48,071	$ 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 October 31, 2016 and 2015, and $0.8 million for each of the nine month periods ended October 31, 2016 and 2015.

During the second quarter of fiscal 2017, we recorded a $15 million other-than-temporary impairment for one of our cost method investments. The impairment expense was 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 8. 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 — 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.

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 October 31, 2016		
Description	Level 1	Level 2	Total
U.S. agency obligations	$—	$973,011	$973,011
U.S. treasury securities	192,345	—	192,345
U.S. corporate securities	—	187,425	187,425
Commercial paper	—	261,177	261,177
Money market funds	162,001	—	162,001
	$354,346	$1,421,613	$1,775,959
Included in cash and cash equivalents			$248,721
Included in marketable securities			$1,527,238

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Description	Fair Value Measurements as of January 31, 2016 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):

	October 31, 2016 Net Carrying Amount Before Unamortized Debt Issuance Costs	Estimated Fair Value	January 31, 2016 Net Carrying Amount Before Unamortized Debt Issuance Costs	Estimated Fair Value
0.75% Convertible senior notes	$321,635	$416,392	$310,013	$362,250
1.50% Convertible senior notes	210,812	310,170	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 9). 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 $86.68 on October 31, 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.

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. Cash flows from such forward contracts are classified as operating activities.

As of October 31, 2016 and January 31, 2016, we had 159 and 65 outstanding foreign currency forward contracts designated as cash flow hedges with total notional values of $224 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 nine months ended October 31, 2016, all cash flow hedges were considered effective.

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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. Cash flows from such forward contracts are classified as operating activities.

As of October 31, 2016 and January 31, 2016, we had 23 and 21 outstanding forward contracts with total notional values of $32 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	October 31, 2016	January 31, 2016
Derivative Assets:			
Foreign currency forward contracts designated as cash flow hedges	Prepaid expenses and other current assets	$ 6,940	$ 4,695
Foreign currency forward contracts designated as cash flow hedges	Other assets	88	—
Foreign currency forward contracts not designated as hedges	Prepaid expenses and other current assets	350	605
Derivative Liabilities:			
Foreign currency forward contracts designated as cash flow hedges	Accrued expenses and other current liabilities	$ 1,445	$ 98
Foreign currency forward contracts not designated as hedges	Accrued expenses and other current liabilities	190	56

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 October 31,		Nine Months Ended October 31,	
		2016	2015	2016	2015
Gains (losses) recognized in OCI (effective portion)[1]	Net change in market value of effective foreign currency forward exchange contracts	$6,107	$182	$1,606	$1,180
Gains (losses) reclassified from OCI into income (effective portion)	Revenues	183	1	436	2
Gains (losses) recognized in income (amount excluded from effectiveness testing and ineffective portion)	Other expense, net	517	44	833	86

(1) Of the total effective portion of foreign currency forward contracts designated as cash flow hedges as of October 31, 2016, net gains of $1.8 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):

	Condensed Consolidated Statement of Operations Location	Three Months Ended October 31,	Nine Months Ended October 31,

Derivative Type		2016	2015	2016	2015
Foreign currency forward contracts not designated as hedges	Other expense, net	$1,195	$270	$654	$348

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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 October 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		Net Assets Exposed
				Financial Instruments	Cash Collateral Received	
Derivative Assets:						
Counterparty A	$ 810	$ —	$ 810	$ (810)	$ —	$ —
Counterparty B	6,568	—	6,568	(783)	—	5,785
Total	$ 7,378	$ —	$ 7,378	$ (1,593)	$ —	$ 5,785

	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		Net Liabilities Exposed
				Financial Instruments	Cash Collateral Pledged	
Derivative Liabilities:						
Counterparty A	$ 852	$ —	$ 852	$ (810)	$ —	$ 42
Counterparty B	783	—	783	(783)	—	—
Total	$ 1,635	$ —	$ 1,635	$ (1,593)	$ —	$ 42

Note 9. 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.

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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 $1 million for each of the three and nine month periods ended October 31, 2016 and 2015. For the 2020 Notes, we recorded liability issuance costs of