Workday, Inc.
Form 10-Q
November 30, 2017
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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, 2017
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, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth 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	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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 October 31, 2017, there were approximately 210 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)

	October 31, 2017	January 31, 2017 *As Adjusted
Assets		
Current assets:		
Cash and cash equivalents	$1,336,984	$539,923
Marketable securities	1,874,139	1,456,822
Trade and other receivables, net	349,309	409,780
Deferred costs	56,304	51,330
Prepaid expenses and other current assets	77,036	66,590
Total current assets	3,693,772	2,524,445
Property and equipment, net	487,234	365,877
Deferred costs, noncurrent	120,173	117,249
Acquisition-related intangible assets, net	34,305	48,787
Goodwill	158,418	158,354
Other assets	70,814	53,570
Total assets	$4,564,716	$3,268,282
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$35,837	$26,824
Accrued expenses and other current liabilities	108,074	61,582
Accrued compensation	139,668	110,625
Unearned revenue	1,129,031	1,086,212
Current portion of convertible senior notes, net	336,936	—
Total current liabilities	1,749,546	1,285,243
Convertible senior notes, net	1,136,494	534,423
Unearned revenue, noncurrent	100,135	135,331
Other liabilities	38,267	36,677
Total liabilities	3,024,442	1,991,674
Stockholders’ equity:		
Common stock	210	202
Additional paid-in capital	3,195,130	2,681,200
Accumulated other comprehensive income (loss)	(16,310)	2,071
Accumulated deficit	(1,638,756)	(1,406,865)
Total stockholders’ equity	1,540,274	1,276,608
Total liabilities and stockholders’ equity	$4,564,716	$3,268,282

*See Note 2 for a summary of adjustments.

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,	
	2017	2016 *As Adjusted	2017	2016 *As Adjusted
Revenues:				
Subscription services	$463,568	$337,910	$1,297,831	$924,148
Professional services	91,821	75,612	262,739	210,708
Total revenues	555,389	413,522	1,560,570	1,134,856
Costs and expenses [(1)]:				
Costs of subscription services	71,898	54,645	197,627	155,224
Costs of professional services	91,657	72,240	260,834	198,140
Product development	239,588	185,311	657,130	488,975
Sales and marketing	176,121	149,537	503,782	412,055
General and administrative	56,184	57,721	163,085	144,609
Total costs and expenses	635,448	519,454	1,782,458	1,399,003
Operating loss	(80,059)	(105,932)	(221,888)	(264,147)
Other income (expense), net	(3,742)	(3,105)	(4,467)	(30,136)
Loss before provision for (benefit from) income taxes	(83,801)	(109,037)	(226,355)	(294,283)
Provision for (benefit from) income taxes	1,745	1,077	5,767	2,147
Net loss	$(85,546)	$(110,114)	$(232,122)	$(296,430)
Net loss per share, basic and diluted	$(0.41)	$(0.55)	$(1.12)	$(1.50)
Weighted-average shares used to compute net loss per share, basic and diluted	209,188	199,479	206,715	197,093

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

Costs of subscription services	$6,899	$5,472	$19,170	$14,837
Costs of professional services	9,956	7,436	27,278	18,698
Product development	59,116	45,968	167,068	117,250
Sales and marketing	25,517	22,597	74,618	62,443
General and administrative	20,991	24,982	63,656	59,684

* See Note 2 for a summary of adjustments.

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,	
	2017	2016 *As Adjusted	2017	2016 *As Adjusted
Net loss	$(85,546)	$(110,114)	$(232,122)	$(296,430)
Other comprehensive income (loss), net of tax:				
Net change in foreign currency translation adjustment	(504)	(322)	462	111
Net change in unrealized gains (losses) on available-for-sale investments	(302)	(392)	(931)	542
Net change in market value of effective foreign currency forward exchange contracts	6,693	5,924	(17,912)	1,170
Other comprehensive income (loss), net of tax	5,887	5,210	(18,381)	1,823
Comprehensive loss	$(79,659)	$(104,904)	$(250,503)	$(294,607)

*See Note 2 for a summary of adjustments.

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,	
	2017	2016 *As Adjusted	2017	2016 *As Adjusted
Cash flows from operating activities				
Net loss	$(85,546)	$(110,114)	$(232,122)	$(296,430)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Depreciation and amortization	34,982	30,453	102,380	83,239
Share-based compensation expenses	122,479	100,098	351,790	266,555
Amortization of deferred costs	14,519	11,561	42,165	32,917
Amortization of debt discount and issuance costs	12,257	6,782	25,992	20,071
Gain on sale of cost method investment	(194)	—	(720)	(65)
Impairment of cost method investment	100	—	100	15,000
Other	(1,294)	78	3,317	1,678
Changes in operating assets and liabilities, net of business combinations:				
Trade and other receivables, net	19,070	(20,693)	59,463	25,289
Deferred costs	(19,245)	(13,040)	(50,063)	(41,807)
Prepaid expenses and other assets	(11,355)	(3,686)	(23,373)	(11,368)
Accounts payable	(7,383)	2,260	2,830	2,080
Accrued expenses and other liabilities	59,171	30,591	49,788	29,619
Unearned revenue	6,470	37,266	7,632	114,117
Net cash provided by (used in) operating activities	144,031	71,556	339,179	240,895
Cash flows from investing activities				
Purchases of marketable securities	(930,783)	(380,620)	(1,829,231)	(1,571,756)
Maturities of marketable securities	372,389	449,592	1,185,730	1,614,495
Sales of available-for-sale securities	32,886	63,340	222,823	92,192
Business combinations, net of cash acquired	—	(144,209)	—	(147,879)
Owned real estate projects	(27,616)	(59,705)	(80,151)	(85,479)
Capital expenditures, excluding owned real estate projects	(36,356)	(27,518)	(105,477)	(88,535)
Purchases of cost method investments	(5,272)	—	(10,722)	(300)
Sale and maturities of cost method investments	294	—	1,026	315
Other	(1,000)	—	(1,000)	(296)
Net cash provided by (used in) investing activities	(595,458)	(99,120)	(617,002)	(187,243)
Cash flows from financing activities				
Proceeds from borrowings on convertible senior notes, net of issuance costs	1,132,101	—	1,132,101	—
Proceeds from issuance of warrants	80,805	—	80,805	—
Purchase of convertible senior notes hedges	(175,530)	—	(175,530)	—
Proceeds from issuance of common stock from employee equity plans	1,974	4,491	36,501	33,267
Other	(36)	435	(112)	1,006
Net cash provided by (used in) financing activities	1,039,314	4,926	1,073,765	34,273

Effect of exchange rate changes	(322)	(137)	261	357
Net increase (decrease) in cash, cash equivalents and restricted cash	587,565	(22,775)	796,203	88,282
Cash, cash equivalents and restricted cash at the beginning of period	750,532	411,144	541,894	300,087
Cash, cash equivalents and restricted cash at the end of period	$1,338,097	$388,369	$1,338,097	$388,369

See Notes to Condensed Consolidated Financial Statements
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	Three Months Ended October 31,		Nine Months Ended October 31,	
	2017	2016	2017	2016
Supplemental cash flow data				
Cash paid for interest, net of amounts capitalized	$ 18	$ 48	$ 64	$ 2,704
Cash paid for income taxes	651	655	3,259	4,802
Non-cash investing and financing activities:				
Vesting of early exercise stock options	$ 106	$ 445	$ 670	$ 1,365
Property and equipment, accrued but not paid	47,055	25,917	47,055	25,917
Non-cash additions to property and equipment	649	67	1,276	982

	October 31, 2017	October 31, 2016 *As Adjusted
Reconciliation of cash, cash equivalents and restricted cash as shown in the statement of cash flows		
Cash and cash equivalents	$ 1,336,984	$ 386,557
Restricted cash included in Other assets	1,113	1,712
Restricted cash included in Property and equipment, net	—	100
Total cash, cash equivalents and restricted cash	$ 1,338,097	$ 388,369

* See Note 2 for a summary of adjustments.

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, 2017 shown in this report are not necessarily indicative of results to be expected for the full year ending January 31, 2018. 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, 2017, filed with the SEC on March 20, 2017.
Effective February 1, 2017, we adopted the requirements of Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers and ASU No. 2016-18, Statement of Cash Flows, Restricted Cash as discussed in Note 2. All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standards, as indicated by the "as adjusted" footnote.
Certain prior period amounts reported in our condensed consolidated financial statements and notes thereto have been reclassified to conform to current period presentation.
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 period of benefit for deferred commissions, 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 where 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.

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Note 2. Accounting Standards and Significant Accounting Policies

Recently Adopted Accounting Pronouncements

ASU No. 2014-09

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, Revenue from Contracts with Customers ("Topic 606"). Topic 606 supersedes the revenue recognition requirements in Accounting Standards Codification ("ASC") Topic 605, Revenue Recognition ("Topic 605"), and requires the recognition of revenue when promised goods or services are transferred to customers in an amount that reflects the considerations to which the entity expects to be entitled to in exchange for those goods or services. Topic 606 also includes Subtopic 340-40, Other Assets and Deferred Costs - Contracts with Customers, which requires the deferral of incremental costs of obtaining a contract with a customer. Collectively, we refer to Topic 606 and Subtopic 340-40 as the "new standard." We early adopted the requirements of the new standard as of February 1, 2017, utilizing the full retrospective method of transition. Adoption of the new standard resulted in changes to our accounting policies for revenue recognition, trade and other receivables, and deferred commissions as detailed below. We applied the new standard using a practical expedient where the consideration allocated to the remaining performance obligations or an explanation of when we expect to recognize that amount as revenue for all reporting periods presented before the date of the initial application is not disclosed.

The impact of adopting the new standard on our fiscal 2017 and fiscal 2016 revenues is not material. The primary impact of adopting the new standard relates to the deferral of incremental commission costs of obtaining subscription contracts. Under Topic 605, we deferred only direct and incremental commission costs to obtain a contract and amortized those costs on a straight-line basis over the term of the related subscription contract, which was generally three years or longer. Under the new standard, we defer all incremental commission costs to obtain the contract. We amortize these costs on a straight-line basis over a period of benefit that we have determined to be five years or the related contractual renewal period, depending on whether the contract is an initial or renewal contract, respectively.

ASU No. 2016-09

In March 2016, the FASB issued ASU No. 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. As of February 1, 2017, we adopted the applicable provisions of ASU No. 2016-09 as follows:

- The guidance requires excess tax benefits and tax deficiencies to be recorded as income tax benefit or expense in the statement of operations when the awards vest or are settled, and eliminates the requirement to reclassify cash flows related to excess tax benefits from operating activities to financing activities on the statement of cash flows. We adopted the guidance prospectively effective February 1, 2017. Amounts previously recorded to Additional paid-in capital related to windfall tax benefits prior to February 1, 2017 remain in Stockholders' equity.
- The guidance eliminates the requirement that excess tax benefits must be realized (through a reduction in income taxes payable) before companies can recognize them. We have applied the modified retrospective transition method upon adoption. The previously unrecognized excess tax effects were recorded as a deferred tax asset in the amount of $448.0 million, of which $447.8 million was fully offset by a valuation allowance, and the remaining $0.2 million resulted in a cumulative-effect adjustment to Accumulated deficit as of February 1, 2017.

ASU No. 2016-18

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows, Restricted Cash (Topic 230), which requires that a statement of cash flows explain the change during the period for the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The guidance is effective for our fiscal year beginning February 1, 2018. We early adopted ASU No. 2016-18 retrospectively, effective February 1, 2017. As a result of including restricted cash with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts presented on the condensed consolidated statement of cash flows, net cash flows for the three months ended October 31, 2016 decreased by $4 million and net cash flows for the nine months ended October 31, 2016 increased by $2 million.

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We adjusted our condensed consolidated financial statements from amounts previously reported due to the adoption of ASU No. 2014-09 and ASU No. 2016-18. Select condensed consolidated balance sheet line items, which reflect the adoption of the new ASU's are as follows (in thousands):

	January 31, 2017			
	As Previously Reported	Adjustments		As Adjusted
Assets				
Trade and other receivables, net	$383,908	$ 25,872	a	$409,780
Prepaid expenses and other current assets	88,336	(21,746)	a	66,590
Deferred costs	27,537	23,793	a	51,330
Deferred costs, noncurrent	43,310	73,939	a	117,249
Liabilities				
Unearned revenue	$1,097,417	$ (11,205)	a	$1,086,212
Unearned revenue, noncurrent	135,970	(639)	a	135,331

Select unaudited condensed consolidated statement of operations line items, which reflect the adoption of the new ASUs are as follows (in thousands, except per share data):

	Three Months Ended October 31, 2016			
	As Previously Reported	Adjustments		As Adjusted
Revenues:				
Subscription services	$335,722	$ 2,188	a	$337,910
Professional services	73,860	1,752	a	75,612
Total revenues	409,582	3,940	a	413,522
Costs and expenses:				
Sales and marketing	149,549	(12)	a	149,537
Operating loss	(109,884)	3,952	a	(105,932)
Net loss	$(114,066)	$ 3,952	a	$(110,114)
Net loss per share, basic and diluted	$(0.57)	$ 0.02	a	$(0.55)

	Nine Months Ended October 31, 2016			
	As Previously Reported	Adjustments		As Adjusted
Revenues:				
Subscription services	$921,953	$ 2,195	a	$924,148
Professional services	210,782	(74)	a	210,708
Total revenues	1,132,735	2,121	a	1,134,856
Costs and expenses:				
Sales and marketing	416,217	(4,162)	a	412,055
Operating loss	(270,430)	6,283	a	(264,147)
Net loss	$(302,713)	$ 6,283	a	$(296,430)
Net loss per share, basic and diluted	$(1.54)	$ 0.04	a	$(1.50)

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Select unaudited condensed consolidated statement of cash flows line items, which reflect the adoption of the new ASUs are as follows (in thousands):

	Three Months Ended October 31, 2016			
	As Previously Reported	Adjustments		As Adjusted
Cash flows from operating activities				
Net loss	$(114,066)	$ 3,952	a	$(110,114)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Amortization of deferred costs	6,507	5,054	a	11,561
Changes in operating assets and liabilities:				
Trade and other receivables, net	(20,360)	(333)	a	(20,693)
Deferred costs	(7,973)	(5,067)	a	(13,040)
Prepaid expenses and other assets	(1,425)	(2,261)	a, b	(3,686)
Unearned revenue	38,514	(1,248)	a	37,266
Net cash provided by (used in) operating activities	71,459	97	b	71,556
Change in restricted cash	3,900	(3,900)	b	—
Net cash provided by (used in) investing activities	(95,220)	(3,900)	b	(99,120)
Net increase (decrease) in cash and cash equivalents	(18,972)	(3,803)	b	(22,775)
Cash, cash equivalents and restricted cash at the beginning of period	405,529	5,615	b	411,144
Cash, cash equivalents and restricted cash at the end of period	$386,557	$ 1,812	b	$388,369

	Nine Months Ended October 31, 2016			
	As Previously Reported	Adjustments		As Adjusted
Cash flows from operating activities				
Net loss	$(302,713)	$ 6,283	a	$(296,430)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:				
Amortization of deferred costs	18,520	14,397	a	32,917
Changes in operating assets and liabilities:				
Trade and other receivables, net	24,695	594	a	25,289
Deferred costs	(23,247)	(18,560)	a	(41,807)
Prepaid expenses and other assets	(14,103)	2,735	a, b	(11,368)
Unearned revenue	117,854	(3,737)	a	114,117
Net cash provided by (used in) operating activities	239,183	1,712	b	240,895
Change in restricted cash	(100)	100	b	—
Net cash provided by (used in) investing activities	(187,343)	100	b	(187,243)
Net increase (decrease) in cash and cash equivalents	86,470	1,812	b	88,282
Cash, cash equivalents and restricted cash at the end of period	$386,557	$ 1,812	b	$388,369

a Adjusted to reflect the adoption of ASU No. 2014-09, Revenue from Contracts with Customers.

b Adjusted to reflect the adoption of ASU No. 2016-18, Statement of Cash Flows, Restricted Cash.

Summary of Significant Accounting Policies

Except for the accounting policies for revenue recognition, trade and other receivables, and deferred commissions that were updated as a result of adopting ASU No. 2014-09, there have been no changes to our significant accounting policies described in the Annual Report on Form 10-K for the year ended January 31, 2017, filed with the SEC on March 20, 2017, that have had a material impact on our condensed consolidated financial statements and related notes.

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Revenue Recognition

We derive our revenues primarily from subscription services and professional services. Revenues are recognized when control of these services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services.

We determine revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations in the contract
- Determination of the transaction price
- Allocation of the transaction price to the performance obligations in the contract
- Recognition of revenue when, or as, we satisfy a performance obligation

Subscription Services Revenues

Subscription services revenues primarily consist of fees that provide customers access to one or more of our cloud applications for finance, human resources, and analytics, with routine customer support. Revenue is generally recognized over time on a ratable basis over the contract term beginning on the date that our service is made available to the customer. Our subscription contracts are generally three years or longer in length, billed annually in advance, and non-cancelable.

Professional Services Revenues

Professional services revenues primarily consist of fees for deployment and optimization services, as well as training. The majority of our consulting contracts are billed on a time and materials basis and revenue is recognized over time as the services are performed. For contracts billed on a fixed price basis, revenue is recognized over time based on the proportion performed.

Contracts with Multiple Performance Obligations

Some of our contracts with customers contain multiple performance obligations. For these contracts, we account for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. We determine the standalone selling prices based on our overall pricing objectives, taking into consideration market conditions and other factors, including the value of our contracts, the cloud applications sold, customer demographics, geographic locations, and the number and types of users within our contracts.

Trade and Other Receivables

Trade and other receivables are primarily comprised of trade receivables that are recorded at the invoice amount, net of an allowance for doubtful accounts, which is not material. Other receivables represent unbilled receivables related to subscription and professional services contracts.

Deferred Commissions

Sales commissions earned by our sales force are considered incremental and recoverable costs of obtaining a contract with a customer. Sales commissions for initial contracts are deferred and then amortized on a straight-line basis over a period of benefit that we have determined to be five years. We determined the period of benefit by taking into consideration our customer contracts, our technology and other factors. Sales commissions for renewal contracts are deferred and then amortized on a straight-line basis over the related contractual renewal period. Amortization expense is included in Sales and marketing expenses in the accompanying condensed consolidated statements of operations.

Recently Issued Accounting Pronouncements

In January 2016, the FASB issued ASU No. 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 and recognize any changes in fair value in net income. We expect to elect the measurement alternative, defined as cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. The guidance is effective for our fiscal year beginning February 1, 2018. Early adoption is permitted. We plan to adopt the new standard in the first quarter of fiscal 2019. 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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In February 2016, the FASB issued ASU No. 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 Topic 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.

In October 2016, the FASB issued ASU No. 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 plan to adopt the new standard in the first quarter of fiscal 2019 and do not expect it to have a material impact on our consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815), which better aligns an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. 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.

Note 3. Marketable Securities

At October 31, 2017, marketable securities consisted of the following (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. agency obligations	$837,650	$ 1	$ (813)	$836,838
U.S. treasury securities	698,398	—	(447)	697,951
Corporate bonds	428,145	14	(406)	427,753
Commercial paper	500,114	—	—	500,114
Money market funds	559,076	—	—	559,076
Certificates of deposit	5,000	—	—	5,000
	$3,028,383	$ 15	$ (1,666)	$3,026,732
Included in cash and cash equivalents	$1,152,599	$ —	$ (6)	$1,152,593
Included in marketable securities	$1,875,784	$ 15	$ (1,660)	$1,874,139

At January 31, 2017, marketable securities consisted of the following (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. agency obligations	$908,874	$ 179	$ (535)	$908,518
U.S. treasury securities	192,028	48	(25)	192,051
Corporate bonds	290,272	42	(429)	289,885
Commercial paper	323,106	—	—	323,106
Money market funds	24,425	—	—	24,425
	$1,738,705	$ 269	$ (989)	$1,737,985
Included in cash and cash equivalents	$281,163	$ —	$ —	$281,163
Included in marketable securities	$1,457,542	$ 269	$ (989)	$1,456,822

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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, 2017. The unrealized losses on marketable securities which have been in a net loss position for 12 months or greater were not material as of October 31, 2017. 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 consider all marketable securities as available for use in current operations, including those with maturity dates beyond one year, and therefore classify these securities 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. We sold $33 million and $63 million of our marketable securities during the three months ended October 31, 2017 and 2016, respectively, and $223 million and $92 million of our marketable securities during the nine months ended October 31, 2017 and 2016, respectively. The realized gains from the sales are immaterial.

Note 4. 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.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents information about our assets and liabilities that are measured at fair value on a recurring basis and their assigned levels within the valuation hierarchy as of October 31, 2017 (in thousands):

Description	Level 1	Level 2	Level 3	Total
U.S. agency obligations	$—	$836,838	$ —	$836,838
U.S. treasury securities	697,951	—	—	697,951
Corporate bonds	—	427,753	—	427,753
Commercial paper	—	500,114	—	500,114
Money market funds	559,076	—	—	559,076
Certificates of deposit	—	5,000	—	5,000
Foreign currency derivative assets	—	2,880	—	2,880
Total assets	$1,257,027	$1,772,585	$ —	$3,029,612
Foreign currency derivative liabilities	$—	$15,172	$ —	$15,172
Total liabilities	$—	$15,172	$ —	$15,172

The following table presents information about our assets and liabilities that are measured at fair value on a recurring basis and their assigned levels within the valuation hierarchy as of January 31, 2017 (in thousands):

Description	Level 1	Level 2	Level 3	Total
U.S. agency obligations	$—	$908,518	$ —	$908,518
U.S. treasury securities	192,051	—	—	192,051
Corporate bonds	—	289,885	—	289,885
Commercial paper	—	323,106	—	323,106
Money market funds	24,425	—	—	24,425
Foreign currency derivative assets	—	7,909	—	7,909
Total assets	$216,476	$1,529,418	$ —	$1,745,894
Foreign currency derivative liabilities	$—	$2,127	$ —	$2,127
Total liabilities	$—	$2,127	$ —	$2,127

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Fair Value Measurements of Other Financial Instruments

The following table presents the carrying amounts and estimated fair values of our financial instruments that are not recorded at fair value in the condensed consolidated balance sheets (in thousands):

	October 31, 2017		January 31, 2017	
	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	$337,930	$475,230	$325,620	$402,259
1.50% Convertible senior notes	220,512	367,425	213,180	310,470
0.25% Convertible senior notes	931,866	1,166,100	—	—

The difference between the principal amount of the notes, $350 million for the 0.75% convertible senior notes, $250 million for the 1.50% convertible senior notes, and $1.15 billion for the 0.25% convertible senior notes, and the net carrying amount before unamortized debt issuance costs represents the unamortized debt discount (see Note 10). 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 $110.99 on October 31, 2017, the if-converted values of the 0.75% convertible senior notes and the 1.50% convertible senior notes were greater than their respective principal amounts, and the if-converted value of the 0.25% convertible senior notes was less than the respective principal amount.

Note 5. Deferred Costs

Deferred costs, which primarily consist of deferred sales commissions, were $176 million and $169 million as of October 31, 2017 and January 31, 2017, respectively. Amortization expense for the deferred costs was $14 million and $12 million for the three months ended October 31, 2017 and 2016, respectively, and $42 million and $33 million for the nine months ended October 31, 2017 and 2016, respectively. There was no impairment loss in relation to the costs capitalized for the periods presented.

Note 6. Property and Equipment, Net

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

	October 31, 2017	January 31, 2017
Land	$7,353	$6,592
Buildings	216,562	115,302
Computers, equipment and software	373,995	323,311
Computers, equipment and software acquired under capital leases	14,358	18,298
Furniture and fixtures	32,729	24,462
Leasehold improvements	122,881	108,673
Property and equipment, gross [(1)]	767,878	596,638
Less accumulated depreciation and amortization	(280,644)	(230,761)
Property and equipment, net	$487,234	$365,877

(1) Property and equipment, gross includes construction-in-progress for owned real estate projects of $137 million and $115 million that have not yet been placed in service as of October 31, 2017 and January 31, 2017, respectively.

Depreciation expense totaled $30 million and $23 million for the three months ended October 31, 2017 and 2016, respectively, and $85 million and $67 million for the nine months ended October 31, 2017 and 2016, respectively. Interest costs capitalized to property and equipment totaled $3 million and $1 million for the three months ended October 31, 2017 and 2016, respectively, and $6 million and $2 million for the nine months ended October 31, 2017 and 2016, respectively.

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Note 7. Acquisition-related Intangible Assets, Net

Acquisition-related intangible assets, net consisted of the following (in thousands):

	October 31, 2017	January 31, 2017
Acquired developed technology	$ 64,900	$ 64,900
Customer relationship assets	1,000	1,000
	65,900	65,900
Less accumulated amortization	(31,595)	(17,113)
Acquisition-related intangible assets, net	$ 34,305	$ 48,787

Amortization expense related to acquired developed technology and customer relationship assets was $4 million and $5 million for the three months ended October 31, 2017 and 2016, respectively, and $14 million and $8 million for the nine months ended October 31, 2017 and 2016, respectively.

As of October 31, 2017, our future estimated amortization expense related to acquired developed technology and customer relationship assets is as follows (in thousands):

Fiscal Period:	
2018	$4,804
2019	18,904
2020	10,281
2021	316
Total	$34,305

Note 8. Other Assets

Other assets consisted of the following (in thousands):

	October 31, 2017	January 31, 2017
Cost method investments	$ 24,320	$ 14,004
Acquired land leasehold interest, net	9,596	9,676
Deposits	4,101	3,488
Net deferred tax assets	1,820	4,336
Other	30,977	22,066
Total	$ 70,814	$ 53,570

Our cost method investments include investments in private companies in which we do not have the ability to exert significant influence. The investments are tested for impairment at least annually, and more frequently upon the occurrence of certain events.

Note 9. Derivative 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 of the fair value hierarchy 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 on 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 are excluded from the assessment of hedge effectiveness and are recorded as incurred in Other income (expense), net on the condensed consolidated statements of operations. Cash flows from such forward contracts are classified as operating activities.

As of October 31, 2017 and January 31, 2017, we had outstanding foreign currency forward contracts designated as cash flow hedges with total notional values of $470 million and $252 million, respectively. All contracts have maturities not greater than 35 months. The notional value represents the amount that will be bought or sold upon maturity of the forward contract.

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 income (expense), net on the 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, 2017 and January 31, 2017, we had outstanding forward contracts with total notional values of $51 million.

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

	Condensed Consolidated Balance Sheets Location	October 31, 2017	January 31, 2017
Derivative Assets:			
Foreign currency forward contracts designated as cash flow hedges	Prepaid expenses and other current assets and Other assets	$ 2,535	$ 7,149
Foreign currency forward contracts not designated as hedges	Prepaid expenses and other current assets	345	760
Derivative Liabilities:			
Foreign currency forward contracts designated as cash flow hedges	Accrued expenses and other current liabilities and Other liabilities	$ 13,424	$ 1,605
Foreign currency forward contracts not designated as hedges	Accrued expenses and other current liabilities	1,748	522

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, 2017	2016	Nine Months Ended October 31, 2017	2016
Gains (losses) recognized in OCI (effective portion) [1]	Net change in market value of effective foreign currency forward exchange contracts	$ 7,372	$ 6,107	$ (16,526)	$ 1,606
Gains (losses) reclassified from OCI into income (effective portion)	Revenues	679	183	1,386	436
Gains (losses) recognized in income (amount excluded from effectiveness testing and ineffective portion)	Other income (expense), net	350	517	1,740	833

(1) Of the total effective portion of foreign currency forward contracts designated as cash flow hedges as of October 31, 2017, net losses of $3 million are expected to be reclassified out of OCI 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 October 31, 2017	2016	Nine Months Ended October 31, 2017	2016
Foreign currency forward contracts not designated as hedges	Other income (expense), net	$829	$1,195	$(1,796)	$654

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.

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As of October 31, 2017, 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	$ 1,781	$ —	$ 1,781	$ (1,781)	$ —	$ —
Counterparty B	236	—	236	(236)	—	—
Counterparty C	863	—	863	(863)	—	—
Total	$ 2,880	$ —	$ 2,880	$ (2,880)	$ —	$ —

	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	$ 2,916	$ —	$ 2,916	$ (1,781)	$ —	$ 1,135
Counterparty B	11,088	—	11,088	(236)	—	10,852
Counterparty C	1,154	—	1,154	(863)	—	291
Counterparty D	14	—	14	—	—	14
Total	$ 15,172	$ —	$ 15,172	$ (2,880)	$ —	$ 12,292

Note 10. 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. 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.

In September 2017, we issued 0.25% convertible senior notes due October 1, 2022 ("2022 Notes") with a principal amount of $1.15 billion (together with the 2018 Notes and 2020 Notes, referred to as "the Notes"). The 2022 Notes are unsecured, unsubordinated obligations, and interest is payable in cash in arrears at a fixed rate of 0.25% on April 1 and October 1 of each year. The 2022 Notes mature on October 1, 2022 unless repurchased or converted in accordance with their terms prior to such date. We cannot redeem the 2022 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. For the 2022 Notes, the initial conversion rate is 6.7982 shares of Class A common stock per $1,000 principal amount, which is equal to an initial conversion price of approximately $147.10 per share of Class A common stock, subject to adjustment. Prior to the close of business on May 31, 2022, the conversion is subject to the satisfaction of certain conditions, as described below.

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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, March 13, 2020 for the 2020 Notes, and May 31, 2022 for the 2022 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 20 trading days during the period of 30 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. This circumstance is effective for the 2022 Notes during any fiscal quarter commencing after the fiscal quarter ending on January 31, 2018;
- 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 using the effective interest rate method. The equity components are not remeasured as long as they continue to meet the conditions for equity classification.

In accounting for the issuance costs related to the Notes, we allocated the total amount of issuance costs incurred to liability and equity components based on their relative values. Issuance costs attributable to the liability components are being amortized on a straight-line basis, which approximates the effective interest rate method, to interest expense over the respective terms of the Notes. 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, 2017 and 2016, respectively. 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 $0.5 million for each of the three and nine month periods ended October 31, 2017 and 2016, respectively. For the 2022 Notes, we recorded liability issuance costs of $14 million and equity issuance costs of $4 million. Amortization expense for the liability issuance costs was $0.4 million for each of the three and nine month periods ended October 31, 2017.

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

	October 31, 2017			January 31, 2017		
	2018 Notes	2020 Notes	2022 Notes	2018 Notes	2020 Notes	2022 Notes
Principal amounts:						
Principal	$350,000	$250,000	$1,150,000	$350,000	$250,000	$ —
Unamortized debt discount	(12,070)	(29,488)	(218,134)	(24,380)	(36,820)	—
Net carrying amount before unamortized debt issuance costs	337,930	220,512	931,866	325,620	213,180	—
Unamortized debt issuance costs	(994)	(1,824)	(14,060)	(2,050)	(2,327)	—
Net carrying amount	$336,936	$218,688	$917,806	$323,570	$210,853	$ —
Carrying amount of the equity component [1]	$74,892	$66,007	$219,702	$74,892	$66,007	$ —

(1)

Included in the condensed consolidated balance sheets within Additional paid-in capital, net of $2 million, $2 million, and $4 million for the 2018 Notes, 2020 Notes, and 2022 Notes, respectively, in equity issuance costs.

As of October 31, 2017, the 2018 Notes have a remaining life of approximately 8 months and are classified as current on the condensed consolidated balance sheet. The 2020 Notes and the 2022 Notes have a remaining life of 32 months and 59 months, respectively, and are classified as non-current on the condensed consolidated balance sheet.

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The effective interest rates of the liability components of the 2018 Notes, 2020 Notes, and 2022 Notes are 5.75%, 6.25%, and 4.60% 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 October 31,						Nine Months Ended October 31,					
	2017			2016			2017			2016		
	2018 Notes	2020 Notes	2022 Notes	2018 Notes	2020 Notes	2022 Notes	2018 Notes	2020 Notes	2022 Notes	2018 Notes	2020 Notes	2022 Notes
Contractual interest expense	$656	$938	$367	$656	$938	$ —	$1,969	$2,813	$367	$1,969	$2,813	$ —
Interest cost related to amortization of debt issuance costs	352	168	365	352	167	—	1,056	503	365	1,056	504	—
Interest cost related to amortization of the debt discount	4,162	2,482	5,042	3,930	2,333	—	12,310	7,332	5,042	11,622	6,889	—

We capitalized interest costs related to the Notes of $3 million and $1 million for the three months ended October 31, 2017 and 2016, respectively, and $6 million and $2 million for the nine months ended October 31, 2017 and 2016, respectively.

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 relating to the 2018 Notes give us the option to purchase, subject to anti-dilution adjustments substantially identical to those in the Notes, approximately 4.2 million shares of our Class A common stock for $83.28 per share, exercisable upon conversion of the Notes. The Purchased Options relating to the 2020 Notes give us the option to purchase, subject to anti-dilution adjustments substantially identical to those in the Notes, approximately 3.1 million shares of our Class A common stock for $81.74 per share, exercisable upon conversion of the Notes. The Purchased Options relating to the 2022 Notes give us the option to purchase, subject to anti-dilution adjustments substantially identical to those in the Notes, approximately 7.8 million shares of our Class A common stock for $147.10 per share, exercisable upon conversion of the Notes. The Purchased Options will expire in 2018 for the 2018 Notes, in 2020 for the 2020 Notes, and in 2022 for the 2022 Notes, if not exercised earlier. 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 relating to the 2018 Notes and 2020 Notes, and $176 million for the Purchased Options relating to the 2022 Notes. The amount paid for the Purchased Options 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 over 60 scheduled trading days beginning in October 2018, 3.1 million shares over 60 scheduled trading days beginning in October 2020, and 7.8 million shares over 60 scheduled trading days beginning in January 2023 of our Class A common stock at an exercise price of $107.96, $107.96, and $213.96 per share, respectively. 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 related to the 2018 Notes and the 2020 Notes, and $81 million from the sale of the Warrants related to the 2022 Notes. The proceeds from the sale of the Warrants are recorded in Additional paid-in capital in the condensed consolidated balance sheets.

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Note 11. Commitments and Contingencies

Facility and Computing Infrastructure-related Commitments

We have entered into non-cancelable agreements for certain of our offices and data centers 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 17). Our 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 $21 million and $19 million for the three months ended October 31, 2017 and 2016, respectively, and $60 million and $53 million for the nine months ended October 31, 2017 and 2016, 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.

Additionally, we have entered into a non-cancelable agreement with a computing infrastructure vendor that expires on October 31, 2024.

Legal Matters

We are a party to various legal proceedings and claims which arise in the ordinary course of business. We make a provision for a liability relating to legal matters when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. In our opinion, as of October 31, 2017, there was not at least a reasonable possibility that we had incurred or will incur a material loss, or a material loss in excess of a recorded accrual, with respect to such loss contingencies.

Note 12. Common Stock and Stockholders’ Equity

Common Stock

As of October 31, 2017, there were 137 million shares of Class A common stock and 73 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 10 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 in March 2017, and as of October 31, 2017, we had approximately 61 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 1 and December 1 and exercisable on or about the succeeding November 30 and May 31, respectively, of each year. Pursuant to the terms of the ESPP, the share reserve increased by 2 million shares in March 2017. As of October 31, 2017, 7 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. 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 nine months ended October 31, 2017 is as follows:

	Outstanding Stock Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in millions)
Balance as of January 31, 2017	9,096,592	$ 4.34	$ 716
Stock options granted	—	—	
Stock options exercised	(2,016,123)	4.60	
Stock options canceled	(9,975)	7.77	
Balance as of October 31, 2017	7,070,494	$ 4.26	$ 755
Vested and expected to vest as of October 31, 2017	7,070,356	$ 4.26	$ 755
Exercisable as of October 31, 2017	7,068,894	$ 4.26	$ 754

As of October 31, 2017, there was a total of $0.3 million in unrecognized compensation cost related to unvested stock options which is expected to be recognized over a weighted-average period of approximately three months.

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 nine months ended October 31, 2017 is as follows:

	Number of Shares	Weighted-Average Grant Date Fair Value
Balance as of January 31, 2017	11,502,721	$ 78.45
RSUs granted	7,011,426	87.22
RSUs vested	(4,445,556)	78.02
RSUs forfeited	(807,255)	78.46
Balance as of October 31, 2017	13,261,336	$ 83.23

As of October 31, 2017, there was a total of $1.0 billion in unrecognized compensation cost related to unvested RSUs, which is expected to be recognized over a weighted-average period of approximately three years.

Performance-based Restricted Stock Units

During fiscal 2017, 0.3 million shares of performance-based restricted stock units ("PRSUs") were granted to all employees other than executive management and included both service conditions and performance conditions related to company-wide goals . These performance conditions were met and the PRSUs vested on March 15, 2017. During the nine months ended October 31, 2017, we recognized $6 million in compensation cost related to these PRSUs. Additionally, during fiscal 2018, 0.4 million shares of PRSUs were granted to all employees other than executive management and included both service conditions and performance conditions related to company-wide goals. We expect to grant additional shares related to this program for employees hired in fiscal 2018. These PRSU awards will vest if the performance conditions are achieved for the fiscal year ended January 31, 2018 and if the individual employee continues to provide service through the vesting date of March 15, 2018. During the three and nine months ended October 31, 2017, we recognized $12 million and $18 million, respectively, in compensation cost related to these PRSUs, and there is a total of $19 million in unrecognized compensation cost which is expected to be recognized over a weighted-average period of approximately five months.

Note 13. Unearned Revenue and Performance Obligations

$421 million and $308 million of subscription services revenue was recognized during the three months ended October 31, 2017 and 2016, respectively, that was included in the unearned revenue balances at the beginning of the respective periods. $1.2 billion and $841 million of subscription services revenue was recognized during the nine months ended October 31, 2017 and 2016, respectively, that was included in the unearned revenue balances at the beginning of the respective periods. Professional services revenue recognized in the same periods from unearned revenue balances at the beginning of the respective periods was not material.

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Transaction Price Allocated to the Remaining Performance Obligations

As of October 31, 2017, approximately $4.5 billion of revenue is expected to be recognized from remaining performance obligations for subscription contracts. We expect to recognize revenue on approximately two thirds of these remaining performance obligations over the next 24 months, with the balance recognized thereafter. Revenue from remaining performance obligations for professional services contracts as of October 31, 2017 was not material.

Note 14. Other Income (Expense), Net

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

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2017	2016	2017	2016
Interest income	$6,394	$2,805	$15,474	$7,916
Interest expense [1]	(12,285)	(7,206)	(26,111)	(23,151)
Gain from sale of cost method investment	194	—	720	65
Impairment of cost method investment	(100)	—	(100)	(15,000)
Other income (expense)	2,055	1,296	5,550	34
Other income (expense), net	$(3,742)	$(3,105)	$(4,467)	$(30,136)

(1) Interest expense includes the contractual interest expense related to the 2018 Notes, 2020 Notes and 2022 Notes and non-cash interest related to amortization of the debt discount and debt issuance costs, net of capitalized interest costs (see Note 10).

Note 15. 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 expense of $6 million and $2 million for the nine months ended October 31, 2017 and 2016, respectively. The income tax provision for the nine months ended October 31, 2017 was primarily attributable to state taxes and income tax expenses in profitable foreign jurisdictions. The income tax provision for the nine months ended October 31, 2016 was primarily attributable to $3 million in state taxes and income tax expenses in profitable foreign jurisdictions, partially offset by $1 million income tax benefits from the valuation allowance release related to certain acquired intangible assets from a business acquisition.

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 October 31, 2017, we continue to maintain a full valuation allowance on our deferred tax assets except for certain jurisdictions.

Note 16. 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 units and 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.

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.

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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 October 31,				Nine Months Ended October 31,			
	2017		2016 * As Adjusted		2017		2016 * As Adjusted	
	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	$(55,592)	$(29,954)	$(68,192)	$(41,922)	$(149,179)	$(82,943)	$(181,470)	$(114,960)
Denominator:								
Weighted-average common shares outstanding	135,941	73,247	123,534	75,945	132,851	73,864	120,658	76,435
Basic and diluted net loss per share	$(0.41)	$(0.41)	$(0.55)	$(0.55)	$(1.12)	$(1.12)	$(1.50)	$(1.50)

* Adjusted to reflect adoption of ASU No. 2014-09, Revenue from Contracts with Customers. For further information, see Note 2.

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 October 31,	
	2017	2016
Outstanding common stock options	7,070	9,694
Shares subject to repurchase	15	236
Unvested restricted stock awards, units, and PRSUs	13,680	12,761
Shares related to the convertible senior notes	15,079	7,261
Shares subject to warrants related to the issuance of convertible senior notes	15,079	7,261
Shares issuable pursuant to the ESPP	375	359
	51,298	37,572

Note 17. 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 $9 million for the fiscal year ended January 31, 2018, and $101 million in total. Rent expense under these agreements was $2 million for each of the three month periods ended October 31, 2017 and 2016, and $6 million for each of the nine month periods ended October 31, 2017 and 2016.

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Note 18. Geographic Information

Disaggregation of Revenue

We sell our subscription contracts and related services in two primary geographical markets: to customers located in the United States, and to customers located outside of the United States. Revenue by geography is generally based on the address of the customer as specified in our master subscription agreement. The following table sets forth revenue by geographic area (in thousands):

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2017	2016 *As Adjusted	2017	2016 *As Adjusted
United States	$439,794	$335,592	$1,242,431	$929,031
Other countries	115,595	77,930	318,139	205,825
Total	$555,389	$413,522	$1,560,570	$1,134,856

* Adjusted to reflect adoption of ASU No. 2014-09, Revenue from Contracts with Customers. For further information, see Note 2.

No single country other than the United States had revenues greater than 10% of total revenues for the three and nine months ended October 31, 2017 and 2016. No customer individually accounted for more than 10% of our trade and other receivables, net as of October 31, 2017 or January 31, 2017.

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):

	October 31, 2017	January 31, 2017
United States	$ 428,040	$ 321,442
Ireland	46,797	35,720
Other countries	12,397	8,715
Total	$ 487,234	$ 365,877

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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," "plan," 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 or longer 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.

Our diverse customer base includes medium-sized and large, global companies. We have achieved significant growth in a relatively short period of time with a substantial amount of our growth coming 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 7,900 and approximately 6,400 employees as of October 31, 2017 and 2016, 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 service 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 service 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 the expanding partner ecosystem, we expect that the rate of professional services revenue growth will decline over time and continue to be lower than subscription revenue growth.

Components of Results of Operations

Revenues

We primarily derive our revenues from subscription services and professional services. 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 83% of our total revenues during the three and nine months ended October 31, 2017 and represented 96% of our total unearned revenue as of October 31, 2017. Subscription services revenues are driven primarily by the number of customers, the number of workers at each customer, the specific 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. Pricing for our applications varies based on many factors, including the maturity of the application and its acceptance in the marketplace. New products or services offerings by competitors in the future could also impact the mix and pricing of our offerings.

Subscription services revenues are recognized over time as they are delivered and consumed concurrently over the contractual term, beginning on the date our service is made available to the customer. Our subscription contracts typically have a term of three years or longer and are generally non-cancelable. We generally invoice our customers annually in advance. Amounts that have been invoiced are initially recorded as unearned revenue.

The majority of our consulting engagements are billed on a time and materials basis, and revenues are typically recognized over time as the services are performed. In some cases, we supplement our consulting teams by subcontracting resources from our service partners and deploying them on customer engagements. As our 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.

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.

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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. Sales commissions are considered incremental costs of obtaining a contract with a customer and are deferred and amortized. Sales commissions for initial contracts are deferred and then amortized on a straight-line basis over a period of benefit that we have determined to be five years. Sales commissions for renewal contracts are deferred and then amortized on a straight-line basis over the related contractual renewal period.

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

Results of Operations

Revenues

Our total revenues for the three and nine months ended October 31, 2017 and 2016 were as follows (in thousands, except percentages):

	Three Months Ended October 31,			Nine Months Ended October 31,		
	2017	2016 *As Adjusted	% Change	2017	2016 *As Adjusted	% Change
Revenues:						
Subscription services	$463,568	$337,910	37%	$1,297,831	$924,148	40%
Professional services	91,821	75,612	21%	262,739	210,708	25%
Total revenues	$555,389	$413,522	34%	$1,560,570	$1,134,856	38%

*See Note 2 of the notes to condensed consolidated financial statements for a summary of adjustments.

Total revenues were $555 million for the three months ended October 31, 2017, compared to $414 million during the prior year period, an increase of $141 million, or 34%. Subscription services revenues were $464 million for the three months ended October 31, 2017, compared to $338 million for the prior year period, an increase of $126 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 $92 million for the three months ended October 31, 2017, compared to $76 million for the prior year period, an increase of $16 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 $1.6 billion for the nine months ended October 31, 2017, compared to $1.1 billion during the prior year period, an increase of $426 million, or 38%. Subscription services revenues were $1.3 billion for the nine months ended October 31, 2017, compared to $924 million for the prior year period, an increase of $374 million, or 40%. 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 $263 million for the nine months ended October 31, 2017, compared to $211 million for the prior year period, an increase of $52 million, or 25%. 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 $635 million for the three months ended October 31, 2017, compared to $519 million for the prior year period, an increase of $116 million, or 22%. The increase was primarily due to increases of $83 million in employee-related costs driven by higher headcount, $8 million in service contracts expense to expand data center capacity, $7 million in depreciation and amortization expense, and $6 million in facility and IT-related expenses.

GAAP operating expenses were $1.8 billion for the nine months ended October 31, 2017, compared to $1.4 billion for the prior year period, an increase of $0.4 billion, or 27%. The increase was primarily due to increases of $0.3 billion in employee-related costs driven by higher headcount and $0.1 billion in expenses related to depreciation, amortization, service contracts to expand data center capacity, facilities and IT.

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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 $505 million for the three months ended October 31, 2017, compared to $406 million for the prior year period, an increase of $99 million, or 24%. The increase was primarily due to increases of $66 million in employee-related costs driven by higher headcount, $8 million in service contracts expense to expand data center capacity, $7 million in depreciation and amortization expense, and $6 million in facility and IT-related expenses.

Non-GAAP operating expenses were $1.4 billion for the nine months ended October 31, 2017, compared to $1.1 billion for the prior year period, an increase of $0.3 billion, or 26%. The increase was primarily due to increases of $0.2 billion in employee-related costs driven by higher headcount and $0.1 billion in expenses related to service contracts to expand data center capacity, depreciation, amortization, facilities and IT.

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

Three
Months
Ended
October
31, 2017