Cornerstone OnDemand Inc
Form 10-Q
November 03, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q
(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 001-35098

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

| | |
|---|---|
| Delaware | 13-4068197 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

1601 Cloverfield Blvd.
Suite 620 South
Santa Monica, CA 90404
(Address of principal executive offices, including zip code)
Registrant’s telephone number, including area code:
(310) 752-0200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý 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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

| | | | |
|---|---|---|---|
| Large accelerated filer | x | Accelerated filer | ¨ |
| Non-accelerated filer | ¨ (Do not check if a smaller reporting company) | Smaller reporting company | ¨ |

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date

| Class | Outstanding as of October 31, 2016 |
|---|---|
| Common Stock | 56,186,698 |

CORNERSTONE ONDEMAND, INC.
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TRADEMARKS

PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements

CORNERSTONE ONDEMAND, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except par values)
(unaudited)

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| Assets | | |
| Cash and cash equivalents | $ 65,290 | $ 107,691 |
| Short-term investments | 172,015 | 136,841 |
| Accounts receivable, net | 99,581 | 104,686 |
| Deferred commissions | 32,642 | 35,910 |
| Prepaid expenses and other current assets | 18,995 | 15,297 |
| Total current assets | 388,523 | 400,425 |
| Capitalized software development costs, net | 28,796 | 23,089 |
| Property and equipment, net | 24,790 | 27,021 |
| Long-term investments | 73,716 | 64,247 |
| Intangible assets, net | 9,638 | 16,713 |
| Goodwill | 25,894 | 25,894 |
| Other assets, net | 482 | 878 |
| Total Assets | $ 551,839 | $ 558,267 |
| Liabilities and Stockholders’ Equity | | |
| Liabilities: | | |
| Accounts payable | $ 13,982 | $ 18,954 |
| Accrued expenses | 40,408 | 44,111 |
| Deferred revenue, current portion | 225,827 | 237,679 |
| Capital lease obligations, current portion | — | 33 |
| Other liabilities | 1,359 | 2,663 |
| Total current liabilities | 281,576 | 303,440 |
| Convertible notes, net | 236,110 | 229,305 |
| Other liabilities, non-current | 2,154 | 3,240 |
| Deferred revenue, net of current portion | 9,240 | 14,460 |
| Total liabilities | 529,080 | 550,445 |
| Commitments and contingencies (Note 9) | | |
| Stockholders’ Equity: | | |
| Common stock, $0.0001 par value; 1,000,000 shares authorized, 56,126 and 54,704 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively | 6 | 5 |
| Additional paid-in capital | 454,399 | 394,089 |
| Accumulated deficit | (435,101) | (386,882) |
| Accumulated other comprehensive income | 3,455 | 610 |
| Total stockholders’ equity | 22,759 | 7,822 |
| Total Liabilities and Stockholders’ Equity | $ 551,839 | $ 558,267 |

See accompanying notes to unaudited condensed consolidated financial statements.

CORNERSTONE ONDEMAND, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue | $107,758 | $87,271 | $314,095 | $243,789 |
| Cost of revenue | 33,369 | 27,246 | 100,974 | 79,801 |
| Gross profit | 74,389 | 60,025 | 213,121 | 163,988 |
| Operating expenses: | | | | |
| Sales and marketing | 53,690 | 53,255 | 168,226 | 150,659 |
| Research and development | 12,130 | 10,457 | 34,927 | 30,207 |
| General and administrative | 18,608 | 13,194 | 51,611 | 36,545 |
| Amortization of certain acquired intangible assets | — | 150 | 150 | 450 |
| Total operating expenses | 84,428 | 77,056 | 254,914 | 217,861 |
| Loss from operations | (10,039) | (17,031) | (41,793) | (53,873) |
| Other income (expense): | | | | |
| Interest income | 451 | 218 | 1,182 | 590 |
| Interest expense | (3,245) | (3,138) | (9,652) | (9,343) |
| Other, net | 663 | (66) | 2,938 | (3,257) |
| Other income (expense), net | (2,131) | (2,986) | (5,532) | (12,010) |
| Loss before income tax provision | (12,170) | (20,017) | (47,325) | (65,883) |
| Income tax provision | (218) | (132) | (894) | (790) |
| Net loss | $(12,388) | $(20,149) | $(48,219) | $(66,673) |
| Net loss per share, basic and diluted | $(0.22) | $(0.37) | $(0.87) | $(1.24) |
| Weighted average common shares outstanding, basic and diluted | 55,964 | 54,260 | 55,359 | 53,917 |

See accompanying notes to unaudited condensed consolidated financial statements.

CORNERSTONE ONDEMAND, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(in thousands)
(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net loss | $(12,388) | $(20,149) | $(48,219) | $(66,673) |
| Other comprehensive income, net of tax: | | | | |
| Foreign currency translation adjustment | 917 | 526 | 2,539 | 291 |
| Net change in unrealized (losses) gains on investments | (162) | 41 | 306 | 105 |
| Other comprehensive income, net of tax | 755 | 567 | 2,845 | 396 |
| Total comprehensive loss | $(11,633) | $(19,582) | $(45,374) | $(66,277) |

See accompanying notes to unaudited condensed consolidated financial statements.

CORNERSTONE ONDEMAND, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net loss | $(48,219) | $(66,673) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 23,867 | 19,897 |
| Accretion of debt discount and amortization of debt issuance costs | 6,805 | 6,478 |
| Purchased investment premium, net of amortization | 219 | (94) |
| Net foreign currency (gain) loss | (1,146) | 1,669 |
| Stock-based compensation expense | 40,750 | 30,668 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,056 | (9,523) |
| Deferred commissions | 1,688 | (2,127) |
| Prepaid expenses and other assets | (3,807) | (4,789) |
| Accounts payable | (4,937) | (1,045) |
| Accrued expenses | (5,211) | 386 |
| Deferred revenue | (7,490) | 16,544 |
| Other liabilities | (1,857) | (675) |
| Net cash provided by (used in) operating activities | 1,718 | (9,284) |
| Cash flows from investing activities: | | |
| Purchases of investments | (174,992) | (162,191) |
| Maturities of investments | 130,229 | 81,415 |
| Capital expenditures | (4,345) | (15,006) |
| Capitalized software costs | (12,236) | (9,996) |
| Net cash used in investing activities | (61,344) | (105,778) |
| Cash flows from financing activities: | | |
| Repayment of debt | — | (295) |
| Principal payments under capital lease obligations | (33) | (185) |
| Proceeds from employee stock plans | 17,770 | 9,197 |
| Net cash provided by financing activities | 17,737 | 8,717 |
| Effect of exchange rate changes on cash and cash equivalents | (512) | (2,285) |
| Net decrease in cash and cash equivalents | (42,401) | (108,630) |
| Cash and cash equivalents at beginning of period | 107,691 | 166,557 |
| Cash and cash equivalents at end of period | $65,290 | $57,927 |
| Supplemental cash flow information: | | |
| Cash paid for interest | $3,796 | $1,914 |
| Cash paid for income taxes | 1,837 | 1,209 |
| Proceeds from employee stock plans received in advance of stock issuance | 1,485 | 1,130 |
| Non-cash investing and financing activities: | | |
| Capitalized assets financed by accounts payable and accrued expenses | $1,993 | $538 |
| Capitalized stock-based compensation | 3,111 | 2,019 |

See accompanying notes to unaudited condensed consolidated financial statements.

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CORNERSTONE ONDEMAND, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

## 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Company Overview

Cornerstone OnDemand, Inc. ("Cornerstone" or the "Company") was incorporated on May 24, 1999 in the state of Delaware and began its principal operations in November 1999.

The Company is a leading global provider of human capital management solutions delivered as Software-as-a-Service ("SaaS"). The Company's Enterprise and Mid-Market solution is a unified cloud-based platform that addresses critical talent needs throughout the entire employee lifecycle, from recruitment, onboarding, training and collaboration, to performance management, compensation, succession planning, people administration and analytics.

The Company's solutions are designed to enable organizations to meet the challenges they face in empowering and maximizing the productivity of their human capital. These challenges include hiring and developing employees throughout their careers, engaging all employees effectively, improving business execution, cultivating future leaders, and integrating with an organization's extended enterprise of clients, vendors and distributors by delivering training, certification programs and other content. The Company's management has determined that the Company operates in one segment as it only reports financial information on an aggregate and consolidated basis to the Company's chief executive officer, who is the Company's chief operating decision maker.

### Office Locations

The Company is headquartered in Santa Monica, California and has offices in Amsterdam, Auckland, Bangalore, Düsseldorf, Hong Kong, London, Madrid, Mumbai, Munich, New Delhi, Paris, San Francisco, São Paulo, Stockholm, Sunnyvale, Sydney, Tel Aviv, and Tokyo.

### Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with (i) United States generally accepted accounting principles ("GAAP") for interim financial information and (ii) the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, such financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the financial statements include all adjustments (consisting of normal recurring adjustments) necessary for the fair presentation of the interim periods presented. Results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016, for any other interim period or for any other future year.

The condensed consolidated balance sheet at December 31, 2015 has been derived from the audited financial statements at that date, but does not include all of the disclosures required by GAAP.

The Company's significant accounting policies are described in "Note 2. Summary of Significant Accounting Policies" in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. The Company follows the same accounting policies for interim reporting. The financial information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company's consolidated financial statements and related notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

### Recently Adopted Accounting Pronouncement

In April 2015, the Financial Accounting Standards Board ("FASB") issued a new accounting standards update ("ASU") to simplify presentation of debt issuance costs, which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The guidance was effective for reporting periods beginning after December 15, 2015 and interim periods within those fiscal years. The Company adopted this accounting guidance as of March 31, 2016 on a retrospective basis. As a result of the adoption, the Company reclassified unamortized debt issuance costs of $2.3 million and $3.3 million as of September 30, 2016 and December 31, 2015, respectively, from Other assets, net and reflected them as a reduction in Convertible notes, net on the Condensed Consolidated Balance Sheets. The adoption of this guidance did not have a significant impact on the Company's results of operations or financial position.

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Recent Accounting Pronouncements

In August 2016, the FASB issued a new ASU to clarify how companies present and classify certain cash receipts and cash payments in the statement of cash flows. This guidance is effective for our interim and annual reporting period beginning January 1, 2018 . The Company is currently evaluating the effects of the adoption of this ASU on its financial statements.

In March 2016, the FASB issued a new ASU to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. This guidance is effective for our interim and annual reporting periods beginning January 1, 2017. The Company is currently evaluating the effects of the adoption of this ASU on its financial statements.

In February 2016, the FASB issued a new ASU, which amends a number of aspects of lease accounting, including requiring lessees to recognize operating leases with a term greater than one year on their balance sheet as a right-of-use asset and corresponding lease liability, measured at the present value of the lease payments. This guidance is effective for our interim and annual reporting periods beginning January 1, 2019. The Company is currently evaluating the effects of the adoption of this ASU on its financial statements.

In January 2016, the FASB issued a new ASU that provides guidance for the recognition, measurement, presentation, and disclosure of financial assets and liabilities. This guidance is effective for our interim and annual reporting periods beginning January 1, 2018. The Company is currently evaluating the effects of the adoption of this ASU on its financial statements.

In May 2014, the FASB issued a new ASU that provides principles for recognizing revenue for the transfer of promised goods or services to customers with the consideration to which the entity expects to be entitled in exchange for those goods or services. In July 2015, the FASB approved a one-year deferral of the effective date for the new standard. As a result, this guidance is effective for our interim and annual reporting periods beginning January 1, 2018. Early adoption is permitted beginning January 1, 2017. The Company is currently evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption.

2. NET LOSS PER SHARE

The following table presents the Company’s basic and diluted net loss per share (in thousands, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net loss | $(12,388) | $(20,149) | $(48,219) | $(66,673) |
| Weighted-average shares of common stock outstanding | 55,964 | 54,260 | 55,359 | 53,917 |
| Net loss per share – basic and diluted | $(0.22) | $(0.37) | $(0.87) | $(1.24) |

At September 30, 2016 and 2015, the following shares were excluded from the computation of diluted net loss per share because the effect of these shares would have been anti-dilutive (in thousands):

| | September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Options to purchase common stock and restricted stock units | 10,920 | 10,884 |
| Shares issuable pursuant to employee stock purchase plan | 77 | 67 |
| Convertible notes | 4,682 | 4,682 |
| Common stock warrants | 4,682 | 4,682 |
| Total shares excluded from net loss per share | 20,361 | 20,315 |

Under the treasury stock method, the convertible notes and common stock warrants will have a dilutive impact on net earnings per share when the average stock price for the period exceeds the respective conversion prices and the Company has net income. The Company also entered into note hedge transactions (“Note Hedges”) in connection with the convertible notes with respect to its common stock to minimize the impact of potential economic dilution upon conversion of the convertible notes. The Note Hedges were outstanding as of September 30, 2016. Since the beneficial impact of the Note Hedges was anti-dilutive, they are excluded from the calculation of diluted net income (loss) per share. See Note 6 of the Notes to Condensed Consolidated Financial Statements.

3. INVESTMENTS

Investments in Marketable Securities

The Company's investments in available-for-sale marketable securities are made pursuant to its investment policy, which has established guidelines relative to the diversification of the Company's investments and their maturities, with the principal objective of capital preservation and maintaining liquidity that is sufficient to meet cash flow requirements.

The following is a summary of investments in marketable securities, including cash equivalents, as of September 30, 2016 (in thousands):

| | September 30, 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost Basis | Unrealized Gains | Unrealized Losses | Fair Value |
| Money market funds | $31,636 | $ — | $ — | $31,636 |
| Corporate bonds | 49,541 | 6 | (30 ) | 49,517 |
| Agency bonds | 36,980 | 11 | (21 ) | 36,970 |
| U.S. treasury securities | 140,878 | 57 | (20 ) | 140,915 |
| Commercial paper | 16,257 | — | — | 16,257 |
| | $275,292 | $ 74 | $ (71 ) | $275,295 |

The following is a summary of investments in marketable securities, including cash equivalents, as of December 31, 2015 (in thousands):

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost Basis | Unrealized Gains | Unrealized Losses | Fair Value |
| Money market funds | $61,986 | $ — | $ — | $61,986 |
| Corporate bonds | 56,205 | 3 | (99 ) | 56,109 |
| Agency bonds | 85,572 | — | (111 ) | 85,461 |
| U.S. treasury securities | 58,004 | 2 | (98 ) | 57,908 |
| | $261,767 | $ 5 | $ (308 ) | $261,464 |

As of September 30, 2016, the Company's investment in corporate bonds, agency bonds, U.S. treasury securities and commercial paper had a weighted-average maturity date of approximately nine months. Unrealized gains and losses on investments were not significant, and the Company does not believe the unrealized losses represent other-than-temporary impairments as of September 30, 2016 and December 31, 2015. No marketable securities held have been in a continuous unrealized loss position for more than 12 months as of September 30, 2016 and December 31, 2015.

Strategic Investments

The following is a summary of the Company's strategic investments in equity securities of privately-held companies as of September 30, 2016 (in thousands):

| | |
|---|---|
| September 2016 investment | $500 |
| April 2016 investment | 112 |
| December 2015 investment | 350 |
| July 2015 investment | 250 |
| May 2015 investment | 500 |
| September 2014 investment | 360 |
| | $2,072 |

The Company accounted for each of these investments using the cost method of accounting, as the Company does not have significant influence or a controlling financial interest over these entities. These investments are subject to periodic impairment reviews and are considered to be impaired when a decline in fair value is judged to be other-than-temporary. As of September 30, 2016, the Company determined there were no impairments of these investments.

In June 2014, the Company invested $0.5 million in a debt security of a privately-held company. The Company accounted for this debt security as an available-for-sale security at fair value, which was determined to have no value as of September 30, 2016.

## 4. INTANGIBLE ASSETS

The Company has finite-lived intangible assets which are amortized over the estimated useful lives on a straight-line basis. The following table presents the gross carrying amount and accumulated amortization of finite-lived intangible assets as of September 30, 2016 and December 31, 2015 (in thousands):

| | September 30, 2016 | | | December 31, 2015 | | |
|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Developed technology | $29,984 | $ (20,529) | $ 9,455 | $29,984 | $ (13,732) | $ 16,252 |
| Customer relationships | 2,400 | (2,400) | — | 2,400 | (2,242) | 158 |
| Software license rights | 1,654 | (1,471) | 183 | 1,654 | (1,351) | 303 |
| Total | $34,038 | $ (24,400) | $ 9,638 | $34,038 | $ (17,325) | $ 16,713 |

Total amortization expense from finite-lived intangible assets was $2.2 million and $7.1 million for the three and nine months ended September 30, 2016, respectively, and $2.6 million and $7.9 million for the three and nine months ended September 30, 2015, respectively. Amortization expense of $2.2 million and $6.9 million for the three and nine months ended September 30, 2016, respectively, and $2.5 million and $7.5 million for the three and nine months ended September 30, 2015, respectively, related to developed technology and software license rights was recorded in cost of revenue and the remainder was recorded in “Amortization of certain acquired intangible assets” in the accompanying Condensed Consolidated Statements of Operations.

The following table presents the Company’s estimate of remaining amortization expense, which will be recorded in cost of revenue, for each of the succeeding fiscal years ending December 31 for finite-lived intangible assets that existed at September 30, 2016 (in thousands):

| | |
|---|---|
| Remainder of 2016 | $2,218 |
| 2017 | 7,420 |
| Total | $9,638 |

The Company evaluates the recoverability of its long-lived assets with finite useful lives, including intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. Based on the assessment of various factors in connection with the preparation of the Company’s financial statements for the quarter ended September 30, 2016, the Company does not believe there were any negative qualitative factors impacting the recoverability of the carrying values. There were no impairment charges related to identifiable intangible assets in the nine months ended September 30, 2016 and the year ended December 31, 2015.

## 5. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value represents the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. Observable inputs are based on market data obtained from independent sources. The fair value hierarchy is based on the following three levels of inputs, of which the first two are considered observable and the last one is considered unobservable:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 – Unobservable inputs.

Assets and liabilities measured at fair value on a recurring basis included the following as of September 30, 2016 and December 31, 2015 (in thousands):

| | September 30, 2016 | | | | December 31, 2015 | | | |
|---|---|---|---|---|---|---|---|---|
| | Fair Value | Level 1 | Level 2 | Level 3 | Fair Value | Level 1 | Level 2 | Level 3 |
| Cash equivalents | $31,636 | $31,636 | $— | $ — | $61,986 | $61,986 | $— | $ — |
| Corporate bonds | 49,517 | — | 49,517 | — | 56,109 | — | 56,109 | — |
| Agency bonds | 36,970 | — | 36,970 | — | 85,461 | — | 85,461 | — |
| U.S. treasury securities | 140,915 | — | 140,915 | — | 57,908 | — | 57,908 | — |
| Commercial paper | 16,257 | — | 16,257 | — | — | — | — | — |
| Strategic investments | — | — | — | — | 150 | — | — | 150 |
| | $275,295 | $31,636 | $243,659 | $ — | $261,614 | $61,986 | $199,478 | $ 150 |

At September 30, 2016 and December 31, 2015, cash equivalents of $31.6 million and $62.0 million, respectively, consisted of money market funds with original maturity dates of three months or less backed by U.S. Treasury bills.
As of September 30, 2016, corporate bonds, agency bonds, U.S. treasury securities and commercial paper were classified within Level 2 of the fair value hierarchy. The bonds were valued using information obtained from pricing services, which obtained quoted market prices from a variety of industry data providers, security master files from large financial institutions, and other third-party sources. The Company performed supplemental analysis to validate information obtained from its pricing services. As of September 30, 2016, no adjustments were made to such pricing information.

Strategic Investments

The Company's investments in privately-held companies are shown in the accompanying Condensed Consolidated Balance Sheets in Long-term investments and accompanying Condensed Consolidated Statements of Cash Flows in Purchases of investments. The strategic investments classified as debt securities are considered Level 3 in the fair value hierarchy as they have been valued using significant unobservable inputs or data from various valuation approaches and is measured each reporting period at fair value.

The following table presents a reconciliation of the investment in debt securities measured at fair value using significant unobservable inputs (Level 3) as of September 30, 2016 (in thousands):

| | |
|---|---|
| Balance as of December 31, 2015 | $150 |
| Change in value | (150 ) |
| Balance as of September 30, 2016 | $— |

Senior Convertible Notes

The Company's senior convertible notes are shown in the accompanying Condensed Consolidated Balance Sheets at their original issuance value, net of unamortized discount and debt issuance costs, and are not re-measured to fair value each period. The approximate fair value of the Company's convertible notes as of September 30, 2016 was $277.4 million. The fair value of the convertible notes was estimated on the basis of quoted market prices, which, due to limited trading activity, are considered Level 2 in the fair value hierarchy.

## 6. DEBT

Senior Convertible Notes

In 2013, the Company issued senior convertible notes (the "Notes") raising gross proceeds of $253.0 million.
The Notes are governed by an Indenture, dated June 17, 2013 (the "Indenture"), between the Company and U.S. Bank National Association, as trustee. The Notes mature on July 1, 2018, unless earlier repurchased or converted, and bear interest at a rate of 1.50% per year payable semi-annually in arrears on January 1 and July 1 of each year, commencing January 1, 2014.

The Notes are convertible at an initial conversion rate of 18.5046 shares of the Company's common stock per $1,000 principal amount of the Notes, which represents an initial conversion price of approximately $54.04 per share, subject to adjustment for anti-dilutive issuances, voluntary increases in the conversion rate and make-whole adjustments upon a fundamental change. A fundamental change includes a change in control, delisting of the Company's common stock and a liquidation of the Company. Upon conversion, the Company will deliver cash for the principal amount, and the Company has the right to settle any amounts in excess of the principal in cash or shares.
Prior to April 1, 2018, the Notes are only convertible upon satisfaction of certain conditions as follows:

- during any calendar quarter after September 30, 2013, if the last reported sale price of common stock for at least 20 trading days (whether or not consecutive) during a 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 on each applicable trading day;
- during the five business day period after any five consecutive trading day period in which the trading price per $1,000 principal amount of the Notes for each trading day of that five consecutive trading day period was less than 98% of the product of the last reported sale price of common stock and the conversion rate on each such trading day; or
- upon the occurrence of specified corporate events as defined in the Indenture.

Holders of the Notes may convert their Notes at any time on or after April 1, 2018, until the close of business on the second scheduled trading day immediately preceding the maturity date.
The holders of the Notes may require the Company to repurchase all or a portion of their Notes at a cash repurchase price equal to 100% of the principal amount of the Notes being repurchased, plus accrued and unpaid interest, upon a fundamental change and events of default, including non-payment of interest or principal and other obligations under the Indenture.
In accounting for the Notes at issuance, the Company separated the Notes into debt and equity components pursuant to the accounting standards for convertible debt instruments that may be fully or partially settled in cash upon conversion. The fair value of the debt component was estimated using an interest rate for nonconvertible debt, with terms similar to the Notes, excluding the conversion feature. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The excess of the principal amount of the Notes over the fair value of the debt component was recorded as a debt discount and a corresponding increase in additional paid-in capital. The debt discount is accreted to interest expense over the term of the Notes using the interest method. The amount recorded to additional paid-in capital is not to be remeasured as long as it continues to meet the conditions for equity classification. Upon issuance of the $253.0 million of Notes, the Company recorded $214.3 million to debt and $38.7 million to additional paid-in capital for the debt discount.
The Company incurred transaction costs of approximately $7.3 million related to the issuance of the Notes. In accounting for these costs, the Company allocated the costs to the debt and equity components in proportion to the allocation of proceeds from the issuance of the Notes to such components. Transaction costs allocated to the debt component of $6.2 million are deferred and amortized to interest expense over the term of the Notes. The transaction costs allocated to the equity component of $1.1 million were recorded to additional paid-in capital.
The net carrying amount of the liability component of the Notes as of September 30, 2016 consists of the following (in thousands):

| | |
|---|---|
| Principal amount | $253,000 |
| Unamortized debt discount | (14,554) |
| Net carrying amount before unamortized debt issuance costs | 238,446 |
| Unamortized debt issuance costs | (2,336) |
| Net carrying amount | $236,110 |

The effective interest rate of the liability component of the Notes is 5.4%. This interest rate was based on the interest rates of similar liabilities at the time of issuance that did not have associated convertible features.

The following table presents the interest expense recognized related to the Notes for the three and nine months ended September 30, 2016 and 2015 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Contractual interest expense at 1.5% per annum | $949 | $949 | $2,847 | $2,846 |
| Amortization of debt issuance costs | 318 | 302 | 942 | 896 |
| Accretion of debt discount | 1,978 | 1,884 | 5,863 | 5,582 |
| Total | $3,245 | $3,135 | $9,652 | $9,324 |

The net proceeds from the Notes were approximately $246.0 million after payment of the initial purchasers' offering expenses. The Company used approximately $49.5 million of the net proceeds of the Notes offering to pay the cost of the Note Hedges described below, which was partially offset by $23.2 million of the proceeds from the Company's sale of the Warrants also described below.

Note Hedges

Concurrent with the issuance of the Notes, the Company entered into note hedges (the "Note Hedges") with certain bank counterparties, with respect to its common stock. The Company paid $49.5 million for the Note Hedges. The Note Hedges cover approximately 4.7 million shares of the Company's common stock at a strike price of $54.04 per share, and are exercisable by the Company upon conversion of the Notes. The Note Hedges will expire upon the maturity of the Notes. The Note Hedges are intended to reduce the potential economic dilution upon conversion of the Notes in the event that the fair value per share of the Company's common stock at the time of exercise is greater than the conversion price of the Notes.

Warrants

Separately and concurrently with the entry by the Company into the Note Hedges, the Company entered into warrant transactions, whereby it sold warrants to the same bank counterparties as the Note Hedges to acquire up to 4.7 million shares of the Company's common stock at a strike price of $80.06 per share (the "Warrants"), subject to anti-dilution adjustments. The Company received proceeds of $23.2 million from the sale of the Warrants. The Warrants expire at various dates during 2018 and 2019. If the fair value per share of the Company's common stock exceeds the strike price of the Warrants, the Warrants will reduce diluted earnings per share to the extent that the calculation does not have an anti-dilutive effect.

The amounts paid and received for the Note Hedges and the Warrants have been recorded in additional paid-in capital. The fair value of the Note Hedges and the Warrants are not remeasured through earnings each reporting period.

## 7. STOCK-BASED AWARDS

Stock Options

The following table summarizes the Company's stock option activity for the nine months ended September 30, 2016 (in thousands, except per share and term information):

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (1) |
|---|---|---|---|---|
| Outstanding, December 31, 2015 | 7,264 | $ 30.75 | 7.1 | $ 63,328 |
| Granted | 101 | 38.67 | | |
| Exercised | (784 ) | 18.17 | | |
| Forfeited | (241 ) | 44.00 | | |
| Outstanding, September 30, 2016 | 6,340 | $ 31.95 | 6.5 | $ 94,986 |

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (1) |
|---|---|---|---|---|
| Exercisable at September 30, 2016 | 4,884 | $ 29.03 | 6.1 | $ 87,084 |
| Vested and expected to vest at September 30, 2016 | 6,289 | 31.87 | 6.5 | 94,651 |

(1) Based on the Company's closing stock price of $45.95 on September 30, 2016 and $34.53 on December 31, 2015.

Unrecognized compensation expense relating to stock options was $25.9 million at September 30, 2016, which is expected to be recognized over a weighted-average period of 1.6 years. The aggregate grant date fair value of stock options granted during the nine months ended September 30, 2016 was $1.8 million.

Restricted Stock Units

The Company granted restricted stock units covering 1.6 million shares of its common stock during the nine months ended September 30, 2016. At September 30, 2016, there were 3.2 million shares of the Company's common stock issuable upon the vesting of outstanding restricted stock units. Unrecognized compensation expense related to shares of the Company's common stock subject to unvested restricted stock units was $94.6 million at September 30, 2016, which is expected to be recognized as expense over the weighted-average period of 3.1 years.

Performance-Based Restricted Stock Units

In July 2014, the Compensation Committee of the Company's Board of Directors (the "Compensation Committee") approved the issuance of performance-based restricted stock units to an executive officer of the Company. The number of shares of the Company's common stock issuable upon the vesting of this performance-based restricted stock award is based upon (a) the performance of the Company's stock price relative to a certain independent market index and (b) the recipient continuing to provide service through the end of the three year term of the award. Achievement of the maximum performance level would result in the issuance of 60,900 shares. The Company used a Monte Carlo simulation to estimate the fair value of this award which factors in the probability of the award vesting. The grant date fair value of the award was $1.8 million, which will be recognized ratably over the three year term of the award.

In December 2014, the Compensation Committee approved the issuance of performance-based restricted stock units to certain executives of the Company. The number of shares of the Company's common stock issuable upon the vesting of these performance-based restricted stock unit awards is based upon (a) the performance of the Company's stock price relative to a certain independent market index, (b) the achievement of the Company's revenue guidance for each of fiscal year 2015 and 2016 and (c) the recipient continuing to provide services to the Company through the end of the three year term of the award. The Company finalizes its revenue guidance in February of each year, thus a grant date was established in February of 2015 and February of 2016 for each of the two tranches of the award related to that year's revenue guidance. Each tranche is treated as a separate grant and recognized from the date the revenue guidance is determined over the remaining portion of the original three year term of the award. Achievement of the maximum performance level would result in the issuance of an aggregate of 1,070,000 shares.

The Company used a Monte Carlo simulation to estimate the fair value each tranche of the awards for which a grant date has been established. The valuation factors in the probability of achieving the performance of the Company's stock price relative to the market index. The aggregate grant date fair value of the first half of the above awards was $9.9 million, which was subsequently decreased to $5.0 million based on the Company's performance in relation to the revenue guidance for fiscal year 2015. The decrease in value was a result of the maximum level of shares decreasing from an aggregate of 1,070,000 shares to an aggregate of 802,500 shares, representing a decrease from 535,000 shares to 267,500 shares for the first half of the awards and the maximum level achievable of 535,000 shares remaining for the second half of the awards. During the nine months ended September 30, 2016, the Company determined that the aggregate grant date fair value of the second half of the awards was $3.6 million, which will be evaluated each reporting period to determine the Company's performance in relation to the revenue guidance for fiscal year 2016. Additionally, during the nine months ended September 30, 2016, an aggregate of 30,000 shares were forfeited as a result of the retirement of an executive officer of the Company.

In July 2016, the Compensation Committee approved the issuance of additional performance-based restricted stock units to certain executives of the Company. The number of shares of the Company's common stock issuable upon the vesting of these performance-based restricted stock unit awards is based upon (a) the Company meeting certain revenue and cash flow targets through December 31, 2018 and (b) the recipient continuing to provide services to the Company through the end of June 2019. Achievement of the maximum performance level would result in the issuance of 499,800 shares. The total amount of compensation expense recognized will be based on the number of estimated eligible shares, which will be evaluated each reporting period and determined by the Company's actual and projected revenue and cash flow performance. These awards have a grant date fair value of $38.67 per share and the total compensation expense will be recognized over the three year vesting term of the awards.

The Company recognized compensation expense related to all performance-based awards in the aggregate amount of $0.6 million and $2.1 million for the three and nine months ended September 30, 2016, respectively. Unrecognized compensation expense related to unvested performance-based restricted stock units was $6.0 million at September 30, 2016, based on the probable performance target at that date, which is expected to be recognized as expense over the weighted-average period of 1.7 years.

Employee Stock Purchase Plan

Under the Company's 2010 Employee Stock Purchase Plan ("ESPP"), eligible employees are granted the right 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. The right to purchase shares is granted twice yearly for six month offering periods in June and December and exercisable on or about the succeeding December and June, respectively, on each year.

Stock-Based Compensation

Stock-based compensation expense related to stock options, restricted stock units, the ESPP and performance-based restricted stock units is included in the following line items in the accompanying Condensed Consolidated Statement of Operations for the three and nine months ended September 30, 2016 and 2015 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Cost of revenue | $1,215 | $1,106 | $3,477 | $2,769 |
| Sales and marketing expense | 6,741 | 6,672 | 19,186 | 16,869 |
| Research and development expense | 2,144 | 1,663 | 5,777 | 4,175 |
| General and administrative expense | 4,646 | 2,726 | 12,310 | 6,855 |
| Total | $14,746 | $12,167 | $40,750 | $30,668 |

## 8. INCOME TAXES

The Company's income tax provision was approximately $0.2 million and $0.9 million with an effective income tax rate of (1.8)% and (1.9)% for the three and nine months ended September 30, 2016, respectively. The Company's effective tax rate differs from the statutory rate primarily due to the change in the valuation allowance on the Company's deferred tax assets and foreign income taxes.

The income tax provision is related to certain foreign income, state income and withholding taxes. We do not have a tax provision in the significant jurisdictions we operate in, such as the United States and United Kingdom, as we have generated losses and have recorded a full valuation allowance against the net deferred tax assets and we do not anticipate recording an income tax benefit related to these deferred tax assets. The Company will reassess the realization of deferred tax assets each reporting period and will be able to reduce the valuation allowance to the extent that the financial results of these operations improve and it becomes more likely than not that the deferred tax assets are realizable.

The Company is subject to U.S. federal income tax, state income tax and various foreign income taxes. The Company is subject to examination for the 2013 through 2015 tax years for its U.S. federal income tax returns. State income tax returns are subject to examination for the 2011 through 2015 tax years. The Company is subject to examination by various foreign jurisdictions for years after 2007. The Company does not reasonably expect significant changes to its uncertain tax positions within the next twelve months.

## 9. COMMITMENTS AND CONTINGENCIES

### Guarantees and Indemnifications

The Company has made guarantees and indemnities under which it may be required to make payments to a guaranteed or indemnified party in relation to certain transactions, including revenue transactions in the ordinary course of business. The Company is obligated to indemnify its directors and officers to the maximum extent permitted under the laws of the State of Delaware. However, the Company has a directors and officers insurance policy that may reduce its exposure in certain circumstances and may enable it to recover a portion of future amounts that may be payable, if any. The duration of the guarantees and indemnities varies and, in many cases, is indefinite but subject to statutes of limitations. To date, the Company has made no payments related to these guarantees and indemnities. The Company estimates the fair value of its indemnification obligations as insignificant based on this history and the Company's insurance coverage and therefore has not recorded any liability for these guarantees and indemnities in the accompanying condensed consolidated balance sheets.

### Lease Commitments

During the nine months ended September 30, 2016, the Company entered into various operating lease agreements with obligations of approximately $0.3 million in 2016 and $0.6 million in 2017.

### Other Commitments

In September 2016, the Company entered into a sponsorship agreement with a professional sports franchise with obligations of approximately $2.7 million in 2017, $0.7 million in 2018 and $0.7 million in 2019.

In February 2016, the Company amended an agreement with one of its third-party service providers, whereby the Company committed to provide certain dollar amounts of professional service projects related to implementation and other services for clients of the Company. The amendment increased the contractual commitment amount by $0.5 million in each of 2016 and 2017.

### Litigation

The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. If the Company determines that it is probable that a loss has been incurred and the amount is reasonably estimable, the Company will record a liability. The Company has determined that it does not have a potential liability related to any legal proceedings or claims that would individually or in the aggregate materially adversely affect its financial condition or operating results.

## 10. RELATED PARTY TRANSACTIONS

In 2010, the Cornerstone OnDemand Foundation (the "Foundation"), was formed to empower communities in the United States and internationally by increasing the impact of the non-profit sector through the utilization of human capital management technology including the Company's Enterprise and Mid-Market solution. The Company's Chief Executive Officer is on the Board of Directors of the Foundation. The Company does not direct the Foundation's activities, and accordingly, the Company does not consolidate the Foundation's statement of activities with its financial results. During the three months ended September 30, 2016 and 2015, the Company provided at no charge certain resources to the Foundation, with approximate values of $0.8 million and $0.9 million, respectively, and for the nine months ended September 30, 2016 and 2015 values of $2.5 million and $2.2 million, respectively.

During June 2010, an executive officer of an accounting software company joined the Company's Board of Directors and resigned in September 2016. During the three months ended September 30, 2016 and 2015, the Company recorded $0.1 million and $0.2 million, respectively, and for the nine months ended September 30, 2016 and 2015 recorded $0.6 million and $0.4 million, respectively, in expenses related to the use of the accounting software from the company whose executive officer served on the Company's Board of Directors during those years.

## 11. SUBSEQUENT EVENTS

During October and November 2016, the Compensation Committee granted restricted stock units covering an aggregate of 151,700 shares of the Company's common stock which generally vest annually over four years.

## ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are any statements that look to future events and consist of, among other things, statements regarding our business strategies; anticipated future operating results and operating expenses; our ability to attract new clients to enter into subscriptions for our solutions; our ability to service those clients effectively and induce them to renew and upgrade their deployments of our solutions; our ability to expand our sales organization to address effectively the new industries, geographies and types of organizations we intend to target; our ability to accurately forecast revenue and appropriately plan our expenses; market acceptance of enhancements to our solutions; alternate ways of addressing human capital management needs or new technologies generally by us and our competitors; continued acceptance of SaaS as an effective method for delivering human capital management solutions and other business management applications; the attraction and retention of qualified employees and key personnel; our ability to protect and defend our intellectual property; costs associated with defending intellectual property infringement and other claims; events in the markets for our solutions and alternatives to our solutions, as well as in the United States and global markets generally; future regulatory, judicial and legislative changes in our industry; and changes in the competitive environment in our industry and the markets in which we operate. In addition, forward-looking statements also consist of statements involving trend analyses and statements including such words as “may,” “believe,” “could,” “anticipate,” “would,” “might,” “p “expect,” and similar expressions or the negative of such terms or other comparable terminology. These forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q and are subject to business and economic risks. As such, our actual results could differ materially from those set forth in the forward-looking statements as a result of the factors set forth below in Part II, Item 1A, “Risk Factors,” and in our other reports filed with the Securities and Exchange Commission. We assume no obligation to update the forward-looking statements to reflect events that occur or circumstances that exist after the date on which they were made.

The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto appearing elsewhere in this Quarterly Report on Form 10-Q.

### Overview

Cornerstone OnDemand is one of the world’s largest cloud computing companies with 2,805 clients across approximately 27.7 million users in 191 countries and 42 different languages. We help organizations around the globe recruit, retain and develop their employees using human capital management solutions delivered as Software-as-a-Service, or SaaS. Our human capital management suite enables organizations to manage the entire employee lifecycle, with a focus on continuous learning and development, to empower employees to realize their potential and drive success within their organization.

We work with clients across all geographies, verticals and market segments to address critical talent needs throughout the entire employee lifecycle. Our Recruiting, Learning, Performance and People Administration modules help with sourcing, recruiting, and onboarding new hires; managing training and development requirements; connecting employees with other individuals in the organization; goal setting and performance reviews; as well as linking compensation to performance; identifying development plans based on performance gaps; and then utilizing all of that data for mobility within the organization. Recently, we strengthened these product offerings with a full Analytics suite that enables our clients to make smarter, more strategic, and more informed decisions around their talent.

Within the Learning module, we also offer Extended Enterprise and Cornerstone for Salesforce to Enterprise and Mid-Market clients. Extended Enterprise allows clients to train and develop their extended ecosystem of vendors, distributors, and customers with certification programs, trainings and other content. Cornerstone for Salesforce is a cloud-based learning solution developed natively on the Salesforce.com platform that allows organizations to seamlessly access sales enablement and just-in-time training embedded within Salesforce.

In addition to our human capital management suite for clients upmarket, we also offer Cornerstone Growth Edition, which is a cloud-based talent management solution with learning and performance product offerings targeted to organizations with 250 or fewer employees. We currently do not include the number of clients and users of our Cornerstone for Salesforce and Cornerstone Growth Edition solutions in our client and user count metrics as they are not significant and we believe the client and user count metrics for our Enterprise and Mid-Market solution give a better indication of our overall performance.

We also provide consulting services in implementation of our solutions through configuration, system integration, business process re-engineering, change management and training services. After the initial purchase of our solution, we continue to market and sell to our existing clients, who may renew their subscriptions, add additional products, broaden the deployment of the solution across their organizations and increase usage of the solution over time.

We generate most of our revenue from the sale of our solutions pursuant to multi-year client agreements. Client agreements for our Enterprise and Mid-Market solution typically have terms of three years. Our sales processes are typically competitive, and sales cycles generally vary in duration from two to nine months depending on the size of the potential client. We generally price our Enterprise and Mid-Market solution based on the number of products purchased and the permitted number of users with access to each product.

We sell our solutions through our direct sales teams and, to a lesser extent, indirectly through our distributors. We intend to continue to invest in our direct sales and distribution activities to address our market opportunity.

We generally recognize revenue from subscriptions ratably over the term of the client agreement and revenue from consulting services as the services are performed. In certain instances, our clients request enhancements to the underlying features and functionality of our Enterprise and Mid-Market solution, and in these instances, revenue from subscriptions is recognized over the remaining term of the agreement once the additional features are delivered to the client. We generally invoice our clients upfront for a portion of the annual subscription fees for multi-year subscriptions and upfront for consulting services. We record amounts invoiced for annual subscription periods that have not occurred or services that have not been performed as deferred revenue on our balance sheet. With the growth in the number of clients, our revenue grew to $107.8 million and $314.1 million for the three and nine months ended September 30, 2016, respectively, from $87.3 million and $243.8 million for the three and nine months ended September 30, 2015, respectively.

We have historically experienced seasonality in terms of when we enter into client agreements. We usually sign a significantly higher percentage of agreements with new clients, as well as renewal agreements with existing clients, in the fourth quarter of each year. In addition, within a given quarter, we typically sign a large portion of these agreements during the last month, and often the last two weeks, of that quarter. We believe this seasonality is driven by several factors, most notably the tendency of procurement departments at our enterprise clients to purchase technology at the end of a quarter or calendar year, possibly in order to use up their available quarterly or annual funding allocations, or to be able to deploy new human capital management capabilities prior to the beginning of a new financial or performance period. As the terms of most of our client agreements are measured in full year increments, agreements initially entered into the fourth quarter or last month of any quarter will generally come up for renewal at that same time in subsequent years. This seasonality is reflected to a much lesser extent, and sometimes is not immediately apparent, in our revenue, due to the fact that we recognize subscription revenue over the term of the client agreement, which is generally three years. In addition, this seasonality is reflected in changes in our deferred revenue balance, which generally is impacted by the timing of when we enter into agreements with new clients, invoice new clients, invoice existing clients for annual subscription periods and recognize revenue. We expect this seasonality to continue, which may cause fluctuations in certain of our operating results and financial metrics, and thus limit our ability to predict future results.

We believe the market for human capital management remains large and underpenetrated, providing us with significant growth opportunities. We expect businesses and other organizations to continue to increase their spending on human capital management solutions in order to maximize the productivity of their employees, manage changing workforce demographics and ensure compliance with global regulatory requirements. Historically, many of these software solutions have been human resource applications running on hardware located on organizations' premises. We have seen many of these organizations increasingly choose SaaS for their human capital management solutions and we anticipate that trend will continue.

We have focused on growing our business to pursue what we believe is a significant market opportunity, and we plan to continue to invest in building for growth. As a result, we expect our cost of revenue and operating expenses to increase in future periods. Sales and marketing expenses are expected to increase, as we continue to expand our direct sales teams, increase our marketing activities, and grow our international operations. Research and development expenses are expected to increase as we continue to improve the existing functionality for our solutions. We also believe that we must invest in maintaining a high degree of client service and support that is critical for our continued success. We plan to continue our policy of implementing best practices across our organization, expanding our technical operations and investing in our network infrastructure and service capabilities in order to support continued future growth. We also expect to incur additional general and administrative expenses as a result of our growth.

Our quarterly operating results have fluctuated in the past and may continue to fluctuate in the future based on a number of factors, many of which are beyond our control, including those described in the “Risk Factors” section of this Quarterly Report on Form 10-Q. One or more of these factors may cause our operating results to vary widely. As such, we believe that our quarterly results of operations may vary significantly in the future and that period-to-period comparisons of our operating results may not be meaningful and should not be relied upon as an indication of future performance.

Metrics

We regularly review a number of metrics, including the following key metrics, to evaluate our business, measure our performance, identify trends affecting our business, formulate financial projections and make strategic decisions.

- Revenue. We generally recognize subscription revenue over the contract period, and as a result of our revenue recognition policy and the seasonality of when we enter into new client agreements, revenue from client agreements signed in the current period may not be fully reflected in the current period.
- Billings. Under our revenue recognition policy, we generally recognize subscription revenue from our client agreements ratably over the terms of those agreements. For this reason, the major portion of our revenue for a period will be from client agreements signed in prior periods rather than from new business activity during the current period. In order to assess our business performance with a metric that more fully reflects current period business activity, we track billings (formerly referred to as “bookings”), which is a non-GAAP financial measure we define as the sum of revenue and the change in the deferred revenue balance for the period. We include changes in the deferred revenue balance to calculate billings so it better reflects new business activity in the period as evidenced by prepayments or billings under our billing policies arising from acquisition of new clients, sales of additional products to existing clients, the addition of incremental users by existing clients and client renewals. Billings are affected by our billing terms, and any changes in those billing terms may shift billings between periods. Due to the seasonality of our sales, billings growth is inconsistent from quarter to quarter throughout a calendar year. Additionally, billings growth can be impacted by fluctuations in foreign exchange rates. For a reconciliation of billings to revenue, please see “Results of Operations – Revenue and Metrics.”
- Constant currency results. We present constant currency information, a non-GAAP financial measure, to provide a framework for assessing how our underlying business performed excluding the effect of foreign currency fluctuations. Due to our legal structure, our international revenues are favorably impacted as the United States dollar weakens relative to the British pound, and unfavorably impacted as the United States dollar strengthens relative to the British pound. We believe the presentation of results on a constant currency basis in addition to reported results helps improve the ability to understand our performance because they exclude the effects of foreign currency volatility that are not indicative of our core operating results. To present this information, current period results for entities reporting in British pounds are translated into United States dollars at the prior period exchange rates as opposed to the actual exchange rates in effect for the current period. These results should be considered in addition to, not as a substitute for, results reported in accordance with GAAP. Results on a constant currency basis, as we present them, may not be comparable to similarly titled measures used by other companies and are not a measure of performance presented in accordance with GAAP.
- Number of Clients. We believe that our ability to expand our client base is an indicator of our market penetration and the growth of our business as we continue to invest in our direct sales teams and distributors. Our client count includes contracted clients for our Enterprise and Mid-Market solution as of the end of the period and excludes clients of our Cornerstone for Salesforce and Cornerstone Growth Edition solutions.
- Number of Users. Since our clients generally pay fees based on the number of users of our solutions within their organizations, we believe the total number of users is an indicator of the growth of our business. Our user count includes active users for our Enterprise and Mid-Market solution and excludes users of our Cornerstone for Salesforce and Cornerstone Growth Edition solutions.

Key Components of Our Results of Operations

Sources of Revenue and Revenue Recognition

Our solutions are designed to enable organizations to meet the challenges they face in maximizing the productivity of their human capital. We generate revenue from the following sources:

- Subscriptions to Our Solutions. Clients pay subscription fees for access to our solutions and support for a specified period of time, typically three years for our Enterprise and Mid-Market solution. Fees are based on a number of factors, including the number of products purchased, which may include e-learning content, and the number of users having access to a solution. We generally recognize revenue from subscriptions ratably over the term of the agreements.
- Professional Services and Other. We offer our clients assistance in implementing our solutions and optimizing their use. Professional services include application configuration, system integration, business process re-engineering, change management and training services. Services are billed either on a time-and-material or a fixed-fee basis. These services are generally purchased as part of a subscription arrangement and are typically performed within the first several months of the arrangement. Clients may also purchase professional services at any other time. We generally recognize revenue from fixed fee professional services using the proportional performance method over the period the services are performed and as time is incurred for time-and-material arrangements.

Our client agreements generally include both a subscription to access our solutions and related professional services. Our agreements generally do not contain any cancellation or refund provisions other than in the event of our default.

Cost of Revenue

Cost of revenue consists primarily of costs related to hosting our solutions; personnel and related expenses, including stock-based compensation, for network infrastructure, IT support, consulting services and on-going client support; payments to external service providers contracted to perform implementation services; depreciation of data centers; amortization of capitalized software costs; amortization of developed technology and software license rights; content and licensing fees; and referral fees. In addition, we allocate a portion of overhead, such as rent, IT costs, depreciation and amortization and employee benefits costs, to cost of revenue based on headcount. The costs associated with providing consulting services are significantly higher as a percentage of revenue than the costs associated with providing access to our solutions due to the labor costs to provide the consulting services. We expect gross margin to increase over time as we optimize the efficiency of our operations and continue to scale our business.

Operating Expenses

Our operating expenses are as follows:

- Sales and Marketing. Sales and marketing expenses consist primarily of personnel and related expenses for our sales and marketing staff, including salaries, benefits, bonuses, stock-based compensation and commissions; costs of marketing and promotional events, corporate communications, online marketing, product marketing and other brand-building activities; and allocated overhead.

We intend to continue to invest in sales and marketing strategically to expand our business both domestically and internationally. We expect sales and marketing expenses as a percentage of revenue to decrease.

- Research and Development. Research and development expenses consist primarily of personnel and related expenses for our research and development staff, including salaries, benefits, bonuses and stock-based compensation; the cost of certain third-party service providers; and allocated overhead. Research and development costs, other than software development costs qualifying for capitalization, are expensed as incurred.

We have focused our research and development efforts on continuously improving our solutions. We believe that our research and development activities are efficient because we benefit from maintaining a single software code base for each of our solutions. We expect research and development expenses to increase proportionately with our business and expand our network infrastructure.

- General and Administrative. General and administrative expenses consist primarily of personnel and related expenses for administrative, legal, finance and human resource staff, including salaries, benefits, bonuses and stock-based compensation; professional fees; insurance premiums; other corporate expenses; and allocated overhead. We expect our general and administrative expenses as a percentage of revenue to decrease.
- Amortization of Certain Acquired Intangible Assets. Amortization of certain acquired intangible assets consists of amortization of acquisition-related intangibles for customer relationships.

Other Income (Expense)

- Interest Income. Interest income consists primarily of interest income from investment securities partially offset by amortization of investment premiums. We expect interest income to vary depending on the level of our investments in marketable securities, which include corporate bonds, agency bonds, U.S. treasury securities and commercial paper in the three and nine months ended September 30, 2016.
- Interest Expense. Interest expense consists primarily of interest expense from our convertible debt, accretion of debt discount and amortization of debt issuance costs.
- Other, Net. Other, net consists of income and expense associated with fluctuations in foreign currency exchange rates, fair value adjustments to strategic investments and other non-operating expenses. We expect other income (expense) to vary depending on the movement in foreign currency exchange rates and the related impact on our foreign exchange gain (loss).

Income Tax Provision

The income tax provision is related to foreign and certain state income taxes. Given our historical losses, we have not recorded a provision, except for state minimum taxes and withholding taxes, for United States, United Kingdom, New Zealand, Hong Kong and Brazil income taxes as we have recorded a full valuation allowance against the net deferred tax assets for each of these countries. Other foreign subsidiaries and branches provide intercompany services and are compensated on a cost-plus basis, and therefore, have incurred liabilities for foreign income taxes in their respective jurisdictions.

Critical Accounting Policies and Estimates

Information with respect to our critical accounting policies that we believe have the most significant effect on our reported results and require subjective or complex judgments of management are contained in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of our Annual Report on Form 10-K filed with the Securities and Exchange Commission, or SEC, on February 27, 2016.

As of September 30, 2016, there have been no material changes to our critical accounting policies since December 31, 2015.

Recent Accounting Pronouncements

For information regarding recent accounting pronouncements, refer to Note 1 of Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

Results of Operations

The following table sets forth our results of operations for each of the periods indicated (in thousands). The period-to-period comparison of financial results is not necessarily indicative of future results.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue | $107,758 | $87,271 | $314,095 | $243,789 |
| Cost of revenue | 33,369 | 27,246 | 100,974 | 79,801 |
| Gross profit | 74,389 | 60,025 | 213,121 | 163,988 |
| Operating expenses: | | | | |
| Sales and marketing | 53,690 | 53,255 | 168,226 | 150,659 |
| Research and development | 12,130 | 10,457 | 34,927 | 30,207 |
| General and administrative | 18,608 | 13,194 | 51,611 | 36,545 |
| Amortization of certain acquired intangibles | — | 150 | 150 | 450 |
| Total operating expenses | 84,428 | 77,056 | 254,914 | 217,861 |
| Loss from operations | (10,039) | (17,031) | (41,793) | (53,873) |
| Other income (expense): | | | | |
| Interest income | 451 | 218 | 1,182 | 590 |
| Interest expense | (3,245) | (3,138) | (9,652) | (9,343) |
| Other, net | 663 | (66) | 2,938 | (3,257) |
| Loss before income tax provision | (12,170) | (20,017) | (47,325) | (65,883) |
| Income tax provision | (218) | (132) | (894) | (790) |
| Net loss | $(12,388) | $(20,149) | $(48,219) | $(66,673) |

The following table sets forth our revenue and key metrics that we use to evaluate our business, measure our performance, identify trends affecting our business, formulate financial projections and make strategic decisions:

Metrics

| | At or For Three Months Ended September 30, | | At or For Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue (in thousands) | $ 107,758 | $ 87,271 | $ 314,095 | $ 243,789 |
| Billings (in thousands) | $ 106,991 | $ 103,683 | $ 297,023 | $ 258,449 |
| Number of clients | 2,805 | 2,466 | 2,805 | 2,466 |
| Number of users (in millions) | 27.7 | 22.2 | 27.7 | 22.2 |

Revenue increased by $20.5 million, or 23%, for the three months ended September 30, 2016 as compared to the same period in 2015 and increased by $70.3 million, or 29%, for the nine months ended September 30, 2016 as compared to the same period in 2015. Revenue growth on a constant currency basis represented a 30% increase for the three months ended September 30, 2016 as compared to the same period in 2015 and a 33% increase for the nine months ended September 30, 2016 as compared to the same period in 2015. The rate of our revenue increase can be impacted by the mix and timing of new client agreements signed, the mix of subscription and professional services revenue, the timing of delivery of our professional services revenue, fluctuations in foreign exchange rates, as well as the growth rate of our emerging markets.

The following table sets forth our revenue by type for each of the periods indicated (dollars in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Subscription revenue | $86,366 | $70,465 | $250,300 | $195,930 |
| Percentage of subscription revenue to total revenue | 80.1 % | 80.7 % | 79.7 % | 80.4 % |
| Professional services revenue | $21,392 | $16,806 | $63,795 | $47,859 |
| Percentage of professional services to total revenue | 19.9 % | 19.3 % | 20.3 % | 19.6 % |
| | $107,758 | $87,271 | $314,095 | $243,789 |

Subscription revenue increased by $15.9 million for the three months ended September 30, 2016 as compared to the same period in 2015 and increased by $54.4 million for the nine months ended September 30, 2016 as compared to the same period in 2015. The increase was attributable to new business, which includes new clients, upsells and renewals from existing clients during the three months ended September 30, 2016. Professional services revenue increased by $4.6 million for the three months ended September 30, 2016 as compared to the same period in 2015 and increased by $15.9 million for the nine months ended September 30, 2016 as compared to the same period in 2015. The increase was primarily due to higher demand for professional services from an increased number of clients at the top end of the market, who generally experience a higher mix of services relative to the total deal size.

Revenue by geography is generally based on the address of the customer as defined in our master subscription agreement. The following table sets forth our revenue by geographic area for each of the periods indicated (dollars in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue for United States | $72,438 | $57,552 | $211,980 | $165,611 |
| Percentage of total revenue for United States | 67.2 % | 65.9 % | 67.5 % | 67.9 % |
| Revenue for all other countries | $35,320 | $29,719 | $102,115 | $78,178 |
| Percentage of total revenue for all other countries | 32.8 % | 34.1 % | 32.5 % | 32.1 % |
| | $107,758 | $87,271 | $314,095 | $243,789 |

Billings increased $3.3 million, or 3% and $38.6 million, or 15%, respectively, for the three and nine months ended September 30, 2016 as compared to the same period in 2015, reflecting the increase in revenue for the period, plus an increase in deferred revenue compared to the same period in 2015. Billings growth on a constant currency basis represented a 9% and 21% increase, respectively, for the three and nine months ended September 30, 2016 as compared to the same periods in 2015. The growth rates for revenue and billings are not correlated with each other in a given period due to the seasonality of when we enter into client agreements, fluctuations in foreign exchange rates, the varied timing of billings, the recognition of subscription revenue generally on a straight-line basis over the term of each client agreement, and the recognition of professional services revenue generally on a proportional performance basis over the period the services are performed.

As discussed above under the heading “Metrics,” billings is a non-GAAP financial measure defined as the sum of revenue and the change in the deferred revenue balance for the period. Management uses billings in analyzing its financial results and believes it is useful to investors, as a supplement to the corresponding GAAP measure, in evaluating our ongoing operational performance and trends and in comparing our financial measures with other companies in the same industry. However, it is important to note that other companies, including companies in our industry, may calculate billings differently or not at all, which may reduce its usefulness as a comparative measure.

The following table presents a reconciliation of revenue to billings for each of the periods presented (in thousands):

| | Deferred Revenue Balance | Three Months Ended September 30, 2016 |
|---|---|---|
| Revenue | | $ 107,758 |
| Deferred revenue at June 30, 2016 | $235,834 | |
| Deferred revenue at September 30, 2016 | 235,067 | |
| Change in deferred revenue | | (767 ) |
| Billings | | $ 106,991 |

| | Deferred Revenue Balance | Three Months Ended September 30, 2015 |
|---|---|---|
| Revenue | | $ 87,271 |
| Deferred revenue at June 30, 2015 | $189,584 | |
| Deferred revenue at September 30, 2015 | 205,996 | |
| Change in deferred revenue | | 16,412 |
| Billings | | $ 103,683 |

| | Deferred Revenue Balance | Nine Months Ended September 30, 2016 |
|---|---|---|
| Revenue | | $ 314,095 |
| Deferred revenue at December 31, 2015 | $252,139 | |
| Deferred revenue at September 30, 2016 | 235,067 | |
| Change in deferred revenue | | (17,072 ) |
| Billings | | $ 297,023 |

| | Deferred Revenue Balance | Nine Months Ended September 30, 2015 |
|---|---|---|
| Revenue | | $ 243,789 |
| Deferred revenue at December 31, 2014 | $191,336 | |
| Deferred revenue at September 30, 2015 | 205,996 | |
| Change in deferred revenue | | 14,660 |
| Billings | | $ 258,449 |

We believe our revenue and billings growth is a result of our continued investment in and development of our direct sales team. We believe these investments have enabled us to achieve greater sales coverage and better sales execution. In addition, we have increased our marketing activities, which we believe has improved brand awareness and created higher demand for our solutions. We have also continued to enhance our Enterprise and Mid-Market solution, which we believe has encouraged existing clients to buy multiple products with their initial purchase and add additional products and users over the term of their agreement.

Our number of clients grew 14% at September 30, 2016 compared to September 30, 2015 and number of users increased 25% at September 30, 2016 compared to September 30, 2015.

Cost of Revenue, Gross Profit and Gross Margin

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (dollars in thousands) | | | |

| | | | | |
|---|---|---|---|---|
| Cost of revenue | $33,369 | $27,246 | $100,974 | $79,801 |
| Gross profit | $74,389 | $60,025 | $213,121 | $163,988 |
| Gross margin | 69.0 % | 68.8 % | 67.9 % | 67.3 % |

Cost of revenue increased $6.1 million, or 22%, for the three months ended September 30, 2016 as compared to the same period in 2015. The increase in cost of revenue is consistent with the increase in revenue. The increase in cost of revenue was primarily due to $2.8 million in increased costs related to outsourced consulting services, $1.2 million in increased amortization of capitalized software and $0.7 million in increased employee-related costs due to higher headcount. These costs were incurred to service our existing clients and support our continued growth. The remaining increase relates to various other costs associated with generating revenue from our clients.

Cost of revenue increased $21.2 million, or 27%, for the nine months ended September 30, 2016 as compared to the same period in 2015. The increase in cost of revenue is consistent with the increase in revenue. The increase in cost of revenue was primarily due to $9.8 million in increased costs related to outsourced consulting services, $3.3 million in increased employee-related costs due to higher headcount and $3.0 million in increased amortization of capitalized software. These costs were incurred to service our existing clients and support our continued growth. The remaining increase relates to various other costs associated with generating revenue from our clients.

The following table presents our estimate of remaining amortization expense, which will be recorded in cost of revenue, for each of the succeeding fiscal years ending December 31 for finite-lived intangible assets that existed at September 30, 2016 (in thousands):

| | |
|---|---|
| Remainder of 2016 | $2,218 |
| 2017 | 7,420 |
| Total | $9,638 |

Sales and Marketing

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (dollars in thousands) | | | |
| Sales and marketing | $53,690 | $53,255 | $168,226 | $150,659 |
| Percent of revenue | 49.8 % | 61.0 % | 53.6 % | 61.8 % |

Sales and marketing expenses remained relatively consistent for the three months ended September 30, 2016 as compared to the same period in 2015. This was attributable to our continued efforts to optimize the efficiency of our existing sales teams. We assess our investments in new and existing markets strategically and we believe we have gained leverage through our operational excellence initiatives. As a percentage of revenue, sales and marketing expense decreased by 11 percentage points as we continued our efforts to strategically scale up our sales teams and their productivity.

Sales and marketing expenses increased $17.6 million, or 12%, for the nine months ended September 30, 2016 as compared to the same period in 2015. The increase was attributable to the expansion of our sales force as well as increased sales commissions and increases in marketing programs to address additional opportunities in new and existing markets. Total sales and marketing headcount contributed to an increase in employee-related costs of $16.1 million. In addition, we incurred increased costs associated with outsourced marketing programs of $3.3 million. As a percentage of revenue, sales and marketing expense decreased by eight percentage points as we continued our efforts to strategically scale up our sales teams and their productivity.

Research and Development

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (dollars in thousands) | | | |
| Research and development | $12,130 | $10,457 | $34,927 | $30,207 |
| Percent of revenue | 11.3 % | 12.0 % | 11.1 % | 12.4 % |

Research and development expenses increased by $1.7 million, or 16%, for the three months ended September 30, 2016 as compared to the same period in 2015. The increase was principally due to an increase in research and development headcount to maintain and improve the functionality of our solutions. We continue to develop and release new products and new features within existing products. As a result, we incurred increased employee-related costs of $1.3 million.

Research and development expenses increased by $4.7 million, or 16%, for the nine months ended September 30, 2016 as compared to the same period in 2015. The increase was principally due to an increase in research and development headcount to maintain and improve the functionality of our solutions. We continue to develop and release new products and new features within existing products. As a result, we incurred increased employee-related costs of $3.8 million.

We capitalize a portion of our software development costs related to the development and enhancements of our solutions, which are then amortized to cost of revenue. The timing of our capitalizable development and enhancement projects may affect the amount of development costs expensed in any given period. We capitalized $5.6 million and $4.4 million of software development costs and amortized $3.5 million and $2.3 million in the three months ended September 30, 2016 and