

RED HAT INC
Form 10-Q/A
August 20, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A
(Amendment No. 1)

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended May 31, 2010

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: 001-33162

RED HAT, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

06-1364380

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

1801 Varsity Drive, Raleigh, North Carolina 27606

(Address of principal executive offices, including zip code)

(919) 754-3700

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted 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 No

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

Large accelerated filer Accelerated filer Non-accelerated filer 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

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

As of July 2, 2010, there were 188,935,864 shares of common stock outstanding.

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EXPLANATORY NOTE

Red Hat, Inc. is filing this Amendment No. 1 on Form 10-Q/A (this Amendment) to correct an erroneous date reference contained in one of the officer certifications included in its Quarterly Report on Form 10-Q for the quarterly period ended May 31, 2010, as filed with the Securities and Exchange Commission (the SEC) on July 9, 2010 (the Original 10-Q).

Specifically, this Amendment is being filed to correct a typographical error in the certifications by our Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by changing the date in the first paragraph from May 31, 2009 to May 31, 2010. This Amendment includes new certifications by our Principal Executive Officer and Principal Financial Officer pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, filed as Exhibits 31.1, 31.2 and 32.1 hereto.

Except as described above, we have not modified or updated any disclosures contained in the Original 10-Q. Accordingly, this Amendment does not reflect events occurring after the date of filing of the Original 10-Q and therefore continues to speak only as of the date of the Original 10-Q.

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RED HAT, INC.

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Table of Contents**RED HAT, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands except share and per share amounts)**

	May 31, 2010 (Unaudited)	February 28, 2010 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 478,370	\$ 388,118
Investments in debt and equity securities, short-term	345,428	372,656
Accounts receivable, net of allowances for doubtful accounts of \$2,165 and \$2,295, respectively	117,426	139,436
Deferred tax assets, net	50,099	57,951
Prepaid expenses	43,187	44,116
Other current assets	941	842
Total current assets	1,035,451	1,003,119
Property and equipment, net of accumulated depreciation and amortization of \$122,575 and \$116,971, respectively	69,952	71,708
Goodwill	438,143	438,749
Identifiable intangibles, net	104,389	108,213
Investments in debt securities, long-term	143,967	209,411
Other assets, net	39,966	39,672
Total assets	\$ 1,831,868	\$ 1,870,872
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 11,028	\$ 16,483
Accrued expenses	65,569	68,334
Deferred revenue	469,141	480,572
Other current obligations	530	878
Total current liabilities	546,268	566,267
Deferred lease credits	4,288	4,184
Long-term deferred revenue	156,473	165,288
Other long-term obligations	23,547	24,081
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, \$0.0001 per share par value, 300,000,000 shares authorized, 218,377,164 and 215,161,306 shares issued, and 188,074,378 and 187,351,195 shares outstanding at May 31, 2010 and February 28, 2010, respectively	22	22
Additional paid-in capital	1,488,655	1,444,848
Retained earnings	161,843	137,772
Treasury stock at cost, 30,302,786 and 27,810,111 shares at May 31, 2010 and February 28, 2010, respectively	(547,008)	(472,646)
Accumulated other comprehensive (loss) income	(2,220)	1,056
Total stockholders' equity	1,101,292	1,111,052
Total liabilities and stockholders' equity	\$ 1,831,868	\$ 1,870,872

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(1) Derived from audited financial statements.

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

Table of Contents**RED HAT, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands except per share amounts)****(Unaudited)**

	Three Months Ended	
	May 31,	May 31,
	2010	2009
Revenue:		
Subscriptions	\$ 179,076	\$ 148,790
Training and services	30,068	25,598
Total subscription and training and services revenue	209,144	174,388
Cost of subscription and training and services revenue:		
Cost of subscriptions	12,664	10,050
Cost of training and services	20,574	16,418
Total cost of subscription and training and services revenue	33,238	26,468
Gross profit	175,906	147,920
Operating expense:		
Sales and marketing	74,564	63,977
Research and development	40,658	35,102
General and administrative	26,445	23,785
Total operating expense	141,667	122,864
Income from operations	34,239	25,056
Interest income	1,663	3,430
Other income (expense), net	1,130	(3)
Income before provision for income taxes	37,032	28,483
Provision for income taxes	12,961	9,969
Net income	\$ 24,071	\$ 18,514
Basic net income per common share	\$ 0.13	\$ 0.10
Diluted net income per common share	\$ 0.12	\$ 0.10
Weighted average shares outstanding		
Basic	187,926	188,916
Diluted	193,266	194,382

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

Table of Contents**RED HAT, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	Three Months Ended	
	May 31, 2010	May 31, 2009
Cash flows from operating activities:		
Net income	\$ 24,071	\$ 18,514
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,722	10,810
Share-based compensation expense	13,174	10,676
Deferred income taxes	8,352	6,428
Excess tax benefits from share-based payment arrangements	(11,007)	(14,200)
Other	(719)	(124)
Changes in operating assets and liabilities net of effects of acquisitions:		
Accounts receivable	19,525	26,278
Accounts payable	(5,069)	2,997
Accrued expenses	1,540	(3,029)
Deferred revenue	(1,058)	2,361
Other	113	492
Net cash provided by operating activities	60,644	61,203
Cash flows from investing activities:		
Purchase of investment in debt securities available for sale	(110,343)	(157,034)
Proceeds from sales and maturities of investment in debt securities available for sale	198,318	122,449
Proceeds from sales of investment in equity securities available for sale	548	221
Purchase of developed software and other intangible assets	(1,621)	(989)
Purchase of property and equipment	(6,722)	(6,028)
Net cash provided by (used in) investing activities	80,180	(41,381)
Cash flows from financing activities:		
Excess tax benefits from share-based payment arrangements	11,007	14,200
Proceeds from exercise of common stock options	37,688	4,400
Payments related to net settlement of employee share-based awards	(7,055)	(1,798)
Purchase of treasury stock	(74,362)	(46,771)
Payments on other borrowings	(877)	(900)
Net cash used in financing activities	(33,599)	(30,869)
Effect of foreign currency exchange rates on cash and cash equivalents	(16,973)	6,115
Net increase (decrease) in cash and cash equivalents	90,252	(4,932)
Cash and cash equivalents at beginning of period	388,118	515,548
Cash and cash equivalents at end of period	\$ 478,370	\$ 510,616

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries (Red Hat or the Company) is a global leader in providing open source software solutions to the enterprise. The Company is also the market leader in providing enterprise-ready open source operating system platforms. The Company applies its technology leadership to create its: enterprise operating platform, Red Hat Enterprise Linux; enterprise middleware platform, JBoss Enterprise Middleware; virtualization solutions and other infrastructure technology solutions, based on open source technology. The Company's enterprise solutions are intended to meet the functionality requirements and performance demands of the enterprise and third-party computer hardware and software applications that are critical to the enterprise. The Company provides these solutions through integrated management services, Red Hat Network, RHN Satellite, JBoss Operations Network and JBoss Customer Support Portal, which allow various Red Hat enterprise technologies to be updated and configured and the performance of these and other technologies to be monitored in an automated fashion. These solutions reflect the Company's continuing commitment to provide an enterprise-wide infrastructure platform and developer solutions based on open source technology. The Company derives its revenue and generates its cash from customers primarily from two sources: (i) subscriptions for its enterprise technologies and (ii) training and services revenue, as further described below in NOTE 2, Summary of Significant Accounting Policies.

NOTE 2 Summary of Significant Accounting Policies

Unaudited Interim Financial Information

The unaudited interim consolidated financial statements as of and for the three months ended May 31, 2010 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the consolidated balance sheets, consolidated operating results and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three months ended May 31, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2011. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the SEC's rules and regulations for interim reporting. For further information, see the Company's Consolidated Financial Statements, including notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2010.

Principles of Consolidation

The accompanying Consolidated Financial Statements include the accounts of the Company and all of its wholly-owned subsidiaries. All significant inter-company accounts and transactions are eliminated in consolidation. There are no significant foreign exchange restrictions on the Company's foreign subsidiaries.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from such estimates.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Revenue Recognition

The Company establishes persuasive evidence of a sales arrangement for each type of revenue transaction based on either a signed contract with the end customer, a click-through contract on the Company's website whereby the customer agrees to the Company's standard subscription terms, signed or click-through distribution contracts with original equipment manufacturers (OEMs) and other resellers, or, in the case of individual training seats, through receipt of payment which indicates acceptance of the Company's training agreement terms.

Subscription Revenue

Subscription revenue is comprised of direct and indirect sales of Red Hat enterprise technologies. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement for the purchase of a subscription, subscription services are made available to the customer and the customer is billed. The deferred revenue amount is recognized as revenue ratably over the life of the subscription. Red Hat enterprise technologies are generally offered with either one or three-year base subscription periods; the majority of the Company's subscriptions have one-year terms. Under these subscription agreements, renewal rates are generally specified for one or three-year renewal terms. The base subscription generally entitles the end user to the technology itself and post-contract customer support (PCS) generally consisting of a specified level of customer support and security errata, bug fixes, functionality enhancements to the technology and upgrades to new versions of the technologies, each on a when-and-if available basis, during the term of the subscription. The Company sells its offerings through two principal channels: (1) direct, which includes sales by the Company's sales-force as well as web store sales, and (2) indirect, which includes distributors, resellers, systems integrators and OEMs. The Company recognizes revenue from the sale of Red Hat enterprise technologies ratably over the period of the subscription beginning on the commencement date of the subscription agreement.

Subscription arrangements with large enterprise customers often have contracts with multiple elements (e.g., software technology, maintenance, training, consulting and other services). The Company allocates revenue to each element of the arrangement based on vendor-specific objective evidence of each element's fair value when the Company can demonstrate sufficient evidence of the fair value of at least those elements that are undelivered. The fair value of each element in multiple element arrangements is created by either (i) providing the customer with the ability during the term of the arrangement to renew that element at the same rate paid for the element included in the initial term of the agreement or (ii) selling the services on a stand-alone basis.

Training and Services Revenue

Training and services revenue is comprised of revenue for consulting, engineering and customer training and education services. Consulting services consist of time-based arrangements, and revenue is recognized as these services are performed. Engineering services represent revenue earned under fixed fee arrangements with the Company's OEM partners and other customers to provide for significant modification and customization of the Company's Red Hat enterprise technologies. The Company recognizes revenue for these fixed fee engineering services using the percentage of completion basis of accounting, provided the Company has the ability to make reliable estimates of progress towards completion, the fee for such services is fixed or determinable and collection of the resulting receivable is probable. Under the percentage of completion method, earnings under the contract are recognized based on the progress toward completion as estimated using the ratio of labor hours incurred to total expected project hours. Changes in estimates are recognized in the period in which they are known. Revenue for customer training and education services is recognized on the dates the services are complete.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Deferred Commissions

Deferred commissions are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to the Company's sales force. The commissions are deferred and amortized over a period that approximates the period of the subscription term. The commission payments are paid in full subsequent to the month in which the customer's service commences. The deferred commission amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. In addition, the Company has the ability and intent under the commission plans with its sales force to recover commissions previously paid to its sales force in the event that customers breach the terms of their subscription agreements and do not fully pay for their subscription agreements. Amortization of deferred commissions is included in sales and marketing expense in the accompanying Consolidated Statements of Operations. Deferred commissions are included in prepaid expenses on the accompanying Consolidated Balance Sheets.

Impairment of Goodwill and Other Long-Lived Assets

The Company tests goodwill for impairment annually and whenever events or circumstances indicate that an impairment may have occurred. Accounting principles generally accepted in the U.S. require goodwill be tested at least annually using a two-step process that begins with identifying potential impairment. Potential impairment is identified if the fair value of the reporting unit to which goodwill applies is less than the recognized or book value of the related reporting entity, including such goodwill. Where the book value of a reporting entity, including related goodwill, is greater than the reporting entity's fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. During the three months ended May 31, 2010 and May 31, 2009, the Company did not identify any potential impairment related to its goodwill or potential risk related to the underlying reporting unit.

The Company evaluates the recoverability of its property and equipment and other long-lived assets whenever events or changes in circumstances indicate that an impairment may have occurred. An impairment loss is recognized when the net book value of such assets exceeds the estimated future undiscounted cash flows attributable to the assets or the business to which the assets relate. Impairment losses, if any, are measured as the amount by which the carrying value exceeds the fair value of the assets. During the three months ended May 31, 2010 and May 31, 2009, no significant impairment losses related to the Company's long-lived assets were identified.

Cash and Cash Equivalents

The Company considers liquid investments purchased with a maturity period of three months or less at the date of purchase to be cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectability. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

determines it is probable the receivable will not be recovered. The Company does not have off-balance-sheet credit exposure related to its customers.

Fair Value Measurements

Fair value is defined as 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 such asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs. To measure fair value, the Company uses the following fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

The Company's investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. Liquid investments with effective original maturities of 90 days or less from the balance sheet date are classified as cash equivalents. Investments with remaining effective maturities of twelve months or less from the balance sheet date are classified as short-term investments. Investments with remaining effective maturities of more than twelve months from the balance sheet date are classified as long-term investments. The Company's Level 1 financial instruments are valued using quoted prices in active markets for identical instruments. The Company's Level 2 financial instruments, including derivative instruments, are valued using quoted prices for identical instruments in less active markets or using other observable market inputs for comparable instruments.

Unrealized gains and temporary losses on investments classified as available for sale are included within accumulated other comprehensive income, net of any related tax effect. Upon realization, such amounts are reclassified from accumulated other comprehensive income to investment income. Realized gains and losses and other than temporary impairments, if any, are reflected in the statements of operations as other income, net. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other-than-temporary. At May 31, 2010 and February 28, 2010, the vast majority of the Company's investments were priced by pricing vendors. These pricing vendors use the most recent observable market information in pricing these securities or, if specific prices are not available for these securities, use other observable inputs. In the event observable inputs are not available, the Company assesses other factors to determine the security's market value, including broker quotes or model valuations. Independent price verifications of all holdings are performed by pricing vendors which are then reviewed by the Company. In the event a price fails a pre-established tolerance check, it is researched so that the Company can assess the cause of the variance to determine what the Company believes is the appropriate fair market value.

The Company minimizes its credit risk associated with investments by investing primarily in investment grade, liquid securities. The Company's policy is designed to limit exposures to any one issuer depending on credit quality. Periodic evaluations of the relative credit standing of those issuers are considered in the Company's investment strategy.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Assets and Liabilities Measured at Fair Value on a Recurring Basis*

The following table summarizes the composition and fair value hierarchy of the Company's financial assets and liabilities at May 31, 2010 (in thousands):

	As of May 31, 2010	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money markets (1)	\$ 175,279	\$ 175,279	\$	\$
Available-for-sale securities (1):				
Treasuries	55,448	55,448		
Certificates of deposit	141,244		141,244	
Commercial paper	62,280		62,280	
Agencies	299,441		299,441	
Municipal bonds	11,764		11,764	
Corporates	149,420		149,420	
Equities (1)	3,684	3,684		
Foreign currency derivatives (2)	73		73	
Liabilities:				
Foreign currency derivatives (3)	(141)		(141)	
Total	\$ 898,492	\$ 234,411	\$ 664,081	\$

(1) Included in either cash and cash equivalents or investments in debt and equity securities in the Company's Consolidated Balance Sheet at May 31, 2010, in addition to \$69.2 million of cash.

(2) Included in prepaid expenses and other current assets in the Company's Consolidated Balance Sheet at May 31, 2010.

(3) Included in accrued expenses in the Company's Consolidated Balance Sheet at May 31, 2010.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes the composition and fair value hierarchy of the Company's financial assets and liabilities at February 28, 2010 (in thousands):

	As of February 28, 2010	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money markets (1)	\$ 216,624	\$ 216,624	\$	\$
Available-for-sale securities (1):				
Treasuries	9,294	9,294		
Certificates of deposit	133,810		133,810	
Commercial paper	21,367		21,367	
Agencies	349,338		349,338	
Municipal bonds	11,754		11,754	
Corporates	160,915		160,915	
Equities (1)	4,687	4,687		
Foreign currency derivatives (2)	77		77	
Liabilities:				
Foreign currency derivatives (3)	(4)		(4)	
Total	\$ 907,862	\$ 230,605	\$ 677,257	\$

(1) Included in either cash and cash equivalents or investments in debt and equity securities in the Company's Consolidated Balance Sheet at February 28, 2010, in addition to \$62.4 million of cash.

(2) Included in prepaid expenses and other current assets in the Company's Consolidated Balance Sheet at February 28, 2010.

(3) Included in accrued expenses in the Company's Consolidated Balance Sheet at February 28, 2010.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table represents the Company's investments measured at fair value as of May 31, 2010 (in thousands):

	Balance Sheet Classification						
	Amortized Cost	Gross Unrealized		Aggregate Fair Value	Cash		
		Gains	Losses (1)		Equivalent Marketable Securities	Short-term Marketable Securities	Long-term Marketable Securities
Money markets	\$ 175,279	\$	\$	\$ 175,279	\$ 175,279	\$	\$
Treasury	55,420	28		55,448	46,149	9,299	
Certificates of deposit	141,242	2		141,244	125,562	15,682	
Commercial paper	62,280			62,280	37,890	24,390	
Agencies	299,308	181	(48)	299,441	23,496	166,417	109,528
Municipal bonds	11,763	1		11,764		11,764	
Corporates	149,070	653	(303)	149,420	789	114,192	34,439
Equities	246	3,438		3,684		3,684	
Total	\$ 894,608	\$ 4,303	\$ (351)	\$ 898,560	\$ 409,165	\$ 345,428	\$ 143,967

(1) Accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer totaled less than \$0.1 million at May 31, 2010.

The following table represents the Company's investments measured at fair value as of February 28, 2010 (in thousands):

	Balance Sheet Classification						
	Amortized Cost	Gross Unrealized		Aggregate Fair Value	Cash		
		Gains	Losses (1)		Equivalent Marketable Securities	Short-term Marketable Securities	Long-term Marketable Securities
Money markets	\$ 216,624	\$	\$	\$ 216,624	\$ 216,624	\$	\$
Treasury	9,253	41		9,294		9,294	
Certificates of deposit	133,810			133,810	108,060	25,750	
Commercial paper	21,367			21,367		21,367	
Agencies	348,940	452	(54)	349,338		196,524	152,814
Municipal bonds	11,739	15		11,754		11,754	
Corporates	159,596	1,399	(80)	160,915	1,038	103,280	56,597
Equities	278	4,409		4,687		4,687	
Total	\$ 901,607	\$ 6,316	\$ (134)	\$ 907,789	\$ 325,722	\$ 372,656	\$ 209,411

(1) Accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer totaled less than \$0.1 million at February 28, 2010.

Internal Use Software

The Company capitalized \$0.5 million and \$1.4 million in costs related to the development of internal use software for its enterprise resource planning system and systems management applications during the three months ended May 31, 2010 and May 31, 2009, respectively. The Company amortizes the costs of computer software developed for internal use on a straight-line basis over an estimated useful life of five years. The carrying value of internal use software is included in property and equipment on the Company's Consolidated Balance Sheets.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Capitalized Software Costs*

Capitalization of software development costs for products to be sold to third parties begins upon the establishment of technological feasibility and ceases when the product is available for general release. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized software development costs require considerable judgment by management concerning certain external factors including, but not limited to, technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technologies. As a result of the Company's practice of releasing source code that it has developed on a weekly basis for unrestricted download on the Internet, there is generally no passage of time between achievement of technological feasibility and the availability of the Company's product for general release. Therefore, at May 31, 2010 and February 28, 2010, the Company had no internally developed capitalized software costs for products to be sold to third parties.

Property and Equipment

Property and equipment is primarily comprised of furniture, computer equipment, computer software and leasehold improvements which are recorded at cost and depreciated or amortized using the straight-line method over their estimated useful lives as follows: furniture and fixtures, seven years; computer equipment, three to four years; computer software, five years; leasehold improvements, over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease. Expenditures for maintenance and repairs are charged to operations as incurred; major expenditures for renewals and betterments are capitalized and depreciated. Property and equipment acquired under capital leases are depreciated over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease.

Share-Based Compensation

The Company measures share-based compensation cost at grant date, based on the estimated fair value of the award and recognizes the cost over the employee requisite service period typically on a straight-line basis, net of estimated forfeitures. The Company estimates the fair value of stock options using the Black-Scholes-Merton valuation model. The fair value of nonvested share awards, nonvested share units and performance share units are measured at their underlying closing share price on the day of grant.

The following summarizes share-based compensation expense recognized in the Company's Consolidated Financial Statements for the three months ended May 31, 2010 and May 31, 2009 (in thousands):

	Three Months Ended May 31, 2010	Three Months Ended May 31, 2009
Cost of revenue	\$ 1,191	\$ 800
Sales and marketing	3,776	3,110
Research and development	3,355	3,274
General and administrative	4,852	3,492
Total share-based compensation	\$ 13,174	\$ 10,676

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months ended May 31, 2010 and May 31, 2009. Accordingly, no share-based compensation expense was capitalized during the three months ended May 31, 2010 and May 31, 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Estimated annual forfeitures An estimated forfeiture rate of 15% per annum, which approximates the Company's historical rate, was applied to options and nonvested share units. Awards are adjusted to actual forfeiture rates at vesting. The Company reassesses its estimated forfeiture rate annually or when new information, including actual forfeitures, indicate a change is appropriate.

During the three months ended May 31, 2010, the Company granted the following share-based awards:

	Three Months Ended May 31, 2010	
	Shares and Shares Underlying Awards	Weighted Average Per Share Fair Value
Nonvested share units	296,140	\$ 31.10
Performance share units target (1)	313,336	\$ 29.31
Performance share awards (2)	166,664	\$ 29.31
Deferred share units	652	\$ 30.52
Total awards	776,792	\$ 29.99

- (1) On May 19, 2010, the Compensation Committee of the Company's Board of Directors (the Compensation Committee) approved a form of award agreement for use with grants of performance share units in FY2011 (PSUs) with payouts based on the Company's financial performance (the FY2011 Operating Performance PSU Agreement) and a form of award agreement for use with grants of PSUs in FY2011 with payouts based on the performance of the Company's common stock (the FY2011 Share Price Performance PSU Agreement). Under the FY2011 Operating Performance PSU Agreement, an executive will be granted an award for a target number of PSUs, and depending on the Company's financial performance, the executive may earn up to 200% of the target number of PSUs (the Maximum PSUs) over a performance period with three separate performance segments corresponding to three fiscal years of the Company. Up to 25% of the Maximum PSUs may be earned in respect of the first performance segment; up to 50% of the Maximum PSUs may be earned in respect of the second performance segment, less the amount earned in the first performance segment; and up to 100% of the Maximum PSUs may be earned in respect of the third performance segment, less the amount earned in the first and second performance segments. Under the FY2011 Share Price Performance PSU Agreement, an executive will be granted an award for a target number of PSUs, and depending on the performance of the Company's common stock over a thirty-six month period beginning on March 1, 2010 (the Share Price Performance Period), the executive may earn up to 200% of the target number of PSUs. The number of PSUs earned, according to the formula specified in the FY2011 Share Price Performance PSU Agreement, will be determined based on a comparison of the performance of the Company's stock price relative to the performance of the stock price of specified peer companies during the Share Price Performance Period. This performance is measured by the change in the average price of common stock calculated over the ninety-day periods ending at both the beginning and the end of the Share Price Performance Period.
- (2) On May 19, 2010, the Compensation Committee approved a form of award agreement for use with grants of performance-based restricted stock awards in FY2011 (the Performance RSA Agreement). Under the Performance RSA Agreement, executives are awarded shares of the Company's common stock subject to achievement of a specified dollar amount of total revenues established by the Committee as the performance objective for FY2011 (the RSA Performance Goal). If the Company fails to achieve the RSA Performance Goal for FY2011, then all shares of restricted stock subject to the award are forfeited. If the Company achieves the RSA Performance Goal for FY2011, 25% of the restricted stock vests on July 16, 2011, and the remainder vests ratably on a quarterly basis over the course of the subsequent three year period, provided that the executive's business relationship with the Company has not ceased.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Sales and Marketing Expenses

Sales and marketing expenses consist of costs, including salaries, sales commissions and related expenses, such as travel, of all personnel involved in the sales and marketing process. Sales and marketing expenses also include costs of advertising, sales lead generation programs, cooperative marketing arrangements and trade shows. Payments made to resellers or other customers are reported in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Section 605-50 Customer Payments and Incentives (formerly referenced as Emerging Issues Task Force Issue Number 01-09, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)) (ASC 605-50). All costs of advertising, to the extent allowable by ASC 605-50, are expensed as incurred. Advertising expense totaled \$5.5 million and \$5.3 million for the three months ended May 31, 2010 and May 31, 2009, respectively.

Research and Development Expenses

Research and development expenses include all direct costs, primarily salaries for Company personnel and outside consultants, related to the development of new software products, significant enhancements to existing software products, and the portion of costs of development of internal use software required to be expensed. Research and development costs are charged to operations as incurred with the exception of those software development costs that may qualify for capitalization.

Deferred Taxes

The Company accounts for income taxes using the liability method in which deferred tax assets or liabilities are recognized for the temporary differences between financial reporting and tax bases of the Company's assets and liabilities and for tax carryforwards at enacted statutory tax rates in effect for the years in which the differences are expected to reverse.

The Company continues to assess the realizability of its deferred tax assets, which primarily consist of share-based compensation expense deductions, tax credit carryforwards and deferred revenue. In assessing the realizability of these deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. As of May 31, 2010, the net deferred tax asset balance was \$72.3 million, of which \$6.2 million was offset by a valuation allowance. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign net operating loss (NOL) carryforwards.

With respect to foreign earnings, it is the Company's policy to invest the earnings of foreign subsidiaries indefinitely outside the U.S. From time to time however, the Company may remit a portion of these earnings to the extent it incurs no additional U.S. tax and it is otherwise feasible.

Because tax laws are complex and subject to different interpretations, significant judgment is required. As a result, the Company makes certain estimates and assumptions in (i) calculating its income tax expense, deferred tax assets and deferred tax liabilities, (ii) determining any valuation allowance recorded against deferred tax assets and (iii) evaluating the amount of unrecognized tax benefits, as well as the interest and penalties related to such uncertain tax positions. The Company's estimates and assumptions may differ significantly from tax benefits ultimately realized.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Foreign Currency Translation

The Euro has been determined to be the primary functional currency for the Company's European operations and local currencies have been determined to be the functional currencies for the Company's Asia Pacific and South American operations. Foreign exchange gains and losses, which result from the process of remeasuring foreign currency transactions into the appropriate functional currency, are included in other income, net in the Company's Consolidated Statements of Operations. Net foreign exchange gains and losses included in other income, net were a \$0.6 million gain and a less than \$0.1 million loss for the three months ended May 31, 2010 and May 31, 2009, respectively. The impact of changes in foreign currency exchange rates resulting from the translation of foreign currency financial statements into U.S. dollars for financial reporting purposes is included in other comprehensive income, which is a separate component of stockholders' equity. Assets and liabilities are translated into U.S. dollars at exchange rates in effect at the balance sheet date. Income and expense items are translated at average rates for the period.

Significant Customers and Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash, cash equivalents, investments and trade receivables. The Company primarily places its cash, cash equivalents and investments with high-credit quality financial institutions which invest predominantly in U.S. Government instruments, investment grade corporate bonds and certificates of deposit guaranteed by banks which are members of the FDIC. Cash deposits are primarily in financial institutions in the United States. However, cash for monthly operating costs of international operations are deposited in banks outside the United States.

The Company performs credit evaluations to reduce credit risk and generally requires no collateral from its customers. Management estimates the allowance for uncollectible accounts based on their historical experience and credit evaluation. The Company's standard credit terms are net 30 days in the U.S., net 30 to 45 days in EMEA, and range from net 30 to net 60 days in Asia Pacific. At May 31, 2010 one customer accounted for approximately 12.3% of the Company's accounts receivable. At February 28, 2010, no individual customer accounted for more than 10% of the Company's accounts receivable. For the three months ended May 31, 2010 and May 31, 2009, there were no individually significant customers from which the Company generated revenue.

Net Income Per Common Share

The Company computes basic net income per common share by dividing net income available to common stockholders by the weighted average number of common shares outstanding. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares and dilutive potential common share equivalents then outstanding. Potential common share equivalents consist of shares issuable upon the exercise of stock options or vesting of share-based awards.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table reconciles the numerators and denominators of the earnings per share calculation for the three months ended May 31, 2010 and May 31, 2009 (in thousands, except per share amounts):

	Three Months Ended	
	May 31, 2010	May 31, 2009
Net income and net income diluted	\$ 24,071	\$ 18,514
Weighted average common shares outstanding	187,926	188,916
Incremental shares attributable to assumed vesting or exercise of outstanding equity awards	5,340	5,466
Diluted shares	193,266	194,382
Diluted net income per share	\$ 0.12	\$ 0.10

The following shares awards are not included in the computation of diluted earnings per share because the aggregate value of proceeds considered received upon either exercise or vesting were greater than the average market price of the Company's common stock during the related periods and the effect of including such share awards in the computation would be anti-dilutive (in thousands):

	Three Months Ended	
	May 31, 2010	May 31, 2009
Number of shares considered anti-dilutive for calculating diluted EPS	183	9,058

Segment Reporting

The Company is organized primarily on the basis of three geographic business units: the Americas, EMEA (Europe, Middle East and Africa) and Asia Pacific. These business units are aggregated into one reportable segment due to the similarity in nature of products provided, financial performance economics (e.g., revenue growth and gross margin), methods of distribution (direct and indirect) and customer classification and base (e.g., distributors, resellers and enterprise).

The Company has offices in more than 65 locations around the world. The Company manages its international business on an Americas-wide, EMEA-wide and Asia Pacific-wide basis. The following summarizes revenue, net income (loss) and total assets by geographic segment at and for the three months ended May 31, 2010 and May 31, 2009 (in thousands):

	Americas	EMEA	Asia Pacific	Total
	Three Months Ended May 31, 2010			
Revenue from unaffiliated customers	\$ 134,605	\$ 45,561	\$ 28,978	\$ 209,144
Net income (loss)	\$ 18,954	\$ 6,913	\$ (1,796)	\$ 24,071
Total assets	\$ 1,536,304	\$ 195,906	\$ 99,658	\$ 1,831,868

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	Three Months Ended May 31, 2009			
Revenue from unaffiliated customers	\$ 113,850	\$ 37,040	\$ 23,498	\$ 174,388
Net income (loss)	\$ 17,195	\$ 3,127	\$ (1,808)	\$ 18,514
Total assets	\$ 1,528,234	\$ 161,528	\$ 76,061	\$ 1,765,823

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table lists, for the three months ended May 31, 2010 and May 31, 2009, revenue from unaffiliated customers in the United States, the Company's country of domicile, revenue from unaffiliated customers in Japan, which in terms of revenue, was the only individually material country outside the United States and revenue from other foreign countries.

	Three Months Ended May 31, 2010	Three Months Ended May 31, 2009
United States, the Company's country of domicile	\$ 119,246	\$ 102,567
Japan	16,647	13,843
Other foreign	73,251	57,978
Total revenue from unaffiliated customers	\$ 209,144	\$ 174,388

Total tangible long-lived assets located in the United States, the Company's country of domicile, and similar tangible long-lived assets held outside the United States are summarized in the following table as of May 31, 2010 and February 28, 2010:

	As of May 31, 2010	As of February 28, 2010
United States, the Company's country of domicile	\$ 51,147	\$ 51,523
Foreign	18,805	20,185
Total tangible long-lived assets	\$ 69,952	\$ 71,708

Comprehensive Income

The Company's comprehensive income is comprised of net income, foreign currency translation adjustments, and unrealized gains and losses on marketable securities classified as available for sale. Comprehensive income for the three months ended May 31, 2010 and May 31, 2009 was as follows (in thousands):

	Three Months Ended May 31, 2010	May 31, 2009
Comprehensive income:		
Net income	\$ 24,071	\$ 18,514
Foreign currency translation adjustments	(1,858)	(7,405)
Change in unrealized gains (losses) on investments in debt and equity securities available for sale	(1,418)	9,293
Total comprehensive income, net of taxes	\$ 20,795	\$ 20,402

As of May 31, 2010 the Company holds investments in debt securities available for sale with an accumulated unrealized gain of \$0.6 million and investments in equity securities available for sale with an accumulated unrealized gain of \$3.4 million, respectively. As of February 28, 2010,

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the Company held investments in debt securities available for sale with an accumulated unrealized gain of \$1.7 million and investments in equity securities available for sale with an accumulated unrealized gain of \$4.4 million.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Recent Accounting Pronouncements*

In January 2010, the FASB issued amended guidance to improve disclosure requirements related to Fair Value Measurements and Disclosures-Overall Subtopic 820-10 of the FASB Accounting Standards Codification (ASC 820-10) originally issued as FASB Statement No. 157, Fair value Measurements. The amended guidance requires companies to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for such transfers. These additional disclosure requirements were effective for reporting periods beginning March 1, 2010. For the three months ended May 31, 2010, the Company did not have any transfers in and out of Level 1 and Level 2 fair value measurements. The amended guidance also requires additional disclosures related to Level 3 fair value measurements. The Company does not currently have Level 3 fair value measurements.

NOTE 3 Identifiable Intangible Assets

Identifiable intangible assets consist primarily of purchased technologies, customer and reseller relationships, trademarks, copyrights and patents, which are amortized over the estimated useful life, generally on a straight line basis with the exception of customer contracts and relationships which are generally amortized over the greater of straight-line or the related asset's pattern of economic benefit. Useful lives range from three to twelve years for purchased technologies and customer and reseller relationships and three to ten years for trademarks, copyrights and patents. As of May 31, 2010 and February 28, 2010, trademarks with an indefinite estimated useful life totaled \$9.0 million. Amortization expense associated with identifiable intangible assets was \$4.5 million and \$5.0 million for the three months ended May 31, 2010 and May 31, 2009, respectively. The following is a summary of identifiable intangible assets (in thousands):

	May 31, 2010			February 28, 2010		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	\$ 52,954	\$ (14,315)	\$ 38,639	\$ 52,204	\$ (13,504)	\$ 38,700
Purchased technologies	42,236	(24,801)	17,435	42,444	(23,593)	18,851
Customer and reseller relationships	80,686	(32,371)	48,315	80,760	(30,098)	50,662
Total identifiable intangible assets	\$ 175,876	\$ (71,487)	\$ 104,389	\$ 175,408	\$ (67,195)	\$ 108,213

NOTE 4 Income Taxes*Income Tax Expense*

During the three months ended May 31, 2010 and May 31, 2009, the Company recorded \$13.0 million and \$10.0 million, respectively of income tax expense, which resulted in an estimated annual effective tax rate of 35% for each of the three months ended May 31, 2010 and May 31, 2009. The Company's estimated annual effective tax rate, which equaled the U.S. federal statutory rate of 35%, includes state income taxes which were offset by foreign income taxed at different rates.

Deferred Taxes

As of May 31, 2010, the net deferred tax asset balance was \$72.3 million, of which \$6.2 million was offset by a valuation allowance. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign NOLs.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

As of May 31, 2010, the Company had U.S. state NOL carryforwards of approximately \$27.5 million. As of May 31, 2010, the Company had a U.S. federal research tax credit carryforward of approximately \$31.2 million and a U.S. foreign tax credit carryforward of approximately \$9.1 million. These NOL and tax credit carryforwards are scheduled to expire in varying amounts beginning in 2011.

Unrecognized tax benefits

The Company's unrecognized tax benefits were \$43.9 million as of May 31, 2010 and \$43.4 million as of February 28, 2010. The Company's unrecognized tax benefits at May 31, 2010 and February 28, 2010, which, if recognized, would affect the Company's effective tax rate, were \$36.6 million and \$36.1 million, respectively.

During the three months ended May 31, 2010, the amount of unrecognized tax benefits increased \$0.5 million, primarily as a result of increases with respect to tax positions taken during prior periods. The Company does not currently anticipate any significant changes in its unrecognized tax benefits for the next 12 months. No settlements of uncertain income tax positions or reductions in long-term obligations related to unrecognized tax benefits occurred during the three months ended May 31, 2010.

It is the Company's policy to recognize interest and penalties related to uncertain tax positions as income tax expense. Accrued interest and penalties related to unrecognized tax benefits totaled \$1.4 million and \$1.1 million as of May 31, 2010 and February 28, 2010, respectively.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The following table summarizes the tax years in the Company's major tax jurisdictions that remain subject to income tax examinations by tax authorities as of May 31, 2010. Due to NOL carryforwards, in some cases the tax years continue to remain subject to examination with respect to such NOLs:

Tax Jurisdiction	Years Subject to Income Tax Examination	
U.S. federal	1994	Present
North Carolina	1999	Present
Ireland	2006	Present
Japan*	2008	Present

* The Company has been examined for income tax for years through February 28, 2007. However, the statute of limitations remains open for 5 years.

The Company is currently undergoing an income tax examination by the U.S. Internal Revenue Service with respect to its fiscal year ended February 28, 2007.

The Company or one of its subsidiaries is currently undergoing income tax examinations in Argentina, Germany and India.

The Company believes it has adequately provided for any reasonably foreseeable outcomes related to tax audits.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 Commitments and Contingencies

As of May 31, 2010, the Company leased office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases was \$5.4 million for each of the three months ended May 31, 2010 and May 31, 2009.

In January 2002, the Company assumed the lease obligation of an unrelated third party for an office building which serves as the Company's headquarters. This lease terminates in June 2020. As compensation to the Company for assuming this obligation, the third party paid rent on the Company's behalf from the commencement of the sublease until February 2003, is allowing the Company the use of all furniture and fixtures, including building improvements, that were in the building at the time of the commencement of the sublease, and paid the Company a certain monthly amount through October 2002, to offset the operating expenses of this building, all of which was valued in the aggregate at \$5.9 million. Included in the aggregate amount was \$3.6 million representing the fair value of furniture and fixtures. This credit balance began to amortize, as a reduction to related rent expense, in fiscal 2004 and will continue to do so until the lease terminates in June 2020. The furniture and fixtures were depreciated over a period of seven years. As of May 31, 2010 and February 28, 2010, the carrying amount of the long-term deferred lease credit was \$3.7 million and \$3.8 million, respectively.

Product Indemnification

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party from losses arising in connection with the Company's services or products, or from losses arising in connection with certain events defined within a particular contract, which may include litigation or claims relating to intellectual property infringement, certain losses arising from damage to property or injury to persons or other matters. In each of these circumstances, payment by the Company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party's claims. Further, the Company's obligations under these agreements may in certain cases be limited in terms of time and/or amount, and in some instances, the Company may have recourse against third-parties for certain payments made by the Company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the facts and circumstances involved in each particular agreement. The Company does not record a liability for claims related to indemnification unless the Company concludes that the likelihood of a material claim is probable and estimable. Historically, payments pursuant to these indemnifications have been immaterial.

NOTE 6 Share Repurchase Program

On March 24, 2010, the Company announced that its Board of Directors had authorized the repurchase of up to an aggregate of \$300.0 million of the Company's common stock from time to time in open market or privately negotiated transactions, as applicable. The program will expire on the earlier of (i) March 31, 2012 or (ii) a determination by the Board of Directors, Chief Executive Officer or Chief Financial Officer to discontinue the program.

As of May 31, 2010, the amount available under the program for the repurchase of the Company's common stock was \$235.3 million. See NOTE 9 to the Consolidated Financial Statements for a discussion of shares repurchased under the program subsequent to May 31, 2010.

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 Foreign Currency Exchange Rate Risk**

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. The Company from time to time enters into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded on the Consolidated Balance Sheets at their respective fair market values. The Company has elected not to prepare and maintain the documentation required to qualify for hedge accounting treatment and, therefore, changes in fair value are recorded in the Consolidated Statements of Operations.

The effects of derivative instruments on the Company's Consolidated Financial Statements are as follows as of May 31, 2010 and for the three months then ended (in thousands):

	As of May 31, 2010			Three Months Ended May 31, 2010	
	Balance Sheet Location	Fair Value	Notional Value	Location of Gain (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative
Assets foreign currency forward contracts not designated as hedges	Other current assets	\$ 73	\$ 8,835	Other income, net	\$ 155
Liabilities foreign currency forward contracts not designated as hedges	Accrued expenses	\$ (141)	\$ 14,497	Other income, net	\$ (663)
TOTAL		\$ (68)	\$ 23,332		\$ (508)

The aggregate notional amount of outstanding forward contracts at February 28, 2010 was \$3.9 million. The fair value of these outstanding contracts at February 28, 2010 was gross, a \$0.1 million asset and a less than \$0.1 million liability, and is recorded in other current assets and accrued expenses, respectively on the Consolidated Balance Sheet.

NOTE 8 Legal Proceedings

Commencing on or about March 2001, the Company and certain of its officers and directors were named as defendants in a series of purported class action suits arising out of the Company's initial public offering and secondary offering. Approximately 310 other IPO issuers were named as defendants in similar class action complaints (together, the IPO Allocation Actions). On August 8, 2001, Chief Judge Michael Mukasey of the U.S. District Court for the Southern District of New York issued an order that transferred all of the IPO Allocation Actions, including the complaints involving the Company, to one judge for coordinated pre-trial proceedings (Case No. 21 MC 92). The plaintiffs contend that the defendants violated federal securities laws by issuing registration statements and prospectuses that contained materially false and misleading information and failed to disclose material information. Plaintiffs also challenge certain IPO allocation practices by underwriters and the lack of disclosure thereof in initial public offering documents. On April 19, 2002, plaintiffs filed amended complaints in each of the 310 consolidated actions, including the Red Hat action. The relief sought consists of unspecified damages, attorneys' and expert fees and other unspecified costs. In October of 2002, the individual director and officer defendants of the Company were dismissed from the case without prejudice. In October of 2004, the District Court certified a class in six of the 310 actions (the focus cases) and noted that

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Company's action is not one of the focus cases. On December 5, 2006, the U.S. Court of Appeals for the Second Circuit vacated the District Court's class certification with respect to the focus cases and remanded the matter for further consideration. In September 2007, discovery moved forward in the focus cases and plaintiff filed and amended complaints against the focus case issuer and underwriter defendants. Defendants in the focus cases filed motions to dismiss the second amended complaints in November 2007 and filed their oppositions to plaintiffs' motion for class certification in December 2007. The motions to dismiss in the focus cases were granted in part and denied in part, and the issue of class certification is currently pending before the Court. On April 2, 2009, the plaintiffs filed a motion for preliminary approval of a settlement agreement to resolve the lawsuit, to which the Company has consented and for which payments called for by the settlement agreement are to be paid by the defendant insurers. The trial court heard arguments on September 10, 2009 on the fairness of the settlement. In an opinion and order filed October 5, 2009, the trial court granted plaintiffs' motion for approval of the settlement and directed the clerk of the court to close the action. Notices of appeal in the matter have been filed, and the appeal is pending before the Court of Appeals for the Second Circuit.

In the summer of 2004, 14 class action lawsuits were filed against the Company and several of its former officers on behalf of investors who purchased the Company's securities during various periods from June 19, 2001 through July 13, 2004. All 14 suits were filed in the U.S. District Court for the Eastern District of North Carolina. In each of the actions, plaintiffs sought to represent a class of purchasers of the Company's common stock during some or all of the period from June 19, 2001 through July 13, 2004. All of the claims arose in connection with the Company's announcement on July 13, 2004 that it would restate certain of its financial statements (the Restatement). One or more of the plaintiffs asserted that certain former officers (the Individual Defendants) and the Company violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (the Securities Exchange Act), and Rule 10b-5 thereunder by issuing the financial statements that the Company subsequently restated. One or more of the plaintiffs sought unspecified damages, interest, costs, attorneys' and experts' fees, an accounting of certain profits obtained by the Individual Defendants from trading in the Company's common stock, disgorgement by the Company's former chief executive officer and former chief financial officer of certain compensation and profits from trading in the Company's common stock pursuant to Section 304 of the Sarbanes-Oxley Act of 2002 and other relief. As of September 8, 2004, all of these class action lawsuits were consolidated into a single action referenced as Civil Action No. 5:04-CV-473BR and titled In re Red Hat, Inc. Securities Litigation. On May 6, 2005, the plaintiffs filed an amended consolidated class action complaint. On July 29, 2005, the Company, on behalf of itself and the Individual Defendants, filed a motion to dismiss the action for failure to state a claim upon which relief may be granted. Also on that date, PricewaterhouseCoopers LLP (PwC), another defendant, filed a separate motion to dismiss. On May 12, 2006, the Court issued an order granting the motion to dismiss the Securities Exchange Act claims against several of the Individual Defendants, but denying the motion to dismiss the Securities Exchange Act claims against the Company, its former chief executive officer and former chief financial officer. The Court dismissed the claims under the Sarbanes-Oxley Act in their entirety, and also granted PwC's motion to dismiss. On November 6, 2006, the plaintiffs filed a motion for class certification. Subsequent to the filing of that motion, several plaintiffs withdrew as potential class representatives, and the Company opposed the certification of the remaining proposed class representatives. On May 11, 2007, the Court entered an order denying class certification and denying all other pending motions as moot. Thereafter, on July 13, 2007 Charles Gilbert filed a renewed motion for appointment as lead plaintiff and approval of selection of lead counsel. On November 13, 2007, the Court entered an Order allowing Gilbert's motion, appointing him lead plaintiff, adding him as a party plaintiff and appointing lead counsel. On January 14, 2008, Gilbert's counsel filed a motion to certify the action as a class action. On August 28, 2009, the Court entered an Order certifying the action as a class action, appointing Gilbert as the class representative, and defining the class as all purchasers of the common stock of Red Hat, Inc.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

between December 17, 2002, and July 12, 2004, inclusive and who were damaged thereby, excluding Company insiders. On December 15, 2009, the Company announced that it had reached an agreement in principle to settle this matter, subject, among other matters, to completion of a final written settlement agreement and court approval. The Company recorded, for its quarter ended November 30, 2009, an estimated liability in the amount of \$8.8 million for its portion of the proposed settlement. On March 29, 2010, counsel for the class filed a Motion for Preliminary Approval of the Settlement and, on June 11, 2010, a United States Magistrate Judge issued a Memorandum and Recommendation to the presiding judge that the motion be approved. Should the efforts to settle this matter not be successful, the Company intends to vigorously defend itself in this matter. There can be no assurance, however, that the Company would be successful, and an adverse resolution of the lawsuit could have a material adverse effect on the Company's financial position and results of operations in the period in which the lawsuit is resolved.

On October 9, 2007, IP Innovation, LLC and Technology Licensing Corporation filed a complaint in the Eastern District of Texas (Civil Action No. 2-07CV-447) against Red Hat, Inc. and Novell, Inc., alleging direct and indirect infringement of U.S. Patent Nos. 5,072,412, 5,394,521 and 5,533,183 with regard to aspects of the Company's Linux-based products. The complaint seeks, among other relief, compensatory damages. The Company answered the complaint on February 1, 2008, including counterclaims against plaintiffs for declaratory judgment of invalidity, unenforceability and noninfringement of the patents-in-suit, and the plaintiffs filed a reply to those counterclaims on February 11, 2008. The court issued a memorandum opinion and order denying defendants' motion for partial summary judgment for invalidity due to indefiniteness and construing disputed claim terms on August 10, 2009. The trial in the case began on April 26 and concluded on April 30 with a jury verdict that the patent in suit was invalid and not infringed. Post trial motions are currently pending, and the plaintiffs' time for appeal has not expired.

On March 3, 2009, Software Tree LLC filed a complaint in the Eastern District of Texas (Civil Action No. 6:09-cv-00097-LED) against Red Hat, Inc., Hewlett-Packard Co., Genuitec, L.L.C., and Dell, Inc. alleging direct and indirect infringement of U.S. Patent No. 6,163,776 with regard to aspects of the Company's JBoss Hibernate product, among other products of the Defendants. The complaint seeks, among other relief, compensatory damages, enhanced damages and injunctive relief. The Company answered the complaint on April 7, 2009 and denied the allegations of direct and indirect infringement, asserted affirmative defenses and filed a counterclaim seeking a declaration that the patent was invalid, unenforceable and not infringed. Discovery in the case is proceeding, and trial has been scheduled for October 12, 2010. Based on the Company's efforts to date, it believes it has meritorious defenses to this matter, and intends to vigorously defend itself. There can be no assurance, however, that the Company will be successful in its defense, and an adverse resolution of the lawsuit could have a material adverse effect on its business, financial position and results of operation, including its ability to continue to commercialize the technologies implicated in the litigation.

On December 9, 2009, the Company filed a complaint in the Eastern District of Texas (Civil Action No. 6:09-cv-00549) against Bedrock Computer Technologies LLC (Bedrock) seeking a declaratory judgment that United States Patent No. 5,893,120 (120 Patent) is invalid, unenforceable and not infringed. The complaint states that Bedrock brought an action in which it wrongly accused some customers of the Company of infringing the 120 Patent based on their use of computer equipment configured with or utilizing software based on various versions of the Linux operating system. The complaint seeks a declaration that anyone's use, sale, or offer for sale of the Linux kernel distributed by the Company has not and does not in any manner infringe any claim of the patent or otherwise infringe or violate any rights of Bedrock and that the 120 Patent is invalid and unenforceable. On January 29, 2010, Bedrock responded denying the contentions in the complaint and asserting a counterclaim alleging that Red Hat has directly and indirectly infringed the 120 Patent. On February 22, 2010,

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Red Hat replied to the counterclaim denying the allegations of infringement and asserting affirmative defenses. On March 26, 2010, Bedrock filed its first amended answer and counterclaim with crossclaims against fifteen parties. Trial in the case has been scheduled for October 11, 2011. Based on information available to date, the Company believes it has meritorious defenses to the counterclaims and does not anticipate that the counterclaims will have a material adverse effect on its business, financial position and results of operations. There can be no assurance, however, that the Company will be successful in its defense.

On January 21, 2010, JuxtaComm-Texas Software, LLC filed a complaint in the Eastern District of Texas (Civil Action No. 6 10-CV-00011-LED) against twenty-two defendants, including Red Hat, Inc., alleging direct and indirect infringement of U.S. Patent No. 6,195,662. The complaint seeks, among other relief, compensatory damages, enhanced damages, and injunctive relief. On May 6, 2010, the Company answered the amended complaint and denied the allegations of direct and indirect infringement, asserted affirmative defenses and filed a counterclaim seeking a declaration that the patent was invalid, unenforceable and not infringed. Based on the Company's efforts to date, it believes it has meritorious defenses to this matter, and intends to vigorously defend itself. There can be no assurance, however, that the Company will be successful in its defense, and an adverse resolution of the lawsuit could have a material adverse effect on its business, financial position and results of operation, including its ability to continue to commercialize the technologies implicated in the litigation.

On February 19, 2010, Implicit Networks, Inc. filed a complaint in the Northern District of California (Civil Action CV 10 720) against Red Hat, Inc. and VMware, Inc. alleging direct and indirect infringement of U.S. Patent No. 6,324,685 and No. 6,976,248 with regard to the Company's JBoss Application Server product family, as well as products of the other defendant. The complaint seeks, among other relief, compensatory damages, enhanced damages, and injunctive relief. The Company's response to the complaint is due July 29, 2010. Based on the Company's efforts to date, it believes it has meritorious defenses to this matter, and intends to vigorously defend itself. There can be no assurance, however, that the Company will be successful in its defense, and an adverse resolution of the lawsuit could have a material adverse effect on its business, financial position and results of operation, including its ability to continue to commercialize the technologies implicated in the litigation.

The Company also experiences routine litigation in the normal course of its business, including patent litigation. The Company presently believes that the outcome of this routine litigation will not have a material adverse effect on its financial position and results of operations.

NOTE 9 Subsequent Events

From June 1, 2010 through July 08, 2010, the Company repurchased an aggregate of 175,600 shares of its common stock for \$5.0 million. These repurchases were made pursuant to the Company's previously announced repurchase program. See NOTE 6 to the Consolidated Financial Statements for further discussion of the repurchase program. As of July 08, 2010, the amount available for repurchase of common stock under the program was \$230.3 million.

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

We are a global leader in providing open source software solutions to the enterprise, including our core enterprise operating system platform, Red Hat Enterprise Linux (RHEL), our enterprise middleware platform, JBoss Enterprise Middleware, our virtualization solutions and other Red Hat enterprise technologies.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is freely shared, there are customarily no licensing fees for the distribution of open source software. Therefore, we do not recognize revenue from the licensing of the code itself. We provide value to our customers through the aggregation, integration, testing, certification, delivery, maintenance and support of our Red Hat enterprise technologies, and by providing a level of scalability, stability and accountability for the enterprise technologies we package and distribute. Moreover, because communities of developers not employed by us assist with the creation of our open source offerings, opportunities for further innovation of our offerings are supplemented by these communities.

We sell our enterprise technologies through subscriptions, and we recognize revenue over the period of the subscription agreements with our customers. In addition, we generally provide certain managed services for each of our enterprise technologies, through Red Hat Network (RHN), Red Hat Network Satellite (RHN Satellite), JBoss Operations Network (JBoss ON) and JBoss Customer Support Portal (JBoss CSP), as a component of our subscriptions. We market our offerings primarily to enterprise customers including large enterprises, government organizations, small- and medium-size businesses and educational institutions.

We have focused on introducing and gaining acceptance for Red Hat enterprise technologies that comprise our open source architecture. Since introducing our initial enterprise open source operating system platform, Red Hat Enterprise Linux, it has gained widespread independent software vendor (ISV) and independent hardware vendor (IHV) support. We have continued to build our open source architecture by expanding our enterprise offerings and introducing new systems management services, middleware, integrated virtualization and clustering capability, file management systems, directory and certificate technologies and enhanced security functionality. We intend to bring the value of open source technology to other key areas of the enterprise infrastructure as the development community efforts support and customer needs dictate.

We derive our revenue and generate cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. The arrangements with our customers that produce this revenue and cash are explained in further detail under Critical Accounting Policies and Estimates below and in NOTE 2 to the Consolidated Financial Statements. These arrangements typically involve subscriptions to Red Hat enterprise technologies. Our revenue is affected by, among other factors, corporate, government and consumer spending levels. In evaluating the performance of our business, we consider a number of factors, including total revenue, deferred revenue, operating income, operating margin and cash flows from operations.

Revenue. For the three months ended May 31, 2010 total revenue increased 19.9% or \$34.8 million to \$209.1 million from \$174.4 million for the three months ended May 31, 2009. Subscription revenue increased 20.4% or \$30.3 million, driven primarily by additional subscriptions related to our principal RHEL technologies, which continue to gain broader market acceptance in mission-critical areas of computing, and our international expansion. The increase is, in part, a result of the continued migration of enterprises in industries such as telecommunications, government and financial services to our open source platform from a proprietary Unix platform. Training and services revenue increased 17.5% or \$4.5 million for the three months ended May 31, 2010 as compared to the same period ended May 31, 2009. The increase is driven primarily by an improving economic environment in which enterprises are increasing discretionary spending in areas such as IT training and consulting.

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We believe the success of our business model is influenced by:

- the extent to which we can expand the breadth and depth of our technology and service offerings;
- our ability to enhance the value of subscriptions for Red Hat enterprise technologies through frequent and continuous innovations to these technologies;
- the acceptance and widespread deployment of open source solutions by small, medium and large enterprises and government agencies;
- our ability to generate subscription revenue for Red Hat enterprise technologies; and
- our ability to provide customers with consulting and training services that generate additional revenue.

Deferred Revenue. Our deferred revenue, current and long-term, balance at May 31, 2010 was \$625.6 million. Because of our subscription model and revenue recognition policies, deferred revenue improves predictability of future revenue. Deferred revenue at May 31, 2010 decreased \$20.2 million or 3.1% as compared to the balance at February 28, 2010 of \$645.9 million. The decrease was driven primarily by changes in foreign currency exchange rates, which accounted for \$19.2 million of the decrease. The remaining decrease of \$1.0 million results from shift in mix in which a number of our largest deals included an initial consulting component resulting in lower-upfront invoicing.

Subscriptions. Our enterprise technologies are sold under subscription agreements. These agreements typically have a one- or three-year subscription period. The subscription entitles the end user to maintenance, which generally consists of a specified level of support, as well as security updates, bug fixes, functionality enhancements and upgrades to the technology, when and if available, during the term of the subscription through our integrated management technologies, RHN, RHN Satellite, JBoss ON and JBoss CSP. Our customers have the ability to purchase higher levels of subscriptions that increase the level of support the customer is entitled to receive. Subscription revenue increased sequentially for the first quarter of 2010 and each quarter of fiscal 2010, 2009 and 2008 and is being driven primarily by the increased market acceptance and use of open source software by the enterprise and our expansion of sales channels and geographic footprint during these periods.

Revenue by geography. We operate our business in three geographic regions: the Americas (U.S., Latin America and Canada); EMEA (Europe, Middle East and Africa); and Asia Pacific (principally Japan, Singapore, India, Australia, South Korea and China). In the three months ended May 31, 2010, approximately \$89.9 million or 43.0% of our revenue was generated outside the United States compared to approximately \$71.8 million or 41.2% for the three months ended May 31, 2009. Our international operations are expected to continue to grow as our international sales force and channels become more mature and as we enter new locations or expand our presence in existing locations. As of May 31, 2010 we had offices in more than 65 locations throughout the world.

Gross profit margin. Primarily as a result of investments made in process and technology infrastructure enhancements to support the delivery of our subscriptions and services, gross profit margin decreased to 84.1% for the three months ended May 31, 2010 from 84.8% for the three months ended May 31, 2009.

Income from operations. Operating income was 16.4% and 14.4% of total revenue for the three months ended May 31, 2010 and the three months ended May 31, 2009, respectively. The increase in operating income as a percentage of revenue is a result of the decrease in operating expenses relative to revenue as we continued to focus on managing discretionary spending and leveraging existing resources within corporate functions. Overall operating expenses as a percentage of revenue decreased to 67.7% for the three months ended May 31, 2010 from 70.5% for the three months ended May 31, 2009.

Cash, cash equivalents, investments in debt and equity securities and cash flow from operations. Cash, cash equivalents and short-term and long-term available-for-sale investments in securities balances at May 31, 2010 totaled \$967.8 million. During the three months ended May 31, 2010, we repurchased \$74.4 million of our

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common stock, which was partially offset by employees' exercise of stock options which generated \$37.7 million of cash proceeds. Cash generated from operating activities for the three months ended May 31, 2010 totaled \$60.6 million, primarily as a result of the increase in subscription revenue and billings during the same period. Our significant cash balance gives us a measure of flexibility to take advantage of opportunities such as acquisitions, increasing investment in international areas and repurchasing our own common stock.

Foreign currency exchange rates' impact on results of operations. Approximately 43.0% of our revenue for the three months ended May 31, 2010 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component in determining net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions results in increased revenue and operating expenses from operations for our non-U.S. operations. Similarly, our revenue and operating expenses will decrease for our non-U.S. operations if the U.S. dollar strengthens against foreign currencies.

Using the average foreign currency exchange rates from the first quarter of our prior fiscal year ended February 28, 2010, our revenue and operating expenses from non-U.S. operations for the three months ended May 31, 2010 would have been lower than we reported using the average exchange rates for the first quarter of our current fiscal year ending February 28, 2011 by approximately \$2.9 million and \$2.9 million, respectively, which would have resulted in income from operations being unchanged.

In our fiscal year ended February 28, 2010, we focused on, and expect in our fiscal year ending February 28, 2011 to continue to focus on, among other things, (i) gaining widespread acceptance and deployment of Red Hat enterprise technologies by enterprise users globally, (ii) generating increasing revenue from our existing customer base by renewing existing subscriptions and providing additional value to our customers and by growing the number of enterprise technologies that comprise our open source architecture, (iii) generating increased revenue by providing additional systems management, developer support and other targeted services and (iv) generating increasing revenue from additional market penetration through a broader and deeper set of channel partner relationships, including OEMs, VARs and systems integrators and our own international expansion, among other means.

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our critical accounting policies and estimates include the following:

- Revenue recognition;