RED HAT INC
Form 10-Q
January 11, 2010

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended November 30, 2009

**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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 x 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 x

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

As of January 7, 2010, there were 188,710,217 shares of common stock outstanding.

**RED HAT, INC.**

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**RED HAT, INC.**

**CONSOLIDATED BALANCE SHEETS**

**(In thousands except share and per share amounts)**

| | November 30, 2009 (Unaudited) | February 28, 2009 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 389,709 | $ 515,548 |
| Investments in debt and equity securities, short-term | 348,187 | 147,178 |
| Accounts receivable, net of allowances for doubtful accounts of $2,613 and $2,387, respectively | 137,237 | 128,669 |
| Prepaid expenses and other current assets | 96,585 | 99,437 |
| Total current assets | 971,718 | 890,832 |
| Property and equipment, net of accumulated depreciation and amortization of $111,034 and $91,140, respectively | 73,220 | 67,913 |
| Goodwill | 439,497 | 438,109 |
| Identifiable intangibles, net | 112,046 | 122,177 |
| Investments in debt securities, long-term | 221,191 | 183,363 |
| Other assets, net | 38,157 | 51,242 |
| Total assets | $ 1,855,829 | $ 1,753,636 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 17,496 | $ 9,576 |
| Accrued expenses | 72,874 | 54,123 |
| Deferred revenue | 446,685 | 382,050 |
| Other current obligations | 878 | 900 |
| Total current liabilities | 537,933 | 446,649 |
| Deferred lease credits | 4,067 | 4,470 |
| Long-term deferred revenue | 172,051 | 161,032 |
| Other long-term obligations | 34,578 | 35,432 |
| Commitments and contingencies (Notes 6 and 9) | | |
| Stockholders equity: | | |
| Preferred stock, 5,000,000 shares authorized, none outstanding | | |
| Common stock, $0.0001 per share par value, 300,000,000 shares authorized, 213,072,816 and 207,794,700 shares issued, and 188,326,249 and 189,998,611 shares outstanding at November 30, 2009 and February 28, 2009, respectively | 21 | 21 |
| Additional paid-in capital | 1,370,795 | 1,281,469 |
| Retained earnings | 114,384 | 50,519 |
| Treasury stock at cost, 24,746,567 and 17,796,089 shares at November 30, 2009 and February 28, 2009, respectively | (382,528) | (236,283) |
| Accumulated other comprehensive income | 4,528 | 10,327 |
| Total stockholders equity | 1,107,200 | 1,106,053 |
| Total liabilities and stockholders equity | $ 1,855,829 | $ 1,753,636 |

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

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**RED HAT, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In thousands except per share amounts)**

**(Unaudited)**

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | November 30, 2009 | November 30, 2008 |
| Revenue: | | | | |
| Subscriptions | $ 164,432 | $ 135,451 | $ 469,496 | $ 401,854 |
| Training and services | 29,914 | 29,881 | 82,872 | 84,497 |
| Total subscription and training and services revenue | 194,346 | 165,332 | 552,368 | 486,351 |
| Cost of subscription and training and services revenue: | | | | |
| Cost of subscriptions | 11,010 | 8,771 | 32,033 | 27,448 |
| Cost of training and services | 18,588 | 17,765 | 52,474 | 53,025 |
| Total cost of subscription and training and services revenue | 29,598 | 26,536 | 84,507 | 80,473 |
| Gross profit | 164,748 | 138,796 | 467,861 | 405,878 |
| Operating expense: | | | | |
| Sales and marketing | 71,498 | 58,514 | 202,242 | 177,350 |
| Research and development | 38,605 | 34,544 | 110,068 | 95,184 |
| General and administrative | 26,102 | 24,768 | 74,411 | 71,060 |
| Litigation settlement | 8,750 | | 8,750 | |
| Total operating expense | 144,955 | 117,826 | 395,471 | 343,594 |
| Income from operations | 19,793 | 20,970 | 72,390 | 62,284 |
| Interest income | 2,206 | 9,294 | 8,161 | 30,568 |
| Interest expense | (42) | (1,249) | (138) | (4,365) |
| Other income (expense), net | 3,295 | 4,501 | 6,580 | 8,025 |
| Income before provision for income taxes | 25,252 | 33,516 | 86,993 | 96,512 |
| Provision for income taxes | 8,838 | 9,211 | 23,128 | 33,779 |
| Net income | $ 16,414 | $ 24,305 | $ 63,865 | $ 62,733 |
| Basic net income per common share | $ 0.09 | $ 0.13 | $ 0.34 | $ 0.33 |
| Diluted net income per common share | $ 0.08 | $ 0.12 | $ 0.33 | $ 0.30 |
| Weighted average shares outstanding | | | | |
| Basic | 187,450 | 190,665 | 187,823 | 190,978 |
| Diluted | 193,733 | 208,408 | 193,366 | 215,605 |

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

**RED HAT, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In thousands Unaudited)**

| | Three Months Ended November 30, | | Nine Months Ended November 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Cash flows from operating activities: | | | | |
| Net income | $ 16,414 | $ 24,305 | $ 63,865 | $ 62,733 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 11,595 | 10,561 | 33,847 | 29,486 |
| Share-based compensation expense | 12,557 | 12,251 | 34,246 | 33,682 |
| Deferred income taxes | 9,578 | 7,031 | 15,066 | 27,260 |
| Excess tax benefits from share-based payment arrangements | (9,524) | (14,790) | (27,280) | (39,246) |
| Gain on sale of investments in equity securities | (4,584) | | (8,247) | (4,996) |
| Gain from repurchase of convertible debentures | | (4,129) | | (4,129) |
| Amortization of debt issuance costs | | 627 | | 2,131 |
| Other | (198) | 314 | (205) | 177 |
| Changes in operating assets and liabilities net of effects of acquisitions: | | | | |
| Accounts receivable | (21,742) | (7,650) | (1,130) | 13,687 |
| Prepaid expenses and other current assets | 2,923 | (7,400) | 7,855 | (14,308) |
| Accounts payable | (843) | 1,836 | 6,944 | (6,138) |
| Accrued expenses | 14,651 | 8,774 | 16,836 | 18,576 |
| Deferred revenue | 23,446 | 27,503 | 35,963 | 58,217 |
| Other assets | (124) | (85) | (402) | (355) |
| Net cash provided by operating activities | 54,149 | 59,148 | 177,358 | 176,777 |
| Cash flows from investing activities: | | | | |
| Purchase of investment in debt securities available-for-sale | (245,788) | | (534,260) | (331,705) |
| Proceeds from sales and maturities of investment in debt securities available-for-sale | 93,089 | 77,498 | 299,193 | 427,314 |
| Proceeds from sales of investment in equity securities available-for-sale | 4,312 | | 8,371 | 5,568 |
| Acquisitions of businesses, net of cash acquired | | (101,338) | | (148,140) |
| Net purchases of strategic equity investments | (1,368) | | (1,368) | |
| Purchase of developed technologies and other intangible assets | (847) | (779) | (2,917) | (3,121) |
| Purchase of property and equipment | (8,655) | (4,212) | (21,318) | (18,164) |
| Net cash used in investing activities | (159,257) | (28,831) | (252,299) | (68,248) |
| Cash flows from financing activities: | | | | |
| Excess tax benefits from share-based payment arrangements | 9,524 | 14,790 | 27,280 | 39,246 |
| Proceeds from exercise of common stock options | 44,985 | 449 | 63,574 | 17,238 |
| Payments related to net settlement of share-based compensation awards | (6,754) | (1,221) | (9,054) | (1,221) |
| Purchase of treasury stock | (52,289) | (29,999) | (146,246) | (39,365) |
| Structured stock repurchase | | | | 1,989 |
| Repurchase of convertible debentures | | (280,058) | | (280,058) |
| Payments on other borrowings | | (48) | (900) | (72) |
| Net cash used in financing activities | (4,534) | (296,087) | (65,346) | (262,243) |
| Effect of foreign currency exchange rates on cash and cash equivalents | 6,299 | (1,850) | 14,448 | (4,169) |
| Net decrease in cash and cash equivalents | (103,343) | (267,620) | (125,839) | (157,883) |
| Cash and cash equivalents at beginning of the period | 493,052 | 787,457 | 515,548 | 677,720 |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents at end of the period | $ 389,709 | $ 519,837 | $ 389,709 | $ 519,837 |

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

**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 and nine months ended November 30, 2009 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 and nine months ended November 30, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2010. 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, 2009.

*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.

**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 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.

**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 and other current assets 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 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. For the three months and nine months ended November 30, 2009 and November 30, 2008, the Company did not identify any potential impairment related to its goodwill.

The Company evaluates the recoverability of its property and equipment and other long-lived assets whenever events or changes in circumstances indicate 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. For the three months and nine months ended November 30, 2009 and November 30, 2008, no potential 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 determines it is probable the receivable will not be recovered. The Company does not have off-balance-sheet credit exposure related to its customers.

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

*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 November 30, 2009 and February 28, 2009, 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.

**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 November 30, 2009 (in thousands):

| | As of November 30, 2009 | 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) | $ 269,455 | $ 269,455 | $ | $ |
| Available-for-sale securities (1): | | | | |
| Treasuries | 9,327 | 9,327 | | |
| Certificate of deposit | 46,976 | | 46,976 | |
| Commercial paper | 17,449 | | 17,449 | |
| Agencies | 342,437 | | 342,437 | |
| Municipals | 11,787 | | 11,787 | |
| Corporates | 164,732 | | 164,732 | |
| Equities | 8,651 | 8,651 | | |
| Foreign currency derivatives (2) | 15 | | 15 | |
| Liabilities: | | | | |
| Foreign currency derivatives (3) | (20) | | (20) | |
| Total | $ 870,809 | $ 287,433 | $ 583,376 | $ |

(1) Included in either cash and cash equivalents or investments in debt and equity securities in the Company s Consolidated Balance Sheet at November 30, 2009, in addition to $88.3 million of cash.

(2) Included in prepaid expenses and other current assets in the Company s Consolidated Balance Sheet at November 30, 2009.

(3) Included in accrued expenses in the Company s Consolidated Balance Sheet at November 30, 2009.

**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, 2009 (in thousands):

| | As of February 28, 2009 | 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) | $ 417,632 | $ 417,632 | $ | $ |
| Available-for-sale securities (1): | | | | |
| Treasuries | 17,163 | 17,163 | | |
| Certificates of deposit | 27,133 | | 27,133 | |
| Agencies | 183,636 | | 183,636 | |
| Corporates | 122,899 | | 122,899 | |
| Equities | 6,022 | 6,022 | | |
| Foreign currency derivatives (2) | 30 | | 30 | |
| Liabilities: | | | | |
| Foreign currency derivatives (3) | (64) | | (64) | |
| Total | $ 774,451 | $ 440,817 | $ 333,634 | $ |

(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, 2009, in addition to $71.6 million of cash.

(2) Included in prepaid expenses and other current assets in the Company s Consolidated Balance Sheet at February 28, 2009.

(3) Included in accrued expenses in the Company s Consolidated Balance Sheet at February 28, 2009.

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The following table represents the Company s investments measured at fair value as of November 30, 2009 (in thousands):

| | | | | | Balance Sheet Classification | | |
|---|---|---|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses (1) | Aggregate Fair Value | Cash Equivalent Marketable Securities | Short-term Marketable Securities | Long-term Marketable Securities |
| Money markets | $ 269,455 | $ | $ | $ 269,455 | $ 269,455 | $ | $ |
| Treasuries | 9,272 | 55 | | 9,327 | | 7,492 | 1,835 |
| Certificates of deposit | 46,976 | | | 46,976 | 31,981 | 14,995 | |
| Commercial paper | 17,449 | | | 17,449 | | 17,449 | |
| Agencies | 341,691 | 779 | (33) | 342,437 | | 182,851 | 159,586 |
| Municipals | 11,775 | 14 | (2) | 11,787 | | 11,787 | |
| Corporates | 162,434 | 2,346 | (48) | 164,732 | | 104,962 | 59,770 |
| Equities | 550 | 8,101 | | 8,651 | | 8,651 | |
| Total | $ 859,602 | $ 11,295 | $ (83) | $ 870,814 | $ 301,436 | $ 348,187 | $ 221,191 |

(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 November 30, 2009.

The following table represents the Company s investments measured at fair value as of February 28, 2009 (in thousands):

| | | | | | Balance Sheet Classification | | |
|---|---|---|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses (1) | Aggregate Fair Value | Cash Equivalent Marketable Securities | Short-term Marketable Securities | Long-term Marketable Securities |
| Money Markets | $ 417,632 | $ | $ | $ 417,632 | $ 417,632 | $ | $ |
| Treasury | 16,873 | 290 | | 17,163 | | 15,316 | 1,847 |
| Certificate of Deposit | 27,133 | | | 27,133 | 26,312 | 821 | |
| Agencies | 182,683 | 989 | (36) | 183,636 | | 70,364 | 113,272 |
| Corporates | 123,874 | 784 | (1,759) | 122,899 | | 54,655 | 68,244 |
| Equities | 1,307 | 4,715 | | 6,022 | | 6,022 | |
| Total | $ 769,502 | $ 6,778 | $ (1,795) | $ 774,485 | $ 443,944 | $ 147,178 | $ 183,363 |

(1) Accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer totaled $0.3 million at February 28, 2009.

*Internal Use Software*

The Company capitalized $4.0 million and $3.7 million in costs related to the development of internal use software for its website, enterprise resource planning system and systems management applications during the nine months ended November 30, 2009 and November 30, 2008,

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.

**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 November 30, 2009 and February 28, 2009, 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, 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 following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the three months and six ended November 30, 2009 and November 30, 2008 (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | November 30, 2009 | November 30, 2008 |
| Cost of revenue | $ 916 | $ 723 | $ 2,475 | $ 2,047 |
| Sales and marketing | 3,627 | 3,352 | 9,875 | 9,554 |
| Research and development | 3,239 | 3,715 | 9,588 | 9,769 |
| General and administrative | 4,775 | 4,461 | 12,308 | 12,312 |
| Total share-based compensation | $ 12,557 | $ 12,251 | $ 34,246 | $ 33,682 |

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months and nine months ended November 30, 2009 and November 30, 2008. Accordingly, no share-based compensation expense was capitalized during the three months and nine months ended November 30, 2009 and November 30, 2008.

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

During the three months and nine months ended November 30, 2009, the Company granted the following share-based awards:

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | Shares and Shares Underlying Awards | Weighted Average Per Share Fair Value | Shares and Shares Underlying Awards | Weighted Average Per Share Fair Value |
| Options | 86,430 | $ 11.10 | 100,080 | $ 10.63 |
| Nonvested shares and share units | 2,162,195 | $ 28.63 | 2,421,250 | $ 27.66 |
| Performance share units target (1) | | $ | 171,667 | $ 19.73 |
| Performance share units target (2) | | $ | 171,667 | $ 29.61 |
| Deferred share units | 786 | $ 28.61 | 27,753 | $ 21.05 |
| Total awards | 2,249,411 | $ 27.96 | 2,892,417 | $ 26.66 |

(1) On May 13, 2009, the Compensation Committee of the Company s Board of Directors approved a Performance Share Unit Agreement for use with certain grants of performance share units ( PSUs ) to executive officers under the Red Hat, Inc. 2004 Amended and Restated Long-Term Incentive Plan, as Amended and Restated (the 2004 Long-Term Incentive Plan ), in FY2010. During the three months ended May 31, 2009, certain executive officers were awarded a target number of PSUs, and depending on the Company s financial performance relative to a specified peer group of companies, these executive officers may earn up to a maximum of 200% of the target number of PSUs over a performance period with three separate performance segments noted below. In respect of the first performance segment, which is the period from March 1, 2009 through February 28, 2010, up to 25% of the maximum number of PSUs may be earned. In respect of the second performance segment, which is the period from March 1, 2009 through February 28, 2011, up to 50% of the maximum number of PSUs (less the amount of PSUs earned in respect of the first performance segment) may be earned. In respect of the third and final performance segment, which is the period from March 1, 2009 through February 29, 2012, up to 100% of the maximum number of PSUs (less the aggregate amount of PSUs earned in respect of the first and second performance segments) may be earned.

(2) On June 23, 2009, the Compensation Committee of the Company s Board of Directors approved a Performance Share Unit Agreement for use with certain grants of performance share units ( Share Price PSUs ) in FY2010 to executive officers under the 2004 Long-Term Incentive Plan. During the three months ended August 31, 2009, certain executive officers were awarded a target number of Share Price PSUs, and depending on the performance of the Company s common stock over a thirty-six month performance period beginning on March 26, 2009 relative to the performance of the stock price of specified peer companies, each of these executive officers may earn up to a maximum of 200% of the target number of Share Price PSUs. Each executive officer will receive a single payout following the end of the performance period.

*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

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**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

605-50 ). All costs of advertising, to the extent allowable by ASC 605-50, are expensed as incurred. Advertising expense totaled $7.0 million and $4.2 million for the three months ended November 30, 2009 and November 30, 2008, respectively. Advertising expense for the nine months ended November 30, 2009 and November 30, 2008 totaled $17.9 million and $13.8 million, 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, deferred revenue and tax credit carryforwards. 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 November 30, 2009, the net deferred tax asset balance was $80.4 million, of which $13.5 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 losses ( NOLs ) and tax carryforwards that are subject to limitations under Section 382 of the Internal Revenue Code.

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.

*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

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

Consolidated Statements of Operations. Net foreign exchange losses included in other income was $0.5 million for the three months and $0.8 million for nine months ended November 30, 2009. Net foreign exchange gains and losses included in other income for the three months and nine months ended November 30, 2008 were a gain of $0.4 million and a loss of $0.6 million, 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 November 30, 2009 no individual customer accounted for more than 10% of the Company s accounts receivable. At February 28, 2009, one customer accounted for 12% of the Company s accounts receivable.

For the three months and nine months ended November 30, 2009 and November 30, 2008, 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 adjusted for interest expense and amortization of debt issuance costs associated with the convertible debentures, 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 and convertible securities such as the Company s convertible debentures. Diluted net income per share for the three months and nine months ended November 30, 2008, assumes the conversion of the convertible debentures using the if converted method. For the three months and nine months ended November 30, 2009, the Company had no convertible debentures outstanding and as a result, an adjustment to diluted net income for related interest or amortization expense was not required.

**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 and nine months ended November 30, 2009 and November 30, 2008 (in thousands, except per share amounts):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | November 30, 2009 | November 30, 2008 |
| Diluted net income per share computation: | | | | |
| Net income | $ 16,414 | $ 24,305 | $ 63,865 | $ 62,733 |
| Interest expense on convertible debt, net of related tax | | 387 | | 1,273 |
| Amortization of debt issuance costs, net of related tax | | 455 | | 1,386 |
| Net income diluted | $ 16,414 | $ 25,147 | $ 63,865 | $ 65,392 |
| Weighted average common shares outstanding | 187,450 | 190,665 | 187,823 | 190,978 |
| Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares | 6,283 | 3,888 | 5,543 | 5,140 |
| Incremental shares attributable to assumed conversion of convertible debentures | | 13,855 | | 19,487 |
| Diluted shares | 193,733 | 208,408 | 193,366 | 215,605 |
| Diluted net income per share | $ 0.08 | $ 0.12 | $ 0.33 | $ 0.30 |

The following share 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 | | Nine Months Ended | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | November 30, 2009 | November 30, 2008 |
| Number of shares considered anti-dilutive for calculating diluted net income per share: | 2,867 | 12,140 | 4,625 | 9,422 |

*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).

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

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 November 30, 2009 and November 30, 2008 (in thousands):

| | Americas | EMEA | Asia Pacific | Total |
|---|---|---|---|---|
| | Three Months Ended November 30, 2009 | | | |
| Revenue from unaffiliated customers | $ 121,943 | $ 45,227 | $ 27,176 | $ 194,346 |
| Net income (loss) | $ 12,444 | $ 5,467 | $ (1,497) | $ 16,414 |
| Total assets | $ 1,571,491 | $ 194,355 | $ 89,983 | $ 1,855,829 |

| | Americas | EMEA | Asia Pacific | Total |
|---|---|---|---|---|
| | Three Months Ended November 30, 2008 | | | |
| Revenue from unaffiliated customers | $ 108,519 | $ 34,807 | $ 22,006 | $ 165,332 |
| Net income (loss) | $ 23,179 | $ 1,968 | $ (842) | $ 24,305 |
| Total assets | $ 1,771,978 | $ 119,053 | $ 73,448 | $ 1,964,479 |

The following summarizes revenue, net income (loss) and total assets by geographic segment at and for the nine months ended November 30, 2009 and November 30, 2008 (in thousands):

| | Americas | EMEA | Asia Pacific | Total |
|---|---|---|---|---|
| | Nine Months Ended November 30, 2009 | | | |
| Revenue from unaffiliated customers | $ 352,308 | $ 123,356 | $ 76,704 | $ 552,368 |
| Net income (loss) | $ 55,240 | $ 12,770 | $ (4,145) | $ 63,865 |
| Total assets | $ 1,571,491 | $ 194,355 | $ 89,983 | $ 1,855,829 |

| | Americas | EMEA | Asia Pacific | Total |
|---|---|---|---|---|
| | Nine Months Ended November 30, 2008 | | | |
| Revenue from unaffiliated customers | $ 314,627 | $ 106,760 | $ 64,964 | $ 486,351 |
| Net income (loss) | $ 57,436 | $ 10,551 | $ (5,254) | $ 62,733 |
| Total assets | $ 1,771,978 | $ 119,053 | $ 73,448 | $ 1,964,479 |

The following table lists, for the three months ended November 30, 2009 and November 30, 2008, 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 (in thousands).

| | Three Months Ended November 30, 2009 | Three Months Ended November 30, 2008 |
|---|---|---|
| United States, the Company s country of domicile | $ 110,413 | $ 98,848 |
| Japan | 15,700 | 12,431 |
| Other foreign | 68,233 | 54,053 |
| Total revenue from unaffiliated customers | $ 194,346 | $ 165,332 |

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The following table lists, for the nine months ended November 30, 2009 and November 30, 2008, 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 (in thousands).

| | Nine Months Ended November 30, 2009 | Nine Months Ended November 30, 2008 |
|---|---|---|
| United States, the Company s country of domicile | $ 316,702 | $ 287,632 |
| Japan | 44,419 | 36,266 |
| Other foreign | 191,247 | 162,453 |
| Total revenue from unaffiliated customers | $ 552,368 | $ 486,351 |

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 November 30, 2009 and February 28, 2009 (in thousands):

| | As of November 30, 2009 | As of February 28, 2009 |
|---|---|---|
| United States, the Company s country of domicile | $ 52,007 | $ 53,106 |
| Foreign | 21,213 | 14,807 |
| Total tangible long-lived assets | $ 73,220 | $ 67,913 |

*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 and nine months ended November 30, 2009 and November 30, 2008 was as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | November 30, 2009 | November 30, 2008 |
| Comprehensive income: | | | | |
| Net income | $ 16,414 | $ 24,305 | $ 63,865 | $ 62,733 |
| Foreign currency translation adjustments | (4,021) | 6,736 | (12,029) | 8,824 |
| Change in unrealized losses on marketable debt securities available-for-sale | (219) | (1,736) | 2,844 | (8,540) |
| Change in unrealized gains on marketable equity securities available-for-sale | (999) | (6,168) | 3,386 | 7,934 |
| Total comprehensive income, net of taxes | $ 11,175 | $ 23,137 | $ 58,066 | $ 70,951 |

As of November 30, 2009 the Company holds investments in debt securities available for sale with a net accumulated unrealized gain of $3.1 million and investments in equity securities available for sale with a net accumulated unrealized gain of $8.1 million. As of February 28, 2009, the Company held investments in debt securities available for sale with a net accumulated unrealized gain of $0.3 million and investments in equity securities available for sale with a net accumulated unrealized gain of $4.7 million.

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

*Recent Accounting Pronouncements*

In May 2009, the FASB issued authoritative guidance regarding subsequent events. The authoritative guidance establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The authoritative guidance requires disclosure of the date through which subsequent events have been evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The authoritative guidance is effective for interim and annual periods ending after June 15, 2009. The Company has evaluated subsequent events through January 11, 2010, the date of issuance of the accompanying consolidated financial statements.

In June 2009, the FASB issued Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162 ( the Codification ). The Codification, which was launched on July 1, 2009, became the single source of authoritative non-governmental U.S. generally accepted accounting principles ( GAAP ), superseding various existing authoritative accounting pronouncements. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company adopted the Codification for its reporting period ending on November 30, 2009. The adoption of the Codification had no significant impact on the Company s consolidated financial statements.

In August 2009, the FASB issued Accounting Standards Update 2009-05, Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value, ( Update 2009-05 ). Update 2009-05 clarifies that in circumstances in which a quoted price in an active market for an identical liability is not available, a reporting entity is required to measure fair value of such liability using one or more of the techniques prescribed by the update. On November 1, 2009 the Company adopted Update 2009-05. There was no significant impact on the Company s consolidated financial statements.

**NOTE 3 Business Combinations**

*Acquisition of Qumranet, Inc.*

On September 4, 2008, the Company completed its acquisition of Qumranet, Inc. ( Qumranet ), a privately held software company that produces and sells virtualization technologies. The acquisition of Qumranet broadens the Company s technology solutions, communities of development and use, and additional influence in, and acceptance of, virtualization technology in the Linux kernel, upon which the Company s Red Hat Enterprise Linux platform is based. Under the terms of the purchase agreement the Company paid approximately $104.8 million in cash. The total consideration paid by the Company in connection with the acquisition as of November 30, 2009 is summarized in the following table (in thousands):

| | Total Consideration |
|---|---|
| Cash consideration paid to and or on behalf of Qumranet stockholders | $ 104,772 |
| Transaction costs | 703 |
| Total consideration | $ 105,475 |

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The table below represents the allocation of the total consideration to the Company s tangible and identifiable intangible assets and liabilities (in thousands) based on management s assessment of their respective fair values as of the date of the acquisition:

| | Total Consideration Allocated |
|---|---|
| Identifiable intangible assets at fair value (see detail below) | $ 21,200 |
| Cash | 4,333 |
| Accounts receivable at fair value | 28 |
| Fixed assets at fair value | 959 |
| Other assets at fair value | 247 |
| Accrued liabilities at fair value | (1,069) |
| Goodwill | 79,777 |
| Total consideration allocated | $ 105,475 |

The following table summarizes the allocation of identifiable intangible assets resulting from the acquisition (in thousands). For purposes of this allocation, the Company has assessed a fair value of Qumranet identifiable intangible assets related to employee covenants not to compete, developed technology and tradenames and trademarks based on the net present value of the projected income stream of these identifiable intangible assets. The resulting fair value is being amortized over the estimated useful life of each identifiable intangible asset on a straight-line basis which approximates the economic pattern of benefits (in thousands):

| | Expense Type | Estimated Life (Years) | Total |
|---|---|---|---|
| Developed technology | Research and development | 6 | $ 17,000 |
| Employee covenants not to compete | Research and development | 3 | 2,600 |
| Tradenames and trademarks | General and administrative | 10 | 1,600 |
| Total identifiable intangible assets | | | $ 21,200 |

*Pro forma consolidated financial information*

The following unaudited pro forma consolidated financial information reflects the results of operations of the Company for the nine months ended November 30, 2008 (in thousands, except per share amounts) as if the acquisition of Qumranet had occurred at March 1, 2008, after giving effect to certain purchase accounting adjustments. These pro forma results are not necessarily indicative of what the Company s operating results would have been had the acquisitions actually taken place at the beginning of the period.

| | Nine Months Ended November 30, 2008 |
|---|---|
| Revenue | $ 486,476 |
| Net income | $ 57,060 |
| Diluted net income | $ 59,719 |
| Basic net income per common share | $ 0.30 |

| | | |
|---|---|---|
| Diluted net income per common share | $ | 0.28 |

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

*Goodwill*

The following is a summary of goodwill for the nine months ended November 30, 2009 (in thousands):

| | |
|---|---|
| Balance at February 28, 2009 | $ 438,109 |
| Less: adjustments to purchase price for finalization of allocation | (372) |
| Impact of foreign currency fluctuations | 1,760 |
| Balance at November 30, 2009 | $ 439,497 |

**NOTE 4 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 November 30, 2009 and February 28, 2009, trademarks with an indefinite estimated useful life totaled $9.9 million and $9.1 million, respectively. Amortization expense associated with identifiable intangible assets was $5.0 million and $5.1 million for the three months ended November 30, 2009 and November 30, 2008, respectively. For the nine months ended November 30, 2009 and November 30, 2008 amortization expense associated with identifiable intangible assets was $15.0 million and $12.7 million, respectively. The following is a summary of identifiable intangible assets (in thousands):

| | November 30, 2009 | | | February 28, 2009 | | |
|---|---|---|---|---|---|---|
| | Gross Amount | Accumulated Amortization | Net Amount | Gross Amount | Accumulated Amortization | Net Amount |
| Trademarks, copyrights and patents | $ 51,378 | $ (12,699) | $ 38,679 | $ 47,046 | $ (10,296) | $ 36,750 |
| Purchased technologies | 42,652 | (22,365) | 20,287 | 43,972 | (19,108) | 24,864 |
| Customer and reseller relationships | 80,843 | (27,763) | 53,080 | 80,704 | (20,141) | 60,563 |
| Total identifiable intangible assets | $ 174,873 | $ (62,827) | $ 112,046 | $ 171,722 | $ (49,545) | $ 122,177 |

**NOTE 5 Income Taxes**

*Income Tax Expense*

During the three months and nine months ended November 30, 2009, the Company recorded $8.8 million and $23.1 million, respectively of income tax expense. Tax expense for the nine months ended November 30, 2009 includes a discrete tax benefit from research tax credits, net of a corresponding reduction of NOLs, which resulted in a net reduction of income tax expense of $7.3 million. Excluding the impact of the discrete tax benefit, the Company s estimated annual effective tax rate was 35% as of November 30, 2009. The estimated annual effective tax rate as of November 30, 2009, which equals the U.S., includes state income taxes which are offset by foreign income taxed at different rates. The Company s estimated annual effective tax rate as of November 30, 2008 was 35%.

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The following table summarizes the Company s tax provision for the three months and nine months ended November 30, 2009 and November 30, 2008 (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | November 30, 2009 | November 30, 2008 |
| Provision for income taxes: | | | | |
| Income before provision for income taxes | $ 25,252 | $ 33,516 | $ 86,993 | $ 96,512 |
| Estimated annual effective tax rate on current year ordinary income (1) | 35% | 27% | 35% | 35% |
| Provision for income taxes on current year ordinary income | 8,838 | 9,211 | 30,449 | 33,779 |
| Discrete tax benefit from research tax credit carryforwards | | | 7,319 | |
| Provision for income taxes | $ 8,838 | $ 9,211 | $ 23,128 | $ 33,779 |

(1) An effective income tax rate of 27% for the three months ended November 30, 2008 results from a change in the Company s estimated annual effective tax rate from 39% as of August 31, 2008 to 35% as of November 30, 2008.

*Deferred Taxes*

As of November 30, 2009, the net deferred tax asset balance was $80.4 million, of which $13.5 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 and acquired tax carryforwards that are subject to limitations under Section 382 of the Internal Revenue Code.

As of November 30, 2009, the Company had U.S. federal and state NOL carryforwards of approximately $14.0 million and $33.7 million, respectively. As of November 30, 2009, the Company had a U.S. federal research tax credit carryforward of approximately $12.8 million and a U.S. foreign tax credit carryforward of approximately $12.6 million. These NOL and tax credit carryforwards are scheduled to expire in varying amounts beginning in 2010.

*Uncertain Tax Positions*

The Company s unrecognized tax benefits were $46.5 million as of November 30, 2009 and $38.5 million as of February 28, 2009. The Company s unrecognized tax benefits at November 30, 2009 and February 28, 2009, which, if recognized, would impact its effective tax rate were $24.3 million and $15.9 million, respectively.

During the three months and nine months ended November 30, 2009, the amount of unrecognized tax benefits increased by approximately $0.4 million and $8.0 million, respectively, primarily as a result of increases with respect to tax positions taken during prior periods. The Company does not currently expect any other 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 nine months ended November 30, 2009.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

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 $1.5 million and $0.9 million as of November 30, 2009 and February 28, 2009, 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 November 30, 2009. 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 | 2001 | 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 2007.

The Company or one of its subsidiaries is currently undergoing an income tax examination in Germany.

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

**NOTE 6 Commitments and Contingencies**

As of November 30, 2009, the Company leased office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases was $6.0 million for the three months ended November 30, 2009 and $5.7 million for the three months ended November 30, 2008. For the nine months ended November 30, 2009 and November 30, 2008 rent expense under operating leases was $17.1 million and $16.8 million, respectively.

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

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

November 30, 2009 and February 28, 2009, the carrying amount of the long-term deferred lease credit was $4.0 million and $4.4 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 7 Share Repurchase Program**

On September 25, 2007, the Company announced that its Board of Directors had authorized a continuation of the Company s common stock and debenture repurchase program that was announced in October 2006. Under the continued program, the Company was authorized to repurchase up to an aggregate of $250.0 million of common stock from time to time on the open market or in privately negotiated transactions, as applicable.

On November 17, 2008, the Company announced that its Board of Directors had amended the repurchase program to authorize the repurchase of up to an aggregate of $250.0 million of common stock, without regard to amounts previously repurchased under prior programs. The amended program expires on the earlier of (i) October 31, 2010 or (ii) a determination by the Board of Directors, the Chief Executive Officer or the Chief Financial Officer to discontinue the program.

During the three months ended November 30, 2009 the Company repurchased 1,900,000 shares under the program for $52.3 million, including transaction costs. As of November 30, 2009, the remaining amount available under the program for the repurchase of Common Stock was $99.8 million. See NOTE 10 to the Consolidated Financial Statements for a discussion of shares repurchased under the program subsequent to November 30, 2009.

**NOTE 8 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 sometimes 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

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

respective fair market values. The Company has elected not to prepare and maintain the documentation required to qualify as an accounting hedge 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 November 30, 2009 and for the three months and nine months then ended (in thousands):

| | As of November 30, 2009 | | | Three Months Ended November 30, 2009 | Nine Months Ended November 30, 2009 |
|---|---|---|---|---|---|
| | 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 | Prepaid expenses and other current assets | $ 15 | $ 1,821 | Other income, net | $ 40 | $ 225 |
| Liabilities foreign currency forward contracts not designated as hedges | Accrued expenses | $ (20) | $ 2,145 | Other income, net | $ (66) | $ (317) |
| **TOTAL** | | $ (5) | $ 3,966 | | $ (26) | $ (92) |

**NOTE 9 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 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

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

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 court to close the action. Notices of appeal in the matter have been filed.

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 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 and 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. 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. 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

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

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 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. Discovery in the case has closed, and trial has been scheduled for April 12, 2010. Based on information available to date, the Company believes it has meritorious defenses to this matter and does not anticipate that the lawsuit 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. The Company estimates that an adverse resolution of the lawsuit could result in damages ranging from approximately $0.1 million to $11.0 million.

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 September 13, 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. Bedrock is entitled to answer or otherwise respond to the complaint.

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

**NOTE 10 Subsequent Events**

On December 15, 2009, the Company announced that it had reached an agreement to settle the class action lawsuit, pending in the United States District Court for the Eastern District of North Carolina, brought on behalf

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

of a class of shareholders in connection with the restatement of financial results which we announced in July 2004. The Company has recognized in its consolidated financial statements as of and for the three months and nine months ended November 30, 2009, an $8.8 million expense and corresponding accrued liability for the Company s portion of the settlement.

From December 1, 2009 through January 8, 2010, the Company repurchased an aggregate of 1,080,000 shares of its common stock for $33.4 million. These repurchases were made pursuant to the Company s previously announced repurchase program. See NOTE 7 to the Consolidated Financial Statements for further discussion of the repurchase program. As of January 8, 2010, the amount available for repurchase of common stock under the program was $66.4 million.

**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, 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 the 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 November 30, 2009 total revenue increased 17.5% or $29.0 million to $194.3 million from $165.3 million for the three months ended November 30, 2008. Subscription revenue increased 21.4% or $29.0 million, driven primarily by additional subscriptions related to our principal RHEL technologies, which have gained 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 remained unchanged at $29.9 million for the three months ended November 30, 2009 as compared to the same period ended November 30, 2008. The flat revenue was a result of a challenging economic environment in which enterprises are scaling back discretionary spending in areas such as training and travel.

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

- 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;
- our ability to provide customers with consulting and training services that generate additional revenue;
- the extent to which we can expand the breadth and depth of our technology and service offerings; and
- our ability to enhance the value of subscriptions for Red Hat enterprise technologies through frequent and continuous innovations to these technologies.

*Deferred Revenue.* Our deferred revenue, current and long-term, balance at November 30, 2009 was $618.7 million. Because of our subscription model and revenue recognition policies, deferred revenue improves predictability of future revenue. Deferred revenue at November 30, 2009 increased $75.7 million or 13.9% as compared to the balance at February 28, 2009 of $543.1 million. As a result of changes in foreign currency exchange rates, our deferred revenue balance at November 30, 2009 was $39.7 million higher than what it would have been if spot exchange rates on that date were the same as at February 28, 2009.

*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, second and third quarter of fiscal 2010 and each quarter of fiscal 2009, 2008 and 2007 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 November 30, 2009, approximately $83.9 million or 43.2% of our revenue was generated outside the United States compared to approximately $66.5 million or 40.2% for the three months ended November 30, 2008. Our international operations are expected to continue increasing 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 November 30, 2009, we had offices in more than 65 locations throughout the world.

*Gross profit margin.* Primarily as a result of changes in mix with a greater proportion of total revenue generated by subscription revenue, gross profit margin increased to 84.8% for the three months ended November 30, 2009 from 83.9% for the three months ended November 30, 2008. Training and services revenue decreased as a percentage of total revenue to 15.4% for the three months ended November 30, 2009 from 18.1% for the three months ended November 30, 2008.

*Income from operations.* Operating income was 10.2% and 12.7% of total revenue for the three months ended November 30, 2009 and November 30, 2008, respectively. The decrease in operating income as a percentage of revenue is a result of an $8.8 million expense, representing our portion of an agreement in principle to settle the class action lawsuit brought on behalf of certain shareholders in connection with the restatement of our financial results announced in July 2004. Excluding the litigation settlement expense, operating income as a percentage of revenue was 14.7% as compared to 12.7% for the same period ended November 30, 2008, and this increase is primarily the result of changes in mix, described above. Additionally, operating expenses as a percentage of revenue, excluding the litigation settlement expense, decreased to 70.0% for the three months

ended November 30, 2009 from 71.3% for the three months ended November 30, 2008 as efficiencies realized in our general and administrative functions offset additional sales and marketing expenses related to our recent Red Hat Summit-JBoss World conference. General and administrative expenses as a percentage of revenue decreased to 13.4% for the three months ended November 30, 2009 from 15.0% for the three months ended November 30, 2008.

*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 November 30, 2009 totaled $959.1 million. During the three months ended November 30, 2009, we repurchased $52.3 million of our common stock under a previously announced common stock repurchase program which was partially offset by employees exercise of stock options which generated $45.0 million of cash proceeds. Cash generated from operating activities for the three months ended November 30, 2009 totaled $54.1 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 43.2% of our revenue for the three months ended November 30, 2009 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, operating expenses and income from operations for our non-U.S. operations. Similarly, our revenue, operating expenses and net income 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 third quarter of our prior fiscal year ended February 28, 2009, our revenue and operating expenses from non-U.S. operations for the three months ended November 30, 2009 would have been lower than we reported using the average exchange rates for the third quarter of our current fiscal year ending February 28, 2010 by approximately $6.9 million and $4.6 million, respectively, which would have resulted in income from operations being $2.3 million lower. Using the average foreign currency exchange rates from the nine months ending November 30, 2008, our revenue and operating expenses from non-U.S. operations for the nine months ended November 30, 2009 would have been higher than we reported using the average exchange rates for the nine months ending November 30, 2009 by approximately $1.8 million and $3.6 million, respectively, which would have resulted in income from operations being $1.8 million lower.

*Business combinations.* On September 4, 2008, we announced our acquisition of Qumranet, including its Kernel Virtualized Machine ( KVM ) and SolidICE virtualization technologies, for approximately $104.8 million in cash. The acquisition provides server and desktop virtualization technologies and expertise, related virtualization management capabilities, communities of development and use, and additional influence in, and acceptance of, virtualization technology in the Linux kernel, upon which our Red Hat Linux platform is based. For further discussion, see NOTE 3 to the Consolidated Financial Statements.

In our fiscal year ended February 28, 2009 we focused on, and expect in our fiscal year ending February 28, 2010 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.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our critical accounting policies and estimates include the following:

- Revenue recognition;
- Impairment of goodwill and other long-lived assets;
- Share-based compensation; and
- Deferred taxes and uncertain tax positions.

**Revenue recognition**

We recognize revenue in accordance with FASB ASC Section 985-605 (formerly referenced as Statement of Position No. 97-2, Software Revenue Recognition). We establish persuasive evidence of an arrangement for each type of revenue transaction based on either a signed contract with the end customer, a click-through contract on our website whereby the customer agrees to our standard subscription terms, signed or click-through distribution contracts with OEMs and other resellers, or, in the case of individual training seats, through receipt of payment which indicates acceptance of our 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 our 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. We sell our open source technologies through two principal channels: (1) direct, which includes sales by our sales force as well as web store sales, and (2) indirect, which includes distributors, resellers and OEMs. We recognize 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). We allocate revenue to each element of the arrangement based on vendor-specific objective evidence of each element s fair value when we 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 element 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 our OEM partners and other customers to provide for significant modification and customization of our Red Hat enterprise technologies. We recognize revenue for these fixed fee engineering services using the percentage of completion basis of accounting, provided we have 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.

**Impairment of goodwill and other long-lived assets**

We test goodwill for impairment annually and whenever events or circumstances indicate an impairment may exist. We test goodwill at least annually using a two-step process that begins with identifying any 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. For the three months and nine months ended November 30, 2009 and November 30, 2008, we did not identify any potential impairment related to our goodwill.

We evaluate the recoverability of our property and equipment and other long-lived assets whenever events or changes in circumstances indicate 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 are measured as the amount by which the carrying value exceeds the fair value of the assets. For the three months and nine months ended November 30, 2009 and November 30, 2008, no potential impairment losses related to our long-lived assets were identified. For further discussion, see NOTE 2 to the Consolidated Financial Statements.

**Share-based compensation**

Effective March 1, 2006, we adopted the fair value recognition provisions of FASB ASC Section 718 Compensation-Stock Compensation (formerly referenced as Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment) ( ASC 718 ), using the modified-prospective transition method. Under the modified-prospective method, compensation costs include (a) compensation cost for all share-based awards granted prior to, but not yet vested as of, March 1, 2006 based on the grant date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-based Compensation ( SFAS 123 ) and (b) compensation costs for all share-based awards granted or modified on or subsequent to March 1, 2006, based on the grant date fair value estimated in accordance with the provisions of ASC 718.

In applying ASC 718, we are required to make estimates and assumptions with regards to the number of share-based awards that we expect will ultimately vest and the amount of tax benefits we expect will ultimately be realized, among other things. The amount of share-based awards that actually vest and the amount of tax benefits from share-based awards actually realized may differ significantly from our estimates. For further discussion, see NOTE 2 to the Consolidated Financial Statements.

**Deferred taxes and uncertain tax positions**

We account 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 our 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.

We continue to assess the realizability of our deferred tax assets, which primarily consist of share-based compensation expense deductions, deferred revenue and tax credit carryforwards. 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 November 30, 2009, the net deferred tax asset balance was $80.4 million, of which $13.5 million was offset by a valuation allowance. We continue to maintain a valuation allowance against our deferred tax assets with respect to certain foreign NOLs and tax carryforwards that are subject to limitations under Section 382 of the Internal Revenue Code.

With respect to foreign earnings, it is our policy to invest the earnings of foreign subsidiaries indefinitely outside the U.S. From time to time, however, we may remit a portion of these earnings to the extent we incur 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, we make certain estimates and assumptions, in (i) calculating our 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. Our estimates and assumptions may differ significantly from tax benefits ultimately realized.

**RESULTS OF OPERATIONS**

**Three months ended November 30, 2009 and November 30, 2008**

The following table is a summary of our results of operations for the three months ended November 30, 2009 and November 30, 2008 (in thousands):

| | Three Months Ended (Unaudited) | | | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | $ Change | % Change |
| Revenue: | | | | |
| Subscriptions | $ 164,432 | $ 135,451 | $ 28,981 | 21.4% |
| Training and services | 29,914 | 29,881 | 33 | 0.1 |
| Total subscription and training and services revenue | 194,346 | 165,332 | 29,014 | 17.5 |
| Cost of subscription and training and services revenue: | | | | |
| Cost of subscriptions | 11,010 | 8,771 | 2,239 | 25.5 |
| As a % of subscription revenue | 6.7% | 6.5% | | |
| Cost of training and services | 18,588 | 17,765 | 823 | 4.6 |
| As a % of training and services revenue | 62.1% | 59.5% | | |
| Total cost of subscription and training and services revenue | 29,598 | 26,536 | 3,062 | 11.5 |
| As a % of total revenue | 15.2% | 16.1% | | |
| Total gross profit | 164,748 | 138,796 | 25,952 | 18.7 |
| Operating expense: | | | | |
| Sales and marketing | 71,498 | 58,514 | 12,984 | 22.2 |
| Research and development | 38,605 | 34,544 | 4,061 | 11.8 |
| General and administrative | 26,102 | 24,768 | 1,334 | 5.4 |
| Litigation settlement | 8,750 | | 8,750 | |
| Total operating expense | 144,955 | 117,826 | 27,129 | 23.0 |
| Income from operations | 19,793 | 20,970 | (1,177) | (5.6) |
| Interest income | 2,206 | 9,294 | (7,088) | (76.3) |
| Interest expense | (42) | (1,249) | 1,207 | 96.6 |
| Other income, net | 3,295 | 4,501 | (1,206) | (26.8) |
| Income before provision for income taxes | 25,252 | 33,516 | (8,264) | (24.7) |
| Provision for income taxes | 8,838 | 9,211 | (373) | (4.0) |
| Net income | $ 16,414 | $ 24,305 | $ (7,891) | (32.5)% |
| Gross profit margin-subscriptions | 93.3% | 93.5% | | |
| Gross profit margin-training and services | 37.9% | 40.5% | | |
| Gross profit margin | 84.8% | 83.9% | | |
| As a % of total revenue: | | | | |
| Subscription revenue | 84.6% | 81.9% | | |
| Training and services revenue | 15.4% | 18.1% | | |
| Sales and marketing expense | 36.8% | 35.4% | | |
| Research and development expense | 19.9% | 20.9% | | |
| General and administrative expense | 13.4% | 15.0% | | |

| | | |
|---|---|---|
| Litigation settlement | 4.5% | |
| Total operating expenses | 74.6% | 71.3% |
| Income from operations | 10.2% | 12.7% |
| Income before provision for income taxes | 13.0% | 20.3% |
| Net income | 8.4% | 14.7% |
| Effective income tax rate for the three months ended | 35.0% | 27.5% |

**Revenue**

*Subscription revenue*

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat enterprise technologies, increased by 21.4% or $29.0 million to $164.4 million for the three months ended November 30, 2009 from $135.4 million for the three months ended November 30, 2008. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion, and continuing innovation, which attracts new customers and helps to drive renewals from existing customers.

*Training and services revenue*

Training revenue includes fees paid by our customers for delivery of educational materials and instruction. Services revenue includes fees for services received from customers for consulting regarding our offerings, deployment of Red Hat enterprise technologies and for delivery of added functionality to Red Hat enterprise technologies for our major customers and OEM partners. Total training and services revenue was unchanged at $29.9 million for the three months ended November 30, 2009 as compared to the three months ended November 30, 2008. Training revenue decreased 7.9% or $1.0 million as some enterprises reduced overall spending on discretionary items such as training and related travel in response to the challenging overall economic environment. Offsetting the decrease in training revenue, our services revenue increased by 5.7% or $1.0 million. Combined training and services revenue decreased as a percentage of total revenue to 15.4% for the three months ended November 30, 2009 from 18.1% for the three months ended November 30, 2008.

**Cost of revenue**

*Cost of subscription revenue*

The cost of subscription revenue primarily consists of expenses we incur to support, distribute, manufacture and package Red Hat enterprise technologies. These costs include labor related cost to provide technical support and maintenance, as well as cost for fulfillment, physical media, literature, packaging and shipping. Cost of subscription revenue increased by 25.5% or $2.2 million to $11.0 million for the three months ended November 30, 2009 from $8.8 million for the three months ended November 30, 2008. The increase is primarily the result of continued additions to our technical support staff to meet the demands of our growing subscriber base for support and maintenance. Gross profit margin on subscriptions decreased slightly to 93.3% for the three months ended November 30, 2009 from 93.5% for the three months ended November 30, 2008.

*Cost of training and services revenue*

Cost of training and services revenue is mainly comprised of personnel and third-party consulting costs for the design, development and delivery of custom engineering, training courses and professional services provided to various customers. Cost of training and services revenue increased by 4.6% or $0.8 million to $18.6 million for the three months ended November 30, 2009 from $17.8 million for the three months ended November 30, 2008. The cost to deliver training increased 1.5% or $0.1 million to $7.2 million for the three months ended November 30, 2009 compared to $7.1 million for the three months ended November 30, 2008. The increase in training costs relate primarily to increased internal training facilities costs which are relatively fixed in comparison to training revenues. Costs to deliver our services revenue increased by 6.7% or $0.7 million primarily as a result of increased travel and facilities costs. As a result of the reduction in training revenue, without a corresponding reduction in training costs, due to the fixed nature of our internal training facilities costs, total costs to deliver training and services as a percentage of training and services revenue increased to 62.1% for the three months ended November 30, 2009 from 59.5% for the three months ended November 30, 2008.

**Gross profit**

Primarily as a result of changes in mix with a greater proportion of total revenue generated by subscription revenue, gross profit margin increased to 84.8% for the three months ended November 30, 2009 from 83.9% for the three months ended November 30, 2008. Training and services revenue decreased as a percentage of total revenue to 15.4% for the three months ended November 30, 2009 from 18.1% for the three months ended November 30, 2008.

**Operating expenses**

*Sales and marketing*

Sales and marketing expense consists primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations and marketing materials and trade shows. Sales and marketing expense increased by 22.2% or $13.0 million to $71.5 million for the three months ended November 30, 2009 from $58.5 million for the three months ended November 30, 2008. This increase was partially due to an $8.7 million increase in selling costs, primarily related to increased employee compensation, attributable to the expansion of our sales force as compared to the prior year. The remaining increase relates to marketing costs, which grew $4.3 million or 36.8% for the three months ended November 30, 2009 as compared to the three months ended November 30, 2008. The increase in marketing costs are due to significant investments made to expand our distribution channel and promote our new technologies, including virtualization. Sales and marketing expense as a percentage of revenue increased to 36.8% for the three months ended November 30, 2009 from 35.4% for the three months ended November 30, 2008.

*Research and development*

Research and development expense consists primarily of personnel and related costs for development of software technologies and systems management offerings. Research and development expense increased by 11.8% or $4.1 million to $38.6 million for the three months ended November 30, 2009 from $34.5 million for the three months ended November 30, 2008. The increase in research and development costs primarily resulted from both the expansion of our engineering group through direct hires and the acquisition of businesses and technologies. Employee compensation increased by $3.3 million. The remaining increase in research and development costs relates to process and technology infrastructure enhancements, which increased $0.8 million. Research and development expense was 19.9% and 20.9% of total revenue for the three months ended November 30, 2009 and November 30, 2008, respectively. Investing in research and development has been a priority for Red Hat, and we anticipate continued spending as we expand our capabilities in middleware, virtualization, cloud computing and other technologies.

*General and administrative*

General and administrative expense consists primarily of personnel and related costs for general corporate functions, including information systems, finance, accounting, legal, human resources and facilities expense. General and administrative expense increased by 5.4% or $1.3 million to $26.1 million for the three months ended November 30, 2009 from $24.8 million for the three months ended November 30, 2008. The net increase relates to process and technology infrastructure enhancements, including incremental depreciation and amortization charges which increased $0.7 million and other employee benefit costs which increased $0.6 million. General and administrative expense decreased as a percentage of revenue to 13.4% for the three months ended November 30, 2009 from 15.0% for the three months ended November 30, 2008 as we continued to leverage our corporate functions.

*Litigation settlement*

On December 15, 2009 we announced that we had reached an agreement in principle to settle the class action lawsuit, pending in the United States District Court for the Eastern District of North Carolina, brought on behalf of a class of shareholders in connection with the restatement of our financial results announced in July 2004. The $8.8 million expense we recorded for the three months ended November 30, 2009 represents our portion of the settlement.

**Interest income**

Interest income consists of interest income earned on cash deposits in money market accounts and investments in short and long-term fixed income instruments. Interest income decreased by 76.3% or $7.1 million to $2.2 million for the three months ended November 30, 2009 from $9.3 million for the three months ended November 30, 2008. The decrease in interest income for the three months ended November 30, 2009 is attributable to (i) lower yields on our investments due to an overall lower interest rate environment and (ii) lower cash balances, which were reduced by outlays for acquisitions and the repurchase and redemption of our convertible debentures and repurchase of our common stock.

**Interest expense**

Prior year s interest expense primarily consists of interest and the related amortization of deferred debt issuance costs associated with the convertible debentures and totaled $1.2 million for the three months ended November 30, 2008. During the second half of fiscal 2009 we repurchased or redeemed all of our outstanding convertible debentures. Accordingly, there was no interest expense or related amortization of debt issuance costs associated with the convertible debentures for the three months ended November 30, 2009.

**Other income, net**

Other income, net consists of net gains and losses realized on the sale of investments, gains realized on the repurchase of our convertible debentures and foreign currency transaction and revaluation gains and losses. Other income, net decreased by 26.8% or $1.2 million to $3.3 million for the three months ended November 30, 2009 from $4.5 million for the three months ended November 30, 2008. The decrease is due to foreign currency transactions. For the three months ended November 30, 2009 we recognized net losses from foreign currency transactions of $0.5 million as compared to the three months ended November 30, 2008 in which we recognized a $0.6 million net gain from foreign currency transactions.

**Income taxes**

During the three months ended November 30, 2009, we recorded $8.8 million of income tax expense, which is based on our estimated annual effective tax rate of 35%. The estimated annual effective tax rate, which equals the U.S. federal statutory rate of 35%, includes state income taxes that are offset by foreign income taxed at different rates.

During the three months ended November 30, 2008, we recorded $9.2 million of income tax expense, which resulted in an effective tax rate of 27% for the three months ended November 30, 2008. The lower effective rate resulted from a change in our then estimated annual effective tax from 39% as of August 31, 2008 to 35% as of November 30, 2008. Our then estimated annual effective tax rate of 35%, which equaled the U.S. federal statutory rate of 35%, included state income taxes which were offset by foreign income taxed at different rates.

**Nine months ended November 30, 2009 and November 30, 2008**

The following table is a summary of our results of operations for the nine months ended November 30, 2009 and November 30, 2008 (in thousands):

| | Nine Months Ended (Unaudited) | | | |
|---|---|---|---|---|
| | November 30, 2009 | November 30, 2008 | $ Change | % Change |
| Revenue: | | | | |
| Subscriptions | $ 469,496 | $ 401,854 | $ 67,642 | 16.8% |
| Training and services | 82,872 | 84,497 | (1,625) | (1.9) |
| Total subscription and training and services revenue | 552,368 | 486,351 | 66,017 | 13.6 |
| Cost of subscription and training and services revenue: | | | | |
| Cost of subscriptions | 32,033 | 27,448 | 4,585 | 16.7 |
| As a % of subscription revenue | 6.8% | 6.8% | | |
| Cost of training and services | 52,474 | 53,025 | (551) | (1.0) |
| As a % of training and services revenue | 63.3% | 62.8% | | |
| Total cost of subscription and training and services revenue | 84,507 | 80,473 | 4,034 | 5.0 |
| As a % of total revenue | 15.3% | 16.5% | | |
| Total gross profit | 467,861 | 405,878 | 61,983 | 15.3 |
| Operating expense: | | | | |
| Sales and marketing | 202,242 | 177,350 | 24,892 | 14.0 |
| Research and development | 110,068 | 95,184 | 14,884 | 15.6 |
| General and administrative | 74,411 | 71,060 | 3,351 | 4.7 |
| Litigation settlement | 8,750 | | 8,750 | |
| Total operating expense | 395,471 | 343,594 | 51,877 | 15.1 |
| Income from operations | 72,390 | 62,284 | 10,106 | 16.2 |
| Interest income | 8,161 | 30,568 | (22,407) | (73.3) |
| Interest expense | (138) | (4,365) | 4,227 | 96.8 |
| Other income, net | 6,580 | 8,025 | (1,445) | (18.0) |
| Income before provision for income taxes | 86,993 | 96,512 | (9,519) | (9.9) |
| Provision for income taxes | 23,128 | 33,779 | (10,651) | (31.5) |
| Net income | $ 63,865 | $ 62,733 | $ 1,132 | 1.8% |
| Gross profit margin-subscriptions | 93.2% | 93.2% | | |
| Gross profit margin-training and services | 36.7% | 37.2% | | |
| Gross profit margin | 84.7% | 83.5% | | |
| As a % of total revenue: | | | | |
| Subscription revenue | 85.0% | 82.6% | | |
| Training and services revenue | 15.0% | 17.4% | | |
| Sales and marketing expense | 36.6% | 36.5% | | |
| Research and development expense | 19.9% | 19.6% | | |
| General and administrative expense | 13.5% | 14.6% | | |
| Litigation settlement | 1.6% | | | |
| Total operating expenses | 71.6% | 70.6% | | |

| | | |
|---|---|---|
| Income from operations | 13.1% | 12.8% |
| Income before provision for income taxes | 15.7% | 19.8% |
| Net income | 11.6% | 12.9% |
| Estimated annual effective income tax rate (1) | 35.0% | 35.0% |

(1) Estimated annual effective tax rate is based on estimated annual ordinary income and excludes discrete benefits from research tax credits of $7.3 million we recognized during the nine months ended November 30, 2009. See NOTE 5 to the Consolidated Financial Statements for further discussion.

**Revenue**

*Subscription revenue*

Subscription revenue increased by 16.8% or $67.6 million to $469.5 million for the nine months ended November 30, 2009 from $401.9 million for the nine months ended November 30, 2008. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion, and continuing innovation, which attracts new customers and helps to drive renewals from existing customers.

*Training and services revenue*

Total training and services revenue decreased by 1.9% or $1.6 million to $82.9 million for the nine months ended November 30, 2009 from $84.5 million for the nine months ended November 30, 2008. Training revenue decreased 11.6% or $4.1 million as some enterprises reduced overall spending on discretionary items such as training and related travel in response to the challenging overall economic environment. Partially offsetting the reduction in training revenue, our services revenue increased by 5.1% or $2.5 million. Combined training and services revenue decreased as a percentage of total revenue to 15.0% for the nine months ended November 30, 2009 from 17.4% for the nine months ended November 30, 2008.

**Cost of revenue**

*Cost of subscription revenue*

Cost of subscription revenue increased by 16.7% or $4.6 million to $32.0 million for the nine months ended November 30, 2009 from $27.4 million for the nine months ended November 30, 2008. The increase is primarily the result of continued additions to our technical support staff to meet the demands of our growing subscriber base for support and maintenance. As the number of open source technology subscriptions continues to increase, we expect associated support cost will continue to increase, although we anticipate this will continue to occur at a rate slower than that of subscription revenue growth due to economies of scale. Gross profit margin on subscriptions was 93.2% for each of the nine months ended November 30, 2009 and November 30, 2008.

*Cost of training and services revenue*

Cost of training and services revenue decreased by 1.0% or $0.6 million to $52.5 million for the nine months ended November 30, 2009 from $53.0 million for the nine months ended November 30, 2008. The cost to deliver training decreased 8.5% or $1.8 million to $20.0 million for the nine months ended November 30, 2009 compared to $21.8 million for the nine months ended November 30, 2008. The overall decrease in training costs is driven by a decrease in external training costs such as rental expense for offsite training rooms and outsourced instructors in response to an overall reduced demand for our training services during the first half of fiscal 2010. Costs to deliver our services revenue increased by 4.1% or $1.3 million primarily as a result of increased travel and internal facilities costs. Because a significant portion of our costs to deliver both training and professional services are fixed in nature, as compared to our training and services revenue, overall costs to deliver training and services as a percentage of training and services revenue increased to 63.3% for the nine months ended November 30, 2009 from 62.8% for the nine months ended November 30, 2008.

**Gross profit**

Primarily as a result of changes in mix with a greater proportion of total revenue generated by subscription revenue, gross profit margin increased to 84.7% for the nine months ended November 30, 2009 from 83.5% for the year nine months ended November 30, 2008. Training and services revenue decreased as a percentage of total revenue to 15.0% for the nine months ended November 30, 2009 from 17.4% for the nine months ended November 30, 2008.

**Operating expenses**

*Sales and marketing*

Sales and marketing expense increased by 14.0% or $24.9 million to $202.2 million for the nine months ended November 30, 2009 from $177.4 million for the nine months ended November 30, 2008. This increase was partially due to a $16.6 million increase in selling costs, primarily related to increased employee compensation, attributable to the expansion of our sales force from the prior year. The remaining increase relates to marketing costs, which grew $8.3 million or 24.1% for the nine months ended November 30, 2009 as compared to the nine months ended November 30, 2008. The increase in marketing costs includes $5.0 million related to increased advertising and tradeshow expenditures. Sales and marketing expense as a percentage of revenue increased to 36.6% for the nine months ended November 30, 2009 from 36.5% for the nine months ended November 30, 2008.

*Research and development*

Research and development expense increased by 15.6% or $14.9 million to $110.1 million for the nine months ended November 30, 2009 from $95.2 million for the nine months ended November 30, 2008. The increase in research and development costs primarily resulted from both the expansion of our engineering group through direct hires and the acquisition of businesses and technologies. Employee compensation increased by $10.1 million. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased $4.0 million. Research and development expense was 19.9% and 19.6% of total revenue for the nine months ended November 30, 2009 and November 30, 2008, respectively. Incremental costs described above related to Qumranet totaled $7.4 million for the nine months ended November 30, 2009.

*General and administrative*

General and administrative expense increased by 4.7% or $3.4 million to $74.4 million for the nine months ended November 30, 2009 from $71.1 million for the nine months ended November 30, 2008. Increased headcount across all functions to help the business scale increased employee compensation costs by $1.6 million for the nine months ended November 30, 2009 as compared to the nine months ended November 30, 2008. The remaining net increase in general and administrative expenses of $1.8 million for the nine months ended November 30, 2009 as compared to the nine months ended November 30, 2008 relate to process and technology infrastructure enhancements, including incremental depreciation and amortization charges. General and administrative expense decreased as a percentage of revenue to 13.5% for the nine months ended November 30, 2009 from 14.6% for the nine months ended November 30, 2008 as we continued to leverage our corporate functions.

*Litigation settlement*

On December 15, 2009 we announced that we had reached an agreement in principle to settle the class action lawsuit, pending in the United States District Court for the Eastern District of North Carolina, brought on behalf of a class of shareholders in connection with the restatement of our financial results announced in July 2004. The $8.8 million expense we recorded for the nine months ended November 30, 2009 represents our portion of the settlement.

**Interest income**

Interest income decreased by 73.3% or $22.4 million to $8.2 million for the nine months ended November 30, 2009 from $30.6 million for the nine months ended November 30, 2008. The decrease in interest income for the nine months ended November 30, 2009 is attributable to (i) lower yields on our investments due

to an overall lower interest rate environment and (ii) lower cash balances, which were reduced by outlays for acquisitions and the repurchase and redemption of our convertible debentures and repurchase of our common stock.

**Interest expense**

Prior year s interest expense primarily consists of interest and the related amortization of deferred debt issuance costs associated with the convertible debentures and totaled $4.1 million for the nine months ended November 30, 2008. During the second half of fiscal 2009 we repurchased or redeemed all of our outstanding convertible debentures. Accordingly, there was no interest expense or related amortization of debt issuance costs associated with the convertible debentures for the nine months ended November 30, 2009.

**Other income, net**

Other income, net decreased by 18.0% or $1.4 million to $6.6 million for the nine months ended November 30, 2009 from $8.0 million for the nine months ended November 30, 2008. The decrease is primarily due to a reduction of realized gains from the repurchase or redemption of our convertible debentures which totaled $4.1 million for the nine months ended November 30, 2008. Partially offsetting the prior year s gain from the repurchase or redemption of our convertible debentures was a $3.3 million increase in gains realized from the sale of our investments in available-for-sale equity securities for the nine months ended November 30, 2009. The remaining decrease in other income, net is due to changes in exchange rates related to foreign currency transactions.

**Income taxes**

During the nine months ended November 30, 2009 and November 30, 2008, we recorded $23.1 million and $33.8 million, respectively of income tax expense. Tax expense for the nine months ended November 30, 2009 includes a discrete tax benefit from research tax credits, net of a corresponding reduction of NOLs, which resulted in a net reduction of income tax expense of $7.3 million. Excluding the impact of the discrete tax benefit, our estimated annual effective tax rate was 35% as of November 30, 2009. The estimated annual effective tax rate as of November 30, 2009, which equals the U.S. federal statutory rate of 35%, includes state income taxes which are offset by foreign income taxed at different rates.

Our estimated annual effective tax rate as of November 30, 2008 was 35%, which also equaled the U.S. federal statutory rate of 35%, and included state income taxes which were offset by foreign income taxed at different rates.

## LIQUIDITY AND CAPITAL RESOURCES

We have historically derived a significant portion of our liquidity and operating capital from cash flows from operations as well as the sale of equity securities, including private sales of preferred stock and the sale of common stock in our initial and follow-on public offerings, the issuance of convertible debentures and borrowings under working capital lines of credit. At November 30, 2009, we had total cash and investments of $959.1 million, which was comprised of $389.7 million in cash and cash equivalents, $339.5 million of short-term, available-for-sale fixed-income investments, $8.7 million of available-for-sale equity securities and $221.2 million of long-term, available-for-sale fixed-income investments. This compares to total cash and investments of $846.1 million at February 28, 2009.

We believe that we currently have sufficient liquidity with $389.7 million in cash and cash equivalents on hand, and we presently do not intend to liquidate our short and long-term investments in debt securities prior to their scheduled maturity dates. However, in the event that we did liquidate these investments prior to their scheduled maturities and there were adverse changes in market interest rates or the overall economic

environment, we could be required to recognize a realized loss on those investments when we liquidate. At November 30, 2009, we have accumulated unrealized gains of $3.1 million on our investments in debt securities compared to an accumulated unrealized gain of $0.3 million at February 28, 2009. At November 30, 2009 and February 28, 2009, accumulated unrealized gains related to short-term equity securities available for sale totaled $8.1 million and $4.7 million, respectively.

**Nine months ended November 30, 2009**

*Cash flows overview*

At November 30, 2009, cash and cash equivalents totaled $389.7 million, a decrease of $125.8 million as compared to February 28, 2009. The decrease in cash and cash equivalents for the nine months ended November 30, 2009 is a result of net cash used for investing and financing activities. During the nine months ended November 30, 2009, we repurchased 6,950,478 shares of our common stock at an average price of $21.04 per share totaling $146.2 million, including transactions costs. Purchases of available-for-sale debt securities, net of proceeds from sales and maturities, totaled $235.1 million for the nine months ended November 30, 2009. These investing and financing uses of cash were partially offset by cash generated from operating activities and equity transactions related to employee share-based compensation awards, which totaled $177.4 million and $81.8 million, respectively for the nine months ended November 30, 2009. Net cash generated by operating activities and used for investing and financing activities is further described below.

*Cash flows from operations*

Cash provided by operations of $177.4 million during the nine months ended November 30, 2009 includes net income of $63.9 million, adjustments to exclude the impact of non-cash revenues and expenses, which totaled a $47.4 million net source of cash, and changes in working capital, which totaled a $66.1 million net source of cash. Cash provided by changes in operating assets and liabilities for the nine months ended November 30, 2009 was primarily the result of an increase in our deferred revenue which generated operating cash flow of $36.0 million. The increase in deferred revenue is due to growth in billings as we generally bill our customers in advance of subscription periods. This increase in deferred revenue of $36.0 million excludes the impact of foreign currency translation which increased our total consolidated deferred revenue by $39.7 million for the nine months ended November 30, 2009.

*Cash flows from investing*

Cash used in investing activities of $252.3 million for the nine months ended November 30, 2009 includes net purchases of investments in available-for-sale debt securities of $235.0 million. Investments in property and equipment, primarily related to process and information technology infrastructure enhancements, totaled $21.3 million for the nine months ended November 30, 2009. Investments in patents and externally developed technology totaled $2.9 million for the nine months ended November 30, 2009. Partially offsetting these investments were proceeds from the sale of available-for-sale equity securities which totaled $8.4 million for the nine months ended November 30, 2009.

*Cash flows from financing*

Cash used in financing activities of $65.3 million for the nine months ended November 30, 2009 includes $146.2 million used to repurchase 6,950,478 shares of our common stock at an average price of $21.04 per share, including transaction costs. Payments made in return for common shares received from employees to satisfy employees minimum tax withholding obligations related to restricted share awards vesting during the nine months ended November 30, 2009 totaled $9.1 million. Partially offsetting financing activities using cash were excess tax benefits related to share-based employee compensation which totaled $27.3 million and proceeds from employees exercise of common stock options which totaled $63.6 million. Payments on other borrowings totaled $0.9 million for the nine months ended November 30, 2009.

*Investments in debt and equity securities*

Our investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. At November 30, 2009 and February 28, 2009, the vast majority of our 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, we assess other factors to determine the securities market value, including broker quotes or model valuations. Independent price verifications of all of our holdings are performed by the pricing vendors, which we review. In the event a price fails a pre-established tolerance check, it is researched so that we can assess the cause of the variance to determine what we believe is the appropriate fair market value.

*Capital requirements*

We have experienced a substantial increase in our operating expenses since our inception in connection with the growth of our operations, the development of our enterprise technologies, the expansion of our services operations and our acquisition activity. Our capital requirements during the year ending February 28, 2010 will depend on numerous factors, including the amount of resources we devote to:

- funding the continued development of our enterprise technology offerings;
- accelerating the development of our systems management services;
- improving and extending our services and the technologies used to deliver these services to our customers and support our business;
- pursuing strategic acquisitions and alliances; and
- investing in businesses, products and technologies.

We have utilized, and will continue from time to time to utilize, cash and investments to fund, among other potential uses, purchases of our common stock, purchases of fixed assets and mergers and acquisitions.

Given our historically strong operating cash flow and the $959.1 million of cash and investments held at November 30, 2009, we do not presently anticipate the need to raise cash to fund our operations, either through the sale of additional equity or through the issuance of debt, in the foreseeable future. However, we may take advantage of favorable capital market situations that may arise from time to time to raise additional capital.

We believe that cash flow from operations will continue to improve; however, there can be no assurances that we will improve our cash flow from operations from the current rate or that such cash flows will be adequate to fund other investments or acquisitions that we may choose to make. We may choose to accelerate the expansion of our business from our current plans, which may require us to raise additional funds through the sale of equity or debt securities or through other financing means. There can be no assurances that any such financing would occur in amounts or on terms favorable to us, if at all.

*Off-balance sheet arrangements*

As of November 30, 2009 and February 28, 2009, we have no off-balance sheet financing arrangements and do not utilize any structured debt , special purpose or similar unconsolidated entities for liquidity or financing purposes.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2009, the FASB issued authoritative guidance regarding subsequent events. The authoritative guidance establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The authoritative guidance requires disclosure of the date through which subsequent events have been evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The authoritative guidance is effective for interim and annual periods ending after June 15, 2009. We have evaluated subsequent events through January 11, 2010, the date of issuance of the accompanying consolidated financial statements.

In June 2009, the FASB issued Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162 ( the Codification ). The Codification, which was launched on July 1, 2009, became the single source of authoritative non-governmental U.S. generally accepted accounting principles ( GAAP ), superseding various existing authoritative accounting pronouncements. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. We adopted the Codification for our reporting period ending on November 30, 2009. The adoption of the Codification had no significant impact on our consolidated financial statements.

In August 2009, the FASB issued Accounting Standards Update 2009-05, Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value, ( Update 2009-05 ). Update 2009-05 clarifies that in circumstances in which a quoted price in an active market for an identical liability is not available, a reporting entity is required to measure fair value of such liability using one or more of the techniques prescribed by the update. On November 1, 2009 we adopted Update 2009-05. There was no significant impact on our consolidated financial statements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to the impact of interest rate changes, foreign currency exchange rate fluctuations and changes in the market value of our investments.

*Interest Rate Risk*

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and short-term and long-term investments in a variety of fixed-income securities, including both government and corporate obligations and money market funds. Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in prevailing interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates, or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates or perceived credit risk related to the securities issuers. A hypothetical one percentage point change in interest rates would result in a $3.4 million change in interest income on an annual basis.

*Investment Risk*

The fair market value of our investment portfolio is subject to interest rate risk. Based on a sensitivity analysis performed on this investment portfolio, a hypothetical one percentage point increase in prevailing interest rates would result in an approximate $7.7 million decrease in the fair value of our available-for-sale investment securities as of November 30, 2009.

*Credit Risk*

The fair market values of our investment portfolio and cash balances are exposed to counterparty credit risk. Accordingly, while we periodically review our portfolio for risk mitigation, the principal values of our cash balances, money market accounts and investments in available-for-sale securities could suffer a loss of value.

*Derivative Instruments*

We transact business in various foreign countries and are, therefore, subject to risk of foreign currency exchange rate fluctuations. We sometimes enter 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 in accordance with FASB ASC Section 815 (formerly referenced as Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities). The Company has elected not to prepare and maintain the documentation required to qualify as an accounting hedge and, therefore, changes in fair value are recorded in the Consolidated Statements of Operations.

The aggregate notional amount of outstanding forward contracts at November 30, 2009 was $4.0 million. The fair value of these outstanding contracts at November 30, 2009 was gross, a less than $0.1 million asset and a less than $0.1 million liability, and is recorded in prepaid expenses and other current assets and accrued expenses, respectively on the Consolidated Balance Sheets. The forward contracts generally expire within two months of the period ended November 30, 2009. The forward contracts will settle in Swiss francs, Swedish krona, Czech koruna, Canadian dollars and Norwegian kroner.

The aggregate notional amount of outstanding forward contracts at February 28, 2009 was $3.8 million. The fair value of these outstanding contracts at February 28, 2009 was gross, a $0.1 million liability and a less than $0.1 million asset, and is recorded in accrued expenses on the Consolidated Balance Sheets.

*Foreign Currency Risk*

Approximately 43.2% of our revenue for the three months ended November 30, 2009 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, operating expenses and income from operations for our non-U.S. operations. Similarly, our revenue, operating expenses and net income will decrease for our non-U.S. operations if the U.S. dollar strengthens against foreign currencies.

**Impact on results of operations for the three months ended November 30, 2009:**

Using the average foreign currency exchange rates from the third quarter of our fiscal year ended February 28, 2009, our revenue and operating expenses from non-U.S. operations for the three months ended November 30, 2009, would have been lower than we reported using the exchange rates for the three months ending November 30, 2009 by approximately $6.9 million and $4.6 million, respectively, which would have resulted in income from operations being $2.3 million lower.

**Impact on results of operations for the nine months ended November 30, 2009:**

Using the average foreign currency exchange rates from the first three quarters of our fiscal year ended February 28, 2009, our revenue and operating expenses from non-U.S. operations for the nine months ended November 30, 2009, would have been higher than we reported using the exchange rates for the nine months ending November 30, 2009 by approximately $1.8 million and $3.6 million, respectively, which would have resulted in income from operations being $1.8 million lower.

**ITEM 4. CONTROLS AND PROCEDURES**

**Role of Controls and Procedures**

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) or our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of the controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error and mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Also projections of any evaluation of effectiveness of controls and procedures to future periods are subject to the risk that the controls and procedures may become inadequate because of changes in conditions, or that the degree of compliance with the controls and procedures may have deteriorated.

**Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at a reasonable assurance level.

**Changes in Internal Control Over Financial Reporting**

No changes in our internal control over financial reporting occurred during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II**

**ITEM 1. 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 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 court to close the action. Notices of appeal in the matter have been filed.

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 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 and 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. 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. 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 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. Discovery in the case has closed, and trial has been scheduled for April 12, 2010. Based on information available to date, the Company believes it has meritorious defenses to this matter and does not anticipate that the lawsuit 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. The Company estimates that an adverse resolution of the lawsuit could result in damages ranging from approximately $0.1 million to $11.0 million.

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 September 13, 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. Bedrock is entitled to answer or otherwise respond to the complaint.

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

**ITEM 1A. RISK FACTORS**

*Set forth below are certain risks and cautionary statements, which supplement other disclosures in this report.*

*Moreover, certain statements contained in this report and the documents incorporated by reference in this report, including in Management s Discussion and Analysis of Financial Condition and Results of Operations, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that is not strictly a historical statement (for example, statements regarding current or future financial performance, management s plans and objectives for future operations, product plans and performance, management s expectations regarding market risk and market penetration, management s assessment of market factors or strategies, objectives and plans of Red Hat and its partners). Words such as anticipates, believes, expects, estimates, intends, plans, projects, and similar expressions, may also identify such forward-looking statements. Investors are cautioned that these forward-looking statements are not guarantees of Red Hat s future performance and are subject to a number of risks and uncertainties that could cause Red Hat s actual results to differ materially from those found in the forward-looking statements and from historical trends. These risks and uncertainties include the risks and cautionary statements detailed below and elsewhere in this report as well as in Red Hat s other filings with the Securities and Exchange Commission ( SEC ), copies of which may be accessed through the SEC s web site at http://www.sec.gov. Readers are urged to carefully review these risks and cautionary statements. The forward-looking statements included in this report represent our views as of the date of this report. We specifically disclaim any obligation to update these forward-looking statements in the future. These forward-looking statements should not be relied upon as representing our views as of any date subsequent to the date of this report.*

**RISKS RELATED TO BUSINESS UNCERTAINTY**

**Unfavorable economic and market conditions could adversely affect our business, financial condition and results of operations.**

Economic weakness and constrained IT spending from time to time contribute, and are now contributing, to slowdowns in the technology industry, as well as in the specific segments and markets in which the Company operates, resulting in reduced demand and increased price competition for our products and services. Our operating results in one or more geographic regions may also be affected by uncertain or changing economic conditions within that region, such as the challenges that are currently affecting economic conditions in the United States and elsewhere. This slowdown and the uncertainty about future economic conditions may, among other things, negatively impact our current and prospective customers and result in delays or reductions in technology purchases or lengthen our sales cycle. Adverse economic conditions also may negatively impact our ability to obtain payment for outstanding debts owed to us by our customers or other parties with whom we do business. In addition, these conditions may impact our investment portfolio, and we could determine that some of our investments have experienced an other-than-temporary decline in fair value, requiring an impairment charge

that could adversely impact our financial condition and results of operations. See NOTE 2 to the Consolidated Financial Statements. Also, these conditions may make it more difficult to forecast operating results. If global economic and market conditions, or economic conditions in the United States or other key markets, remain uncertain or persist, spread or deteriorate further, companies may delay or reduce their IT spending, which could adversely affect our business, financial condition and results of operations.

**If we fail to continue to establish and maintain strategic distribution and other collaborative relationships with industry-leading companies, we may not be able to attract and retain a larger customer base.**

Our success depends in part on our ability to continue to establish and maintain strategic distribution and other collaborative relationships with industry-leading hardware manufacturers, distributors, software vendors and enterprise solutions providers such as SAP AG ( SAP ), Dell Inc. ( Dell ), Hewlett-Packard Co. ( HP ), International Business Machines Corporation ( IBM ), Sun Microsystems, Inc. ( SUN ), Fujitsu Limited ( Fujitsu ), NEC Corporation ( NEC ) and others. These relationships allow us to offer our products and services to a much larger customer base than we would otherwise be able through our direct sales and marketing efforts. We may not be able to maintain these relationships or replace them on attractive terms. In addition, our existing strategic relationships do not, and any future strategic relationships may not, afford us any exclusive marketing or distribution rights. As a result, many of the companies with which we have strategic alliances pursue alternative technologies and develop alternative products and services in addition to or in lieu of our products and services, either on their own or in collaboration with others, including our competitors. Moreover, we cannot guarantee that the companies with which we have strategic relationships will market our products effectively or continue to devote the resources necessary to provide us with effective sales, marketing and technical support.

**We have entered into and may continue to enter into or seek to enter into business combinations and acquisitions, which may be difficult to complete and integrate, disrupt our business, divert management s attention, adversely effect our financial condition or results of operations and dilute stockholder value.**

As part of our business strategy, we have in the past entered into business combinations and acquisitions (for example, our acquisition of JBoss in June 2006 and our acquisition of Qumranet in September 2008), and we may continue to do so in the future. We have limited experience in making acquisitions, and acquisitions present significant challenges and risks, including:

- The difficulty of integrating the operations, systems and personnel of the acquired companies;
- The difficulty of gathering full information regarding the target business prior to the acquisition;
- The maintenance of acceptable standards, controls, procedures and policies;
- The potential disruption of our ongoing business and distraction of management;
- The impairment of relationships with employees and customers as a result of any integration of new management and other personnel;
- The inability to maintain a relationship with customers of the acquired business;
- The potential loss of key employees of the acquired business;
- Challenges in maintaining good and effective relations with existing business partners or of those of the acquired business, including as a result of the changes in the competitive landscape effected by the acquisition;

- The difficulty of incorporating acquired technology and rights into our products and services and of maintaining quality standards consistent with our brand;

- The potential failure to achieve the expected benefits of the combination or acquisition;

- Expenses related to the acquisition;

- Potential unknown liabilities associated with the acquired businesses;

- Unanticipated expenses related to acquired technology and its integration into existing technology; and

- The issuance of shares of our common stock in connection with an acquisition or business combination would dilute our current stockholders percentage of ownership.

There can be no assurance that we will manage these challenges and risks successfully. Moreover, if we are not successful in completing acquisitions that we have pursued or may pursue, our business may be adversely affected, and we may incur substantial expenses and divert significant management time and resources. In addition, in pursuing such acquisitions, we could use substantial portions of our available cash as all or a portion of the purchase price. We could also issue additional securities as consideration for these acquisitions, which could cause our stockholders to suffer significant dilution, or we may incur substantial debt. Any acquisition may not generate additional revenue or profit for us, which may adversely affect our operating results.

**If we fail to effectively manage our growth, our operations and financial results could be adversely affected.**

We have expanded our operations rapidly in recent years. For example, our total revenue increased from approximately $523.0 million for the fiscal year ended February 29, 2008 to approximately $652.6 million for the fiscal year ended February 28, 2009. Moreover, the total number of our employees increased from over 2,200 as of February 29, 2008 to over 2,800 as of February 28, 2009 and is expected to generally increase in the foreseeable future. In addition, we continue to explore ways to extend our product and service offerings and geographic reach. Our growth has placed and will likely continue to place a strain on our management systems, information systems, resources and internal controls. Our ability to successfully offer products and services and implement our business plan requires adequate information systems and resources and oversight from our senior management. As we grow, we must also continue to hire, train, supervise and manage new employees. As we grow and expand globally, controls and oversight functions will become more complex and distributed and may in part be outsourced. We may not be able to adequately screen and hire or adequately train, supervise and manage sufficient personnel or develop management, or effectively manage and develop our controls and oversight functions and information systems to adequately manage our expansion effectively. If we are unable to adequately manage our growth and expansion, our business, operating results and financial condition could be materially adversely affected.

**We rely, to a significant degree, on an indirect sales channel for distribution of our products and services, and disruption of any part of this channel could adversely affect the sales of our products.**

We use a variety of different distribution methods to sell our products and services, including indirect channel partners, such as third-party OEMs, resellers and distributors. A number of these partners in turn distribute via their own networks of channel partners (e.g., distributors and resellers), with whom we have no direct relationship. We rely, to a significant degree, on our channel partners to, among other activities, select, screen and maintain relationships with our indirect distribution network and for the distribution of our products and services in a manner that is consistent with Red Hat s quality standards. Our indirect distribution channel could be affected by disruptions in the relationships of and with our channel partners and their networks, including their customers or suppliers. As a result, we may be required to devote greater support and professional services resources to distribute our products and support our customers, which could drive up costs and may not be as effective. We cannot guarantee that our channel partners will market our products effectively. Disruptions in our distribution channel or poor marketing support by channel partners could lead to decreased sales or slower than expected growth or increased distribution and support costs.

**We rely on software licensed from other parties, the loss of which could increase our costs and delay software shipments.**

We utilize various types of software licensed from unaffiliated third parties. Aspects of our business could be disrupted if any of the software we license from others or functional equivalents of this software were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to either redesign our products to function with software available from other parties, develop these components ourselves or eliminate the functionality, which would result in increased costs, delays in our product shipments and the release of new product offerings and limit the features available in our current or future products.

**We may not be able to continue to attract and retain capable management personnel.**

Our ability to retain key management personnel or hire capable new management personnel as we grow may be challenged to the extent the technology sector performs well and/or if companies with more generous compensation packages or greater perceived growth opportunities compete for the same personnel. In addition, historically we have used share-based compensation as a key component of our compensation packages. Changes in the accounting for share-based compensation could adversely affect our earnings or force us to use more cash compensation to attract and retain capable personnel. Volatility in the stock market may reduce the value of our share-based awards to the recipient. Such events, or if we are unable to secure shareholder approval for increases in the number of shares eligible for share-based compensation grants, could adversely affect our ability to successfully attract and retain key management personnel.

**We depend on our key personnel that we employ.**

Our future success depends on the services and effectiveness of a number of key officers and employees, including our CEO, who assumed his role on January 1, 2008. The loss of the technical knowledge and industry expertise of any of these individuals could seriously impede our success. Moreover, the loss of these individuals, particularly to a competitor, some of which may be in a position to offer greater compensation, and any resulting loss of customers could reduce our market share and diminish the Red Hat brand and adversely affect our business or stock price.

A number of our key employees have become, or will soon become, vested in a significant amount of their equity compensation awards. Employees may be more likely to leave us after a significant portion of their equity compensation awards fully vest, especially if the shares underlying the equity awards have significantly appreciated in value. If we do not succeed in retaining and motivating our CEO and key employees and attracting new key personnel, our business, its financial performance and our stock price may decline.

**Our corporate culture has contributed to our success, and if we cannot maintain this culture as we grow, we could lose the innovation, creativity and teamwork fostered by our culture, and our business may be harmed.**

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity and teamwork. As our organization grows, and we are required to implement more complex organizational management structures, we may find it increasingly difficult to maintain beneficial aspects of our corporate culture. If we are unable to maintain our corporate culture, we may find it difficult to attract and retain motivated employees.

**Our subscription-based contract model may encounter customer resistance or we may experience a decline in the demand for our products.**

The subscription agreement used for many of our products, including Red Hat Enterprise Linux, requires customers to agree to a subscription for our services for each installed system on which they deploy our

subscription based products. At the same time, the subscription agreement places no restriction on the customer s right to redistribute the products. While we believe this practice complies with the requirements of the GNU General Public License, and while we have reviewed this practice with the Free Software Foundation, the organization that maintains and provides interpretations of the GNU General Public License, we may still encounter customer resistance to this distribution model or customers may fail to honor the terms of our subscription agreements. To the extent we are unsuccessful in promoting or defending this distribution model, our business and operating results could be materially and adversely affected.

**If our current and future customers do not renew their subscription agreements with us, our operating results may be adversely impacted.**

Our customers may not renew their subscriptions for our service after the expiration of their subscription agreements and in fact, some customers elect not to do so. In addition, our customers may opt for a lower priced edition of our services or for fewer subscriptions. We have limited historical data with respect to rates of customer subscription renewals, so we cannot accurately predict customer renewal rates. Our customers renewal rates may decline or fluctuate as a result of a number of factors, including their level of satisfaction with our services and their ability to continue their operations and spending levels. Government contracts could be subject to future funding that may affect the extension or termination of programs and generally are subject to the right of the government to terminate for convenience or non-appropriation. If we experience a decline in the renewal rates for our customers or they opt for lower priced editions of our offerings or fewer subscriptions, our operating results may be adversely impacted.

**If open source software programmers, most of whom we do not employ, do not continue to develop and enhance open source technologies, we may be unable to develop new products, adequately enhance our existing products or meet customer requirements for innovation, quality and price.**

We rely to a significant degree on a number of largely informal communities of independent open source software programmers to develop and enhance our products. For example, Linus Torvalds, a prominent open source software developer, and a relatively small group of software engineers, many of whom are not employed by us, are primarily responsible for the development and evolution of the Linux kernel, which is the heart of the Red Hat Enterprise Linux operating system. If these groups of programmers fail to adequately further develop and enhance open source technologies, we would have to rely on other parties to develop and enhance our products or we would need to develop and enhance our products with our own resources. We cannot predict whether further developments and enhancements to these technologies would be available from reliable alternative sources. In either event, our development expenses could be increased and our product release and upgrade schedules could be delayed. Moreover, if third-party software programmers fail to adequately further develop and enhance open source technologies, the development and adoption of these technologies could be stifled and our products could become less competitive. Delays in developing, completing or shipping new or enhanced products could result in delayed or reduced revenue for those products and could also adversely affect customer acceptance of those offerings.

**If third-party enterprise hardware and software providers do not continue to make offerings compatible with our offerings, our software will cease to be competitive.**

Our products will not be competitive unless third-party enterprise hardware and software offerings are compatible with our offerings. We intend to encourage the development of additional applications that operate on both current and new versions of our offerings by, among other means, attracting third-party developers to the Linux platform, providing open source tools to create these applications and maintaining our existing developer relationships through marketing and technical support. We intend to encourage the compatibility of our software with various hardware platforms by maintaining and expanding our relationships, both business and technical, with relevant independent hardware vendors. If we are not successful in achieving these goals, however, our products will not be competitive and our sales growth will be adversely affected.

**We may be unable to predict the future course of open source technology development, which could reduce the market appeal of our products and damage our reputation.**

We do not exercise control over many aspects of the development of open source technology. Different groups of open source software programmers compete with one another to develop new technology. Typically, the technology developed by one group will become more widely used than that developed by others. If we acquire or adopt new technology and incorporate it into our products but competing technology becomes more widely used or accepted, the market appeal of our products may be reduced and that could harm our reputation, diminish the Red Hat brand and result in decreased revenue.

**Because of the characteristics of open source software, there are few technology barriers to entry in the open source market by new competitors and it may be relatively easy for new competitors with greater resources than we have to enter our markets and compete with us.**

One of the characteristics of open source software is that anyone can modify the existing software or develop new software that competes with existing open source software. Such competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. It is possible for new competitors with greater resources than ours to develop their own open source solutions, potentially reducing the demand for, and putting price pressure on, our solutions. For example, in October 2006 Oracle Corporation ( Oracle ) announced plans to sell support for its version of the Linux operating system. In addition, some competitors make their open source software available for free download and use on an ad hoc basis or may position their open source software as a loss leader. We cannot guarantee that we will be able to compete successfully against current and future competitors or that competitive pressure and/or the availability of open source software will not result in price reductions, reduced operating margins and loss of market share, any one of which could seriously harm our business.

**Industry consolidation may lead to increased competition and may harm our operating results.**

There has been a trend in industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This could have a material adverse effect on our business, financial condition and results of operations.

**Our continued success depends on our ability to adapt to a rapidly changing industry as well as maintaining a strong brand. Investment in new business strategies and initiatives could disrupt our ongoing business and may present risks not originally contemplated.**

We must continue to invest significant resources in research and development in order to enhance our existing products and services and introduce new high-quality products and services and technology infrastructure. If we are unable to ensure that our users and customers have a high quality experience with our products and services, then they may become dissatisfied and move to competitors products and services. In addition, if we are unable to predict user preferences or industry changes, or if we are unable to modify our products and services on a timely basis, we may lose customers.

We believe that the brand identity that we have developed has contributed significantly to the success of our business. We also believe that maintaining and enhancing the Red Hat brand is important to expanding our customer base and attracting talented employees. In order to maintain and enhance our brand, we may be required to make substantial investments that may or may not be successful. If we fail to promote and maintain our brand, or if we incur excessive costs in doing so, our business, operating results and financial condition may be materially and adversely affected. Maintaining our brand will depend in part on our ability to remain a leader in open source technology and our ability to continue to provide high quality products and services.

Our future success will depend on our ability to adapt to rapidly changing technologies, to adapt our services to evolving industry standards and to improve the performance and reliability of our services. Our failure to adapt to such changes would harm our business. In addition, the widespread adoption of other technological changes could require substantial expenditures to modify or adapt our services or infrastructure.

Moreover, we believe that our continued success depends on our investing in new business strategies or initiatives that complement our strategic direction and product road map. Such endeavors may involve significant risks and uncertainties, including distraction of management s attention away from other business operations, and insufficient revenue generation to offset liabilities and expenses undertaken with such strategies and initiatives. Because these endeavors may be inherently risky, no assurance can be given that such endeavors will not materially adversely affect our business, operating results or financial condition.

**We must effectively develop, deliver and stimulate demand for new products and technologies in order to remain competitive.**

We operate in highly competitive markets that are characterized by rapid technological change and frequent new product and service announcements. To retain and grow our market share, we must continually introduce new and innovative offerings and technologies, enhance and adapt existing offerings and technologies and effectively stimulate customer demand for our new offerings. Delays in developing, completing or shipping new or enhanced offerings and technologies could result in delayed or reduced revenue for those offerings and could also adversely affect customer acceptance of those offerings and technologies. The success of new and enhanced offering introductions depend on several factors, including our ability to develop and complete in a timely manner, successfully promote the offerings, manage the risks associated with the offerings, make sufficient resources available to support them and address any quality or other defects in the early stages of introduction. Our failure to deliver new and enhanced offerings and technologies in a timely and cost-effective manner and to effectively stimulate demand for them may harm our reputation as a leader in open source technology, diminish the Red Hat brand and adversely affect our business, operating results and financial condition.

**Security and privacy breaches may expose us to liability and cause us to lose customers.**

Our security and testing measures may not prevent security breaches that could harm our business. Advances in computer capabilities, new discoveries in the field of cryptography, inadequate technology or facility security measures or other factors may result in a compromise or breach of our systems and the data we process. Any compromise of our systems or the data we process could harm our reputation or financial condition and, therefore, our business. In addition, a party who is able to circumvent our security measures or exploit inadequacies in our security measures, could, among other effects, misappropriate proprietary information, cause interruptions in our operations or expose customers to computer viruses or other disruptions or vulnerabilities. Actual or perceived vulnerabilities may lead to claims against us by customers, partners or other third-parties, which could be material. While our customer agreements typically contain provisions that seek to limit our liability, there is no assurance these provisions will be enforceable and effective under applicable law.

**We are vulnerable to system failures, which could harm our reputation and business.**

We rely on our technology infrastructure, among other functions, to sell our products and services, support our partners, fulfill orders and bill, collect and make payments. Our systems are vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, terrorist attacks, computer intrusions and viruses, computer denial-of-service attacks and other events. A significant number of our systems are not redundant, and our disaster recovery planning is not sufficient for every eventuality. Our systems are also subject to break-ins, sabotage and intentional acts of vandalism by internal employees, contractors and third-parties. Despite any precautions we may take, such problems could result in, among other consequences, interruptions in our services, which could harm our reputation, business and financial condition. We do not carry business interruption insurance sufficient to protect us from all losses that may result from interruptions in our services as a result of system failures or to cover all contingencies.

Any interruption in the availability of our websites and on-line interactions with customers and partners would create a large volume of user questions and complaints that would need to be addressed by our support personnel rather than by self-help. If our support personnel cannot meet this demand, customer and partner satisfaction levels may fall, which in turn could cause additional claims or reduced revenue.

**If we fail to comply with our customer contracts or government contracting regulations, our business could suffer.**

Our contracts with our customers may include unique and specialized performance requirements. In particular, our contracts with federal, state, provincial and local governmental customers are subject to various procurements regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us to comply with the specific provisions in our customer contracts or any violation of government contracting regulations could result in the imposition of various civil and criminal penalties, which may include termination of contracts, forfeiture of profits, suspension of payments and, in the case of our government contracts, fines and suspension from future government contracting. Further, any negative publicity related to our customer contracts or any proceedings surrounding them, regardless of its accuracy, may damage our business and affect our ability to compete for new contracts. If our customer contracts are terminated, if we are suspended from government work, or of our ability to compete for new contracts is adversely affected, we could suffer an adverse affect on our business, operating results or financial condition.

## RISKS RELATED TO LEGAL UNCERTAINTY

**If our products are found or alleged to infringe third-party intellectual property rights, we could be required to redesign our products, replace components of our products, enter into license agreements with third parties and provide infringement indemnification.**

We regularly commit to our subscription customers that if portions of our enterprise products are found to infringe any third-party intellectual property rights we will, at our expense and option: (i) obtain the right for the customer to continue to use the product consistent with their subscription agreement with us; (ii) modify the product so that it is non-infringing; or (iii) replace the infringing component with a non-infringing component, and indemnify them against specified infringement claims. Although we cannot predict whether we will need to satisfy these commitments and often have limitations on these commitments, satisfying the commitments could be costly and time consuming and could materially and adversely affect our operating results and financial condition. In addition, our insurance policies would likely not adequately cover our exposure to this type of claim.

**We are vulnerable to claims that our products infringe third-party intellectual property rights because our products are comprised of software components, many of which are developed by numerous independent parties, and an adverse legal decision affecting our intellectual property could materially harm our business.**

We are vulnerable to claims that our products infringe third-party intellectual property rights, including patent, copyright and trade secrets because our products are comprised of software components, many of which are developed by numerous independent parties. Moreover, because the scope of software patent protection is often not well defined or readily determinable, patent applications in the United States are not publicly disclosed at the time of filing, and the number of software patents that are issued each year is significant and growing, we may be unable to assess the relevance of patents to our products, or take appropriate responsive action, in a timely or economic manner. We expect that our products could increasingly be subject to intellectual property infringement claims as the size of our business and market share grow, the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Defending patent infringement, copyright infringement and/or trade secret claims, even claims without significant merit, can be expensive.

The SCO Group, Inc. ( SCO ) as well as others have publicly alleged that Linux may infringe certain third-party intellectual property rights. SCO filed suit against IBM, alleging, among other things, that certain Linux kernels wrongfully include SCO s intellectual property. Uncertainty concerning allegations of this type, regardless of their merit, could adversely affect our reputation and business. If those asserting such claims were to prevail in this or other actions related to their claims regarding Linux or other products, our operating results and financial condition could be materially and adversely affected.

An adverse legal decision regarding the intellectual property in and to our technology and other offerings could harm our business and may do so materially. See Legal Proceedings .

**We could be prevented from selling or developing our software if the GNU General Public License and similar licenses under which our products are developed and licensed are not enforceable or are modified so as to become incompatible with other open source licenses.**

A number of our offerings, including Red Hat Enterprise Linux, have been developed and licensed under the GNU General Public License and similar open source licenses. These licenses state that any program licensed under them may be liberally copied, modified and distributed. It is possible that a court would hold these licenses to be unenforceable or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Any ruling by a court that these licenses are not enforceable, or that open source components of our product offerings may not be liberally copied, modified or distributed, may have the effect of preventing us from distributing or developing all or a portion of our products. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of their license agreements in such a manner that those license terms may no longer be compatible with other open source licenses in our offerings or our end user license agreement, and thus could, among other consequences, prevent us from continuing to distribute the software code subject to the modified license.

**Our products may contain defects that may be costly to correct, delay market acceptance of our products and expose us to claims and litigation.**

Despite our testing procedures, errors have been and will continue to be found in our products after commencement of commercial shipments. This risk is exacerbated by the fact that much of the code in our products is developed by independent parties over whom we exercise no supervision or control. If errors are discovered, we may have to make significant expenditures of capital and devote significant technical resources to analyze, correct, eliminate or work around them and may not be able to successfully do so in a timely manner or at all. Errors and failures in our products could result in a loss of, or delay in, market acceptance of our products, loss of existing or potential customers and delayed or lost revenue and could damage our reputation and our ability to convince commercial users of the benefits of Linux-based operating systems and other open source software products.

In addition, failures in our products could cause system or other failures for our customers who may assert warranty and other claims for substantial damages against us. Although our license agreements with our customers often contain provisions which seek to limit our exposure to potential product liability claims, it is possible that these provisions may not be effective or enforceable under the laws of some jurisdictions. In addition, our insurance policies may not adequately limit our exposure to this type of claim. These claims, even if unsuccessful, could be costly and time consuming to defend and could materially harm our business.

**Our efforts to protect our trademarks may not be adequate to prevent third-parties from misappropriating our intellectual property rights in our trademarks.**

Our collection of trademarks is valuable and important to our business. The protective steps we have taken in the past have been, and may in the future continue to be, inadequate to protect and deter misappropriation of, our trademark rights. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce,

our trademark rights in a timely manner. We have registered some of our trademarks in countries in North America, South America, Europe, Asia, Africa and Australia and have other trademark applications pending in each of those regions. Effective trademark protection may not be available in every country in which we offer or intend to offer our products and services. Failure to adequately protect our trademark rights could damage or even destroy the Red Hat brand and impair our ability to compete effectively. Furthermore, defending or enforcing our trademark rights could result in the expenditure of significant financial and managerial resources.

**Efforts to assert intellectual property ownership rights in our products could impact our standing in the open source community, which could limit our product innovation capabilities and adversely affect our business.**

When we undertake actions to protect and maintain ownership and control over our intellectual property, including patents, copyrights and trademark rights, our standing in the open source community could be adversely affected, which in turn could limit our ability to continue to rely on this community, upon which we are dependent, as a resource to help develop and improve our products and further our research and development efforts, and could adversely affect our business.

**We are, and may become, involved in disputes and lawsuits that could have a material adverse affect on our performance or stock price.**

Following our announcement in July 2004 of our intention to restate certain historical financial statements, 14 class action lawsuits were commenced against us and certain of our current and former directors and officers, by or on behalf of persons claiming to be our stockholders and persons claiming to have purchased or otherwise acquired our securities at specified dates beginning as early as June 19, 2001 and continuing through July 13, 2004. The 14 class action lawsuits have since been consolidated into a single lawsuit. Additional lawsuits or legal proceedings may be commenced against us. If we do not prevail in these matters, we could be required to pay substantial damages or settlement costs, which could have a material adverse affect on our financial condition or results of operations. See Legal Proceedings for additional information on this and other certain matters that may affect our performance or stock price.

**Our business is subject to a variety of U.S. and international laws regarding data protection.**

Our business is subject to federal, state and international laws regarding privacy and protection of user data. We post, on our website, our privacy policies and practices concerning the use and disclosure of user data. Any failure by us to comply with our posted privacy policies or other federal, state or international privacy-related or data protection laws and regulations could result in proceedings against us by governmental entities or others which could have a material adverse effect on our business, results of operations and financial condition.

It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines and penalties, a governmental order requiring that we change our data practices could result, which in turn could have a material adverse effect on our business. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we cease conducting the noncompliant activity.

## RISKS RELATED TO FINANCIAL UNCERTAINTY

**Our quarterly operating results may not be a reliable indicator of our future operating results.**

Due to the unpredictability of the technology spending environment, among other reasons, our revenue and operating results have fluctuated and may continue to fluctuate. We base our current and projected future expense levels, in part, on our estimates of future revenue. Our expenses are, to a large extent, fixed in the short

term. Accordingly, we may not be able to adjust our spending quickly enough to protect our projected operating results for a quarter if our revenue in that quarter falls short of our expectations. If, among other considerations, our future operating results fall below expectations of securities analysts or investors or we are unable to increase or maintain profitability, the market price of our common stock may decline.

**Our stock price has been volatile historically and may continue to be volatile. Further, the sale of our common stock by significant stockholders may cause the price of our common stock to decrease.**

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new products by us or our competitors, announcements relating to strategic decisions, announcements related to key personnel, customer purchase delays, service disruptions, changes in financial estimates and recommendations by securities analysts, the operating and stock price performance of other companies that investors may deem comparable to us and news reports relating to trends in our markets or general economic conditions.

In addition, several of our stockholders own significant portions of our common stock. If these stockholders were to sell all or a portion of their holdings of our common stock, then the market price of our common stock could be negatively impacted. The effect of such sales, or of significant portions of our stock being offered or made available for sale, could result in strong downward pressure on our stock price. Investors should be aware that they could experience significant short-term volatility in our stock if such stockholders decide to sell all or a portion of their holdings of our common stock at once or within a short period of time.

**We may lack the financial and operational resources needed to increase our market share and compete effectively.**

In the market for operating systems and applications, we face significant competition from larger companies with greater financial, operational and technical resources and name recognition than we have. Competitors, which offer hardware-independent multi-user operating systems for Intel platforms and/or Linux and UNIX-based operating systems, include Microsoft, Oracle, Novell, IBM, Sun and HP. We may lack the resources needed to compete successfully with our current competitors as well as potential new competitors. Moreover, we compete in certain areas with our strategic partners and potential strategic partners, and this may adversely impact our relationship with an individual partner or a number of partners. Competitive pressures could affect prices or demand for our products and services, resulting in reduced profit margins and loss of market opportunity. We may have to lower the prices of our products and services to stay competitive, which could affect our margins and financial condition. In addition, if our pricing and other factors are not sufficiently competitive, we may lose market share. Industry consolidation may also effect competition by creating larger and potentially stronger competitors in the markets in which we compete, which may have an adverse effect on our business.

In the market for services offerings, we face significant competition from larger companies, including those that currently provide service and training related to the Linux operating system as well as other operating systems, particularly UNIX-based operating systems, due to the fact that Linux-and UNIX-based operating systems share many common features. These larger companies, including IBM, Oracle, Novell and HP, may be able to leverage their existing service organizations and provide higher levels of consulting and training on a more cost-effective basis than we can. We may not be able to compete successfully with our current or potential competitors.

During fiscal 2007, several of our largest competitors made announcements relevant to markets in which we operate, including an announcement by Oracle to offer Linux support services and an announcement by Novell regarding an agreement with Microsoft to collaborate on technology, a cross covenant not to sue the other party s customers for patent infringement and an agreement by Microsoft to purchase and distribute coupons for SUSE

Linux maintenance and support. Microsoft and Novell announced an extension of their partnership and the purchase and distribution of an additional $100 million in coupons for SUSE Linux by Microsoft in August 2008.

**We may not be able to meet the financial and operational challenges that we will encounter as our international operations, which represented approximately 40.9% of our total revenue for the fiscal year ended February 28, 2009, continue to expand.**

Our international operations accounted for approximately 40.9% of total revenue for the fiscal year ended February 28, 2009. As we expand our international operations, we may have difficulty managing and administering a globally-dispersed business and we may need to expend additional funds to, among other activities, reorganize our sales force and technical support services team, outsource or supplement general and administrative functions, staff key management positions, obtain additional information technology infrastructure and successfully localize software products for a significant number of international markets, which may negatively affect our operating results.

Additional challenges associated with the conduct of our business overseas that may negatively affect our operating results include:

- Fluctuations in exchange rates;
- Longer payment cycles and less financial stability of customers;
- Compliance with a wide variety of foreign laws;
- Difficulty selecting and monitoring channel partners outside of the United States;
- Difficulty protecting our intellectual property rights overseas due to, among other reasons, the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property rights;
- Difficulty maintaining quality standards consistent with the Red Hat brand;
- Export control regulations could prevent us from shipping our products into and out of certain markets;
- Changes in import/export duties, quotas or other trade barriers could affect the competitive pricing of our products and service and reduce our market share in some countries; and
- Economic or political instability or terrorist acts in some international markets could result in the loss or forfeiture of some foreign assets and the loss of sums spent developing and marketing those assets and the revenue associated with them.

Moreover, in many foreign countries, particularly in certain developing economies, it is not uncommon to engage in business practices that are prohibited by regulations applicable to us, such as the Foreign Corrupt Practices Act and similar laws. Although we have policies and procedures designed to promote compliance with these laws, our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, may take actions in violation of our policies and procedures. Any such violation, even if prohibited by our policies and procedures or the law, could have a material adverse effect on our business. Any failure by us to effectively manage the challenges associated with the international expansion of our operations could adversely affect our business, operating results and financial condition.

**We may be subject to greater tax liabilities.**

We are subject to income and other taxes in the U.S. and in numerous foreign jurisdictions. Our domestic and foreign tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions. Additionally, the amount of taxes paid is subject to our interpretation of

applicable tax laws in the jurisdictions in which we operate. We are regularly subject to audits by tax authorities. While we endeavor to comply with all applicable tax laws, there can be no assurance that a governing tax authority will not have a different

interpretation of the law than we do or that we will comply in all respects with applicable tax laws, which could result in additional taxes. There can be no assurance that the outcomes from these audits will not have an adverse effect on our results of operations in the period for which the review is made.

**Because we recognize revenue from subscriptions for our service over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our operating results.**

We generally recognize subscription revenue from customers ratably over the term of their subscription agreements, which are generally 12 to 36 months. As a result, much of the revenue we report in each quarter is deferred revenue from subscription agreements entered into during previous quarters. Consequently, a decline in subscriptions in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect this reduced revenue. Accordingly, the effect of significant downturns in sales and market acceptance of our service may not be fully reflected in our results of operations until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term.

**If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings.**

Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization, future cash flows and slower growth rates in our industry. We may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined resulting in an adverse impact on our results of operations.

**We may be exposed to potential risks if we do not have an effective system of disclosure controls or internal controls or fail on an ongoing basis to properly address Section 404 of the Sarbanes-Oxley Act of 2002.**

We must comply, on an on-going basis, with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ( SOX ), including those provisions that establish the requirements for both management and auditors of public companies with respect to reporting on internal control over financial reporting. We cannot be certain that measures we have taken, and will take, will be sufficient or timely completed to meet the Section 404 requirements on an on-going basis, or that we will be able to implement and maintain adequate disclosure controls and controls over our financial processes and reporting in the future, particularly in light of our rapid growth, international expansion and changes in our products and services, which are expected to result in on-going changes to our control systems and areas of potential risk.

If we fail to maintain an effective system of disclosure controls or internal control over financial reporting, including satisfaction of the requirements of Section 404 of SOX, we may not be able to accurately or timely report on our financial results or adequately identify and reduce fraud. As a result, the financial position of our business could be harmed; current and potential future shareholders could lose confidence in us and/or our reported financial results, which may cause a negative effect on our trading price; and we could be exposed to litigation or regulatory proceedings, which may be costly or divert management attention.

**Our investment portfolio is subject to credit and illiquidity risks and fluctuations in the market value of our investments and interest rates. These risks may result in an impairment in or the loss of all or portion of the value of our investments, an inability to sell our investments and a decline in interest income.**

We maintain an investment portfolio of various holdings, types and maturities. Our portfolio as of February 28, 2009 consisted primarily of money market funds, U.S. government securities, certificates of deposit, agency securities, corporate securities and equity securities. Although we follow an established investment policy and seek to minimize the risks associated investments by investing primarily in investment grade, highly liquid securities and by limiting the amounts invested with any one institution, type of security or issuer, we cannot give assurances that the assets in our investment portfolio will not lose value or become impaired, or that our interest income will not decline.

During fiscal 2009 we recorded an other-than-temporary impairment charge of $2.2 million to recognize an estimated, unrealized loss in one of our debt security investments. This charge had an adverse impact on net income and earnings per share. We may be required to record additional impairment charges for other-than-temporary declines in fair market value in our investments. Future fluctuations in economic and market conditions could adversely affect the market value of our investments, and we could record additional impairment charges and lose some or all of the principal value of investments in our portfolio. A total loss of an investment or a significant decline in the value of our investment portfolio could adversely affect our operating results and financial condition. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, see Quantitative and Qualitative Disclosures About Market Risk .

Our investments in private companies are subject to risk of loss of investment capital. These investments are inherently risky because the markets for the technologies they have under development are typically in the early stages and may never materialize. We could lose the value of our entire investment in these companies.

**We are subject to risks of currency fluctuations and related hedging operations.**

A portion of our business is conducted in currencies other than the U.S. dollar. Changes in exchange rates among other currencies and the U.S. dollar will affect our net revenue, operating expenses and operating margins. We cannot predict the impact of future exchange rate fluctuations. We have begun to use financial instruments, primarily forward purchase contracts, to economically hedge U.S. dollar and other currency commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations. If these hedging activities are not successful or we change or reduce these hedging activities in the future, we may experience significant unexpected expenses from fluctuations in exchange rates. For information regarding our hedging activity, see Quantitative and Qualitative Disclosures About Market Risk .

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**
**Issuer Purchases of Equity Securities**

The table below sets forth information regarding the Company s purchases of its Common Stock during its third fiscal quarter ended November 30, 2009:

**Issuer Purchases of Equity Securities**

| Period | Total Number of Shares Purchased (1) | Weighted Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2) | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (2) |
|---|---|---|---|---|
| September 1, 2009 September 30, 2009 | 153 | $ 24.98 | | $ 152.1 million |
| October 1, 2009 October 31, 2009 | 2,141,406 | $ 27.65 | 1,900,000 | $ 99.8 million |
| November 1, 2009 November 30, 2009 | 203 | $ 28.61 | | $ 99.8 million |
| Total | 2,141,762 | $ 27.65 | 1,900,000 | $ 99.8 million |

(1) During the three months ended November 30, 2009, the Company withheld an aggregate of 241,762 shares of common stock from employees to satisfy minimum tax withholding obligations relating to the vesting of restricted share awards. These shares were not withheld pursuant to the program described in Note 2 below.

(2) On November 17, 2008, the Company announced that its Board of Directors had amended the repurchase program that was announced in October 2006 to authorize the repurchase of up to an aggregate of $250.0 million of common stock, without regard to amounts previously repurchased. The amended program expires on the earlier of (i) October 31, 2010 or (ii) a determination by the Board of Directors, the Chief Executive Officer or the Chief Financial Officer to discontinue the program. As of November 30, 2009, the amount available under the program for the repurchase of common stock was $99.8 million. See Note 10 to the Consolidated Financial Statements for information regarding shares repurchased under the program subsequent to November 30, 2009.

**ITEM 6. EXHIBITS**
(a) List of Exhibits

| Exhibit No. | Description of Exhibit |
|---|---|
| 10.1*+ | Red Hat, Inc. Stock Ownership Policy for Directors and Senior Executives, effective as of March 1, 2010 (incorporated by reference to Exhibit 99.1 to the registrant's Current Report filed on Form 8-K with the SEC on November 24, 2009 (File No. 001-33162)). |
| 31.1 | Certification of the registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/Rule 15(d)-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/Rule 15(d)-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the registrant's Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 |

* Indicates a management contract or compensatory plan, contract or arrangement.

+ Previously filed.

**SIGNATURES**

**Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.**

RED HAT, INC.

Date: January 11, 2010 By: /s/ JAMES M. WHITEHURST

**James M. Whitehurst**

**President and Chief Executive Officer**

**(Duly Authorized Officer on Behalf of the Registrant)**

RED HAT, INC.

Date: January 11, 2010 By: /s/ CHARLES E. PETERS, JR.

**Charles E. Peters, Jr.**

**Executive Vice President and Chief Financial Officer**

**(Principal Financial Officer)**

RED HAT, INC.

Date: January 11, 2010 By: /s/ MARK E. COOK

**Mark E. Cook**

**Vice President and Controller**

**(Principal Accounting Officer)**