

RED HAT INC  
Form 10-Q  
July 10, 2009  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended May 31, 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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

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

As of June 30, 2009, there were 188,007,091 shares of common stock outstanding.

**Table of Contents**

**RED HAT, INC.**

**TABLE OF CONTENTS**

	<b>Page</b>
<b>PART I</b>	
<b>FINANCIAL INFORMATION:</b>	
<b>ITEM 1:</b>	
<b>FINANCIAL STATEMENTS</b>	
<u>Consolidated Balance Sheets at May 31, 2009 (unaudited) and February 28, 2009</u>	3
<u>Consolidated Statements of Operations for the three months ended May 31, 2009 (unaudited) and 2008 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flows for the three months ended May 31, 2009 (unaudited) and 2008 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<b>ITEM 2:</b>	
<u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	29
<b>ITEM 3:</b>	
<u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	42
<b>ITEM 4:</b>	
<u>CONTROLS AND PROCEDURES</u>	44
<b>PART II</b>	
<b>OTHER INFORMATION:</b>	
<b>ITEM 1:</b>	
<u>LEGAL PROCEEDINGS</u>	45
<b>ITEM 1A:</b>	
<u>RISK FACTORS</u>	48
<b>ITEM 2:</b>	
<u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	62
<b>ITEM 6:</b>	
<u>EXHIBITS</u>	62
<u>SIGNATURES</u>	64

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

	May 31, 2009 (Unaudited)	February 28, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 510,616	\$ 515,548
Investments in debt and equity securities, short-term	206,891	147,178
Accounts receivable, net of allowances for doubtful accounts of \$2,758 and \$2,387, respectively	106,639	128,669
Prepaid expenses and other current assets	95,387	99,437
<b>Total current assets</b>	<b>919,533</b>	<b>890,832</b>
Property and equipment, net of accumulated depreciation and amortization of \$96,923 and \$91,140, respectively	69,619	67,913
Goodwill	438,901	438,109
Identifiable intangibles, net	119,638	122,177
Investments in debt securities, long-term	167,028	183,363
Other assets, net	51,104	51,242
<b>Total assets</b>	<b>\$ 1,765,823</b>	<b>\$ 1,753,636</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 13,089	\$ 9,576
Accrued expenses	52,104	54,123
Deferred revenue	402,764	382,050
Other current obligations	878	900
<b>Total current liabilities</b>	<b>468,835</b>	<b>446,649</b>
Deferred lease credits	4,319	4,470
Long-term deferred revenue	164,576	161,032
Other long-term obligations	34,573	35,432
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, \$0.0001 per share par value, 300,000,000 shares authorized, 208,435,308 and 207,794,700 shares issued, and 187,937,113 and 189,998,611 shares outstanding at May 31, 2009 and February 28, 2009, respectively	21	21
Additional paid-in capital	1,295,305	1,281,469
Retained earnings	69,033	50,519
Treasury stock at cost, 20,498,267 and 17,796,089 shares at May 31, 2009 and February 28, 2009, respectively	(283,054)	(236,283)
Accumulated other comprehensive income	12,215	10,327
<b>Total stockholders' equity</b>	<b>1,093,520</b>	<b>1,106,053</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,765,823</b>	<b>\$ 1,753,636</b>

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



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

	<b>Three Months Ended</b>	
	<b>May 31,</b>	<b>May 31,</b>
	<b>2009</b>	<b>2008</b>
<b>Revenue:</b>		
Subscriptions	\$ 148,790	\$ 130,694
Training and services	25,598	25,941
<b>Total subscription and training and services revenue</b>	<b>174,388</b>	<b>156,635</b>
<b>Cost of subscription and training and services revenue:</b>		
Cost of subscriptions	10,050	8,957
Cost of training and services	16,418	17,472
<b>Total cost of subscription and training and services revenue</b>	<b>26,468</b>	<b>26,429</b>
<b>Gross profit</b>	<b>147,920</b>	<b>130,206</b>
<b>Operating expense:</b>		
Sales and marketing	63,977	59,271
Research and development	35,102	28,911
General and administrative	23,785	22,114
<b>Total operating expense</b>	<b>122,864</b>	<b>110,296</b>
<b>Income from operations</b>	<b>25,056</b>	<b>19,910</b>
Other income, net	3,480	10,020
Interest expense	(53)	(1,586)
<b>Income before provision for income taxes</b>	<b>28,483</b>	<b>28,344</b>
Provision for income taxes	9,969	11,054
<b>Net income</b>	<b>\$ 18,514</b>	<b>\$ 17,290</b>
<b>Basic net income per common share</b>	<b>\$ 0.10</b>	<b>\$ 0.09</b>
<b>Diluted net income per common share</b>	<b>\$ 0.10</b>	<b>\$ 0.08</b>
<b>Weighted average shares outstanding</b>		
Basic	188,916	190,779
Diluted	194,382	218,853

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

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

	<b>Three Months Ended</b>	
	<b>May 31, 2009</b>	<b>May 31, 2008</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 18,514	\$ 17,290
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	10,810	9,097
Share-based compensation expense	10,676	10,561
Deferred income taxes	6,428	8,767
Excess tax benefits from share-based payment arrangements	(14,200)	(8,967)
Other	(124)	561
<b>Changes in operating assets and liabilities net of effects of acquisitions:</b>		
Accounts receivable	26,278	19,320
Prepaid expenses and other current assets	644	(5,003)
Accounts payable	2,997	(5,570)
Accrued expenses	(3,029)	1,986
Deferred revenue	2,361	15,454
Other assets, net	(152)	(134)
<b>Net cash provided by operating activities</b>	<b>61,203</b>	<b>63,362</b>
<b>Cash flows from investing activities:</b>		
Purchase of investment in debt securities available for sale	(157,034)	(305,646)
Proceeds from sales and maturities of investment in debt securities available for sale	122,449	216,534
Proceeds from sales of investment in equity securities available for sale	221	
Acquisitions of businesses, net of cash acquired		(43,750)
Purchase of developed software and other intangible assets	(989)	(1,615)
Purchase of property and equipment	(6,028)	(9,522)
<b>Net cash used in investing activities</b>	<b>(41,381)</b>	<b>(143,999)</b>
<b>Cash flows from financing activities:</b>		
Excess tax benefits from share-based payment arrangements	14,200	8,967
Proceeds from exercise of common stock options	4,400	11,447
Payments related to net settlement of employee share-based awards	(1,798)	
Purchase of treasury stock	(46,771)	(9,147)
Structured stock repurchase		1,989
Proceeds from other borrowings		66
Payments on other borrowings	(900)	(23)
<b>Net cash provided by (used in) financing activities</b>	<b>(30,869)</b>	<b>13,299</b>
<b>Effect of foreign currency exchange rates on cash and cash equivalents</b>	<b>6,115</b>	<b>158</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(4,932)</b>	<b>(67,180)</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>515,548</b>	<b>677,720</b>

Edgar Filing: RED HAT INC - Form 10-Q

Cash and cash equivalents at end of period	\$ 510,616	\$ 610,540
--	------------	------------

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



---

**Table of Contents**

**RED HAT, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1 Company**

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

**NOTE 2 Summary of Significant Accounting Policies**

*Unaudited Interim Financial Information*

The unaudited interim consolidated financial statements as of and for the three months ended May 31, 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 ended May 31, 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.

**Table of Contents**

**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.

---

**Table of Contents**

**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 exist. 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 ended May 31, 2009 and May 31, 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 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 ended May 31, 2009 and May 31, 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 collectibility. 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.

**Table of Contents****RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Investments in Debt and Equity Securities*

The Company's investments at May 31, 2009 and February 28, 2009 are in debt and equity securities which are classified as available for sale and carried at market value as described below. Investments in debt securities are classified as either a cash equivalent, current asset (Investments in debt and equity securities, short-term) or long-term asset (Investments in debt securities, long-term) based on the maturity date. Investments with a maturity date of one year or less from the balance sheet date are classified as a current asset and those with a maturity date of greater than one year are classified as a long-term asset. The weighted average maturity period of the Company's investment in debt securities was 0.4 years at May 31, 2009 and February 28, 2009.

The Company's investments are considered available for sale as these securities are available for sale at any time in response to needs for liquidity, changes in the availability of and the yield on alternative instruments or changes in funding sources or terms. The following table summarizes the Company's average total return and resulting unrealized gain or loss related to these investments which is recorded as other comprehensive income, a separate component of stockholders' equity (in thousands):

	<b>Three Months Ended May 31, 2009</b>	<b>Three Months Ended May 31, 2008</b>
<i>Debt securities:</i>		
Unrealized gains (losses) on available-for-sale debt securities during the period	\$ 2,556	\$ (4,848)
Average rate of total return on investment in debt securities portfolio	1.8%	3.4%
<i>Equity securities:</i>		
Unrealized gains on available-for-sale equity securities during the period (1)	\$ 6,734	\$

- (1) Investments in equity securities available for sale at May 31, 2009 consist of equity ownership in a company which underwent an initial public offering (IPO) in 2008. Prior to completing its IPO, the Company accounted for this investment on a cost basis, which totaled \$2.2 million at May 31, 2008. At May 31, 2009 and February 28, 2009 this equity investment is carried at fair value which totaled \$12.7 million and \$6.0 million, respectively, and is classified as available for sale and included in investments in debt and equity securities, short-term on the Company's Consolidated Balance Sheets.

*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 the 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 that are significant to the fair value of the assets or liabilities.



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

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

Unrealized gains and temporary losses on investments classified as available for sale are included within accumulated other comprehensive income, net of any related tax effect. Upon realization, such amounts are reclassified from accumulated other comprehensive income to investment income. Realized gains and losses and other than temporary impairments, if any, are reflected in the statements of operations as other income, net. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other-than-temporary. At May 31, 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.

*Assets and Liabilities Measured at Fair Value on a Recurring Basis*

The following table summarizes the composition and fair value hierarchy of the Company's financial assets and liabilities at May 31, 2009 (in thousands):

	As of May 31, 2009	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Money markets (1)	\$ 396,468	\$ 396,468	\$	\$
<b>Available-for-sale securities (1):</b>				
Treasuries	17,198	17,198		
Certificate of deposit	51,618		51,618	
Commercial paper	1,999		1,999	
Agencies	192,992		192,992	
Corporates	132,831		132,831	
Equities (1)	12,733	12,733		
Foreign currency derivatives (2)	49		49	
<b>Total</b>	<b>\$ 805,888</b>	<b>\$ 426,399</b>	<b>\$ 379,489</b>	<b>\$</b>



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

(1) Included in either cash and cash equivalents or investments in debt and equity securities in the Company's Consolidated Balance Sheet at May 31, 2009, in addition to \$78.7 million of cash.

(2) Included in prepaid expenses and other current assets in the Company's Consolidated Balance Sheet at May 31, 2009.

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)
<b>Assets:</b>				
Money markets (1)	\$ 417,632	\$ 417,632	\$	\$
<b>Available-for-sale securities (1):</b>				
Treasuries	17,163	17,163		
Certificate of deposit	27,133		27,133	
Agencies	183,636		183,636	
Corporates	122,899		122,899	
Equities (1)	6,022	6,022		
Foreign currency derivatives (3)	30		30	
<b>Liabilities:</b>				
Foreign currency derivatives (2)	(64)		(64)	
<b>Total</b>	<b>\$ 774,451</b>	<b>\$ 440,817</b>	<b>\$ 333,634</b>	<b>\$</b>

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

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

The following table represents the Company's investments measured at fair value as of May 31, 2009 (in thousands):

Amortized Cost	Gross Unrealized		Aggregate Fair Value	Balance Sheet Classification		
	Gains	Losses (1)		Cash Equivalent Marketable	Short-term Marketable Securities	Long-term Marketable Securities



Edgar Filing: RED HAT INC - Form 10-Q

	Securities						
Money Markets	\$ 396,468	\$	\$	\$ 396,468	\$ 396,468	\$	\$
Treasury	17,043	155		17,198		15,342	1,856
Certificate of Deposit	51,618			51,618	35,452	16,166	
Commercial Paper	1,999			1,999		1,999	
Agencies	192,139	906	(53)	192,992		93,643	99,349
Corporates	131,013	2,342	(524)	132,831		67,008	65,823
Equities	1,283	11,450		12,733		12,733	
Total	\$ 791,563	\$ 14,853	\$ (577)	\$ 805,839	\$ 431,920	\$ 206,891	\$ 167,028

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

(1) Accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer totaled \$0.5 million at May 31, 2009.

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

	Gross Unrealized			Aggregate Fair Value	Balance Sheet Classification		
					Cash		
	Amortized Cost	Gains	Losses (1)	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	
Commercial Paper							
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 \$2.7 million in costs related to the development of internal use software for its website, enterprise resource planning system and systems management applications during each of the three months ended May 31, 2009 and May 31, 2008. 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.

*Capitalized Software Costs*

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

## Edgar Filing: RED HAT INC - Form 10-Q

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;

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

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 ended May 31, 2009 and May 31, 2008 (in thousands):

	Three Months Ended May 31, 2009	Three Months Ended May 31, 2008
Cost of revenue	\$ 800	\$ 681
Sales and marketing	3,110	3,996
Research and development	3,274	2,508
General and administrative	3,492	3,376
<b>Total share-based compensation</b>	<b>\$ 10,676</b>	<b>\$ 10,561</b>

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months ended May 31, 2009 and May 31, 2008. Accordingly, no share-based compensation expense was capitalized during the three months ended May 31, 2009 and May 31, 2008.

During the three months ended May 31, 2009, the Company granted the following share-based awards:

	Three Months Ended May 31, 2009	
	Shares and Shares Underlying Awards	Weighted Average Per Share Fair Value
Options	6,481	\$ 7.04
Nonvested shares and share units	123,835	\$ 18.28
Performance share units - target (1)	171,667	\$ 19.73
Deferred share units	813	\$ 19.86
<b>Total awards</b>	<b>302,796</b>	<b>\$ 18.87</b>

- (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, 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,

## Edgar Filing: RED HAT INC - Form 10-Q

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.

---

**Table of Contents**

**RED HAT, INC.**

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

**(Unaudited)**

*Sales and Marketing Expenses*

Sales and marketing expenses consist of costs, including salaries, sales commissions and related expenses, such as travel, of all personnel involved in the sales and marketing process. Sales and marketing expenses also include costs of advertising, sales lead generation programs, cooperative marketing arrangements and trade shows. Payments made to resellers or other customers are reported in accordance with 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) (EITF 01-09). All costs of advertising, to the extent allowable by EITF 01-09, are expensed as incurred. Advertising expense totaled \$5.3 million and \$4.9 million for the three months ended May 31, 2009 and May 31, 2008, 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 accordance with Statement of Financial Accounting Standard 109, Accounting for Income Taxes as modified by FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which requires the recognition of deferred tax assets or liabilities 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, including net operating loss (NOL) carryforwards related to such share-based compensation expense deductions and deferred revenue. In assessing the realizability of these deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. As of May 31, 2009, the net deferred tax asset balance was \$87.8 million, of which \$12.5 million is offset by a valuation allowance. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign NOLs, an acquired NOL carryforward that is subject to a limitation under Section 382 of the Internal Revenue Code and NOLs attributable to certain share-based compensation expense deductions related to excess benefits recognized prior to the adoption of SFAS 123R.

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.

With respect to share-based compensation expense, in accordance with the provisions of SFAS 123R, the benefit of the deferred tax asset attributable to U.S. NOL carryforwards from share-based compensation expense deductions, generated prior to adoption of SFAS 123R, are being recognized as and only to the extent that taxes payable are reduced. As these deferred tax assets attributable to NOLs from share-based compensation expense deductions are realized, the benefit of the deferred tax asset is recorded in additional paid-in capital.

---

**Table of Contents**

**RED HAT, INC.**

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

**(Unaudited)**

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 Consolidated Statements of Operations. Net foreign exchange losses included in other income were less than \$0.1 million for the three months ended May 31, 2009 and \$0.5 million for the three months ended May 31, 2008. 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 temporary cash, cash equivalents, investments and trade receivables. The Company primarily places its temporary 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. One customer accounted for 18% and 12% of the Company's accounts receivable at May 31, 2009 and February 28, 2009, respectively.

For the three months ended May 31, 2009 and May 31, 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

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

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 ended May 31, 2008, assumes the conversion of the convertible debentures using the "if converted" method. The Company had no convertible debentures outstanding during the three months ended May 31, 2009.

The following table reconciles the numerators and denominators of the earnings per share calculation for the three months ended May 31, 2009 and May 31, 2008 (in thousands, except per share amounts):

	<b>Three Months Ended</b>	
	<b>May 31, 2009</b>	<b>May 31, 2008</b>
<b>Diluted net income per share computation:</b>		
Net income	\$ 18,514	\$ 17,290
Interest expense on convertible debt, net of related tax		435
Amortization of debt issuance costs, net of related tax		459
<b>Net income - diluted</b>	<b>\$ 18,514</b>	<b>\$ 18,184</b>
Weighted average common shares outstanding	188,916	190,779
Incremental shares attributable to assumed vesting or exercise of outstanding equity awards	5,466	5,801
Incremental shares attributable to assumed conversion of convertible debentures		22,273
<b>Diluted shares</b>	<b>194,382</b>	<b>218,853</b>
<b>Diluted net income per share</b>	<b>\$ 0.10</b>	<b>\$ 0.08</b>

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

	<b>Three Months Ended</b>	
	<b>May 31, 2009</b>	<b>May 31, 2008</b>
Number of shares considered anti-dilutive for calculating diluted EPS	9,058	8,103

*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).





**Table of Contents**

**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 May 31, 2009 and May 31, 2008 (in thousands):