HOUSTON AMERICAN ENERGY CORP
Form 10-Q
May 14, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2018

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 1-32955

HOUSTON AMERICAN ENERGY CORP.

(Exact name of registrant as specified in its charter)

Delaware	76-0675953
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

801 Travis Street, Suite 1425, Houston, Texas 77002
(Address of principal executive offices)(Zip Code)

(713) 222-6966
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definition of "large accelerated filer," "accelerated filer," "smaller reporting company" or an "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	[ ]	Accelerated filer	[ ]	Non-accelerated filer	[ ]
Smaller reporting company	[X]	Emerging growth company	[ ]		

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

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

As of May 11, 2018, we had 59,510,101 shares of $0.001 par value Common Stock outstanding.

HOUSTON AMERICAN ENERGY CORP.

FORM 10-Q

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PART I - FINANCIAL INFORMATION

ITEM 1 Financial Statements

HOUSTON AMERICAN ENERGY CORP.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS		
Cash	$211,559	$392,062
Accounts receivable – oil and gas sales	437,566	347,548
Prepaid expenses and other current assets	41,666	3,750
TOTAL CURRENT ASSETS	687,791	743,360
PROPERTY AND EQUIPMENT		
Oil and gas properties, full cost method		
Costs subject to amortization	60,143,292	60,139,526
Costs not being amortized	2,312,852	2,309,341
Office equipment	90,004	90,004
Total	62,546,148	62,538,871
Accumulated depletion, depreciation, amortization, and impairment	(55,821,790)	(55,725,080)
PROPERTY AND EQUIPMENT, NET	6,724,358	6,813,791
Other assets	3,167	3,167
TOTAL ASSETS	$7,418,316	$7,560,318
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$87,390	$127,036
Accrued expenses	13,222	24,621
TOTAL CURRENT LIABILITIES	100,612	151,657
LONG-TERM LIABILITIES		
Reserve for plugging and abandonment costs	36,432	35,658
Deferred rent obligation	47,926	49,245
TOTAL LONG-TERM LIABILITIES	84,358	84,903
TOTAL LIABILITIES	184,970	236,560

COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preferred stock, par value $0.001; 10,000,000 shares authorized, 2,020 and 2,070 shares issued and outstanding, respectively	2	2
Common stock, par value $0.001; 150,000,000 shares authorized 59,510,101 and 59,260,101 shares issued and outstanding, respectively	59,510	59,260
Additional paid-in capital	72,444,552	72,482,303
Accumulated deficit	(65,270,718)	(65,217,807)
TOTAL SHAREHOLDERS' EQUITY	7,233,346	7,323,758
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$7,418,316	$7,560,318

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

HOUSTON AMERICAN ENERGY CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE MONTHS ENDED MARCH 31, 2018 AND 2017

(Unaudited)

	Three Months Ended March 31, 2018			2017		
OIL AND GAS REVENUE	$	754,157		$	57,633	
EXPENSES OF OPERATIONS						
Lease operating expense and severance tax		263,285			23,154	
General and administrative expense		421,724			449,343	
Stock-based compensation		25,349			69,954	
Depreciation and depletion		96,710			17,696	
Total operating expenses		807,068			560,147	
Loss from operations		(52,911	)		(502,514	)
OTHER INCOME						
Interest income		—			115	
Total other income		—			115	
Net loss before taxes		(52,911	)		(502,399	)
Income tax expense		—			—	
Net loss	$	(52,911	)	$	(502,399	)
Basic and diluted loss per common share	$	(0.00	)	$	(0.01	)
Based and diluted weighted average number of common		59,460,101			51,277,388	

shares outstanding

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

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HOUSTON AMERICAN ENERGY CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED MARCH 31, 2018 AND 2017

(Unaudited)

	For the Three Months Ended March 31, **2018**			2017		
CASH FLOWS FROM OPERATING ACTIVITIES						
Net loss	$	(52,911	)	$	(502,399	)
Adjustments to reconcile net loss to net cash used in operations:						
Depreciation and depletion		96,710			17,696	
Accretion of asset retirement obligation		774			558	
Stock-based compensation		25,349			69,954	
Changes in operating assets and liabilities:						
Decrease/(increase) in accounts receivable		(90,018	)		—	
Decrease/(increase) in prepaid expenses and other current assets		(37,916	)		(33,750	)
Increase/(decrease) in accounts payable and accrued expenses		(51,045	)		86,003	
Increase/(decrease) in deferred rent		(1,319	)		—	
Net cash used in operating activities		(110,376	)		(361,938	)
CASH FLOWS FROM INVESTING ACTIVITIES						
Payments for the acquisition and development of oil and gas properties		(7,277	)		(997,985	)

Net cash used in investing activities		(7,277	)		(997,985	)
CASH FLOWS FROM FINANCING ACTIVITIES						
Payment of Preferred Stock dividends		(62,850	)		—	
Proceeds from issuance of Series A Preferred Stock		—			1,200,000	
Net cash provided by (used in) financing activities		(62,850	)		1,200,000	
Decrease in cash		(180,503	)		(159,923	)
Cash, beginning of period		392,062			481,172	
Cash, end of period	$	211,559		$	321,249	
SUPPLEMENTAL CASH FLOW INFORMATION						
Interest paid	$	—		$	—	
Taxes paid	$	—		$	—	
SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES						
Conversion of Series A Convertible Preferred Stock to common stock	$	250		$	—	
Retirement of treasury shares	$	—		$	174,125	

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

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HOUSTON AMERICAN ENERGY CORP.

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The accompanying unaudited consolidated financial statements of Houston American Energy Corp., a Delaware corporation (the “Company”), have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for a complete financial presentation. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation, have been included in the accompanying unaudited consolidated financial statements. Operating results for the periods presented are not necessarily indicative of the results that may be expected for the full year.

These unaudited consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and footnotes, which are included as part of the Company’s Form 10-K for the year ended December 31, 2017.

Consolidation

The accompanying consolidated financial statements include all accounts of the Company and its subsidiaries (HAEC Louisiana E&P, Inc., HAEC Oklahoma E&P, Inc., and HAEC Caddo Lake E&P, Inc.). All significant inter-company balances and transactions have been eliminated in consolidation.

Accounting Principles and Use of Estimates

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing financial statements, management makes informed judgments and estimates that affect the reported amounts of assets and liabilities as of the date of the financial statements and affect the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management reviews its estimates, including those related to such potential matters as litigation, environmental liabilities, income taxes and the related valuation allowance, determination of proved reserves of oil and gas and asset retirement obligations. Changes in facts and circumstances may result in revised estimates and actual results may differ from these estimates.

Reclassifications

Certain amounts for prior periods have been reclassified to conform to the current presentation.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk include cash, cash equivalents and any marketable securities. The Company had cash deposits of $6,967 in Colombian banks at March 31, 2018 that are not insured by the FDIC. The Company has not experienced any losses on its deposits of cash and cash equivalents.

Revenue Recognition

ASU 2014-09, *"Revenue from Contracts with Customers (Topic 606)"*, supersedes the revenue recognition requirements and industry-specific guidance under *Revenue Recognition (Topic 605)*. Topic 606 requires an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services. The Company adopted Topic 606 on January 1, 2018, using the modified retrospective method applied to contracts that were not completed as of January 1, 2018. Under the modified retrospective method, prior period financial positions and results will not be adjusted. The cumulative effect adjustment recognized in the opening balances included no significant changes as a result of this adoption. While the Company does not expect 2018 net earnings to be materially impacted by revenue recognition timing changes, Topic 606 requires certain changes to the presentation of revenues and related expenses beginning January 1, 2018. Refer to Note 2 – Revenue from Contracts with Customers for additional information.

The Company’s revenue is comprised entirely of revenue from exploration and production activities. The Company’s oil is sold primarily to marketers, gatherers, and refiners. Natural gas is sold primarily to interstate and intrastate natural-gas pipelines, direct end-users, industrial users, local distribution companies, and natural-gas marketers. NGLs are sold primarily to direct end-users, refiners, and marketers. Payment is generally received from the customer in the month following delivery.

Contracts with customers have varying terms, including spot sales or month-to-month contracts, contracts with a finite term, and life-of-field contracts where all production from a well or group of wells is sold to one or more customers. The Company recognizes sales revenues for oil, natural gas, and NGLs based on the amount of each product sold to a customer when control transfers to the customer. Generally, control transfers at the time of delivery to the customer at a pipeline interconnect, the tailgate of a processing facility, or as a tanker lifting is completed. Revenue is measured based on the contract price, which may be index-based or fixed, and may include adjustments for market differentials and downstream costs incurred by the customer, including gathering, transportation, and fuel costs.

Revenues are recognized for the sale of the Company’s net share of production volumes. Sales on behalf of other working interest owners and royalty interest owners are not recognized as revenues.

Loss per Share

Basic loss per share is computed by dividing net loss available to common shareholders by the weighted average common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted into common shares that then shared in the earnings of the Company. The Company’s only outstanding potentially dilutive securities are stock options. For the three months ended March 31, 2018 and 2017, using the treasury stock method, there were no outstanding ‘in-the-money’ options that would have increased our diluted weighted average shares outstanding and, due to losses during these periods, all outstanding options were excluded from the diluted earnings per share calculation because their effect would have been anti-dilutive.

Recently Adopted Accounting Pronouncements

See discussion of the adoption of ASU 2014-09, *“Revenue from Contracts with Customers (Topic 606)”*, above.

In August 2016, the Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") 2016-15, *"Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments"* ("ASU 2016-15"). ASU 2016-15 will make eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017. The Company adopted this standard on January 1, 2018, on a retrospective basis. There was no impact of the standard on the Company's consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, *"Statement of Cash Flows (Topic 230)"*, requiring that the statement of cash flows explain the change in the total cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. This guidance is effective for fiscal years, and interim reporting periods therein, beginning after December 15, 2017, with early adoption permitted. The Company adopted this standard on January 1, 2018, on a retrospective basis. There was no impact of the standard on the Company's consolidated financial statements.

Recently Issued Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, a new lease standard requiring lessees to recognize lease assets and lease liabilities for most leases classified as operating leases under previous U.S. GAAP. The guidance is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The Company will be required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Company has evaluated the adoption of the standard and, due to there being only one operating lease currently in place, there will be minimal impact of the standard on its consolidated financial statements.

The Company does not expect the adoption of any recently issued accounting pronouncements to have a significant impact on its financial position, results of operations, or cash flows.

Subsequent Events

The Company has evaluated all transactions from March 31, 2018 through the financial statement issuance date for subsequent event disclosure consideration.

NOTE 2 – REVENUE FROM CONTRACTS WITH CUSTOMERS

Change in Accounting Policy

The Company adopted ASU 2014-09, *"Revenue from Contracts with Customers (Topic 606)"*, on January 1, 2018, using the modified retrospective method applied to contracts that were not completed as of January 1, 2018. Refer to Note 1 – Basis of Presentation and Significant Accounting Policies for additional information.

Exploration and Production

There were no significant changes to the timing or valuation of revenue recognized for sales of production from exploration and production activities.

Disaggregation of Revenue from Contracts with Customers

The following table disaggregates revenue by significant product type for the three months ended March 31, 2018:

Oil sales	$485,532
Natural gas sales	268,625
Natural gas liquids sales	—
Total revenue from customers	$754,157

There were no significant contract liabilities or transaction price allocations to any remaining performance obligations as of December 31, 2017 or March 31, 2018.

NOTE 3 – OIL AND GAS PROPERTIES

During the three months ended March 31, 2018, the Company invested $7,277, net, for the acquisition and development of oil and gas properties, consisting of (1) cost of development of U.S. properties of $3,766, net, principally attributable to acreage in Reeves County, Texas, and (2) preparation and evaluation costs in Colombia of $3,511. Of the amount invested, the Company capitalized $3,511 to oil and gas properties not subject to amortization and capitalized $3,766 to oil and gas properties subject to amortization.

Geographical Information

The Company currently has properties in two geographical areas, the United States and Colombia. Revenues for the three months ended March 31, 2018 and long lived assets (net of depletion, amortization, and impairments) as of March 31, 2018 attributable to each geographical area are presented below:

	Three Months Ended March 31, 2018	As of March 31, 2018
	Revenues	Long Lived Assets, Net
United States	$754,157	$4,411,506
Colombia	—	2,312,852
Total	$754,157	$6,724,358

NOTE 4 – STOCK-BASED COMPENSATION EXPENSE

In 2008, the Company's Board of Directors adopted the Houston American Energy Corp. 2008 Equity Incentive Plan (the "2008 Plan"). The terms of the 2008 Plan, as amended in 2012 and 2013, allow for the issuance of up to 6,000,000 shares of the Company's common stock pursuant to the grant of stock options and restricted stock. Persons eligible to participate in the Plans are key employees, consultants and directors of the Company.

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In March 2017, the Company's Board of Directors adopted, subject to shareholder approval, the Houston American Energy Corp. 2017 Equity Incentive Plan (the "2017 Plan" and, together with the 2008 Plan, the "Plans"). The terms of the 2017 Plan, allow for the issuance of up to 5,000,000 shares of the Company's common stock pursuant to the grant of stock options and restricted stock. Persons eligible to participate in the Plans are key employees, consultants and directors of the Company.

The Company periodically grants options to employees, directors and consultants under the Plans and is required to make estimates of the fair value of the related instruments and recognize expense over the period benefited, usually the vesting period.

Stock Option Activity

In February and March 2018, options to purchase an aggregate of 1,500,000 shares were granted to an executive officer and a non-officer employee of the Company. All of the options have a ten-year life and vest 1/3 on each of the first three anniversaries of the grant date. 1,000,000 of the options are exercisable at $0.2922 per share and 500,000 of the options are exercisable at $0.30, the fair market value on respective dates of grant. The options were valued on the date of grant at $254,394 using the Black-Scholes option-pricing model with the following parameters: (1) risk-free interest rate of 2.68%; (2) expected life in years of 5.78; (3) expected stock volatility of 105.4%; and (4) expected dividend yield of 0%. The Company determined the options qualify as 'plain vanilla' under the provisions of SAB 107 and the simplified method was used to estimate the expected option life.

A summary of stock option activity and related information for the three months ended March 31, 2018 is presented below:

	Options	Weighted-Average Exercise Price	**Aggregate Intrinsic Value**
Outstanding at January 1, 2018	6,012,165	$ 1.86	
Granted	1,500,000	0.29	
Exercised	—	—	
Forfeited	—	—	
Outstanding at March 31, 2018	7,512,165	$ 1.55	$ 306,283

Exercisable at March 31, 2018	5,252,165	$ 2.09	$ 186,253

During the three months ended March 31, 2018, the Company recognized $23,915 of stock-based compensation expense attributable to the amortization of stock options. As of March 31, 2018, total unrecognized stock-based compensation expense related to non-vested stock options was $292,997. The unrecognized expense is expected to be recognized over a weighted average period of 2.09 years and the weighted average remaining contractual term of the outstanding options and exercisable options at March 31, 2018 is 6.5 years and 5.3 years, respectively.

Shares available for issuance under the 2008 Plan as of March 31, 2018 totaled 87,835. Shares available for issuance under the 2017 Plan, as of March 31, 2018, totaled 3,400,000.

Stock-Based Compensation Expense

The following table reflects total stock-based compensation recorded by the Company for the three months ended March 31, 2018 and 2017:

	Three Months Ended March 31,	
	2018	2017
Stock-based compensation expense included in general and administrative expense	$25,349	$69,954
Earnings per share effect of share-based compensation expense – basic and diluted	$(0.00)	$(0.00)

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NOTE 5 – CAPITAL STOCK

Series A Convertible Preferred Stock

During the three months ended March 31, 2018, (i) 50 shares of Series A Convertible Preferred Stock were converted into 250,000 shares of common stock and (ii) the Company paid dividends on Series A Convertible Preferred Stock in the amount of $34,500. At March 31, 2018, there were 1,125 shares of Series A Convertible Preferred Stock issued and outstanding.

Series B Convertible Preferred Stock

During the three months ended March 31, 2018, the Company paid dividends on Series B Convertible Preferred Stock in the amount of $28,350. At March 31, 2018, there were 895 shares of Series B Convertible Preferred Stock issued and outstanding.

Warrants

A summary of warrant activity and related information for 2018 is presented below:

	Warrants	Weighted-Average Exercise Price		**Aggregate Intrinsic Value**	
Outstanding at January 1, 2018	3,651,680	$	0.44		
Issued	—		—		
Exercised	—		—		
Expired	3,001,680		0.43		
Outstanding at March 31, 2018	650,000	$	0.50	$	—
Exercisable at March 31, 2018	612,500	$	0.50	$	—

During the three months ended March 31, 2018, the Company recognized $1,344 of stock-based compensation expense attributable to the amortization of warrants. As of March 31, 2018, total unrecognized stock-based compensation expense related to non-vested stock warrants was $13,094. The unrecognized expense is expected to be recognized over a weighted average period of 3.76 years and the weighted average remaining contractual term of the outstanding warrants and exercisable warrants at March 31, 2018 is 0.51 years and 0.31 years, respectively.

NOTE 6 - COMMITMENTS AND CONTINGENCIES

Lease Commitment

The Company leases office facilities under an operating lease agreement that expires October 31, 2022. As of March 31, 2018, the lease agreement requires future payments as follows:

Year	Amount
2018	$94,484
2019	128,348
2020	130,717
2021	133,087
2022	112,551
Total	$594,187

Total base rental expense was $30,150, and $31,748 for the three months ended March 31, 2018 and March 31, 2017, respectively. The Company does not have any capital leases or other operating lease commitments.

Employment Commitments

In March 2017, the Company's compensation committee approved revised compensation arrangements for John P. Boylan, Chairman, Chief Executive Officer and President of the Company. The principal terms of Mr. Boylan's compensation, as so revised, include (i) an annual base salary of $250,000, effective January 1, 2017, with $10,000 per month being payable on a current basis, and full salary and accrued unpaid salary being payable at such time as the compensation committee determines that the Company has sufficient financial capability to pay such amounts; (ii) annual bonuses as determined by the compensation committee; (iii) grant, pursuant to the Company's Production Incentive Compensation Plan, of a 1% interest in the Company revenues from all wells drilled on the Company's Reeves County, Texas acreage; and (iv) grant of a stock option to purchase 500,000 shares of common stock. During 2017, the compensation committee determined that the Company had sufficient financial capability to pay all deferred and accrued salary at which time such accrued amount was paid and the Company began paying the full annual base salary.

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

Forward-Looking Information

This Form 10-Q quarterly report of Houston American Energy Corp. (the "Company") for the three months ended March 31, 2018, contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbors created thereby. To the extent that there are statements that are not recitations of historical fact, such statements constitute forward-looking statements that, by definition, involve risks and uncertainties. In any forward-looking statement, where we express an expectation or belief as to future results or events, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will be achieved or accomplished.

The actual results or events may differ materially from those anticipated and as reflected in forward-looking statements included herein. Factors that may cause actual results or events to differ from those anticipated in the forward-looking statements included herein include the Risk Factors described in Item 1A herein and in our Form 10-K for the year ended December 31, 2017.

Readers are cautioned not to place undue reliance on the forward-looking statements contained herein, which speak only as of the date hereof. We believe the information contained in this Form 10-Q to be accurate as of the date hereof. Changes may occur after that date, and we will not update that information except as required by law in the normal course of our public disclosure practices.

Additionally, the following discussion regarding our financial condition and results of operations should be read in conjunction with the financial statements and related notes contained in Item 1 of Part 1 of this Form 10-Q, as well as the Risk Factors in Item 1A and the financial statements in Item 7 of Part II of our Form 10-K for the fiscal year ended December 31, 2017.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. We believe certain critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements. A description of our critical accounting policies is set forth in our Form 10-K for the year ended December 31, 2017. As of, and for the three months ended, March 31, 2018, there have been no material changes or updates to our critical accounting policies.

Unevaluated Oil and Gas Properties

Unevaluated oil and gas properties not subject to amortization, include the following at March 31, 2018:

	March 31, 2018
Acquisition costs	$141,319
Development and evaluation costs	2,171,533
Total	$2,312,852

All of the carrying value of unevaluated oil and gas prospects above was attributable to properties in the South American country of Colombia. We are maintaining our interest in these properties.

Recent Developments

Drilling Activity

During the quarter ended March 31, 2018, we drilled no wells. At March 31, 2018, no drilling operations were ongoing.

During the quarter ended March 31, 2018, our capital investment expenditures totaled $7,277, principally relating to our two lease blocks in Reeves County, Texas. At March 31, 2018, we were in discussions with the operator, and principal owner, of those blocks regarding drilling of an additional well.

Our operator in Colombia is continuing discussions with federal and local officials in order to either secure necessary permits and drill on our Serrania concession or to secure compensation for the value of, and our investment in, the concession. Pending resolution of such discussions, no drilling activities are presently contemplated on our Colombian concessions.

Results of Operations

Oil and Gas Revenues. Total oil and gas revenues increased 1,209% to $754,157 in the three months ended March 31, 2018 compared to $57,633 in the three months ended March 31, 2017. The increase in revenue was due to increased production volumes attributable to our two initial Reeves County wells and improved commodity pricing, including a 27% increase in crude oil prices realized and a 24% increase in natural gas prices realized.

The following table sets forth the gross and net producing wells, net oil and gas production volumes and average hydrocarbon sales prices for the quarters ended March 31, 2018 and 2017:

	Three Months Ended March 31,	
	2018	2017
Gross producing wells	10	9
Net producing wells	0.98	0.47
Net oil production (Bbl)	7,978	876
Net gas production (Mcf)	63,409	4,590
Average sales price – oil (per barrel)	$60.85	$47.91
Average sales price – natural gas (per Mcf)	$4.24	$3.42

The increase in production reflects a full quarter of production from our two Reeves County wells, which had not yet been drilled during the first quarter of 2017, partially offset by natural decline rates and abandonment of a well in Matagorda County, Texas. The change in average sales prices realized reflects increasing global commodity prices.

Oil and gas sales revenues by region were as follows:

	Colombia	U.S.	Total
2018 First Quarter			
Oil sales	$ —	$485,432	$485,432
Gas sales	$ —	$268,625	$268,625
2017 First Quarter			
Oil sales	$ —	$41,959	$41,959
Gas sales	$ —	$15,674	$15,674

Lease Operating Expenses. Lease operating expenses increased 1,037% to $263,585 during the three months ended March 31, 2018 from $23,154 during the three months ended March 31, 2017. The change in total lease operating expenses was attributable to operation of our two new Reeves County wells. Lease operating expenses, by region were as follows:

	Colombia	U.S.	Total
2018 First Quarter	$ —	$263,585	$263,585
2017 First Quarter	$ —	$23,154	$23,154

Consistent with our business model and operating history, we experience steep declines in lease operating expenses following strategic divestitures and anticipate lease operating expenses to ramp up to levels consistent with regional costs as new wells are brought on line.

Depreciation and Depletion Expense. Depreciation and depletion expense was $96,710 and $17,696 for the three months ended March 31, 2018 and 2017, respectively. The change in depreciation and depletion was due to an increased depletion base and higher production rates, both attributable to the Reeves County wells.

General and Administrative Expenses. General and administrative expense decreased by 6% to $421,724 during the three months ended March 31, 2018 from $449,343 during the three months ended March 31, 2017. The decrease in general and administrative expense was primarily attributable to a reduction in cost associated with acquisition and financing activities in 2017.

Stock-Based Compensation. Stock-based compensation decreased by 64% to $25,349 during the three months ended March 31, 2018 from $69,954 during the three months ended March 31, 2017. The decrease was attributable to a lower stock price during 2018, resulting in a lower value of options granted.

Financial Condition

Liquidity and Capital Resources. At March 31, 2018, we had a cash balance of $208,559 and working capital of $587,179, compared to a cash balance of $392,062 and working capital of $591,703 at December 31, 2017. The change in cash and working capital during the period was primarily attributable to the loss during the three months ended March 31, 2018, payments of dividends on preferred stock and payments with respect to properties.

Operating activities used cash of $110,376 during the three months ended March 31, 2018 compared to $361,938 during the three months ended March 31, 2017. The change in operating cash flow was primarily attributable to a reduced net loss, which reflects an increase in operating revenue from our two new Reeves County wells, partially offset by net changes in current assets and liabilities.

Investing activities used $7,277 during the three months ended March 31, 2018 compared to $997,985 used during the three months ended March 31, 2017. The decrease in funds used by investing activities is attributable to the acquisition of the Reeves County acreage during the 2017 quarter.

Financing activities used $62,850 during the three months ended March 31, 2018 compared to $1,200,000 provided during the quarter ended March 31, 2017. The change in cash flows from financing activities reflects the receipt, during 2017, of proceeds from the sale of Series A Preferred Stock and the payment, during 2018 of dividends on our preferred stock.

Long-Term Liabilities. At March 31, 2018, we had long-term liabilities of $84,358 compared to $84,903 at December 31, 2017. Long-term liabilities at March 31, 2018 and December 31, 2017, consisted of a reserve for plugging costs and deferred rent obligation.

Capital and Exploration Expenditures and Commitments. Our principal capital and exploration expenditures during 2018 are expected to relate to drilling additional wells on our Reeves County acreage and possibly opportunistic acquisitions of additional acreage in the Permian Basin. We plan to drill additional wells on our Reeves County acreage during 2018. The actual timing and number of wells drilled during 2018 will be principally controlled by Founders Oil & Gas, operator of the Reeves County acreage, based on a number of factors, including but not limited to availability of financing, performance of existing wells on the acreage, energy prices and industry condition and outlook, costs of drilling and completion services and equipment and other factors beyond our control or that of Founders.

During the three months ended March 31, 2018, we invested $7,277, net, for the acquisition and development of oil and gas properties, consisting of (1) cost of development of U.S. properties of $3,766, net, principally attributable to acreage acquired in Reeves County, Texas, and (2) preparation and evaluation costs in Colombia of $3,511. Of the amount invested, we capitalized $3,511 to oil and gas properties not subject to amortization and capitalized $3,766 to oil and gas properties subject to amortization. Capital investments during the quarter ended March 31, 2018 were reduced pending proposal of a new well in Reeves County.

As our allocable share of well costs will vary depending on the timing and number of wells drilled as well as our working interest in each such well and the level of participation of other interest owners, we have not as yet established a drilling budget for 2018. With the completion of sales lines and other infrastructure serving our Reeves County acreage and experience gained from drilling our initial wells, we anticipate that costs to drill and bring future wells onto production will decrease, and delays in bringing production on line will be minimized or eliminated, as compared to our experience in bringing our initial wells onto production.

Our cash holdings, together with revenues from our initial Reeves County wells, are expected to be adequate to support operations during 2018 but are not adequate to fund our share of drilling and completion costs on any wells that may be drilled in Reeves County in 2018.

Given the delays in proposing new Reeves County wells by Founders, we are actively seeking opportunities to acquire additional acreage or other strategic transactions with a view to adding scale to our operations.

In order to fund our estimated drilling and completion of wells on our Reeves County acreage, or costs of any acquisitions or other operations we may participate in, during 2018, and beyond, we expect that we will be required to raise additional capital.

While we may, among other efforts, pursue additional sales of shares in our ATM Offering, private sales of equity and debt securities and may realize additional funding from exercise of outstanding warrants, we presently have no commitments to provide additional funding, through the exercise of warrants or otherwise, and there can be no assurance that we can secure the necessary capital to fund our share of drilling, acquisition or other costs on acceptable terms or at all. If, for any reason, we are unable to fund our share of drilling and completion costs and fail to satisfy commitments relative to our interest in our Reeves County, or other, acreage, we may be subject to penalties or to the possible loss of some of our rights and interests in prospects with respect to which we fail to satisfy funding commitments and we may be required to curtail operations and forego opportunities.

Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements or guarantees of third party obligations at March 31, 2018.

Inflation

We believe that inflation has not had a significant impact on operations since inception.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Commodity Price Risk

The price we receive for our oil and gas production heavily influences our revenue, profitability, access to capital and future rate of growth. Crude oil and natural gas are commodities and, therefore, their prices are subject to wide fluctuations in response to relatively minor changes in supply and demand. Historically, the markets for oil and gas have been volatile, and these markets will likely continue to be volatile in the future. The price we receive for production depends on numerous factors beyond our control.

We have not historically entered into any hedges or other transactions designed to manage, or limit, exposure to oil and gas price volatility.

ITEM 4 CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Under the supervision and the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation as of March 31, 2018 of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were not effective as of March 31, 2018. Such conclusion reflects the 2013 departure of our chief financial officer and assumption of duties of principal financial officer by our chief executive officer and the resulting lack of segregation of duties. Until we are able to remedy these material weaknesses, we are relying on third party consultants and our accounting firm to assist with financial reporting.

Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the quarter ended March 31, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

ITEM 6 EXHIBITS

Exhibit Number	Description
31.1	Certification of CEO and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of CEO and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

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

	HOUSTON AMERICAN ENERGY CORP.
Date: May 14, 2018	
	By: */s/ John Boylan*
	John Boylan
	CEO and President (Principal Executive Officer and Principal Financial Officer)

mily:Times New Roman" SIZE="2"> 7,336 3,600 49.1

Interest expense

(164) (4,798) 4,634 96.6

Income before provision for income taxes

121,502 121,532 (30)

Provision for income taxes

34,249 42,811 (8,562) (20.0)

Net income

$87,253 $78,721 $8,532 10.8%

Gross profit margin subscriptions

93.2% 93.1%

Gross profit margin training and services

35.7% 38.2%

Gross profit margin

84.8% 83.7%

As a % of total revenue:

Subscription revenue

85.4% 82.9%

Training and services revenue

14.6% 17.1%

Sales and marketing expense

36.4% 36.6%

Research and development expense

19.8% 19.9%

General and administrative expense

13.9% 14.6%

Litigation settlement

1.2%

Total operating expenses

71.4% 71.1%

Income from operations

13.4% 12.6%

Interest income

1.4% 5.6%

Other income, net

1.5% 1.1%

Income before provision for income taxes

16.2% 18.6%

Net income

11.7% 12.1%

Effective income tax rate

28.2% 35.2%

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Revenue

Subscription revenue

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat enterprise technologies, increased by 18.0% or $97.4 million to $638.7 million for the year ended February 28, 2010 from $541.2 million for the year ended February 28, 2009. 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 received from customers for consulting services 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 decreased by 1.6% or $1.8 million to $109.6 million for the year ended February 28, 2010 from $111.4 million for the year ended February 28, 2009. Training revenue decreased 8.3% or $3.7 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 3.0% or $2.0 million. Combined training and services revenue decreased as a percentage of total revenue to 14.6% for the year ended February 28, 2010 from 17.1% for the year ended February 28, 2009.

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 16.5% or $6.2 million to $43.4 million for the year ended February 28, 2010 from $37.3 million for the year ended February 28, 2009. 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 increased to 93.2% for the year ended February 28, 2010 from 93.1% for the year ended February 28, 2009 as we leveraged existing infrastructure to deliver support and maintenance to our growing subscriber base.

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 2.3% or $1.6 million to $70.4 million for the year ended February 28, 2010 from $68.9 million for the year ended February 28, 2009. The cost to deliver training decreased 2.8% or $0.8 million to $26.7 million for the year ended February 28, 2010 compared to $27.5 million for the year ended February 28, 2009. The overall decrease in training costs was driven by a decrease in external training costs such as rental expense for offsite training rooms and outsourced instructors in response to reduced demand for our training services during the first half of fiscal 2010. Costs to deliver our services revenue increased by 5.6% or $2.3 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 64.3% for the year ended February 28, 2010 from 61.8% for the year ended February 28, 2009.

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Gross profit

Primarily as a result of changes in mix, with a greater proportion of our total revenue generated by subscription revenue, gross profit margin increased to 84.8% for the year ended February 28, 2010 from 83.7% for the year ended February 28, 2009. Training and services revenue decreased as a percentage of total revenue to 14.6% for the year ended February 28, 2010 from 17.1% for the year ended February 28, 2009.

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 14.3% or $34.2 million to $272.7 million for the year ended February 28, 2010 from $238.6 million for the year ended February 28, 2009. This increase was partially due to a $23.3 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 $10.8 million or 23.4% for the year ended February 28, 2010 as compared to the year ended February 28, 2009. The increase in marketing costs includes $6.3 million related to increased advertising and tradeshow expenditures. Sales and marketing expense as a percentage of revenue decreased to 36.4% for the year ended February 28, 2010 from 36.6% for the years ended February 28, 2009 as we leveraged our existing infrastructure to generate increased sales.

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 14.0% or $18.2 million to $148.4 million for the year ended February 28, 2010 from $130.2 million for the year ended February 28, 2009. The increase in research and development costs primarily resulted from the expansion of our engineering group through direct hires and the acquisition of businesses and technologies. Employee compensation increased by $13.7 million. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased $4.1 million. Research and development expense was 19.8% and 19.9% of total revenue for the year ended February 28, 2010 and February 28, 2009, respectively.

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 9.5% or $9.0 million to $104.2 million for the year ended February 28, 2010 from $95.2 million for the year ended February 28, 2009. Increased headcount across all functions to help the business scale increased employee compensation costs by $2.4 million for the year ended February 28, 2010 as compared to the year ended February 28, 2009. The remaining net increase in general and administrative expenses of $6.6 million for the year ended February 28, 2010 as compared to the year ended February 28, 2009, relates to increased outside services fees of $3.1 million, which were primarily for outside legal services, and $3.6 million for process and technology infrastructure enhancements, including incremental depreciation and amortization charges. General and administrative expense decreased as a percentage of revenue to 13.9% for the year ended February 28, 2010 from 14.6% for the year ended February 28, 2009 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 year ended February 28, 2010 represents our portion of the payment pursuant to such agreement in principle. For a discussion of this matter, see Legal Proceedings .

Interest income

Interest income decreased by 71.5% or $26.1 million to $10.4 million for the year ended February 28, 2010 from $36.5 million for the year ended February 28, 2009. The decrease in interest income for the year ended February 28, 2010 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 repurchases of our common stock.

Interest expense

Interest expense for the year ended February 28, 2009 primarily consisted of interest and the related amortization of deferred debt issuance costs associated with the convertible debentures and totaled $4.8 million. 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 year ended February 28, 2010.

Other income, net

Other income, net increased by 49.1% or $3.6 million to $10.9 million for the year ended February 28, 2010 from $7.3 million for the year ended February 28, 2009. The increase is primarily due to an increase in gains realized from the sale of our investments in available-for-sale equity securities for the year ended February 28, 2010.

Income taxes

During the year ended February 28, 2010, we recorded $34.2 million of income tax expense, which resulted in an annual effective tax rate of 28.2%. Our income tax expense for the year ended February 28, 2010 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 annual effective tax rate was 34.2%, which differs from the U.S. federal statutory rate of 35.0% primarily due to foreign income taxed at different rates and foreign tax credits which were partially offset by state income tax expense.

The provision for income tax for the year ended February 28, 2010 consists of $24.8 million of U.S. income tax expense and $9.4 million of foreign income tax expense. During the year ended February 28, 2009, we recorded $42.8 million of income tax expense, which resulted in an annual effective tax rate of 35.2%. Our effective tax rate differed from the U.S. federal statutory rate of 35.0% primarily due to state income taxes which were partially offset by foreign income taxed at different rates and certain nonrecurring income tax deductions. The provision for income tax for the year ended February 28, 2009 consisted of $41.2 million of U.S. income tax expense and $1.6 million of foreign income tax expense.

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Years ended February 28, 2009 and February 29, 2008

The following table is a summary of our results of operations for the years ended February 28, 2009 and February 29, 2008 (in thousands):

	Year Ended February 28, 2009	Year Ended February 29, 2008	$ Change	% Change
Revenue:				
Subscriptions	$ 541,210	$ 449,811	$ 91,399	20.3%
Training and services	111,362	73,205	38,157	52.1
Total subscription and training and services revenue	652,572	523,016	129,556	24.8
Cost of subscription and training and services revenue:				
Cost of subscriptions	37,267	33,581	3,686	11.0
As a % of subscription revenue	6.9%	7.5%		
Cost of training and services	68,859	47,072	21,787	46.3
As a % of training and services revenue	61.8%	64.3%		
Total cost of subscription and training and services revenue	106,126	80,653	25,473	31.6
As a % of total revenue	16.3%	15.4%		
Total gross profit	546,446	442,363	104,083	23.5
Operating expense:				
Sales and marketing	238,552	192,049	46,503	24.2
Research and development	130,177	97,417	32,760	33.6
General and administrative	95,196	82,525	12,671	15.4
Total operating expense	463,925	371,991	91,934	24.7
Income from operations	82,521	70,372	12,149	17.3
Interest income	36,473	58,541	(22,068)	(37.7)
Other income, net	7,336	1,879	5,457	290.4
Interest expense	(4,798)	(6,252)	1,454	23.3
Income before provision for income taxes	121,532	124,540	(3,008)	(2.4)
Provision for income taxes	42,811	47,873	(5,062)	(10.6)
Net income	$ 78,721	$ 76,667	$ 2,054	2.7%
Gross profit margin subscriptions	93.1%	92.5%		
Gross profit margin training and services	38.2%	35.7%		
Gross profit margin	83.7%	84.6%		
As a % of total revenue:				
Subscription revenue	82.9%	86.0%		
Training and services revenue	17.1%	14.0%		
Sales and marketing expense	36.6%	36.7%		
Research and development expense	19.9%	18.6%		
General and administrative expense	14.6%	15.8%		
Total operating expenses	71.1%	71.1%		
Income from operations	12.6%	13.5%		
Interest income	5.6%	11.2%		

Other income, net	1.1%	0.4%
Income before provision for income taxes	18.6%	23.8%
Net income	12.1%	14.7%
Effective income tax rate	35.2%	38.4%

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Revenue

Subscription revenue

Subscription revenue increased by 20.3% or $91.4 million to $541.2 million for the year ended February 28, 2009 from $449.8 million for the year ended February 29, 2008. The increase in subscription revenue was primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion, and continuing innovation, which attracted new customers and helped drive renewals from existing customers.

Training and services revenue

Total training and services revenue increased by 52.1% or $38.2 million to $111.4 million for the year ended February 28, 2009 from $73.2 million for the year ended February 29, 2008. Training revenue increased 7.4% or $3.1 million as a result of continued demand for Red Hat Certified Engineers, Technicians and Architects. Additionally, we enabled more resellers to provide our training which increased the availability of training classes. Services revenue increased by 112.7% or $35.0 million primarily as a result of Amentra, which provided an additional $30.1 million of consulting revenue. As a result of increased demand for training and continued investment in our services capabilities, training and services revenue increased as a percentage of total revenue to 17.1% for the year ended February 28, 2009 from 14.0% for the year ended February 29, 2008.

Cost of revenue

Cost of subscription revenue

Cost of subscription revenue increased by 11.0% or $3.7 million to $37.3 million for the year ended February 28, 2009 from $33.6 million for the year ended February 29, 2008. The increase was 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 increased to 93.1% for the year ended February 28, 2009 from 92.5% for the year ended February 29, 2008.

Cost of training and services revenue

Cost of training and services revenue increased by 46.3% or $21.8 million to $68.9 million for the year ended February 28, 2009 from $47.1 million for the year ended February 29, 2008. The cost to deliver training increased 8.5% or $2.1 million to $27.5 million for the year ended February 28, 2009 compared to $25.3 million for the year ended February 29, 2008. The increase in training costs were directly related to increased training revenue as the costs to deliver training as a percentage of training revenue was unchanged at 60.1% for each of the years ended February 28, 2009 and February 29, 2008. Costs to deliver our services revenue increased 86.2% or $19.3 million primarily as a result of costs to deliver consulting services related to Amentra, which added $17.6 million to the year-over-year increase. The remaining increase in costs to deliver services resulted from increased staffing to meet the growing demand for our existing consulting services. Costs to deliver training and services as a percentage of training and services revenue decreased to 61.8% for the year ended February 28, 2009 from 64.3% for the year ended February 29, 2008 due to improved margins resulting from better labor and facilities utilization.

Gross profit

As a result of changes in mix, gross profit margin decreased slightly to 83.7% for the year ended February 28, 2009 from 84.6% for the year ended February 29, 2008. Training and services revenue increased as a percentage of total revenue to 17.1% for the year ended February 28, 2009 from 14.0% for the year ended February 29, 2008, primarily due to the acquisition of Amentra. Gross profit margin on services increased to 38.2% for the year ended February 28, 2009 from 35.7% for the year ended February 29, 2008. Additionally, gross profit margin on subscriptions continued to increase, growing to 93.1% for year ended February 28, 2009 from 92.5% for the year ended February 29, 2008.

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Operating expenses

Sales and marketing

Sales and marketing expense increased by 24.2% or $46.5 million to $238.6 million for the year ended February 28, 2009 from $192.0 million for the year ended February 29, 2008. This increase was primarily due to a $39.5 million increase in selling costs, of which $28.3 million relates to increased employee compensation, primarily due to expansion of our sales force from the prior year. Further, costs related to process and technology infrastructure enhancements and incremental amortization expense related to identifiable intangibles, including licensing agreements, trademarks and customer reseller relationships increased $9.9 million and include $3.0 million related to fees paid to outside contractors for processes and systems improvements. The remaining increase relates to marketing costs which increased $7.0 million or 17.8% for the year ended February 28, 2009 as compared to the year ended February 29, 2008. Sales and marketing expense as a percentage of revenue decreased slightly to 36.6% for the year ended February 29, 2008 from 36.7% for the year ended February 29, 2008.

Research and development

Research and development expense increased by 33.6% or $32.8 million to $130.2 million for the year ended February 28, 2009 from $97.4 million for the year ended February 29, 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 $20.1 million. The remaining increase in research and development costs relates to process and technology infrastructure enhancements, which increased $9.6 million, and an increase of $3.0 million in the cost related to facilities expansion. Research and development expense was 19.9% and 18.6% of total revenue for the year ended February 28, 2009 and February 29, 2008, respectively, as a result of continued investing to expand our capabilities in virtualization and other emerging technologies. Incremental costs described above related to Qumranet totaled $6.2 million for year ended February 28, 2009.

General and administrative

General and administrative expense increased by 15.4% or $12.7 million to $95.2 million for the year ended February 28, 2009 from $82.5 million for the year ended February 29, 2008. Increased headcount across all functions increased employee compensation related costs by $7.3 million. Technology infrastructure enhancements, including incremental depreciation and amortization charges, increased administrative costs by $3.2 million. The remaining increase is primarily increased facilities costs of $4.9 million. Partially offsetting these increases was a reduction in outside consulting fees of $2.1 million incurred during the year ended February 28, 2009. General and administrative expense decreased as a percentage of revenue to 14.6% for the year ended February 28, 2009 from 15.8% for the year ended February 29, 2008 as we continued to leverage our corporate functions.

Interest income

Interest income decreased by 37.7% or $22.1 million to $36.5 million for the year ended February 28, 2009 from $58.5 million for the year ended February 29, 2008. The decrease in interest income for the year ended February 28, 2009 was primarily 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.

Other income, net

Other income, net increased by 290.4% or $5.5 million to $7.3 million for the year ended February 28, 2009 from $1.9 million for the year ended February 29, 2008. The increase is primarily due to a $4.1 million realized gain on the repurchase of $284.5 million face-value convertible debentures.

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Interest expense

Interest expense primarily consisted of interest and the related amortization of deferred debt issuance costs associated with the convertible debentures and totaled $4.8 million and $6.3 million for the years ended February 28, 2009 and February 29, 2008, respectively. The decrease in interest expense resulted from the repurchase and redemption of an aggregate of $570.0 million of convertible debentures during the second half of fiscal 2009. The face amount of convertible debentures outstanding at February 29, 2008 totaled $570.0 million. No debentures were outstanding at February 28, 2009.

Income taxes

During the year ended February 28, 2009, we recorded $42.8 million of income tax expense, which resulted in an annual effective tax rate of 35.2%. Our annual effective tax rate of 35.2% differed from the U.S. Federal statutory rate of 35.0% primarily due to state income taxes which were partially offset by foreign income taxed at different rates and certain nonrecurring income tax deductions. The provision for income tax for the year ended February 28, 2009 consisted of $41.2 million of U.S. income tax expense and $1.6 million of foreign income tax expense. During the year ended February 29, 2008, we recorded $47.9 million of income tax expense, which resulted in an annual effective tax rate of 38.4%. Our effective tax rate differed from the U.S. federal statutory rate of 35% primarily due to state income taxes and the foreign income taxed at different rates. The provision for income tax for the year ended February 29, 2008 consisted of $42.3 million of U.S. income tax expense and $5.6 million of foreign income tax expense.

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 February 28, 2010, we had total cash and investments of $970.2 million, which was comprised of $388.1 million in cash and cash equivalents, $366.5 million of short-term, available-for-sale fixed-income investments, $4.7 million of available-for-sale equity securities, $209.4 million of long-term, available-for-sale fixed-income investments, and $1.5 million in certificates of deposit with maturity dates greater than 30 days. This compares to total cash and investments of $846.1 million at February 28, 2009.

We believe that we currently have sufficient liquidity with $388.1 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 February 28, 2010, we have accumulated unrealized gains of $1.7 million on our investments in debt securities compared to an accumulated unrealized gain of $0.3 million at February 28, 2009. At February 28, 2010 and February 28, 2009, accumulated unrealized gains related to short-term equity securities available for sale totaled $4.4 million and $4.7 million, respectively.

Year ended February 28, 2010

Cash flows overview

At February 28, 2010, cash and cash equivalents totaled $388.1 million, a decrease of $127.4 million as compared to February 28, 2009. The decrease in cash and cash equivalents for the year ended February 28, 2010 is a result of net cash used for investing and financing activities. During the year ended February 28, 2010, we repurchased 10,014,022 shares of our common stock at an average price of $23.61 per share totaling

$236.4 million, including transaction costs. Purchases of available-for-sale debt securities, net of proceeds from sales and maturities, totaled $254.4 million for the year ended February 28, 2010. 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 $255.2 million and $127.0 million, respectively for the year ended February 28, 2010. 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 $255.2 million during the year ended February 28, 2010 includes net income of $87.3 million, adjustments to exclude the impact of non-cash revenues and expenses, which totaled a $67.8 million net source of cash, and changes in working capital, which totaled a $100.2 million net source of cash. Cash provided by changes in operating assets and liabilities for the year ended February 28, 2010 was primarily the result of an increase in our deferred revenue which generated operating cash flow of $82.6 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 $82.6 million excludes the impact of foreign currency translation which increased our total consolidated deferred revenue by $20.2 million for the year ended February 28, 2010.

Cash flows from investing

Cash used in investing activities of $276.2 million for the year ended February 28, 2010 includes net purchases of investments in available-for-sale debt securities of $254.4 million. Investments in property and equipment, primarily related to process and information technology infrastructure enhancements, totaled $28.4 million for the year ended February 28, 2010. Investments in patents and externally developed technology totaled $4.7 million for the year ended February 28, 2010. Partially offsetting these investments were proceeds from the sale of available-for-sale equity securities which totaled $13.1 million for the year ended February 28, 2010.

Cash flows from financing

Cash used in financing activities of $110.2 million for the year ended February 28, 2010 includes $236.4 million used to repurchase 10,014,022 shares of our common stock at an average price of $23.61 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 year ended February 28, 2010 totaled $11.9 million. Partially offsetting financing activities using cash were excess tax benefits related to share-based employee compensation which totaled $35.6 million and proceeds from employees exercise of common stock options which totaled $103.3 million. Payments on other borrowings totaled $0.9 million for the year ended February 28, 2010.

Year ended February 28, 2009

Cash flows overview

At February 28, 2009, cash and cash equivalents totaled $515.5 million, a decrease of $162.2 million as compared to February 29, 2008. The decrease in cash and cash equivalents for the year ended February 28, 2009 is a result of net cash used for investing and financing activities. During the year ended February 28, 2009, we repurchased and redeemed for $565.6 million our convertible debentures with an aggregate face amount of $570.0 million and repurchased 2,875,052 million shares of our common stock at an average price of $14.70 per share totaling $42.3 million. Additionally, during the third quarter of fiscal 2009 we acquired Qumranet for net cash of $101.3 million. These significant investing and financing uses of cash were partially offset by cash generated from operating activities, which totaled $236.4 million for the year ended February 28, 2009, and proceeds from sales and maturities of our available-for-sale securities which, net of purchases, totaled $317.2

million for the year ended February 28, 2009. Net cash generated by operating activities and investing and used for financing activities are further described below.

Cash flows from operations

Cash provided by operations of $236.4 million during the year ended February 28, 2009 includes net income of $78.7 million, adjustments to exclude the impact of non-cash revenues and expenses, which totaled a $71.9 million net source of cash, and changes in working capital, which totaled a $85.8 million net source of cash. Cash provided by changes in operating assets and liabilities for the year ended February 28, 2009 was primarily the result of an increase in our deferred revenue which generated operating cash flow of $97.9 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 $97.9 million excludes the impact of foreign currency translation which reduced our total consolidated reported deferred revenue by $27.7 million for the year ended February 28, 2009.

Cash flows from investing

Cash provided by investing activities of $146.2 million for the year ended February 28, 2009 includes net proceeds from sales and maturities of investments in debt securities of $317.2 million and proceeds from the sale of investments in equity securities of $5.6 million. Partially offsetting these proceeds from the sale and maturity of investments were acquisitions of businesses and technologies which totaled $148.1 million, including our acquisition of Qumranet during the third quarter of fiscal 2009 for net cash of $101.3 million. The remaining $46.8 million of investment relates to businesses and technologies we acquired during the first and second quarters of fiscal 2009 to enhance our services capabilities in the middleware and security management markets. Investments in property and equipment, primarily related to process and information technology infrastructure enhancements, totaled $24.5 million for the year ended February 28, 2009. Investments in patents and externally developed technology totaled $3.9 million for the year ended February 28, 2009.

Cash flows from financing

Cash used in financing activities of $539.2 million for the year ended February 28, 2009 is comprised of $565.6 million used to repurchase and redeem our convertible debentures with an aggregate face amount of $570.0 million. Additionally, under our common stock repurchase program we repurchased 2,875,052 of our common stock at an average price of $14.70 per share using $42.3 million of cash. Purchases of treasury shares from employees to satisfy employee minimum tax withholding obligations related to restricted share awards vesting during the year ended February 28, 2009 totaled $2.7 million. Partially offsetting financing activities using cash were proceeds from excess tax benefits related to share-based employee compensation which totaled $51.1 million, proceeds from employees exercise of common stock options which totaled $18.4 million and proceeds from a structured stock repurchase transaction which totaled $2.0 million for the year ended February 28, 2009.

Convertible debentures

During the year ended February 28, 2009, we repurchased and redeemed all of our convertible debentures. As a result of the repurchase and redemption, there were no debentures or related accrued interest payable outstanding at February 28, 2009. Interest expense related to the debentures, including amortization of debt offering costs totaled $4.4 million and $5.9 million for the years ended February 28, 2009 and February 29, 2008, respectively.

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 February 28, 2010 and February 28, 2009, the vast majority of our

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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, 2011 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 $970.2 million of cash and investments held at February 28, 2010, 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 February 28, 2010 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.

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Contractual obligations

The following table summarizes our principal contractual obligations at February 28, 2010 (in thousands):

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating lease obligations	$ 89,170	$ 21,874	$ 27,691	$ 17,719	$ 21,886
Purchase obligations					
Other debt obligations, including related interest	1,575	1,000	575		
Total	$ 90,745	$ 22,874	$ 28,266	$ 17,719	$ 21,886

Because we are unable to reasonably estimate the timing of settlements and any future payments related to uncertain tax positions, such liabilities are not included in the above table. However, as of February 28, 2010, we have recognized a total of $23.6 million related to such liabilities, which are included in other long-term obligations on our Consolidated Balance Sheets.

RECENT ACCOUNTING PRONOUNCEMENTS

In January 2010 the FASB issued amended guidance to improve disclosure requirements related to Fair Value Measurements and Disclosures-Overall Subtopic 820-10 of the FASB Accounting Standards Codification (ASC 820-10) originally issued as FASB Statement No. 157, Fair Value Measurements. The amended guidance requires companies to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for such transfers. These additional disclosure requirements are effective for reporting periods beginning March 1, 2010.

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 adoption of the Codification had no significant impact on our consolidated financial statements.

ITEM 7A. 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 $7.1 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 $3.6 million decrease in the fair value of our available-for-sale investment securities as of February 28, 2010.

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 February 28, 2010 was $8.4 million. The fair value of these outstanding contracts at February 28, 2010 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 three months of the period ended February 28, 2010. The forward contracts will settle in Japanese yen, Swiss francs, Swedish krona, Czech koruna, Canadian dollars and Norwegian kroner.

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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 43.4% of our revenue for the year ended February 28, 2010 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component in determining net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decreases if the U.S. dollar strengthens against foreign currencies.

Impact on results of operations for the year ended February 28, 2010:

Using the average foreign currency exchange rates from our fiscal year ended February 28, 2009, our revenue and operating expenses from non-U.S. operations for the year ended February 28, 2010, would have been higher than we reported using the exchange rates from our fiscal year ended February 28, 2009 by approximately $0.6 million and $3.4 million, respectively, which would have resulted in income from operations being $2.8 million lower. For further discussion, see NOTE 2 to the Consolidated Financial Statements.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Company s internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of the end of the period covered by this report based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the Company s internal control over financial reporting was effective as of the end of the period covered by this report.

Our independent registered public accounting firm, which has audited the financial statements included in Part II, Item 8 of this report, has also audited the effectiveness of the Company s internal control over financial reporting as of February 28, 2010, as stated in their report, which is included below.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Red Hat, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of stockholders equity and comprehensive income and of cash flows present fairly, in all material respects, the financial position of Red Hat, Inc. and its subsidiaries at February 28, 2010 and February 28, 2009, and the results of their operations and their cash flows for each of the three years in the period ended February 28, 2010 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of February 28, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management s Report on Internal Control over Financial Reporting appearing in Item 8. Our responsibility is to express opinions on these financial statements and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 11 to the consolidated financial statements, the Company changed the manner in which it accounts for uncertain tax positions for the year ended February 29, 2008.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Raleigh, North Carolina
April 28, 2010

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RED HAT, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands except share and per share amounts)

	February 28, 2010	February 28, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 388,118	$ 515,548
Investments in debt and equity securities, short-term	372,656	147,178
Accounts receivable, net of allowances for doubtful accounts of $2,295 and $2,387, respectively	139,436	128,669
Prepaid expenses and other current assets	102,909	99,437
Total current assets	1,003,119	890,832
Property and equipment, net of accumulated depreciation and amortization of $116,971 and $91,140, respectively	71,708	67,913
Goodwill	438,749	438,109
Identifiable intangibles, net	108,213	122,177
Investments in debt securities, long-term	209,411	183,363
Other assets, net	39,672	51,242
Total assets	$ 1,870,872	$ 1,753,636
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 16,483	$ 9,576
Accrued expenses	68,334	54,123
Deferred revenue	480,572	382,050
Other current obligations	878	900
Total current liabilities	566,267	446,649
Deferred lease credits	4,184	4,470
Long-term deferred revenue	165,288	161,032
Other long-term obligations	24,081	35,432
Commitments and contingencies (NOTE 14)		
Stockholders equity:		
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, $0.0001 per share par value, 300,000,000 shares authorized, 215,161,306 and 207,794,700 shares issued, 187,351,195 and 189,998,611 shares outstanding at February 28, 2010 and February 28, 2009, respectively	22	21
Additional paid-in capital	1,444,848	1,281,469
Retained earnings	137,772	50,519
Treasury stock at cost, 27,810,111 and 17,796,089 shares at February 28, 2010 and February 28, 2009, respectively	(472,646)	(236,283)
Accumulated other comprehensive income	1,056	10,327
Total stockholders equity	1,111,052	1,106,053
Total liabilities and stockholders equity	$ 1,870,872	$ 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)

	Year Ended February 28, 2010	February 28, 2009	February 29, 2008
Revenue:			
Subscriptions	$ 638,654	$ 541,210	$ 449,811
Training and services	109,582	111,362	73,205
Total subscription and training and services revenue	748,236	652,572	523,016
Cost of subscription and training and services revenue:			
Cost of subscriptions	43,426	37,267	33,581
Cost of training and services	70,419	68,859	47,072
Total cost of subscription and training and services revenue	113,845	106,126	80,653
Gross profit	634,391	546,446	442,363
Operating expense:			
Sales and marketing	272,705	238,552	192,049
Research and development	148,360	130,177	97,417
General and administrative	104,227	95,196	82,525
Litigation settlement	8,750		
Total operating expense	534,042	463,925	371,991
Income from operations	100,349	82,521	70,372
Interest income	10,381	36,473	58,541
Other income, net	10,936	7,336	1,879
Interest expense	(164)	(4,798)	(6,252)
Income before provision for income taxes	121,502	121,532	124,540
Provision for income taxes	34,249	42,811	47,873
Net income	$ 87,253	$ 78,721	$ 76,667
Basic net income per common share	$ 0.46	$ 0.41	$ 0.40
Diluted net income per common share	$ 0.45	$ 0.39	$ 0.36
Weighted average shares outstanding			
Basic	187,845	190,772	193,485
Diluted	193,546	211,344	221,313

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

(in thousands)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at February 28, 2007			204,017	$ 20	$ 1,040,892	$ (92,092)	$ (125,789)	$ (1,795)	$ 821,236
Net income						76,667			76,667
Other comprehensive income:									
Unrealized gain on investments in marketable securities, net of tax								7,337	
Foreign currency translation adjustment, net of tax								(3,552)	
Other comprehensive income								3,785	3,785
Comprehensive income									80,452
Exercise of common stock options			1,715	1	15,512				15,513
Common stock repurchase							(67,157)		(67,157)
Share-based compensation expense					36,456				36,456
Tax benefits related to share-based awards					77,468				77,468
Adoption of ASC 740 subtopic 10, section 05-06 (formerly FIN 48)						(12,777)			(12,777)
Balance at February 29, 2008			205,732	$ 21	$ 1,170,328	$ (28,202)	$ (192,946)	$ 1,990	$ 951,191
Net income						78,721			78,721
Other comprehensive income:									
Unrealized loss on investments in marketable securities, net of tax								(272)	
Foreign currency translation adjustment, net of tax								8,609	
Other comprehensive income								8,337	8,337
Comprehensive income									87,058
Exercise of common stock options			2,063		18,355				18,355
Common stock repurchase							(42,318)		(42,318)
Structured stock repurchase					1,989				1,989
Share-based compensation expense					48,315				48,315
Tax benefits related to share-based awards					44,161				44,161
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards					(1,679)		(1,019)		(2,698)
Balance at February 28, 2009			207,795	$ 21	$ 1,281,469	$ 50,519	$ (236,283)	$ 10,327	$ 1,106,053
Net income						87,253			87,253
Other comprehensive income:									
Unrealized loss on investments in marketable securities, net of tax								(988)	

Foreign currency translation adjustment, net of tax						(8,283)	
Other comprehensive income						(9,271)	(9,271)
Comprehensive income							77,982
Exercise of common stock options	7,366	1	103,332				103,333
Common stock repurchase					(236,363)		(236,363)
Share-based compensation expense			48,288				48,288
Tax benefits related to share-based awards			23,614				23,614
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards			(11,855)				(11,855)
Balance at February 28, 2010	215,161	$ 22	$ 1,444,848	$ 137,772	$ (472,646)	$ 1,056	$ 1,111,052

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended		
	February 28, 2010	**February 28, 2009**	**February 29, 2008**
Cash flows from operating activities:			
Net income	$ 87,253	$ 78,721	$ 76,667
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	45,861	40,309	33,002
Deferred income taxes	20,636	38,979	41,211
Excess tax benefits from share-based payment arrangements	(35,569)	(51,137)	(61,247)
Share-based compensation expense	48,288	48,315	36,457
Gain from repurchase of convertible debentures		(4,129)	
Amortization of debt issuance costs		2,319	3,010
Net gain on sale of investments	(12,656)	(3,848)	(4,799)
Other	1,248	1,094	1,092
Changes in operating assets and liabilities net of effects of acquisitions:			
Accounts receivable	(7,290)	(2,341)	(33,741)
Prepaid expenses and other current assets	3,147	(18,968)	(7,761)
Accounts payable	6,569	(7,275)	4,713
Accrued expenses	15,423	17,056	1,600
Deferred revenue	82,625	97,861	113,138
Other assets, net	(286)	(517)	(266)
Net cash provided by operating activities	255,249	236,439	203,076
Cash flows from investing activities:			
Purchase of investment in debt securities available-for-sale	(666,890)	(396,810)	(1,173,012)
Proceeds from sales and maturities of investment in debt securities available-for-sale	412,514	714,015	1,155,854
Acquisitions of businesses, net of cash acquired		(148,140)	(11,784)
Proceeds from sales of investment in equity securities available for sale	13,053	5,568	6,199
Purchase of strategic equity investments	(1,768)		
Purchase of developed software and other intangible assets	(4,692)	(3,932)	(5,616)
Purchase of property and equipment	(28,420)	(24,485)	(41,797)
Net cash provided by (used in) investing activities	(276,203)	146,216	(70,156)
Cash flows from financing activities:			
Excess tax benefits from share-based payment arrangements	35,569	51,137	61,247
Redemption and repurchase of convertible debentures		(565,558)	
Proceeds from exercise of common stock options	103,332	18,355	15,512
Purchase of treasury stock	(236,393)	(42,319)	(67,157)
Structured stock repurchase		1,989	
Proceeds from other borrowings			2,898
Payments on other borrowings	(900)	(69)	(756)
Payments related to settlement of employee shared-based awards	(11,855)	(2,698)	
Net cash provided by (used in) financing activities	(110,247)	(539,163)	11,744
Effect of foreign currency exchange rates on cash and cash equivalents	3,771	(5,664)	5,817

Net increase (decrease) in cash and cash equivalents	(127,430)	(162,172)	150,481
Cash and cash equivalents at beginning of year	515,548	677,720	527,239
Cash and cash equivalents at end of year	$ 388,118	$ 515,548	$ 677,720
Supplemental cash flow information:			
Cash paid during the year for:			
Interest	$ 129	$ 2,475	$ 2,850
Income taxes	$ 5,730	$ 4,950	$ 6,895

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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.

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

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 treated 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.

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.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 years ended February 28, 2010, February 28, 2009 and February 29, 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 years ended February 28, 2010, February 28, 2009 and February 29, 2008, no significant impairment losses related to the Company s long-lived assets were identified.

Cash and Cash Equivalents

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

Accounts Receivable and Allowance for Doubtful Accounts

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

Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for such asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs. To measure fair value, the Company uses the following fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable:

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

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 February 28, 2010 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.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 February 28, 2010 (in thousands):

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

(1) Included in either cash and cash equivalents or investments in debt and equity securities in the Company s Consolidated Balance Sheet at February 28, 2010, in addition to $62.4 million of cash.
(2) Included in prepaid expenses and other current assets in the Company s Consolidated Balance Sheet at February 28, 2010.
(3) Included in accrued expenses in the Company s Consolidated Balance Sheet at February 28, 2010.

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 (1)	6,022	6,022		

Foreign currency derivatives (2)	30		30	
Liabilities:				
Foreign currency derivatives (3)	(64)		(64)	
Total	$ 774,451	$ 440,817	$ 333,634	$

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(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.

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

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

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

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

		Gross Unrealized			Balance Sheet Classification		
	Amortized Cost	Gains	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
Certificates 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.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the stated maturities of the Company s investments at February 28, 2010 (in thousands):

	Total	Less than 1 Year	2-3 Years	4-5 Years	More than 5 Years
Maturity of Short and Long Term Investments	$ 577,380	$ 368,007	$ 206,870	$ 2,503	$

Internal Use Software

The Company capitalized $8.3 million, $9.9 million and $12.7 million in costs related to the development of internal use software for its website, enterprise resource planning system and systems management applications during years ended February 28, 2010, February 28, 2009 and February 29, 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.

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 February 28, 2010 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, three to four years; computer software, five years; leasehold improvements, over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease. Expenditures for maintenance and repairs are charged to operations as incurred; major expenditures for renewals and betterments are capitalized and depreciated. Property and equipment acquired under capital leases are depreciated over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease.

Share-Based Compensation

The Company measures share-based compensation cost at grant date, based on the estimated fair value of the award and recognizes the cost over the employee requisite service period typically on a straight-line basis, net of estimated forfeitures. The Company estimates the fair value of stock options using the Black-Scholes-Merton valuation model.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 (in thousands):

	Year Ended February 28, 2010	Year Ended February 28, 2009	Year Ended February 29, 2008
Cost of revenue	$ 3,630	$ 3,065	$ 2,393
Sales and marketing	14,041	13,826	10,193
Research and development	13,614	14,027	8,717
General and administrative	17,003	17,397	15,154
Total share-based compensation expense	$ 48,288	$ 48,315	$ 36,457

Share-based compensation expense qualifying for capitalization was insignificant for each of the Company s fiscal years ended February 28, 2010, February 28, 2009 and February 29, 2008. Accordingly, no share-based compensation expense was capitalized during these years.

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

The Company s share-based compensation is described further in NOTE 13 to the Consolidated Financial Statements.

Sales and Marketing Expenses

Sales and marketing expenses consist of costs, including salaries, sales commissions and related expenses, such as travel, of all personnel involved in the sales and marketing process. Sales and marketing expenses also include costs of advertising, sales lead generation programs, cooperative marketing arrangements and trade shows. Payments made to resellers or other customers are reported in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Section 605-50 Customer Payments and Incentives (formerly referenced as Emerging Issues Task Force Issue Number 01-09, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products)) (ASC 605-50). All costs of advertising, to the extent allowable by ASC 605-50, are expensed as incurred. Advertising expense totaled $23.5 million, $18.1 million, and $18.0 million for the years ended February 28, 2010, February 28, 2009 and February 29, 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.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred Taxes

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

The Company continues to assess the realizability of its deferred tax assets, which primarily consist of share-based compensation expense deductions, tax credit carryforwards and deferred revenue. In assessing the realizability of these deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. As of February 28, 2010, the net deferred tax asset balance was $79.7 million, of which $6.8 million was offset by a valuation allowance. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign net operating loss (NOL) carryforwards.

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

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

The Company s income tax expense and deferred taxes are described further in NOTE 11 to the Consolidated Financial Statements.

Foreign Currency Translation

The Euro has been determined to be the primary functional currency for the Company s European operations and local currencies have been determined to be the functional currencies for the Company s Asia Pacific and South American operations. Foreign exchange gains and losses, which result from the process of remeasuring foreign currency transactions into the appropriate functional currency, are included in other income, net in the Company s Consolidated Statements of Operations. Net foreign exchange gains and losses included in other income were a $0.6 million gain, a $0.3 million loss and a $2.2 million loss for the years ended February 28, 2010, February 28, 2009 and February 29, 2008, 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

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 February 28, 2010, no individual customer accounted for more than 10% of the Company s accounts receivable. For the years ended February 28, 2010, February 28, 2009 and February 29, 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 years ended February 28, 2009 and February 29, 2008, assumes the conversion of the convertible debentures using the if converted method. For the year ended February 28, 2010, 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.

The following table reconciles the numerators and denominators of the earnings per share calculation for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 (in thousands, except per share amounts):

		Year Ended	
	February 28, 2010	**February 28, 2009**	**February 29, 2008**
Diluted net income per share computation:			
Net income	$ 87,253	$ 78,721	$ 76,667
Interest expense on convertible debt, net of related tax		1,413	1,754
Amortization of debt issuance costs, net of related tax		1,463	1,853
Net income diluted	$ 87,253	$ 81,597	$ 80,274
Weighted average common shares outstanding	187,845	190,772	193,485
Incremental shares attributable to assumed vesting or exercise of outstanding equity awards	5,701	4,942	5,555
Incremental shares attributable to assumed conversion of convertible debentures		15,630	22,273
Diluted shares	193,546	211,344	221,313
Diluted net income per share	$ 0.45	$ 0.39	$ 0.36

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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):

	Year Ended		
	February 28, 2010	February 28, 2009	February 29, 2008
Number of shares considered anti-dilutive for calculating diluted EPS	3,525	9,269	3,970

Segment Reporting

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

The Company has offices in more than 65 locations around the world. The Company manages its international business on an Americas-wide, EMEA-wide and Asia Pacific-wide basis. The following disclosure aggregates immaterial international operations and separately discloses the significant international operations at and for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 (in thousands):

	Americas	EMEA	Asia Pacific	Total
	Year Ended February 28, 2010			
Revenue from unaffiliated customers	$ 474,633	$ 168,134	$ 105,469	$ 748,236
Net income	$ 62,849	$ 20,263	$ 4,141	$ 87,253
Total assets	$ 1,566,140	$ 205,097	$ 99,635	$ 1,870,872
	Year Ended February 28, 2009			
Revenue from unaffiliated customers	$ 421,994	$ 141,679	$ 88,899	$ 652,572
Net income (loss)	$ 73,120	$ 11,552	$ (5,951)	$ 78,721
Total assets	$ 1,539,840	$ 142,539	$ 71,257	$ 1,753,636
	Year Ended February 29, 2008			
Revenue from unaffiliated customers	$ 340,488	$ 111,341	$ 71,187	$ 523,016
Net income (loss)	$ 81,065	$ 3,225	$ (7,623)	$ 76,667
Total assets	$ 1,886,376	$ 129,662	$ 63,944	$ 2,079,982

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table lists, for the years ended February 28, 2010, February 28, 2009 and February 29, 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.

	Year Ended February 28, 2010	Year Ended February 28, 2009	Year Ended February 29, 2008
United States, the Company s country of domicile	$ 423,295	$ 385,556	$ 316,488
Japan	60,725	50,531	40,425
Other foreign	264,216	216,485	166,103
Total revenue from unaffiliated customers	$ 748,236	$ 652,572	$ 523,016

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 for the years ended February 28, 2010 and February 28, 2009:

	As of February 28, 2010	As of February 28, 2009
United States, the Company s country of domicile	$ 51,523	$ 53,106
Foreign	20,185	14,807
Total tangible long-lived assets	$ 71,708	$ 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 years ended February 28, 2010, February 28, 2009 and February 29, 2008 was as follows (in thousands):

		Year Ended	
	February 28, 2010	February 28, 2009	February 29, 2008
Comprehensive income:			
Net income	$ 87,253	$ 78,721	$ 76,667
Foreign currency translation adjustments, net of taxes	(8,283)	8,609	(3,552)
Change in unrealized gains (losses) on marketable securities, net of taxes	(988)	(272)	7,337
Total comprehensive income, net of taxes	$ 77,982	$ 87,058	$ 80,452

As of February 28, 2010, the Company holds investments in debt securities with an unrealized gain of $1.7 million and investments in equity securities with an unrealized gain of $4.4 million. As of February 28, 2009, the Company holds investments in debt securities with an unrealized gain of $0.3 million and investments in equity securities with an unrealized gain of $4.7 million.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Recent Accounting Pronouncements

In January 2010, the FASB issued amended guidance to improve disclosure requirements related to Fair Value Measurements and Disclosures-Overall Subtopic 820-10 of the FASB Accounting Standards Codification (ASC 820-10) originally issued as FASB Statement No. 157, Fair value Measurements. The amended guidance requires companies to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for such transfers. These additional disclosure requirements are effective for reporting periods beginning March 1, 2010.

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 adoption of the Codification had 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 February 28, 2010 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

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the allocation of estimated 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 (in thousands, except per share amounts) of the Company for the years ended February 28, 2009 and February 29, 2008 as if the acquisition of Qumranet had occurred at the beginning of each period, 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 acquisition actually taken place at the beginning of each period.

	Year Ended February 28, 2009	Year Ended February 29, 2008
Revenue	$ 652,697	$ 523,016
Net income	$ 73,048	$ 69,945
Diluted net income	$ 75,924	$ 73,552
Basic net income per common share	$ 0.38	$ 0.36
Diluted net income per common share	$ 0.36	$ 0.33

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Goodwill and other business combinations

The Company completed its annual goodwill impairment test as of February 28, 2010 and no goodwill impairment was deemed to have occurred. The following is a summary of goodwill for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 (in thousands):

Balance at February 28, 2007	$ 328,837
Add: acquisition of other businesses (1)	7,758
Add: adjustment to purchase price for finalization of allocation	1,514
Add: tax adjustment related to acquired NOL carryforwards and unrecognized tax benefits	1,364
Impact of foreign currency fluctuations and other	841
Balance at February 29, 2008	$ 340,314
Add: acquisition of Qumranet	80,030
Add: acquisition of other businesses (2)	19,723
Impact of foreign currency fluctuations and other	(1,958)
Balance at February 28, 2009	$ 438,109
Less: adjustment to Qumranet purchase price for finalization of allocation	(253)
Impact of foreign currency fluctuations	893
Balance at February 28, 2010	$ 438,749

(1) During the year ended February 29, 2008, goodwill additions represent the excess of purchase price over tangible and identifiable intangible assets of acquired businesses operating in the middleware space.

(2) During the year ended February 28, 2009, goodwill additions represent the excess of purchase price over tangible and identifiable intangible assets of businesses acquired which provide the Company additional services capability within the middleware and security management markets. The aggregate purchase price paid for these businesses, net of cash acquired, totaled $46.8 million.

NOTE 4 Accounts Receivable

Accounts receivable are presented net of an allowance for doubtful accounts. Activity in the Company s allowance for doubtful accounts for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 is presented in the following table (in thousands):

	Balance at beginning of period	Charged to (recovery of) expense	Adjustments (a)	Balance at end of period
2008	$ 3,206	$ 825	$ (1,820)	$ 2,211
2009	$ 2,211	$ 495	$ (319)	$ 2,387
2010	$ 2,387	$ (295)	$ 203	$ 2,295

(a) Represents foreign currency translation adjustments and amounts written-off as uncollectible accounts receivable.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 5 Property and Equipment

The Company s property and equipment is recorded at cost and consists of the following (in thousands):

	February 28, 2010	February 28, 2009
Computer equipment	$ 75,354	$ 62,675
Software, including software developed for internal use	74,742	66,550
Furniture and fixtures	11,645	9,092
Leasehold improvements	26,938	20,736
Property and Equipment	$ 188,679	$ 159,053
Less: accumulated depreciation	(116,971)	(91,140)
Property and equipment, net	$ 71,708	$ 67,913

Depreciation expense was $26.2 million, $22.9 million and $20.0 million for the years ended February 28, 2010, February 28, 2009 and February 29, 2008, respectively. The average useful lives of property and equipment range from 3 to 7 years.

NOTE 6 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 February 28, 2010 and February 28, 2009, trademarks with an indefinite estimated useful life totaled $9.0 million and $9.1 million, respectively. Amortization expense associated with identifiable intangible assets was $19.7 million, $17.6 million and $13.0 million for the years ended February 28, 2010, February 28, 2009 and February 29, 2008, respectively. The following is a summary of identifiable intangible assets (in thousands):

	February 28, 2010			February 28, 2009		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$ 52,204	$ (13,504)	$ 38,700	$ 47,046	$ (10,296)	$ 36,750
Purchased technologies	42,444	(23,593)	18,851	43,972	(19,108)	24,864
Customer and reseller relationships	80,760	(30,098)	50,662	80,704	(20,141)	60,563
Total identifiable intangible assets	$ 175,408	$ (67,195)	$ 108,213	$ 171,722	$ (49,545)	$ 122,177

As of February 28, 2010, amortization expense on existing intangibles for the next five fiscal years is as follows (in thousands):

2011	$ 18,070

2012	$ 16,538
2013	$ 13,961
2014	$ 11,378
2015	$ 8,404

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 7 Other Assets

Other assets were comprised of the following (in thousands):

	February 28, 2010	February 28, 2009
Equity-method investment	$ 17,252	$ 19,388
Cost-basis investments	2,732	1,732
Net non-current deferred tax assets (see NOTE 11)	14,967	25,985
Security deposits	4,721	4,137
Total	$ 39,672	$ 51,242

The Company reviews the non-marketable cost-basis investments in equity securities for other than temporary declines in fair value based on prices recently paid for shares in that company, as well as changes in market conditions. The carrying values are not necessarily representative of the amounts that the Company could realize in a current transaction. During the years ended February 28, 2010, February 28, 2009 and February 29, 2008, no significant losses were recognized for equity investments in other companies.

Equity-method investment represents $17.3 million related to the Company s investment in Open Inventions Network LLC (OIN) and the related share of OIN s accumulated deficit. The Company uses the equity method to account for its investment in OIN. The equity method requires the Company to increase or decrease the carrying amount of its investment in OIN to reflect the Company s pro rata share of OIN s gains and losses, respectively.

NOTE 8 Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets were comprised of the following (in thousands):

	February 28, 2010	February 28, 2009
Net current deferred tax assets (see NOTE 11)	$ 57,951	$ 54,711
Prepaid expenses	44,116	41,792
Other receivables	577	2,497
Inventory	265	437
Total	$ 102,909	$ 99,437

Prepaid expenses include deferred commissions which 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 to approximate the period of the subscription term. Deferred commissions at February 28, 2010 and February 28, 2009 totaled $30.8 million and $28.4 million, respectively. For further discussion on deferred commissions see NOTE 2 to the Consolidated Financial Statements.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 9 Accrued Expenses

Accrued expenses were comprised of the following (in thousands):

	February 28, 2010	February 28, 2009
Wages and other compensation related expenses	$ 41,990	$ 32,863
Other trade payables	14,885	15,051
Income and other taxes payable	10,375	5,205
Other	1,084	1,004
Total accrued expenses	$ 68,334	$ 54,123

NOTE 10 Foreign Currency Exchange Rate Risk

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

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of February 28, 2010 and for the year then ended (in thousands):

	As of February 28, 2010			Year Ended February 28, 2010	
	Balance Sheet Location	Fair Value	Notional Value	Location of Gain (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative
Assets foreign currency forward contracts not designated as hedges	Prepaid expenses and other current assets	$ 77	$ 3,888	Other income, net	$ 387
Liabilities foreign currency forward contracts not designated as hedges	Accrued expenses	$ (4)	$ 4,548	Other income, net	$ (442)
TOTAL		$ 73	$ 8,436		$ (55)

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.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 11 Income Taxes

The U.S. and foreign components of the Company s income before provision for income taxes consisted of the following (in thousands):

	February 28, 2010	February 28, 2009	February 29, 2008
U.S.	$ 92,130	$ 116,293	$ 128,961
Foreign	29,372	5,239	(4,421)
Income before provision for income taxes	$ 121,502	$ 121,532	$ 124,540

The components of the Company s provision for income taxes consisted of the following (in thousands):

	February 28, 2010	February 28, 2009	February 29, 2008
Current:			
Foreign	$ 10,445	$ 3,206	$ 5,136
Federal	13,615	(1,642)	(420)
State	4,368	775	2,209
Current tax expense	28,428	2,339	6,925
Deferred:			
Foreign	(998)	(1,628)	431
Federal	9,119	39,298	36,423
State	(2,300)	2,802	4,094
Deferred tax expense	5,821	40,472	40,948
Net provision for income taxes	$ 34,249	$ 42,811	$ 47,873

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Significant components of the Company s deferred tax assets and liabilities at February 28, 2010 and February 28, 2009, consist of the following (in thousands):

	February 28, 2010	February 28, 2009
Deferred tax assets:		
Domestic net operating loss carryforwards	$	$ 32,724
Foreign net operating loss carryforwards	14,620	11,778
Domestic credit carryforwards	26,955	14,088
Goodwill	3,163	3,695
Share-based compensation	22,668	27,172
Compensation-related accruals		156
Deferred revenue and costs	34,396	28,657
Other	7,459	5,414
Total deferred tax assets	109,261	123,684
Valuation allowance for deferred tax assets	(6,770)	(12,384)
Total deferred tax assets, net of valuation allowance	102,491	111,300
Deferred tax liabilities:		
Fixed and intangible assets	26,218	30,578
Other	3,355	26
Total deferred tax liabilities	29,573	30,604
Net deferred tax asset	$ 72,918	$ 80,696
Net current deferred tax asset, recorded in prepaid expenses and other current assets	$ 57,951	$ 54,711
Net non-current deferred tax asset, recorded in other assets, net	14,967	25,985
Net deferred tax asset	$ 72,918	$ 80,696

As of February 28, 2010, the Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign NOLs. The following is a summary of the Company s valuation allowance for the three years ended February 28, 2010 (in thousands):

Balance at February 28, 2007	$ 131,026
Add: Provisions for valuation allowance	4,174
Less: Release of valuation allowance	(76,395)
Balance at February 29, 2008	$ 58,805
Add: Provisions for valuation allowance	1,572
Less: Release of valuation allowance	(47,993)

Balance at February 28, 2009	$ 12,384
Add: Provisions for valuation allowance	2,622
Less: Release of valuation allowance	(8,236)
Balance at February 28, 2010	$ 6,770

As of February 28, 2010, the Company had U.S. state NOL carryforwards of approximately $27.5 million. These NOL carryforwards expire in varying amounts beginning in 2011. As of February 28, 2010, the Company had a U.S. research tax credit carryforward of $31.2 million and a U.S. foreign tax credit of $8.7 million. These tax credit carryforwards expire in varying amounts beginning in 2011.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Taxes computed at the statutory federal income tax rates are reconciled to the provision for income taxes for the years ended February 28, 2010, February 28, 2009 and February 29, 2008, respectively, as follows (in thousands):

	February 28, 2010	February 28, 2009	February 29, 2008
Effective rate	28.2%	35.2%	38.4%
Provision at federal statutory rate, 35%	$ 42,526	$ 42,543	$ 43,589
State tax (net of federal tax benefit)	2,068	3,576	4,454
Foreign rate differential	(2,173)	(2,276)	3,593
Change in valuation allowance			(2,013)
Nondeductible items	875	832	2,652
Research and development tax credit (including net discrete item of $7,300)	(7,800)		
Foreign tax credit	(1,577)	(2,406)	(4,063)
Other	330	542	(339)
Provision for income taxes	$ 34,249	$ 42,811	$ 47,873

The Company has not provided U.S. deferred taxes on the cumulative earnings of foreign subsidiaries that have been reinvested outside the U.S. indefinitely; these earnings were approximately $29.4 million at February 28, 2010. Determination of the deferred tax liability, if any, on these earnings reinvested indefinitely outside the U.S. is not practicable because of available foreign tax credits. 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 remits a portion of these earnings to the extent it does not incur additional U.S. tax and it is otherwise feasible. The Company has provided U.S. income taxes on the earnings of certain foreign subsidiaries that are not considered as permanently reinvested outside the U.S. The U.S. income tax on such earnings is completely offset by U.S. foreign tax credits.

Unrecognized tax benefits

The following table reconciles unrecognized tax benefits from adoption of ASC 740 Subtopic 10, section 05-06 (formerly referenced as FIN 48) at March 01, 2007 to February 28, 2010:

Balance at March 1, 2007	$ 27,408
Additions based on tax positions related to the current year	147
Additions for tax positions of prior years	8,325
Balance at February 29, 2008	$ 35,880
Additions based on tax positions related to the current year	2,627
Balance at February 28, 2009	$ 38,507
Additions based on tax positions related to the current year	2,320
Additions based on tax positions related to prior years	2,977
Reductions related to settlements with tax authorities	(430)
Balance at February 28, 2010	$ 43,374

The Company s unrecognized tax benefits as February 28, 2010 and February 28, 2009, which, if recognized, would affect the Company s effective tax rate were $36.1 million and $15.9 million, respectively.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 $1.1 million and $0.9 million as of February 28, 2010 and February 28, 2009, respectively.

The results and timing of the resolution of tax audits is highly uncertain and the Company is unable to estimate the range of the possible changes to the balance of unrecognized tax benefits. However, the Company does not anticipate that within the next 12 months that the total amount of unrecognized tax benefits will significantly increase or decrease as a result of any such potential tax audit resolutions.

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 February 28, 2010. Due to NOL carryforwards, in some cases the tax years continue to remain subject to examination with respect to such NOLs:

Tax Jurisdiction	**Years Subject to Income Tax Examination**
U.S. federal	1994 Present
North Carolina	1999 Present
Ireland	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 year ended February 28, 2007.

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

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

NOTE 12 Common and Preferred Stock

Common Stock

The Company has authorized 300,000,000 shares of common stock with a par value of $0.0001 per share. Holders of these shares have one vote per share. Upon the dissolution, liquidation or winding up of the Company, holders of common stock will be entitled to receive the assets of the Company after satisfaction of the preferential rights of any outstanding preferred stock or any other outstanding stock ranking on liquidation senior to or on parity with the common stock.

The Company purchased 10,014,022 shares, 2,875,052 shares and 3,747,327 shares of its common stock during the fiscal years ended February 28, 2010, February 28, 2009 and February 29, 2008, respectively, at an aggregate cost of $236.4 million, $42.3 million and $67.2 million, respectively. This amount is recorded as treasury stock on the Company s Consolidated Balance Sheets.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Preferred Stock

At February 28, 2010, the Company has authorized 5,000,000 shares of preferred stock with a par value of $0.0001 per share. No shares of preferred stock were outstanding as of February 28, 2010 or February 28, 2009.

NOTE 13 Share-based Awards

Overview

The Company s 2004 Long-Term Incentive Plan, as amended and restated (the 2004 Plan), provides for the granting of stock options, nonvested shares and nonvested share units, deferred share units (DSUs) and performance share units (PSUs), among other awards. As of February 28, 2010, approximately 7.9 million shares of common stock were reserved for issuance under future share-based awards to be granted to any employee, officer or director or consultant of the Company at terms and prices to be determined by the Board of Directors.

The following table summarizes share-based awards, by type, granted during the years ended February 28, 2010, February 28, 2009 and February 29, 2008:

	Awards Granted Year Ended February 28, 2010		Awards Granted Year Ended February 28, 2009		Awards Granted Year Ended February 29, 2008	
	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value
Stock options	100,080	$ 10.63	84,460	$ 4.66	1,432,490	$ 8.06
Nonvested shares and share units	2,570,243	$ 27.78	3,526,605	$ 14.20	1,817,056	$ 20.74
Performance share units target	343,334	$ 19.68	202,500	$ 23.82	232,625	$ 21.00
Deferred share units	28,673	$ 21.29	9,369	$ 17.04	20,983	$ 21.46
Total share-based award	3,042,330	$ 26.24	3,822,934	$ 14.51	3,503,154	$ 15.58

Stock Options

The 2004 Plan provides that the purchase price per share for each option shall not be less than the fair market value of the underlying share on the date of grant. Options granted under the 2004 Plan to date include contract terms of five years and generally vest 25% upon completion of one full year of service and 6.25% on the first day of each subsequent three-month period of service. The maximum contract term for an option granted under the 2004 Plan is seven years from the date of grant.

Options granted under the Company s previous long-term incentive plan, the 1999 Stock Option and Incentive Plan (the 1999 Plan), were generally issued with a purchase price equal to the fair market value of the underlying share on the date of grant and included contract terms of ten years. Vesting under the 1999 Plan was typically 25% upon completion of one full year of service and 6.25% on the first day of each subsequent three-month period of service.

The total fair value of stock options recognized in the Consolidated Financial Statements for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was $11.4 million, $20.1 million and $29.3 million, respectively.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the activity for the Company s stock options for the years ended February 28, 2010, February 28, 2009 and February 29, 2008:

	Shares Underlying Options	Weighted Average Exercise Price Per Share
Outstanding at February 28, 2007	19,628,726	$ 15.12
Granted	1,432,490	21.16
Exercised	(1,547,810)	10.10
Forfeited	(1,073,990)	20.28
Outstanding at February 29, 2008	18,439,416	$ 15.73
Granted	84,460	13.15
Exercised	(1,583,329)	11.59
Forfeited	(1,135,185)	20.32
Outstanding at February 28, 2009	15,805,362	$ 15.80
Granted	100,080	27.40
Exercised	(6,217,251)	16.62
Forfeited	(463,882)	62.97
Outstanding at February 28, 2010	9,224,309	$ 13.03

As described above, options are typically granted with an exercise price equal to the fair market value of the Company s common stock on the date of grant. No options were granted under Red Hat Plans during the years ended February 28, 2010, February 28, 2009 and February 29, 2008 with exercise prices less than the grant date fair value of the Company s common stock.

The following summarizes information, as of February 28, 2010, about the Company s outstanding and exercisable stock options:

		Options Outstanding			Options Exercisable	
Exercise Prices		Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.00	$ 3.21	1,228,315	2.1	$ 0.53	1,228,315	$ 0.53
$ 3.22	$ 6.41	2,155,572	1.9	$ 4.94	2,155,572	$ 4.94
$ 6.42	$ 9.62	724,109	2.8	$ 7.51	724,109	$ 7.51
$ 9.63	$12.03	21,344	2.0	$ 11.10	21,344	$ 11.10
$12.04	$16.03	1,168,785	1.6	$ 14.44	1,117,910	$ 14.53
$16.04	$19.24	145,609	2.3	$ 17.44	101,891	$ 17.39
$19.25	$22.44	2,517,086	2.1	$ 20.31	1,682,982	$ 20.38
$22.45	$28.86	1,215,056	1.6	$ 25.47	980,884	$ 25.48

$28.87 $32.06	42,976	0.9	$	29.24	42,086	$	29.24
$32.07 and over	5,457	0.2	$	81.94	5,457	$	81.94
Total	9,224,309	2.0	$	13.03	8,060,550	$	11.90

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The intrinsic value of options outstanding and options exercisable at February 28, 2010 was $139.0 million and $130.5 million, respectively. At February 28, 2010, the weighted average remaining contractual life of exercisable options was 1.9 years.

The intrinsic value at February 28, 2010 of options expected to vest was $7.4 million.

The intrinsic value of stock options exercised during the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was $62.8 million, $13.2 million and $17.9 million, respectively.

As of February 28, 2010, compensation cost related to unvested stock options not yet recognized in the Company s Consolidated Financial Statements totaled $8.1 million. The weighted average period over which these unvested stock options are expected to be recognized is approximately 0.8 years.

The fair values of options granted during the years ended February 28, 2010, February 28, 2009 and February 29, 2008 were estimated on the date of grant using the Black-Scholes-Merton option-pricing model based on the following weighted average assumptions:

	Year Ended February 28, 2010	Year Ended February 28, 2009	Year Ended February 29, 2008
Expected dividend yield	0.00%	0.00%	0.00%
Risk-free interest rate	1.59%	2.01%	3.92%
Expected volatility (1)	53.51%	47.45%	48.43%
Expected life (in years) (2)	3.27	3.27	3.27
Weighted average fair value of options granted during the period	$ 10.63	$ 4.66	$ 8.06

(1) The expected volatility rates for options granted during the years ended February 28, 2010, February 28, 2009 and February 29, 2008 were estimated based on an approximate equal weighting of the historical volatility of the Company s common stock over a period of approximately 3.27 years and the implied volatility of publicly traded options for the Company s common stock.

(2) The expected term for options granted during the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was determined based on the Company s historical exercise data. The Company reassesses its estimate of expected term annually or when new information indicates a change is appropriate.

Nonvested Shares and Nonvested Share Units

Nonvested shares and nonvested share units granted under the 2004 Plan generally vest 25% on the first anniversary of the date of grant and (i) 6.25% on the first day of each subsequent three-month period for nonvested shares and (ii) 25% each year over a four-year period beginning on the date of grant for nonvested share units. Nonvested shares and nonvested share units are generally amortized to expense on a straight-line basis over four years. The total fair value of nonvested shares and nonvested share units recognized in the Company s Consolidated Financial Statements for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was $28.0 million, $16.8 million and $4.7 million, respectively.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the activity for the Company s nonvested shares and nonvested share units for the years ended February 28, 2010, February 28, 2009 and February 29, 2008:

	Nonvested Shares and Share Units	Weighted Average Grant-date Fair Value
Nonvested at February 28, 2007	427,487	$ 19.45
Granted	1,817,056	20.74
Vested	(145,291)	19.30
Forfeited	(74,517)	20.67
Nonvested at February 29, 2008	2,024,735	$ 20.57
Granted	3,526,605	14.20
Vested	(517,810)	20.24
Forfeited	(200,145)	18.55
Nonvested at February 28, 2009	4,833,385	$ 16.04
Granted	2,570,243	27.78
Vested	(1,409,415)	16.77
Forfeited	(261,375)	17.92
Nonvested at February 28, 2010	5,732,838	$ 21.04

The intrinsic value of nonvested shares and nonvested share units outstanding at February 28, 2010 was $160.8 million.

The intrinsic value of nonvested shares and nonvested share units vesting in the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was $23.6 million, $10.5 million and $2.9 million, respectively.

As of February 28, 2010, compensation cost related to nonvested shares and nonvested share units not yet recognized in the Company s Consolidated Financial Statements totaled $107.9 million. The weighted average period over which these nonvested awards are expected to be recognized is approximately 1.6 years. At February 28, 2010, the number of nonvested shares expected to vest, after applying an estimated annual forfeiture rate of 15%, was 4,507,557.

Deferred Share Units

Deferred share units are awarded to directors and generally vest within one year. Deferred share units awarded during the years ended February 28, 2010, February 28, 2009 and February 29, 2008 totaled 28,673 shares, 9,369 shares and 20,983 shares, respectively, with a weighted average fair value per share of $21.29, $17.04 and $21.46, respectively. The total fair value of deferred share units recognized in the Company s Consolidated Financial Statements for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was $0.4 million, $0.1 million and $0.3 million, respectively.

Performance Share Units

The total fair value of PSUs recognized in the Company s Consolidated Financial Statements for the years ended February 28, 2010, February 28, 2009 and February 29, 2008 was $8.5 million, $11.2 million and $2.2 million, respectively. The fair value of awards vested during the year ended February 28, 2010 and February 28,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2009 totaled $4.1 million and $2.0 million, respectively. As of February 28, 2010, the intrinsic value of awards expected to vest totaled $35.2 million. Compensation expense related to PSUs not yet recognized in the Consolidated Financial Statements totaled $7.9 million as of February 28, 2010.

The following table details the performance criteria and summarizes the activity for the Company s PSUs for the years ended February 28, 2010, February 28, 2009 and February 29, 2008:

	At Target		Expected to Vest	
Activity	**Shares underlying Performance Share Units**	**Weighted Average Grant Date Fair Value**	**Underlying Shares Expected to Vest**	**Shares Expected to Vest as a % of Target**
Outstanding at February 28, 2007				
Granted (4)	232,625	$ 21.00	446,640	192%
Vested				
Forfeited				
Outstanding at February 29, 2008	232,625	$ 21.00	446,640	192%
Granted (3)	202,500	$ 23.82	405,000	200%
Vested	(46,525)	$ 21.00	(93,050)	200%
Forfeited				
Outstanding at February 28, 2009	388,600	$ 22.46	758,590	195%
Granted (1) (2)	343,334	$ 19.68	686,668	200%
Vested	(120,413)	$ 21.00	(190,200)	158%
Forfeited				
Outstanding at February 28, 2010	611,521	$ 21.19	1,255,058	198%

(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 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, 2010 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, 2011 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(3) On May 22, 2008, the Board approved a Performance Share Unit Agreement for use with grants of performance share units to executive officers under the Red Hat, Inc. 2004 Amended and Restated Long-Term Incentive Plan, as amended, beginning May 2008. During the year ended February 28, 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, 2008 through February 28, 2009, 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, 2010, 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, 2010 through February 28, 2011, 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. The maximum number of PSUs that may be earned during any performance segment is capped at 100% of the target for that segment if total shareholder return for both the one- and three-year periods preceding the conclusion of the relevant performance segment are negative (as calculated using a 20-day average closing price).

(4) On October 12, 2007, the Board approved a form of Performance Share Unit Agreement for use with grants of PSUs to executive officers under the Red Hat, Inc. 2004 Long-Term Incentive Plan, as amended. 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 200% of the target number of PSUs over a performance period that has three performance segments noted below. In respect of the first performance segment, which is the period from March 1, 2007 through February 29, 2008, up to 20% of the maximum number of PSUs may be earned. In respect of the second performance segment, which is the period from March 1, 2008 through February 28, 2009, 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 28, 2010, 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.

NOTE 14 Commitments and Contingencies

As of February 28, 2010, the Company leased office space and certain equipment under various non-cancelable operating leases. Future minimum lease payments required under the operating leases at February 28, 2010 are as follows (in thousands):

Fiscal Year	Operating Leases
2011	$ 21,874
2012	16,352
2013	11,339
2014	9,916
2015	7,803
Thereafter	21,886
Total minimum lease payments	$ 89,170

Rent expense under operating leases was $20.9 million, $18.5 million and $13.2 million for the fiscal years ended February 28, 2010, February 28, 2009 and February 29, 2008, respectively.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 are being depreciated over a period of seven years. As of February 28, 2010 and February 28, 2009, the carrying amount of the long-term deferred lease credit was $3.8 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 15 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

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 complaint seeks, among other relief, compensatory damages. The Company answered the complaint on February 1, 2008, including counterclaims against plaintiffs for declaratory judgment of invalidity, unenforceability and noninfringement of the patents-in-suit, and the plaintiffs filed a reply to those counterclaims on February 11, 2008. The court issued a memorandum opinion and order denying defendants motion for partial summary judgment for invalidity due to indefiniteness and construing disputed claim terms on August 10, 2009. Discovery in the case is complete, and trial began on April 26, 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. On January 29, 2010, Bedrock responded denying the contentions in the complaint and asserting a counterclaim alleging that Red Hat has directly and indirectly infringed the 120 Patent. On February 22, 2010, Red Hat replied to the counterclaim denying the allegations of infringement and asserting affirmative defenses. On March 26, 2010, Bedrock filed its first amended answer and counterclaim with crossclaims against fifteen parties. Based on information available to date, the Company believes it has meritorious defenses to the

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

counterclaims and does not anticipate that the counterclaims will have a material adverse effect on its business, financial position and results of operations. There can be no assurance, however, that the Company will be successful in its defense.

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

NOTE 16 Employee Benefit Plans

401(k) Plan

The Company provides a retirement plan qualified under Section 401(k) of the Internal Revenue Code of 1986, as amended (IRC). Participants may elect to contribute a portion of their annual compensation to the plan, after complying with certain limitations set by the IRC. Employees are eligible to participate in the plan if they are over 21 years of age. The Company has the option to make contributions to the plan and contributed $7.2 million, $6.0 million and $4.8 million to the plan for the years ended February 28, 2010, February 28, 2009 and February 29, 2008, respectively.

NOTE 17 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 year ended February 28, 2010, the Company repurchased 10,014,022 shares under the program for $236.4 million, including transaction costs. As of February 28, 2010, the remaining amount available under the program for the repurchase of Common Stock was $9.7 million.

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

See NOTE 19 to the Consolidated Financial Statements for a discussion of shares repurchased subsequent to February 28, 2010.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 18 Unaudited Quarterly Results

Below are unaudited condensed quarterly results for the year ended February 28, 2010:

	Year Ended February 28, 2010 Unaudited			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
	(in thousands, except per share data)			
Revenue:				
Subscriptions	$ 169,159	$ 164,432	$ 156,273	$ 148,790
Training and services	26,710	29,914	27,360	25,598
Total subscription and training and services revenue	$ 195,869	$ 194,346	$ 183,633	$ 174,388
Gross profit	$ 166,530	$ 164,748	$ 155,193	$ 147,920
Income from operations	$ 27,958	$ 19,793	$ 27,542	$ 25,056
Interest income	$ 2,220	$ 2,206	$ 2,525	$ 3,430
Other income, net	$ 4,357	$ 3,295	$ 3,234	$ 50
Net income	$ 23,388	$ 16,414	$ 28,937	$ 18,514
Diluted net income	$ 23,388	$ 16,414	$ 28,937	$ 18,514
Net income per common share (a):				
Basic	$ 0.12	$ 0.09	$ 0.15	$ 0.10
Diluted	$ 0.12	$ 0.08	$ 0.15	$ 0.10
Weighted average shares outstanding:				
Basic	187,911	187,450	187,099	188,916
Diluted	193,822	193,733	192,659	194,382

(a) Earnings per common share are computed independently for each of the quarters presented. Therefore, the sum of the quarterly per common share information may not equal the annual earnings per common share.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Below are unaudited condensed quarterly results for the year ended February 28, 2009:

	Year Ended February 28, 2009 Unaudited			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
	(in thousands, except per share data)			
Revenue:				
Subscriptions	$ 139,356	$ 135,451	$ 135,709	$ 130,694
Training and services	26,865	29,881	28,674	25,941
Total subscription and training and services revenue	$ 166,221	$ 165,332	$ 164,383	$ 156,635
Gross profit	$ 140,568	$ 138,796	$ 136,875	$ 130,206
Income from operations	$ 20,237	$ 20,970	$ 21,404	$ 19,910
Interest income	$ 5,904	$ 9,294	$ 10,442	$ 10,833
Other income (expense), net	$ (688)	$ 4,501	$ 4,336	$ (813)
Net income	$ 15,988	$ 24,305	$ 21,138	$ 17,290
Diluted net income (b)	$ 16,210	$ 25,147	$ 22,032	$ 18,184
Net income per common share (a):				
Basic	$ 0.08	$ 0.13	$ 0.11	$ 0.09
Diluted	$ 0.08	$ 0.12	$ 0.10	$ 0.08
Weighted average shares outstanding:				
Basic	190,146	190,665	191,485	190,779
Diluted	197,820	208,408	220,039	218,853

(a) Earnings per common share are computed independently for each of the quarters presented. Therefore, the sum of the quarterly per common share information may not equal the annual earnings per common share.

(b) Diluted net income is computed by adjusting net income for the interest expense and amortization of debt issuance costs associated with the debentures, assuming the debentures were converted to common stock.

NOTE 19 Subsequent Events

From March 1, 2010 through April 28, 2010, the Company repurchased an aggregate of 1,905,000 shares of its common stock for $57.4 million. These repurchases were made pursuant to the Company s previously announced repurchase programs. See NOTE 17 to the Consolidated Financial Statements for further discussion of the repurchase programs. As of April 28, 2010, the amount available for repurchase of common stock was $252.3 million.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There were no changes in or disagreements with our accountants on accounting and financial disclosure matters.

ITEM 9A. 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.

Report of Management on Internal Control Over Financial Reporting

Report of Management on Internal Control Over Financial Reporting is set forth above under PART II, Item 8, Financial Statements and Supplementary Data Report of Management on Internal Control Over Financial Reporting.

Changes in Internal Control Over Financial Reporting

No changes in our internal control over financial reporting occurred during the fiscal quarter ended February 28, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

We intend to file with the SEC a definitive proxy statement with respect to the Annual Meeting of Stockholders to be held on August 12, 2010 (the 2010 Annual Meeting). The information under the sections entitled Item No. 1: Election of Directors , Corporate Governance and Board of Director Information , Compensation and Other Information Concerning Executive Officers and Other Matters from our definitive proxy statement for the 2010 Annual Meeting, which is to be filed with the SEC not later than 120 days after the close of our fiscal year ended February 28, 2010 (the 2010 Proxy Statement), is hereby incorporated by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information under the section entitled Compensation and Other Information Concerning Executive Officers and Corporate Governance and Board of Director Information from the 2010 Proxy Statement is hereby incorporated by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information under the sections entitled Beneficial Ownership of Our Common Stock and Compensation and Other Information Concerning Executive Officers from the 2010 Proxy Statement is hereby incorporated by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information under the section entitled Corporate Governance and Board of Directors Information from the 2010 Proxy Statement is hereby incorporated by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information under the sections entitled Item No. 2: Ratification of Selection of Independent Registered Public Accounting Firm from the 2010 Proxy Statement is hereby incorporated by reference.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Report under Item 8 Financial Statements and Supplementary Data :

1. Financial Statements:

2. Financial Statement Schedules:

All other schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

3. List of Exhibits:

Exhibit No.	Description of Exhibits
3.1+	Third Amended and Restated Certificate of Incorporation, as amended, of the registrant (incorporated by reference to Exhibit 3.1 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on July 10, 2007 (File no. 001-33162))
3.2+	Amended and Restated By-Laws of the registrant dated April 21, 2010 (incorporated by reference to Exhibit 3.1 to the registrant s Current Report on Form 8-K filed with the SEC on April 26, 2010 (File no. 001-33162))
4.1+	Specimen certificate representing the common stock of the registrant (incorporated by reference to Exhibit 4.1 to the registrant s Registration Statement on Form S-1/A filed with the SEC on July 19, 1999 (File no. 333-94775))
4.2+	See Exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and By-Laws of the registrant defining the rights of holders of common stock of the registrant
4.3+	First Amended and Restated Investor Rights Agreement by and among the registrant and the Investors and Founders listed therein, dated as of February 25, 1999, as amended (incorporated by reference to Exhibit 10.7 to the registrant s Registration Statement on Form S-1 filed with the SEC on June 4, 1999 (File no. 333-80051))
10.1+*	Red Hat, Inc. 1998 Stock Option Plan, as amended (incorporated by reference to Exhibit 10.1 to the registrant s Registration Statement on Form S-1 filed with the SEC on June 4, 1999 (File no. 333-80051))
10.2+*	Red Hat, Inc. 1999 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.3 to the registrant s Registration Statement on Form S-1 filed with the SEC on June 4, 1999 (File no. 333-80051)

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Exhibit No.	Description of Exhibits
10.3+	GNU General Public License (incorporated by reference to Exhibit 10.13 to the registrant s Registration Statement on Form S-1 filed with the SEC on June 4, 1999 ((File no. 333-80051))
10.4+*	Employment Agreement by and between the registrant and Matthew Szulik dated July 24, 2002 (incorporated by reference to Exhibit 10.2 to the registrant s Quarterly Report on Form 10-K filed with the SEC on October 10, 2008 (File No. 001-33162))
10.5+*	Restricted Stock Award Agreement by and between the registrant and Matthew Szulik dated June 27, 2001 (incorporated by reference as Exhibit 10.03 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 10, 2008 (File no. 001-33162))
10.6+*	Red Hat, Inc. 1999 Stock Option and Incentive Plan, as Amended and Restated August 2, 2001 (incorporated by reference to Exhibit 10.4 to the registrant s Quarterly Report on Form 10-Q filed with the SEC on October 10, 2008 (File no. 001-33162))
10.7+*	Restricted Stock Award Agreement by and between the registrant and Matthew Szulik dated December 17, 2003 (incorporated by reference to Exhibit 10.12 to the registrant s Annual Report filed on Form 10-K with the SEC on May 14, 2004 (File no. 000-26281))
10.8+*	Letter Agreement by and between registrant and Charles E. Peters, Jr. dated August 16, 2004 (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 12, 2004 (File no. 000-26281))
10.9+*	Incentive Stock Option Agreement by and between registrant and Charles E. Peters, Jr. dated August 31, 2004 (incorporated by reference to Exhibit 10.2 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 12, 2004 (File no. 000-26281))
10.10+*	Non-Qualified Stock Option Agreement by and between registrant and Charles E. Peters dated August 31, 2004 (incorporated by reference to Exhibit 10.3 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 12, 2004 (File no. 000-26281))
10.11+*	Form of Long Term Incentive Plan Non-Qualified Stock Option Agreement for Directors pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.3 to the registrant s Current Report filed on Form 8-K with the SEC on December 21, 2004 (File No. 000-26281))
10.12+*	Form of Long Term Incentive Plan Restricted Stock Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.5 to the registrant s Current Report filed on Form 8-K with the SEC on December 21, 2004 (File No. 000-26281))
10.13+*	Form of Non-Qualified Stock Option Agreement pursuant to Red Hat, Inc. 1999 Stock Option and Incentive Plan, as amended (incorporated by reference to Exhibit 10.12 to the registrant s Annual Report filed on Form 10-K with the SEC on May 16, 2005 (File no. 000-26281))
10.14+*	Form of Incentive Plan and Stock Option Agreement pursuant to Red Hat, Inc. 1999 Stock Option and Incentive Plan, as amended (incorporated by reference to Exhibit 10.13 to the registrant s Annual Report filed on Form 10-K with the SEC on May 16, 2005 (File no. 000-26281))
10.15+*	Letter Agreement by and between registrant and Paul J. Cormier dated April 17, 2001 (incorporated by reference to Exhibit 10.26 to the registrant s Annual Report filed on Form 10-K with the SEC on May 16, 2005 (File no. 000-26281))
10.16+*	Letter Agreement by and between registrant and Alex Pinchev dated March 18, 2003 (incorporated by reference to Exhibit 10.27 to the registrant s Annual Report filed on Form 10-K with the SEC on May 16, 2005 (File no. 000-26281))

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Exhibit No.	Description of Exhibits
10.17+*	Letter Agreement by and between registrant and Michael R. Cunningham dated April 16, 2004 (incorporated by reference to Exhibit 10.29 to the registrant s Annual Report filed on Form 10-K with the SEC on May 16, 2005 (File no. 000-26281))
10.18+*	Amendment to Non-Qualified Stock Option Agreement by and between the registrant and Matthew J. Szulik dated effective December 30, 2005 (incorporated by reference to Exhibit 10.1 to the registrant s Current Report filed on Form 8-K with the SEC on January 6, 2006 (File No. 000-26281))
10.19+*	Amendment to Restricted Stock Award Agreement by and between the registrant and Matthew J. Szulik dated December 30, 2005 (incorporated by reference to Exhibit 10.2 to the registrant s Current Report filed on Form 8-K with the SEC on January 6, 2006 (File No. 000-26281))
10.20+-	Limited Liability Company Agreement of Open Inventions Network dated November 8, 2005 (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report on Form 10-Q filed with the SEC on January 9, 2006 (File no. 000-26281))
10.21+*	Form of Long-Term Incentive Plan Restricted Stock Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.2 to the registrant s Quarterly Report on Form 10-Q filed with the SEC on January 9, 2006 (File No. 000-26281))
10.22+*	2006 Performance Compensation Plan (incorporated by reference to Exhibit 10.1 to the registrant s Current Report filed on Form 8-K with the SEC on August 23, 2006 (File no. 000-26281))
10.23+*	Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report on Form 10-Q filed with the SEC on October 10, 2008 (File no. 001-33162))
10.24+*	Form of Indemnification Agreement (incorporated by reference to Exhibit 10.1 to the registrant s Current Report filed on Form 8-K with the SEC on February 28, 2007 (File No. 001-33162))
10.25+*	Form of Restricted Stock Award Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.2 to the registrant s Current Report filed on Form 8-K with the SEC on February 28, 2007 (File No. 001-33162))
10.26+*	Form of Non-Qualified Stock Option Agreement for Executive Employees pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.3 to the registrant s Current Report filed on Form 8-K with the SEC on February 28, 2007 (File No. 001-33162))
10.27+*	Form of Amendment to Equity Awards of Executive pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.4 to the registrant s Current Report filed on Form 8-K with the SEC on February 28, 2007 (File No. 001-33162))
10.28+*	Senior Management Change in Control Severance Policy (incorporated by reference to Exhibit 10.5 to the registrant s Current Report filed on Form 8-K with the SEC on February 28, 2007 (File No. 001-33162))
10.29+*	Executive Variable Compensation Plan (incorporated by reference to Exhibit 99.1 to the registrant s Current Report filed on Form 8-K with the SEC on May 16, 2007 (File No. 001-33162))

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Exhibit No.	Description of Exhibits
10.30+*	Form of Restricted Stock Unit Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (Non-Executive, U.S. Participants) (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 10, 2007 (File No. 001-33162))
10.31+*	Form of Restricted Stock Unit Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (Non-Executive, Non U.S. Participants) (incorporated by reference to Exhibit 10.2 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 10, 2007 (File No. 001-33162))
10.32+*	Form of Performance Share Unit Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.1 to the registrant s Current Report filed on Form 8-K with the SEC on October 15, 2007 (File No. 001-33162))
10.33+*	Executive Employment Agreement, dated December 19, 2007, between Red Hat, Inc. and James M. Whitehurst (incorporated by reference to Exhibit 10.5 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on January 9, 2008 (File No. 001-33162))
10.34+*	Form of Amendment to Performance Share Unit Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.38 to the registrant s Annual Report filed on Form 10-K with the SEC on April 29, 2008 (File No. 001-33162))
10.35+*	Form of Director Deferred Stock Unit Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.39 to the registrant s Annual Report filed on Form 10-K with the SEC on April 29, 2008 (File No. 001-33162))
10.36+*	Executive Transition Agreement between Red Hat, Inc. and Matthew J. Szulik dated February 28, 2008 (incorporated by reference to Exhibit 10.40 to the registrant s Annual Report filed on Form 10-K with the SEC on April 29, 2008 (File No. 001-33162))
10.37+*	Non-Executive Chairman Agreement between Red Hat, Inc. and Matthew J. Szulik dated February 28, 2008 (incorporated by reference to Exhibit 10.41 to the registrant s Annual Report filed on Form 10-K with the SEC on April 29, 2008 (File No. 001-33162))
10.38+*	2008 Independent Director Compensation Plan (incorporated by reference to Exhibit 10.42 to the registrant s Annual Report filed on Form 10-K with the SEC on April 29, 2008 (File No. 001-33162))
10.39+*	Form of Performance Share Unit Agreement adopted May 2008 pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 99.1 to the registrant s Current Report filed on Form 8-K with the SEC on May 23, 2008 (File No. 001-33162))
10.40+*	Form of Director Deferred Stock Unit Agreement (Vested) pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.2 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on July 10, 2008 (File No. 001-33162))
10.41+*	Form of Director Deferred Stock Unit Agreement (With Vesting) pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.3 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on July 10, 2008 (File No. 001-33162))

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Exhibit No.	Description of Exhibits
10.42+*	Form of Director Restricted Stock Unit Agreement pursuant to the Red Hat, Inc. 2004 Long-Term Incentive Plan, as Amended and Restated (incorporated by reference to Exhibit 10.4 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on July 10, 2008 (File No. 001-33162))
10.43+*	Senior Management Severance Plan (incorporated by reference to Exhibit 10.1 to the registrant s Current Report filed on Form 8-K with the SEC on December 29, 2008 (File No. 001-33162))
10.44+*	Form of Executive Agreement by and between Red Hat, Inc. and each Plan Participant (incorporated by reference to Exhibit 10.2 to the registrant s Current Report filed on Form 8-K with the SEC on December 29, 2008 (File No. 001-33162))
10.45+*	Form of Amendment to Equity Awards with Independent Directors (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on January 9, 2009 (File No. 001-33162))
10.46+*	Letter Agreement dated December 23, 2008 between Red Hat, Inc. and James M. Whitehurst amending the Executive Employment Agreement between the parties dated December 19, 2007 (incorporated by reference to Exhibit 10.4 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on January 9, 2009 (File No. 001-33162))
10.47+*	Employee Inventions Assignment Agreement and Restrictive Obligations Agreement dated January 1, 2008 between Red Hat, Inc. and James M. Whitehurst (incorporated by reference to Exhibit 10.5 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on January 9, 2009 (File No. 001-33162))
10.48+*	Letter Agreement dated December 29, 2008 between Red Hat, Inc. and Matthew J. Szulik amending the Non-executive Chairman Agreement between the parties dated February 28, 2008 (incorporated by reference to Exhibit 10.6 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on January 9, 2009 (File No. 001-33162))
10.49+*	Letter Agreement dated December 29, 2008 between Red Hat, Inc. and Matthew J. Szulik amending the Executive Transition Agreement between the parties dated February 28, 2008 (incorporated by reference to Exhibit 10.7 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on January 9, 2009 (File No. 001-33162))
10.50+*	Executive Base Salaries and Target Award Amounts under Red Hat, Inc. s Executive Variable Compensation Plan for the Fiscal Year Ending February 28, 2010 (incorporated by reference to Exhibit 99.1 to registrant s Current Report filed on Form 8-K with the SEC on May 19, 2009 (File No. 001-33162))
10.51+*	Form of Performance Share Unit Agreement adopted May 13, 2009 (incorporated by reference to Exhibit 99.2 to the registrant s Current Report filed on Form 8-K with the SEC on May 19, 2009 (File No. 001-33162))
10.52+*	Clawback Policy of Red Hat, Inc. adopted May 13, 2009 (incorporated by reference to Exhibit 99.3 to the registrant s Current Report filed on Form 8-K with the SEC on May 19, 2009 (File No. 001-33162))
10.53+*	Form of Performance Share Unit Agreement (Fiscal Year 2010-SPP Form) adopted June 23, 2009 (incorporated by reference to Exhibit 99.1 to the registrant s Current Report filed on Form 8-K with the SEC on June 29, 2009 (File No. 001-33162))
10.54+*	Target Share Price Performance Units awarded to named executive officers on June 23, 2009 (incorporated by reference to Exhibit 99.2 to registrant s Current Report filed on Form 8-K with the SEC on June 29, 2009 (File No. 001-33162))

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Exhibit No.	Description of Exhibits
10.55+*	Performance Compensation Plan as Amended and Restated Effective June 19, 2008 (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on July 10, 2009 (File No. 001-33162))
10.56+*	Red Hat, Inc. 2010 Non-Employee Director Compensation Plan effective January 1, 2010 (incorporated by reference to Exhibit 10.1 to the registrant s Quarterly Report filed on Form 10-Q with the SEC on October 5, 2009 (File No. 001-33162))
10.57+*	Red Hat, Inc. Stock Ownership Policy for Directors and Senior Executives, dated 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))
10.58*	Letter Agreement dated February 28, 2010 between Red Hat, Inc. and Matthew J. Szulik
10.59*	Red Hat, Inc. 2010 Non-Employee Director Compensation Plan amended and restated effective March 1, 2010
21.1	Subsidiaries of Red Hat, Inc.
23.1	Consent of PricewaterhouseCoopers LLP
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 Principal Executive Officer and the Principal Financial Officer Pursuant to 18 U.S.C. Section 1350

* Indicates a management contract or compensatory plan, contract or arrangement.
\+ Previously filed.
\- Indicates confidential treatment requested as to certain portions of this exhibit which have been filed separately with the SEC.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

By: /s/ JAMES M. WHITEHURST
James M. Whitehurst

President and Chief Executive Officer

Date: April 29, 2010

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ JAMES M. WHITEHURST **James M. Whitehurst**	President, Chief Executive Officer and Director (principal executive officer)	April 29, 2010
/s/ CHARLES E. PETERS, JR. **Charles E. Peters, Jr.**	Executive Vice President and Chief Financial Officer (principal financial officer)	April 29, 2010
/s/ MARK E. COOK **Mark E. Cook**	Vice President Finance and Controller (principal accounting officer)	April 29, 2010
/s/ MICHELINE CHAU **Micheline Chau**	Director	April 29, 2010
/s/ JEFFREY J. CLARKE **Jeffrey J. Clarke**	Director	April 29, 2010
/s/ MARYE ANNE FOX **Marye Anne Fox**	Director	April 29, 2010
/s/ NARENDRA K. GUPTA **Narendra K. Gupta**	Director	April 29, 2010
/s/ WILLIAM S. KAISER **William S. Kaiser**	Director	April 29, 2010

/s/ DONALD H. LIVINGSTONE	Director	April 29, 2010
Donald H. Livingstone		
/s/ HENRY HUGH SHELTON	Director	April 29, 2010
Henry Hugh Shelton		
/s/ MATTHEW J. SZULIK	Chairman of the Board of Directors	April 29, 2010
Matthew J. Szulik		

Exhibit Index

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