RED HAT INC
Form 10-Q
October 06, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended August 31, 2016

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to .

Commission File Number: 001-33162

RED HAT, INC.

(Exact name of registrant as specified in its charter)

Delaware	**06-1364380**
(State or other jurisdiction of **incorporation or organization)**	**(I.R.S. Employer** **Identification No.)**

100 East Davie Street, Raleigh, North Carolina 27601

(Address of principal executive offices, including zip code)

(919) 754-3700

(Registrant s telephone number, including area code)

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

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

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

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

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

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

As of September 30, 2016, there were 179,596,072 shares of common stock outstanding.

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CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS

Certain statements contained in this report and the documents incorporated by reference in this report, including in Management s Discussion and Analysis of Financial Condition and Results of Operations, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations of future events based on certain assumptions, and any statement that is not strictly a historical statement could be deemed to be a forward-looking statement (for example, statements regarding current or future financial performance, management s plans and objectives for future operations, product plans and performance, management s expectations regarding market risk and market penetration, management s assessment of market factors, or strategies, objectives and plans of Red Hat, Inc. together with its subsidiaries (Red Hat) and its partners). Words such as anticipate, believe, estimate, expect, intend, outlook, plan, project, will, and similar expressi identify such forward-looking statements. Red Hat may also make forward-looking statements in other filings made with the Securities and Exchange Commission (SEC), press releases, materials delivered to stockholders and oral statements made by management. Investors are cautioned that these forward-looking statements are inherently uncertain, are not guarantees of Red Hat s future performance and are subject to a number of risks and uncertainties that could cause Red Hat s actual results to differ materially from those found in the forward-looking statements and from historical trends. These risks and uncertainties include the risks and cautionary statements detailed in Part II, Item 1A, Risk Factors and elsewhere in this report as well as in Red Hat s other filings with the SEC, copies of which may be accessed through the SEC s web site at http://www.sec.gov. Readers are urged to carefully review these risks and cautionary statements. Moreover, Red Hat operates in a rapidly changing and highly competitive environment. It is impossible to predict all risks and uncertainties or assess the impact of any new risk or uncertainty on our business or any forward-looking statement. The forward-looking statements included in this report represent our views as of the date of this report. We specifically disclaim any obligation to update these forward-looking statements in the future. These forward-looking statements should not be relied upon as representing our views as of any date subsequent to the date of this report.

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RED HAT, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands except share and per share amounts)

	August 31, 2016 (Unaudited)	February 29, 2016 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 970,569	$ 927,778
Investments in debt securities, short-term	365,128	281,142
Accounts receivable, net of allowances for doubtful accounts of $2,456 and $2,798, respectively	359,893	509,715
Prepaid expenses	149,226	150,877
Other current assets	3,404	2,921
Total current assets	1,848,220	1,872,433
Property and equipment, net of accumulated depreciation and amortization of $221,364 and $194,819, respectively	172,312	166,886
Goodwill	1,053,872	1,027,277
Identifiable intangibles, net	142,794	146,071
Investments in debt securities, long-term	706,948	786,470
Deferred tax assets, net	122,131	111,456
Other assets, net	54,479	44,506
Total assets	$ 4,100,756	$ 4,155,099
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 273,568	$ 284,802
Deferred revenue, short-term	1,233,762	1,272,908
Other current obligations	1,950	1,467
Total current liabilities	1,509,280	1,559,177
Deferred revenue, long-term	446,890	449,636
Convertible notes	734,700	723,942
Other long-term obligations	91,490	87,912
Commitments and contingencies (NOTES 12 and 13)		
Stockholders equity:		
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, $0.0001 per share par value, 300,000,000 shares authorized, 235,937,811 and 234,896,137 shares issued, and 179,573,270 and 181,185,861 shares outstanding at August 31, 2016 and February 29, 2016, respectively	24	23

Additional paid-in capital	2,215,856	2,162,264
Retained earnings	1,219,246	1,099,738
Treasury stock at cost, 56,364,541 and 53,710,276 shares at August 31, 2016 and February 29, 2016, respectively	(2,047,008)	(1,853,144)
Accumulated other comprehensive loss	(69,722)	(74,449)
Total stockholders equity	1,318,396	1,334,432
Total liabilities and stockholders equity	$ 4,100,756	$ 4,155,099

(1) Derived from audited financial statements.

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Revenue:				
Subscriptions	$ 531,209	$ 441,526	$ 1,032,874	$ 866,319
Training and services	68,596	62,622	134,829	118,830
Total subscription and training and services revenue	599,805	504,148	1,167,703	985,149
Cost of subscription and training and services revenue:				
Cost of subscriptions	39,678	30,996	76,222	60,843
Cost of training and services	47,993	44,968	95,496	86,519
Total cost of subscription and training and services revenue	87,671	75,964	171,718	147,362
Gross profit	512,134	428,184	995,985	837,787
Operating expense:				
Sales and marketing	253,255	205,101	496,503	403,973
Research and development	121,265	102,488	236,281	199,919
General and administrative	55,730	44,125	105,954	86,496
Total operating expense	430,250	351,714	838,738	690,388
Income from operations	81,884	76,470	157,247	147,399
Interest income	3,392	2,895	6,821	5,611
Interest expense	5,925	5,733	11,811	11,448
Other income (expense), net	84	(1,245)	(468)	(1,448)
Income before provision for income taxes	79,435	72,387	151,789	140,114
Provision for income taxes	20,663	20,992	31,832	40,633
Net income	$ 58,772	$ 51,395	$ 119,957	$ 99,481
Basic net income per common share	$ 0.33	$ 0.28	$ 0.66	$ 0.54
Diluted net income per common share	$ 0.32	$ 0.28	$ 0.65	$ 0.53
Weighted average shares outstanding				

Basic	180,322	183,179	180,745	183,155
Diluted	183,346	186,750	183,750	186,493

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Net income	$ 58,772	$ 51,395	$ 119,957	$ 99,481
Other comprehensive income (loss):				
Change in foreign currency translation adjustment	(2,472)	2,623	3,445	(3,006)
Available-for-sale securities:				
Unrealized gain (loss) on available-for-sale securities during the period	708	(2,138)	1,946	(2,544)
Reclassification for (gain) loss realized on available-for-sale securities, reported in Other income (expense), net		(2)	(9)	3
Tax benefit (expense)	(211)	672	(655)	719
Net change in available-for-sale securities (net of tax)	497	(1,468)	1,282	(1,822)
Total other comprehensive income (loss)	(1,975)	1,155	4,727	(4,828)
Comprehensive income	$ 56,797	$ 52,550	$ 124,684	$ 94,653

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)

(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2016	**August 31, 2015**	**August 31, 2016**	**August 31, 2015**
Cash flows from operating activities:				
Net income	$ 58,772	$ 51,395	$ 119,957	$ 99,481
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	21,160	18,538	41,862	37,085
Amortization of debt discount and transaction costs	5,393	5,222	10,758	10,417
Share-based compensation expense	45,357	40,537	86,632	77,059
Deferred income taxes	(5,467)	(3,843)	(7,619)	(1,929)
Excess tax benefits from share-based payment arrangements	1,185	2,812	9,135	9,231
Net amortization of bond premium on debt securities available for sale	3,294	3,139	6,834	5,736
Other	328	1,078	(437)	1,908
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	(30,684)	(17,908)	159,645	161,479
Prepaid expenses	8,883	13,077	(490)	12,651
Accounts payable and accrued expenses	18,578	34,415	(19,558)	(17,932)
Deferred revenue	(26,953)	(25,017)	(73,046)	(56,579)
Other	(3,044)	(356)	(4,574)	(340)
Net cash provided by operating activities	96,802	123,089	329,099	338,267
Cash flows from investing activities:				
Purchase of investment in debt securities available for sale	(163,043)	(196,613)	(297,644)	(602,824)
Proceeds from sales and maturities of investment in debt securities available for sale	177,528	170,617	294,710	353,200
Acquisition of businesses, net of cash acquired	(28,667)	(1,700)	(28,667)	(1,700)
Purchase of other intangible assets	(3,521)	(2,068)	(6,389)	(5,997)
Purchase of property and equipment	(15,539)	(10,277)	(33,192)	(20,973)
Other		(1,159)	(111)	(3,158)
Net cash used in investing activities	(33,242)	(41,200)	(71,293)	(281,452)

Cash flows from financing activities:				
Proceeds from exercise of common stock options	689	480	2,068	2,589
Payments related to net settlement of share-based compensation awards	(6,398)	(7,726)	(37,476)	(32,937)
Purchase of treasury stock	(127,386)	(70,079)	(193,864)	(70,079)
Payments on other borrowings	(463)	(385)	(906)	(737)
Other	415		913	
Net cash used in financing activities	(133,143)	(77,710)	(229,265)	(101,164)
Effect of foreign currency exchange rates on cash and cash equivalents	8,587	(3,494)	14,250	(11,517)
Net increase (decrease) in cash and cash equivalents	(60,996)	685	42,791	(55,866)
Cash and cash equivalents at beginning of the period	1,031,565	990,922	927,778	1,047,473
Cash and cash equivalents at end of the period	$ 970,569	$ 991,607	$ 970,569	$ 991,607

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries (Red Hat or the Company) is a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, management, middleware, cloud, mobile and storage technologies.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, the Company does not recognize revenue from the licensing of the code itself. The Company provides value to its customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of its Red Hat technologies, and by providing a level of performance, scalability, flexibility, reliability and security for the technologies the Company packages and distributes. Moreover, because communities of developers not employed by the Company assist with the creation of the Company s open source offerings, opportunities for further innovation of the Company s offerings are supplemented by these communities.

The Company derives its revenue and generates cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat technologies. The arrangements with the Company s customers that produce this revenue and cash are explained in further detail in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company s Annual Report on Form 10-K for the fiscal year ended February 29, 2016.

NOTE 2 Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three and six months ended August 31, 2016 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair statement of the consolidated balance sheets, consolidated operating results, consolidated other comprehensive income and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three and six months ended August 31, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2017. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the SEC s rules and regulations for interim reporting. These unaudited financial statements should be read in conjunction with the Company s Consolidated Financial Statements, including notes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended February 29, 2016. Other than the accounting pronouncement adopted during the three months ended May 31, 2016 related to accounting for share-based compensation as described below, there have been no changes to the Company s significant accounting policies from those described in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company s

Annual Report on Form 10-K for the fiscal year ended February 29, 2016. These unaudited financial statements should be read in conjunction with the financial statements included in the Annual Report on Form 10-K.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Consolidation policy

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 have been eliminated in consolidation. There are no significant foreign currency 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.

Accounting pronouncement adopted

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2016-09, *Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* (ASU 2016-09), to simplify several aspects of the accounting for share-based compensation, including the income tax consequences. This guidance is effective for the Company as of the first quarter of the fiscal year ending February 28, 2018. However, the Company elected to early adopt ASU 2016-09 effective March 1, 2016.

Impact to Consolidated Statements of Operations

One of the more significant impacts of adopting ASU 2016-09 is the required change in how the Company recognizes the excess tax benefits (windfalls) or deficiencies (shortfalls) related to share-based compensation. For example, prior to adopting ASU 2016-09 such windfalls and shortfalls were credited or charged, respectively, to additional paid-in capital in the Company s Consolidated Balance Sheets. Under ASU 2016-09, these windfalls and shortfalls are recognized as a discrete tax benefit or discrete tax expense, respectively, in the Company s Consolidated Statements of Operations. For the three and six months ended August 31, 2016, the Company recognized a discrete tax benefit of $1.0 million and $8.9 million, respectively, related to net windfall tax benefits from share-based compensation.

ASU 2016-09 requires companies to adopt the amendment related to accounting for windfalls and shortfalls on a prospective basis only. As a result, no change has been made to the Consolidated Statement of Operations for the three and six months ended August 31, 2015 related to the $2.9 million and $8.4 million, respectively, of net windfall tax benefits the Company recognized as additional paid-in capital during the three and six months ended August 31, 2015. Net windfall tax benefits of $8.4 million recognized as additional paid-in-capital during the six months ended August 31, 2015 includes gross windfall tax benefits of $9.2 million net of $0.8 million shortfall tax expense. During the three months ended August 31, 2015, shortfall tax expense was less than $0.1 million.

Impact to Consolidated Statements of Cash Flows

In addition to the income tax consequences described above, under ASU 2016-09 all windfall tax benefits related to share-based payments are reported as cash flows from operating activities along with all other income tax cash flows. Previously, windfall tax benefits from share-based payment arrangements were reported as cash flows from financing activities.

With respect to the classification of windfall tax benefits on the statement of cash flows, ASU 2016-09 allows companies to elect either a prospective or retrospective application. The Company has elected to apply

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

this classification amendment retrospectively. As a result, $2.8 million and $9.2 million, respectively, of windfall tax benefits previously reported as cash flows from financing activities on the Company s Consolidated Statement of Cash Flows for the three and six months ended August 31, 2015 have been reclassified as cash flows from operating activities.

Impact to Consolidated Balance Sheets

ASU 2016-09 requires that certain other amendments relevant to the Company be applied using a modified-retrospective transition method by means of a cumulative-effect adjustment to retained earnings as of the beginning of the period in which the guidance is adopted. As a result of adopting ASU 2016-09 during the three months ended May 31, 2016, the Company adjusted retained earnings for amendments related to (i) the timing of when unrealized net windfall tax benefits are recognized and (ii) an entity-wide accounting policy election to recognize share-based award forfeitures only as they occur rather than estimate by applying a forfeiture rate. The following table summarizes the impact to the Company s Consolidated Balance Sheet, including the net amount charged to retained earnings as of March 1, 2016 (in thousands):

	As of March 1, 2016	
	Balance Sheet Classification	**Amount**
Increase to additional paid-in capital resulting from the Company s election to recognize forfeitures as they occur rather than applying an estimated forfeiture rate	Additional paid-in capital	$ 2,369
Recognition of deferred tax assets related to cumulative-effect adjustment from the Company s election to recognize forfeitures as they occur	Deferred tax assets, net	$ 603
Recognition of deferred tax assets related to certain unrealized net windfall tax benefits from share-based compensation	Deferred tax assets, net	$ 1,316
Net charge to retained earnings for cumulative-effect adjustment from adoption of ASU 2016-09	Retained earnings	$ 450

Accounting pronouncements being evaluated

In August 2016, the FASB issued Accounting Standards Update 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* (ASU 2016-15). The FASB issued ASU 2016-15 to decrease the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in this update provide guidance on eight specific cash flow issues. This guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2019 and should be applied using the retrospective transition method to each period presented. Early adoption is permitted but all amendments must be adopted in the same period. The Company is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update 2016-02, *Leases (Topic 842)* (ASU 2016-02   ). The FASB issued ASU 2016-02 to increase transparency and comparability among organizations with respect to accounting for leases. Under ASU 2016-02, lessees will recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. This guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2019. The Company is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In January 2016, the FASB issued Accounting Standards Update 2016-01, *Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* (ASU 2016-01). The FASB issued ASU 2016-01 to require equity investments with readily determinable fair values to be measured at fair value with changes in fair value recognized in net income. Equity investments that do not have readily determinable fair values are allowed to be remeasured upon the occurrence of an observable price change or upon identification of an impairment. This guidance is effective for the Company as of the first quarter of the fiscal year ending February 28, 2019. The Company is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). The FASB issued ASU 2014-09 to clarify the principles for recognizing revenue and to develop a common revenue standard for generally accepted accounting principles (GAAP) and International Financial Reporting Standards. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the most current revenue recognition guidance. This guidance is effective for the Company beginning the first quarter of its fiscal year ending February 28, 2019. The standard must be adopted using either a full retrospective approach for all periods presented in the period of adoption or a modified retrospective approach. The Company has initiated an assessment of its systems, data and processes related to the implementation of this accounting standard. This assessment is expected to be completed during the fiscal year ending February 28, 2017. Additionally, the Company is currently evaluating the potential impact that the implementation of this updated standard will have on its consolidated financial statements.

NOTE 3 Changes in Equity

The following table summarizes the changes in the Company s stockholders equity during the three months ended August 31, 2016 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at May 31, 2016	$ 24	$ 2,176,208	$ 1,160,472	$ (1,919,622)	$ (67,747)	$ 1,349,335
Net income			58,772			58,772
Other comprehensive loss, net of tax					(1,975)	(1,975)
Exercise of common stock options		689				689
				(127,386)		(127,386)

Common stock repurchase (see NOTE 10)						
Share-based compensation expense		45,357				45,357
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(6,398)				(6,398)
Other adjustments			2			2
Balance at August 31, 2016	$ 24	$ 2,215,856	$ 1,219,246	$ (2,047,008)	$ (69,722)	$ 1,318,396

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the three months ended August 31, 2015 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at May 31, 2015	$ 23	$ 2,058,046	$ 948,459	$ (1,590,501)	$ (66,604)	$ 1,349,423
Net income			51,395			51,395
Other comprehensive income, net of tax					1,155	1,155
Exercise of common stock options		480				480
Common stock repurchase				(70,079)		(70,079)
Share-based compensation expense		40,537				40,537
Net tax benefits related to share-based awards		2,865				2,865
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(7,726)				(7,726)
Balance at August 31, 2015	$ 23	$ 2,094,202	$ 999,854	$ (1,660,580)	$ (65,449)	$ 1,368,050

The following table summarizes the changes in the Company s stockholders equity during the six months ended August 31, 2016 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity

Balance at February 29, 2016	$ 23	$ 2,162,264	$ 1,099,738	$ (1,853,144)	$ (74,449)	$ 1,334,432
Net income			119,957			119,957
Other comprehensive income, net of tax					4,727	4,727
Exercise of common stock options	1	2,067				2,068
Common stock repurchase (see NOTE 10)				(193,864)		(193,864)
Share-based compensation expense		86,632				86,632
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(37,476)				(37,476)
Other adjustments			1			1
Cumulative-effect adjustment from adoption of ASU 2016-09		2,369	(450)			1,919
Balance at August 31, 2016	$ 24	$ 2,215,856	$ 1,219,246	$ (2,047,008)	$ (69,722)	$ 1,318,396

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the six months ended August 31, 2015 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at February 28, 2015	$ 23	$ 1,963,851	$ 900,373	$ (1,515,288)	$ (60,621)	$ 1,288,338
Net income			99,481			99,481
Other comprehensive loss, net of tax					(4,828)	(4,828)
Exercise of common stock options		2,589				2,589
Common stock repurchase		75,000		(145,079)		(70,079)
Share-based compensation expense		77,059				77,059
Net tax benefits related to share-based awards		8,427				8,427
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(32,937)				(32,937)
Other adjustments		213		(213)		
Balance at August 31, 2015	$ 23	$ 2,094,202	$ 999,854	$ (1,660,580)	$ (65,449)	$ 1,368,050

Accumulated other comprehensive loss

The following is a summary of accumulated other comprehensive loss as of August 31, 2016 and February 29, 2016 (in thousands):

	As of August 31, 2016	As of February 29, 2016
Accumulated loss from foreign currency translation adjustment	$ (70,331)	$ (73,776)
Accumulated unrealized gain (loss), net of tax, on available-for-sale securities	609	(673)
Accumulated other comprehensive loss	$ (69,722)	$ (74,449)

NOTE 4 Identifiable Intangible Assets

Identifiable intangible assets consist primarily of trademarks, copyrights and patents, purchased technologies, customer and reseller relationships and covenants not to compete, which are amortized over the estimated useful life, generally on a straight-line basis with the exception of customer and reseller relationships, which are generally amortized over the related asset s pattern of economic benefit or on a straight-line basis if a straight-line basis results in a greater amount of amortization for the period reported. Useful lives range from two to ten years. As of August 31, 2016 and February 29, 2016, trademarks with an indefinite estimated useful life totaled $11.3 million and $11.1 million, respectively.

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RED HAT, INC.

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(Unaudited)

The following is a summary of identifiable intangible assets (in thousands):

	As of August 31, 2016			As of February 29, 2016		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$ 145,089	$ (54,541)	$ 90,548	$ 138,106	$ (49,876)	$ 88,230
Purchased technologies	100,581	(75,533)	25,048	96,105	(70,940)	25,165
Customer and reseller relationships	104,950	(84,596)	20,354	104,593	(80,329)	24,264
Covenants not to compete	14,007	(11,522)	2,485	13,240	(9,875)	3,365
Other intangible assets	8,833	(4,474)	4,359	8,833	(3,786)	5,047
Total identifiable intangible assets	$ 373,460	$ (230,666)	$ 142,794	$ 360,877	$ (214,806)	$ 146,071

Amortization expense associated with identifiable intangible assets recognized in the Company s Consolidated Financial Statements for the three and six months ended August 31, 2016 and August 31, 2015 is summarized as follows (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Cost of revenue	$ 4,190	$ 2,963	$ 8,157	$ 5,880
Sales and marketing	1,905	2,009	3,820	4,014
Research and development	34	292	69	542
General and administrative	1,848	1,160	3,601	2,212
Total amortization expense	$ 7,977	$ 6,424	$ 15,647	$ 12,648

NOTE 5 Income Taxes

The following table summarizes the Company s tax provision for the three and six months ended August 31, 2016 and August 31, 2015 (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Income before provision for income taxes	$ 79,435	$ 72,387	$ 151,789	$ 140,114
Estimated annual effective tax rate	27%	29%	27%	29%
Provision for income taxes before discrete tax items	21,447	20,992	40,983	40,633
Discrete tax benefits related to net excess tax benefits from share-based payments	(1,002)		(8,940)	
Other discrete tax expense (benefits)	218		(211)	
Provision for income taxes	$ 20,663	$ 20,992	$ 31,832	$ 40,633

For the three and six months ended August 31, 2016, the Company s estimated annual effective tax rate of 27% differed from the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates, research tax credits and the domestic production activities deduction. Tax expense for the three and six months

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RED HAT, INC.

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(Unaudited)

ended August 31, 2016 included a discrete tax benefit of $1.0 million and $8.9 million, respectively, related to net excess tax benefits from share-based payments resulting from the Company s early adoption of ASU 2016-09. See NOTE 2 Summary of Significant Accounting Policies for more details regarding the adoption of ASU 2016-09.

For the three and six months ended August 31, 2015, the Company s then-estimated annual effective tax rate of 29% differed from the U.S. federal statutory rate of 35%, principally due to foreign income taxed at lower rates, state income taxes net of federal benefits and the domestic production activities deduction.

NOTE 6 Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

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

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

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

The Company s investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. Liquid investments with effective maturities of three months or less at the date of purchase 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 Other income (expense), net. Realized gains and losses and other than temporary impairments, if any, are reflected in the consolidated statements of operations as Other income (expense), 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. The vast majority of the Company s investments are 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.

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(Unaudited)

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.

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities at August 31, 2016 (in thousands):

	As of August 31, 2016	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available-for-sale securities (1):				
Money markets	$ 196,182	$ 196,182	$	$
U.S. agency securities	314,490		314,490	
Corporate securities	757,586		757,586	
Foreign currency derivatives (2)	51		51	
Liabilities:				
Foreign currency derivatives (3)	(89)		(89)	
Total	$ 1,268,220	$ 196,182	$ 1,072,038	$

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company s Consolidated Balance Sheet at August 31, 2016, in addition to $774.4 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet at August 31, 2016.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet at August 31, 2016.

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities at February 29, 2016 (in thousands):

	As of February 29,	Quoted Prices In Active Markets for Identical	Significant Other Observable	Significant Unobservable Inputs (Level 3)

	2016	Assets (Level 1)	Inputs (Level 2)	
Assets:				
Available-for-sale securities (1):				
Money markets	$ 221,970	$ 221,970	$	$
U.S. agency securities	331,117		331,117	
Corporate securities	736,495		736,495	
Foreign currency derivatives (2)	566		566	
Liabilities:				
Foreign currency derivatives (3)	(452)		(452)	
Total	$ 1,289,696	$ 221,970	$ 1,067,726	$

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company s Consolidated Balance Sheet at February 29, 2016, in addition to $705.8 million of cash.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(2) Included in Other current assets in the Company s Consolidated Balance Sheet at February 29, 2016.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet at February 29, 2016.

The following table represents the Company s available-for-sale investments measured at fair value as of August 31, 2016 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (1)	Aggregate Fair Value	Balance Sheet Classification: Cash Equivalent Marketable Securities	Investments in debt securities, short-term	Investments in debt securities, long-term
Money markets	$ 196,182	$	$	$ 196,182	$ 196,182	$	$
U.S. agency securities	314,997	128	(635)	314,490		60,357	254,133
Corporate securities	756,555	1,581	(550)	757,586		304,771	452,815
Total	$ 1,267,734	$ 1,709	$ (1,185)	$ 1,268,258	$ 196,182	$ 365,128	$ 706,948

(1) As of August 31, 2016, there were $0.3 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

The following table represents the Company s available-for-sale investments measured at fair value as of February 29, 2016 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (1)	Aggregate Fair Value	Balance Sheet Classification: Cash Equivalent Marketable Securities	Investments in debt securities, short-term	Investments in debt securities, long-term
Money markets	$ 221,970	$	$	$ 221,970	$ 221,970	$	$
U.S. agency securities	331,302	160	(345)	331,117		50,453	280,664
Corporate securities	737,723	994	(2,222)	736,495		230,689	505,806
Total	$ 1,290,995	$ 1,154	$ (2,567)	$ 1,289,582	$ 221,970	$ 281,142	$ 786,470

(1) As of February 29, 2016, there were $0.9 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

NOTE 7 Derivative Instruments

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 does not designate these forward contracts as hedging instruments under applicable accounting guidance and, therefore, changes in fair value are recorded in the Consolidated Statements of Operations.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of August 31, 2016 and for the three and six months then ended (in thousands):

	As of August 31, 2016			Classification of Gain (Loss) Recognized	Three Months Ended August 31, 2016	Six Months Ended August 31, 2016
					Amount of Gain (Loss) Recognized	
	Balance Sheet Classification	Fair Value	Notional Value	in Income on Derivatives	in Income on Derivatives	
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 51	$ 15,188	Other income (expense), net	$ 1,204	$ 2,403
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(89)	18,783	Other income (expense), net	(321)	(999)
Total		$ (38)	$ 33,971		$ 883	$ 1,404

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of August 31, 2015 and for the three and six months then ended (in thousands):

	As of August 31, 2015			Classification of Gain (Loss) Recognized	Three Months Ended August 31, 2015	Six Months Ended August 31, 2015
					Amount of Gain (Loss) Recognized	
	Balance Sheet Classification	Fair Value	Notional Value	in Income on Derivatives	in Income on Derivatives	
	Other current assets	$ 263	$ 32,302		$ 592	$ 1,272

Assets foreign currency forward contracts not designated as hedges				Other income (expense), net		
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(67)	3,607	Other income (expense), net	(437)	(1,246)
Total		$ 196	$ 35,909		$ 155	$ 26

NOTE 8 Share-based Awards

The Company measures share-based compensation cost at the 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. The Company estimates the fair value of stock options using the Black-Scholes-Merton valuation model. The fair value of nonvested share awards, nonvested share units and performance share units are measured at their underlying closing share price on the day of grant. Effective March 1, 2016, the Company adopted ASU 2016-09. Upon adoption of ASU 2016-09 the Company made an accounting policy election to account for forfeitures as they occur rather than apply an estimated forfeiture rate. See NOTE 2 Summary of Significant Accounting Policies for more details regarding the adoption of ASU 2016-09.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the three and six months ended August 31, 2016 and August 31, 2015 (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Cost of revenue	$ 4,054	$ 4,151	$ 8,359	$ 7,877
Sales and marketing	20,361	16,782	38,802	32,194
Research and development	12,969	12,022	24,971	22,897
General and administrative	7,973	7,582	14,500	14,091
Total share-based compensation expense	$ 45,357	$ 40,537	$ 86,632	$ 77,059

Share-based compensation expense qualifying for capitalization was insignificant for each of the three and six months ended August 31, 2016 and August 31, 2015. Accordingly, no share-based compensation expense was capitalized during the three and six months ended August 31, 2016 and August 31, 2015.

During the three and six months ended August 31, 2016 and August 31, 2015, the Company granted the following share-based awards:

	Three Months Ended			
	August 31, 2016		August 31, 2015	
	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value
Service-based shares and share units	133,550	$ 72.80	118,881	$ 80.58
Performance share units target	1,826(1)	$ 72.80	112,360	$ 80.59
Performance share awards		$	56,180	$ 80.59
Total awards	135,376	$ 72.80	287,421	$ 80.59

Six Months Ended

	August 31, 2016		August 31, 2015	
	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value	Shares and Shares Underlying Awards	Weighted Average Per Share Award Fair Value
Service-based shares and share units	1,068,440	$ 75.12	926,477	$ 75.55
Performance share units target	362,502(1)	$ 76.68	370,478	$ 78.28
Performance share awards	140,182(2)	$ 76.70	154,705	$ 78.48
Total awards	1,571,124	$ 75.62	1,451,660	$ 76.56

(1) Certain executives and senior management were awarded a target number of performance share units (PSUs). PSU grantees may earn up to 200% of the target number of PSUs. Half of the target number of PSUs can be earned by the grantees depending upon the Company s financial performance measured against the financial performance of specified peer companies during a three-year performance period beginning on March 1, 2016. The remaining target number of PSUs can be earned by the grantees depending upon the Company s total shareholder return performance measured against the total shareholder return performance of specified peer companies during a three-year period beginning on March 1, 2016.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(2) Certain executives were granted restricted stock awards. These shares were awarded subject to the achievement of a specified dollar amount of revenue for FY2017 (the RSA Performance Goal). If the Company fails to achieve the RSA Performance Goal for FY2017, then all such shares are forfeited. If the Company achieves the RSA Performance Goal for FY2017, then 25% of the restricted stock vests on or about July 16, 2017, and the remainder vests ratably on a quarterly basis over the course of the subsequent three-year period, provided that the grantee s business relationship with the Company has not ceased.

NOTE 9 Earnings Per Share

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

The following table reconciles the numerators and denominators of the earnings per share (EPS) calculation for the three and six months ended August 31, 2016 and August 31, 2015 (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Net income, basic and diluted	$ 58,772	$ 51,395	$ 119,957	$ 99,481
Weighted average common shares outstanding	180,322	183,179	180,745	183,155
Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares	2,829	2,986	2,923	3,009
Dilutive effect of convertible notes	195	585	82	329
Diluted shares	183,346	186,750	183,750	186,493
Diluted net income per share	$ 0.32	$ 0.28	$ 0.65	$ 0.53

With respect to the Company s convertible notes, the Company has the option to pay cash or deliver, as the case may be, either cash, shares of its common stock or a combination of cash and shares of its common stock for the aggregate amount due upon conversion of the convertible notes. The Company s intent is to settle the principal amount of the convertible notes in cash upon conversion. As a result, upon conversion of the convertible notes, only the amounts payable in excess of the principal amounts of the convertible notes would be considered in diluted earnings per share under the treasury stock method. See NOTE 15 Convertible Notes for detailed information on the convertible notes.

Warrants to purchase 10,965,630 shares of the Company s common stock at $101.65 per share were outstanding during the three and six months ended August 31, 2016 and August 31, 2015 but were not included in the computation of diluted EPS because the warrants exercise price was greater than the average market price of the Company s common stock during the related period.

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(Unaudited)

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

	Three Months Ended		**Six Months Ended**	
	August 31, 2016	**August 31, 2015**	**August 31, 2016**	**August 31, 2015**
Number of shares considered anti-dilutive for calculating diluted EPS	158	105	307	67

NOTE 10 Share Repurchase Programs

On March 25, 2015, the Company announced that its Board of Directors (the Board) had authorized the repurchase of up to $500 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program was discontinued by the Board effective June 30, 2016.

From March 1, 2016 through its discontinuation on June 30, 2016, the Company repurchased 1,291,733 shares of its common stock for $94.4 million under this repurchase program.

On June 22, 2016, the Company announced that its Board authorized the repurchase of up to $1.0 billion of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The new program commenced on July 1, 2016, and will expire on the earlier of (i) June 30, 2018 or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program. The new program replaced the previous $500 million repurchase program, which was discontinued by the Board effective June 30, 2016.

From its commencement on July 1, 2016 through August 31, 2016, the Company repurchased 1,362,532 shares of its common stock for $99.5 million under this repurchase program.

As of August 31, 2016, the amount available under this program for the repurchase of the Company s common stock was $900.5 million.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 Segment Reporting

The following summarizes revenue from unaffiliated customers and income (loss) from operations for the three and six months ended August 31, 2016 and August 31, 2015 and total cash, cash equivalents and available-for-sale investment securities and total assets as of August 31, 2016 and August 31, 2015, by geographic segment (in thousands):

	Americas	EMEA	Asia Pacific	Corporate (1)	Consolidated
	Three Months Ended August 31, 2016				
Revenue from unaffiliated customers	$ 385,529	$ 127,467	$ 86,809	$	$ 599,805
Income (loss) from operations	$ 71,595	$ 28,210	$ 27,436	$ (45,357)	$ 81,884
	Three Months Ended August 31, 2015				
Revenue from unaffiliated customers	$ 332,204	$ 108,454	$ 63,490	$	$ 504,148
Income (loss) from operations	$ 73,944	$ 27,012	$ 16,051	$ (40,537)	$ 76,470
	Six Months Ended August 31, 2016				
Revenue from unaffiliated customers	$ 751,252	$ 251,766	$ 164,685	$	$ 1,167,703
Income (loss) from operations	$ 141,352	$ 53,898	$ 48,629	$ (86,632)	$ 157,247
Total cash, cash equivalents and available-for-sale investment securities	$ 1,113,971	$ 634,013	$ 294,661	$	$ 2,042,645
Total assets	$ 2,714,088	$ 944,290	$ 442,378	$	$ 4,100,756
	Six Months Ended August 31, 2015				
Revenue from unaffiliated customers	$ 654,037	$ 205,927	$ 125,185	$	$ 985,149
Income (loss) from operations	$ 149,475	$ 43,419	$ 31,564	$ (77,059)	$ 147,399
Total cash, cash equivalents and available-for-sale investment securities	$ 1,294,633	$ 490,607	$ 210,590	$	$ 1,995,830
Total assets	$ 2,735,505	$ 760,412	$ 305,554	$	$ 3,801,471

(1) Amounts represent share-based compensation expense for each of the three and six months ended August 31, 2016 and August 31, 2015, which was not allocated to geographic segments.

Supplemental information about geographic areas

The following table lists, for each of the three and six months ended August 31, 2016 and August 31, 2015, revenue from unaffiliated customers in the United States, the Company s country of domicile, and revenue from unaffiliated customers from foreign countries (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
United States, the Company s country of domicile	$ 343,766	$ 300,649	$ 672,295	$ 588,110
Foreign	256,039	203,499	495,408	397,039
Total revenue from unaffiliated customers	$ 599,805	$ 504,148	$ 1,167,703	$ 985,149

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RED HAT, INC.

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(Unaudited)

Total tangible long-lived assets, net of accumulated depreciation, located in the United States, the Company s country of domicile, and similar tangible long-lived assets, net of accumulated depreciation, held outside the United States are summarized in the following table as of August 31, 2016 and February 29, 2016 (in thousands):

	As of August 31, 2016	As of February 29, 2016
United States, the Company s country of domicile	$ 126,955	$ 126,937
Foreign	45,357	39,949
Total tangible long-lived assets	$ 172,312	$ 166,886

Supplemental information about major customers

Major customer revenues and receivables were as follows:

For each of the three and six months ended August 31, 2016 and August 31, 2015, the U.S. government and its agencies represented in the aggregate approximately 10% of the Company s total revenue.

At August 31, 2016, the Company had two customers whose accounts receivable balance individually represented 10% and 11%, respectively, of total accounts receivable. As of February 29, 2016, no individual customer accounted for 10% or more of our total accounts receivable.

Supplemental information about products and services

The following table, for each of the three and six months ended August 31, 2016 and August 31, 2015, provides further detail, by type, of the Company s subscription and services revenues. Infrastructure-related offerings subscription revenue includes subscription revenue generated from Red Hat Enterprise Linux and related technologies such as Red Hat Satellite and Red Hat Enterprise Virtualization. Subscription revenue generated from the Company s Application development-related and other emerging technology offerings includes Red Hat JBoss Middleware, Red Hat Storage, Red Hat Mobile and Red Hat cloud offerings such as Red Hat OpenStack Platform and OpenShift by Red Hat (in thousands):

	Three Months Ended	Six Months Ended

	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Subscription revenue:				
Infrastructure-related offerings	$ 427,035	$ 362,926	$ 830,216	$ 716,667
Application development-related and other emerging technology offerings	104,174	78,600	202,658	149,652
Total subscription revenue	531,209	441,526	1,032,874	866,319
Training and services revenue:				
Consulting services	51,277	47,266	101,586	90,466
Training	17,319	15,356	33,243	28,364
Total training and services revenue	68,596	62,622	134,829	118,830
Total subscription and training and services revenue	$ 599,805	$ 504,148	$ 1,167,703	$ 985,149

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 Commitments and Contingencies

Operating leases

As of August 31, 2016, the Company had leases of office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases for the three months ended August 31, 2016 and August 31, 2015 was $9.2 million and $7.8 million, respectively. Rent expense under operating leases for the six months ended August 31, 2016 and August 31, 2015 was $17.7 million and $15.5 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 13 Legal Proceedings

The Company 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, results of operations or cash flows.

NOTE 14 Business Combinations

Acquisition of 3scale, Inc.

On June 24, 2016, the Company completed its acquisition of all of the shares of 3scale, Inc. (3scale), a provider of application programming interface (API) management technology. By adding 3scale to its existing portfolio, including Red Hat JBoss Middleware, Red Hat OpenShift and Red Hat Mobile Application Platform, the Company strengthens its enablement of the API economy with simplified cloud integration and microservices-based architectures.

The consideration paid was $29.1 million in cash. Based on management s provisional assessment of the acquisition-date fair value of the assets acquired and liabilities assumed, the total consideration transferred of $29.1 million has been allocated to the Company s assets and liabilities on a preliminary basis as follows: $24.3 million to goodwill, $6.4 million to identifiable intangible assets and $1.6 million to working capital as a net current liability.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company incurred approximately $1.8 million in transaction costs, including legal and accounting fees, relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on the Company s Consolidated Statements of Operations for the three and six months ended August 31, 2016.

Acquisition of Ansible, Inc.

On October 16, 2015, the Company completed its acquisition of all of the shares of Ansible, Inc. (Ansible). Ansible is a provider of IT automation solutions that allows its users to manage applications across hybrid cloud environments. The acquisition is intended to augment the Company s management portfolio and help customers to deploy and manage applications across private and public clouds, speed service delivery through development and operations initiatives, streamline OpenStack installations and upgrades and accelerate container adoption by simplifying orchestration and configuration.

The consideration paid was $126.0 million and includes $125.2 million of cash. Based on management s provisional assessment of the acquisition-date fair value of the assets acquired and liabilities assumed, the total consideration transferred of $126.0 million has been allocated to the Company s assets and liabilities on a preliminary basis as follows: $102.4 million to goodwill, $25.1 million to identifiable intangible assets and $1.5 million to working capital as a net current liability.

During February 2016, the Company completed its valuation of the identifiable intangible assets acquired from Ansible. As a result of the valuation, the Company reduced its preliminary estimate of identifiable intangible assets by $17.3 million to $25.1 million as of February 29, 2016 from $42.4 million as of November 30, 2015. The $17.3 million measurement-period adjustment resulted in an increase to goodwill of $10.8 million and a decrease to deferred taxes of $6.5 million. This adjustment had no significant impact on the Company s financial results. Management expects to finalize its assessment of the acquisition-date fair value of Ansible s other assets and liabilities, primarily deferred income taxes, in early fiscal 2017.

Pro forma consolidated financial information

The following unaudited pro forma consolidated financial information reflects the results of operations of the Company for the three and six months ended August 31, 2015 (in thousands, except per share amounts) as if the acquisitions of 3scale and Ansible had closed on March 1, 2015, after giving effect to certain purchase accounting adjustments. These pro forma results are not necessarily indicative of what the Company s operating results would have been had the acquisitions actually taken place at the beginning of the period. Pro forma consolidated financial information for the three and six months ended August 31, 2016 has not been provided because the acquisition of 3scale would not have had a significant impact on consolidated operating results if the acquisition had closed on March 1, 2016.

	Three Months Ended August 31, 2015		Six Months Ended August 31, 2015	
Revenue	$	505,917	$	1,170,825
Net income	$	48,117	$	113,610
Basic net income per common share	$	0.26	$	0.63
Diluted net income per common share	$	0.26	$	0.62

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Goodwill

The following is a summary of changes in goodwill for the six months ended August 31, 2016 (in thousands):

Balance at February 29, 2016	$ 1,027,277
Acquisition of 3scale	24,254
Impact of foreign currency fluctuations and other adjustments	2,341
Balance at August 31, 2016	$ 1,053,872

The excess of purchase price paid for 3scale, Ansible and other acquisitions over the fair value of the net assets acquired was recognized as goodwill. Goodwill comprises the majority of the purchase price paid for each of the acquired businesses because these businesses were focused on emerging technologies such as development and operations automation, mobile technologies, cloud-enabling technologies and software-defined storage technologies, which consequently at the time of acquisition generated relatively little revenue. However, these acquired businesses, with their assembled, highly-specialized workforces and community of contributors, are expected to both expand the Company s existing technology portfolio and advance the Company s market position overall in open source solutions.

NOTE 15 Convertible Notes

Convertible notes offering

On October 7, 2014, the Company completed its offering of $805.0 million aggregate principal amount of its 0.25% Convertible Senior Notes due 2019 (the convertible notes). The convertible notes were sold in a private placement under a purchase agreement, dated as of October 1, 2014, entered into by and among the Company and Morgan Stanley & Co. LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Citigroup Global Markets Inc. and J.P. Morgan Securities LLC as representatives of the several initial purchasers named therein (collectively, the Initial Purchasers), for resale to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended.

The Company used $148.0 million of the net proceeds from the offering of the convertible notes to pay the cost of the privately-negotiated convertible note hedge transactions described below. The Company received proceeds of $79.8 million from the sale of warrants pursuant to the warrant transactions described below.

In addition, the Company used $375.0 million of the net proceeds from the offering of the convertible notes to repurchase shares of its common stock under an accelerated share repurchase program pursuant to an agreement that the Company entered into on October 1, 2014 and completed on February 27, 2015.

The Company intends to use the remaining net proceeds from the offering for working capital and other general corporate purposes, which may include capital expenditures, potential acquisitions or strategic transactions.

Indenture

On October 7, 2014, the Company entered into an indenture (the Indenture) with respect to the convertible notes with U.S. Bank National Association, as trustee (the Trustee). Under the Indenture, the convertible notes

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RED HAT, INC.

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(Unaudited)

will be senior unsecured obligations of the Company and bear interest at a rate of 0.25% per year, payable semiannually in arrears on April 1 and October 1 of each year, and began on April 1, 2015. The convertible notes will mature on October 1, 2019, unless previously purchased or converted.

The convertible notes are convertible into shares of the Company s common stock at an initial conversion rate of 13.6219 shares per $1,000 principal amount of convertible notes (which is equivalent to an initial conversion price of approximately $73.41 per share), subject to adjustment upon the occurrence of certain events. The initial conversion price represents a premium of approximately 30% to the $56.47 per share closing price of the Company s common stock on October 1, 2014. Upon conversion of the convertible notes, holders will receive cash or shares of the Company s common stock or a combination thereof, at the Company s election.

Prior to April 1, 2019, the convertible notes will be convertible only upon the occurrence of certain circumstances, and will be convertible thereafter at any time until the close of business on the second scheduled trading day immediately preceding the maturity date of the convertible notes.

The conversion rate is subject to customary anti-dilution adjustments. If certain corporate events described in the Indenture occur prior to the maturity date, the conversion rate will be increased for a holder who elects to convert its convertible notes in connection with such corporate event in certain circumstances.

The convertible notes are not redeemable prior to maturity, and no sinking fund is provided for the convertible notes. If the Company undergoes a fundamental change, as defined in the Indenture, subject to certain conditions, holders may require the Company to purchase for cash all or any portion of their convertible notes. The fundamental change purchase price will be 100% of the principal amount of the convertible notes to be purchased plus any accrued and unpaid special interest up to but excluding the fundamental change purchase date.

The Indenture contains customary terms and covenants, including that upon certain events of default occurring and continuing, either the Trustee or the holders of at least 25% in principal amount of the outstanding convertible notes may declare 100% of the principal of, and accrued and unpaid interest, if any, on, all the convertible notes to be due and payable.

In accounting for the issuance of the convertible notes, the Company separated the convertible notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the estimated fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the face value of the convertible notes as a whole. The excess of the face value of the convertible notes as a whole over the carrying amount of the liability component (the debt discount) is amortized to interest expense over the term of the convertible notes using the effective interest method with an effective interest rate of 2.86% per annum. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of August 31, 2016 and February 29, 2016, the convertible notes consisted of the following (in thousands):

	As of August 31, 2016	As of February 29, 2016
Liability component:		
Principal	$ 805,000	$ 805,000
Less: debt issuance costs	(8,755)	(10,029)
Less: debt discount	(61,545)	(71,029)
Net carrying amount	$ 734,700	$ 723,942
Equity component (1)	$ 96,890	$ 96,890

(1) Recorded in the Consolidated Balance Sheet in Additional paid-in capital.

In accounting for the transaction costs related to the convertible note issuance, the Company allocated the total amount incurred of $15.2 million to the liability and equity components based on their relative fair values. Issuance costs attributable to the liability component totaled $13.4 million and are being amortized to interest expense over the term of the convertible notes using the effective interest method. The remaining $1.8 million of issuance costs have been allocated to the equity component and are included in Additional paid-in capital on the Company s Consolidated Balance Sheet as of August 31, 2016. Additionally, the Company recorded a deferred tax asset of $0.7 million related to the $1.8 million equity component of transactional costs that are deductible for tax purposes.

The following table includes total interest expense recognized related to the convertible notes for the three and six months ended August 31, 2016 and August 31, 2015 (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2016	August 31, 2015	August 31, 2016	August 31, 2015
Coupon rate 0.25% per year, payable semiannually	$ 503	$ 503	$ 1,006	$ 1,006
Amortization of convertible note issuance costs liability component	640	602	1,274	1,198
Accretion of debt discount	4,753	4,620	9,484	9,219

Total interest expense related to convertible notes	$ 5,896	$ 5,725	$ 11,764	$ 11,423

The fair value of the convertible notes, which was determined based on inputs that are observable in the market (Level 2), and the carrying value of the convertible notes (the carrying value excludes the equity component of the convertible notes classified in equity) are as follows (in thousands):

	As of August 31, 2016	
	Fair Value	Carrying Value
Convertible notes	$ 735,729	$ 734,700

Convertible note hedge transactions and warrant transactions

On October 1, 2014, the Company entered into convertible note hedge transactions and warrant transactions with certain of the Initial Purchasers of the convertible notes or their respective affiliates.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The convertible note hedge transactions are expected to offset the potential dilution with respect to shares of the Company s common stock upon any conversion of the convertible notes and/or offset any cash payments the Company is required to make in excess of the principal amount of the converted notes, as the case may be. To partially offset the $148.0 million cost of the convertible note hedge transactions, the Company issued warrants and received proceeds of $79.8 million. The number of shares of the Company s common stock underlying the warrants total 10,965,630, the same number of shares underlying the convertible notes and the convertible note hedge transactions. The combination of the convertible note hedge transactions and the warrant transactions effectively increases the initial conversion price of the convertible notes from $73.41 per share to $101.65 per share. As a result, the warrant transactions will have a dilutive effect with respect to the Company s common stock to the extent that the market price per share of the Company s common stock, as measured under the terms of the warrant transactions, exceeds the $101.65 strike price of the warrants. However, subject to certain conditions, the Company may elect to settle all of the warrants in cash. The $101.65 strike price of the warrants represents a premium of approximately 80% over the $56.47 per share closing price of the Company s common stock on October 1, 2014.

The purchase of convertible note hedges and proceeds from issuance of warrants were recorded in stockholders equity and will continue to be classified as stockholders equity.

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

OVERVIEW

We are a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, management, middleware, cloud, mobile and storage technologies.

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

We market our offerings primarily to customers in the form of annual or multi-year subscriptions, and we recognize revenue over the period of the subscription agreements with our customers. Our technologies are also offered by certified cloud and service providers (CCSPs) as a service available on demand, and this revenue is recognized by us upon delivery.

We derive our revenue and generate cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat technologies. Our revenue is affected by, among other factors, corporate, government and consumer spending levels. In evaluating the performance of our business, we consider a number of factors, including total revenue, deferred revenue, operating income, operating margin and cash flows from operations. The arrangements with our customers that produce this revenue and cash are explained in further detail in Part II, Item 7 under Critical Accounting Estimates and in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements of our Annual Report on Form 10-K for the fiscal year ended February 29, 2016.

We believe our success is influenced by: (i) the extent to which we can expand the breadth and depth of our offerings, (ii) our ability to enhance the value of our offerings through frequent and continuing innovation while maintaining stable platforms over multi-year periods, (iii) the extent to which adoption of our emerging technology offerings by enterprises and similar institutions continues to increase, (iv) our involvement and leadership in key open source communities, which enable us to develop, enhance and maintain our offerings, (v) our ability to generate increasing revenue directly and through partners and other strategic relationships, including CCSPs, distributors, embedded technology partners, independent hardware vendors (IHVs), independent software vendors (ISVs), original equipment manufacturers (OEMs), systems integrators, and value added resellers, (vi) our ability to generate new and recurring revenue for our offerings, (vii) the widespread and increasing deployment of open source technologies by enterprises and similar institutions, (viii) our software, hardware, application and cloud service certification programs, which are intended to create an ecosystem of technologies that are compatible with our offerings and supported by us, and (ix) our ability to provide customers with consulting and training services that generate additional subscription revenue.

In our fiscal year ended February 29, 2016 we focused on and in our fiscal year ending February 28, 2017 we expect to focus on, among other things: (i) driving the widespread adoption of our offerings, (ii) expanding our portfolio of technology offerings that enable cloud computing, (iii) investing in the development of open source technologies and promoting the use of our technologies by software developers globally, (iv) pursuing strategic acquisitions and alliances, (v) increasing revenue from our existing customer base, (vi) increasing

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revenue by promoting a range of services to help our customers derive additional value, (vii) expanding routes to market, and (viii) growing our presence in international markets.

Revenue

For the three months ended August 31, 2016, total revenue increased 19.0%, or $95.7 million, to $599.8 million from $504.1 million for the three months ended August 31, 2015. Excluding the impact of foreign currency exchange rate fluctuations, total revenue increased by 18.3% for the three months ended August 31, 2016, as detailed in the following table.

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The growth rates of subscription revenue by offering type, training and services revenue and total revenue, as reported and excluding the impact of foreign currency exchange rate fluctuations, for the three and six months ended August 31, 2016 versus the three and six months ended August 31, 2015 are as follows (in thousands):

	Three Months Ended (1)			Six Months Ended (1)		
	August 31, 2016	August 31, 2015	Year-Over-Year Growth Rate	August 31, 2016	August 31, 2015	Year-Over-Year Growth Rate
Infrastructure-related subscription revenue, as reported	$ 427,035	$ 362,926	17.7%	$ 830,216	$ 716,667	15.8%
Adjustment for foreign currency exchange rates	(3,824)			(5,572)		
Infrastructure-related subscription revenue, excluding foreign currency impact	423,211	362,926	16.6%	824,644	716,667	15.1%
Application development-related and other emerging technology subscription revenue, as reported	104,174	78,600	32.5%	202,658	149,652	35.4%
Adjustment for foreign currency exchange rates	(629)			(894)		
Application development-related and other emerging technology subscription revenue, excluding foreign currency impact	103,545	78,600	31.7%	201,764	149,652	34.8%
Total subscription revenue, as reported	531,209	441,526	20.3%	1,032,874	866,319	19.2%
Adjustment for foreign currency exchange rates	(4,453)			(6,466)		
Total subscription revenue, excluding foreign currency impact	526,756	441,526	19.3%	1,026,408	866,319	18.5%
Total training and services revenue, as reported	68,596	62,622	9.5%	134,829	118,830	13.5%
Adjustment for foreign currency exchange rates	974			1,577		
Total training and services revenue, excluding foreign currency impact	69,570	62,622	11.1%	136,406	118,830	14.8%
	599,805	504,148	19.0%	1,167,703	985,149	18.5%

Total subscription and training and services revenue, as reported						
Adjustment for foreign currency exchange rates	(3,479)			(4,889)		
Total subscription and training and services revenue, excluding foreign currency impact	$ 596,326	$ 504,148	18.3%	$ 1,162,814	$ 985,149	18.0%

(1) Revenue from our non-U.S. operations has been translated into U.S. dollars using the average foreign currency exchange rates for each month of the three and six months ended August 31, 2016. In an effort to provide a comparable framework for assessing how our business performed when compared to the three and six months ended August 31, 2015 in light of the effect of exchange rate differences, we believe it is helpful to exclude the impact of foreign currency exchange rate fluctuations by translating revenue from our non-U.S. operations for the three and six months ended August 31, 2016 using the average foreign currency exchanges rates for the three and six months ended August 31, 2015.

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Subscription revenue

Our enterprise technologies are delivered primarily under subscription agreements. These agreements typically have a one- or three-year subscription period. A subscription generally entitles a customer to, among other things, a specified level of support, as well as security updates, fixes, functionality enhancements, upgrades to the technologies, each if and when available, and compatibility with an ecosystem of certified hardware and software. Subscription revenue increased sequentially for the first and second quarters of fiscal 2017 and for each quarter of fiscal 2016 and fiscal 2015 and was driven primarily by the increased use of our offerings by customers and our expansion of sales channels and geographic footprint during these periods.

Subscription revenue increased 20.3%, or $89.7 million, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015. Excluding the impact of foreign currency exchange rate fluctuations, subscription revenue increased by 19.3% for the three months ended August 31, 2016. The increase in subscription revenue is driven primarily by additional subscriptions related to our principal Red Hat Enterprise Linux and Red Hat JBoss Middleware offerings, which continue to gain broader market acceptance in mission-critical areas of computing, and our expansion of sales channels and geographic footprint. The increase is, in part, a result of the continued migration of enterprises in industries such as financial services, government, technology and telecommunications to our open source solutions from proprietary technologies.

Training and services revenue

Training and services revenue increased 9.5%, or $6.0 million, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015. Excluding the impact of foreign currency exchange rates, training and services revenue increased by 11.1%. The increase is driven primarily by customer interest in new products and increased demand for our open source solutions.

Deferred revenue and billings proxy

Year-to-date deferred revenue

Our deferred revenue, current and long-term, balance at August 31, 2016 was $1.68 billion. Total deferred revenue at August 31, 2016 decreased 2.4%, or $41.9 million, as compared to the balance of $1.72 billion at February 29, 2016. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue decreased by 4.2% or $73.0 million from February 29, 2016 to August 31, 2016. The decrease in deferred revenue is primarily attributable to our typically lower seasonal first and second quarter billings. Because of our subscription model and revenue recognition policies, deferred revenue improves predictability of future revenue. For example, current deferred revenue provides a baseline for revenue to be recognized over the next twelve months. Similarly, long-term deferred revenue provides a baseline for revenue to be recognized beyond twelve months. Revenue derived from CCSPs for the delivery of our technologies as a service available on demand is recognized by us in the period earned and billed in arrears. As a result, revenue derived from CCSPs has no associated deferred revenue.

The decrease in deferred revenue reported on our Consolidated Balance Sheets of $41.9 million differs from the decrease of $73.0 million we reported on our Consolidated Statements of Cash Flows for the six months ended August 31, 2016 as the amount reported on our Consolidated Statements of Cash Flows for the six months ended August 31, 2016 excludes (i) the impact of changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries functional currency into U.S. dollars and (ii) deferred revenue acquired as part of a business combination.

Year-over-year deferred revenue

Total deferred revenue increased by 18.9%, or $267.2 million, to $1.68 billion at August 31, 2016 from $1.41 billion at August 31, 2015. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue increased by 17.3%, or $244.7 million, from August 31, 2015 to August 31, 2016. This increase in deferred revenue of $244.7 million is the summation of the changes in deferred revenue that we reported on our Consolidated Statements of Cash Flows for each quarter of the four-fiscal-quarter period ended August 31, 2016, plus $0.7 million related to deferred revenue acquired from business combinations during the same period.

Current deferred revenue increased by 17.8%, or $186.0 million, to $1.23 billion at August 31, 2016 from $1.05 billion at August 31, 2015 and long-term deferred revenue increased by 22.2%, or $81.2 million, to $446.9 million at August 31, 2016 from $365.7 million at August 31, 2015. Excluding the impact of foreign currency exchange rate fluctuations, current deferred revenue increased by 16.2%, or $169.3 million, and long-term deferred revenue increased by 20.6%, or $75.5 million, from August 31, 2015 to August 31, 2016.

Billings proxy

We approximate our quarterly billings by adding revenue recognized on our Consolidated Statements of Operations to the change in total deferred revenue reported on our Consolidated Statements of Cash Flows. We use the change in deferred revenue as reported on our Consolidated Statements of Cash Flows because the amount has been adjusted for the impact of changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries functional currencies into U.S. dollars.

For the four-fiscal-quarter period ended August 31, 2016, our rolling average billings proxy increased by 14.9%, or $80.4 million, to $619.7 million from $539.3 million for the four-fiscal-quarter period ended August 31, 2015. Using the average foreign currency exchange rates for each quarter of our four-fiscal-quarter period ended August 31, 2015, our rolling average billings proxy for the four-fiscal-quarter period ended August 31, 2016 would have increased by approximately 16.8%, or $90.4 million. For information regarding seasonality, see Part II, Item 7 under Overview of our Annual Report on Form 10-K for the fiscal year ended February 29, 2016.

Revenue by geography

For the three months ended August 31, 2016, approximately $256.0 million, or 42.7%, of our revenue was generated outside the U.S. compared to approximately $203.5 million, or 40.4%, for the three months ended August 31, 2015. The relative increase in the percentage of revenue generated outside the U.S. for the three months ended August 31, 2016 compared to the percentage of revenue generated outside the U.S. for the three months ended August 31, 2015 is due to foreign currency exchange rate fluctuations. Our international operations are expected to grow as our international sales force and channels become more mature and as we enter new locations outside the U.S. or expand our presence in existing international locations. As of August 31, 2016, we had offices in more than 85 locations throughout the world.

We operate our business in three geographic regions: the Americas (U.S., Latin America and Canada); EMEA (Europe, Middle East and Africa); and Asia Pacific (principally Australia, China, India, Japan, Singapore and South Korea). Revenue generated by the Americas, EMEA and Asia Pacific for the three months ended August 31, 2016 and the three months ended August 31, 2015 was as follows (in thousands):

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended August 31, 2016	$ 385,529	$ 127,467	$ 86,809	$ 599,805
Three Months Ended August 31, 2015	$ 332,204	$ 108,454	$ 63,490	$ 504,148

Year-over-year revenue growth rates in U.S. dollars for our three geographical regions were as follows for the three months ended August 31, 2016 and three months ended August 31, 2015:

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended August 31, 2016	16.1%	17.5%	36.7%	19.0%
Three Months Ended August 31, 2015	17.7%	4.8%	5.4%	13.1%

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Excluding the impact of changes in foreign currency exchange rates, year-over-year revenue growth rates for our three geographical regions were as follows for the three months ended August 31, 2016 and the three months ended August 31, 2015:

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended August 31, 2016	17.0%	17.0%	27.4%	18.3%
Three months ended August 31, 2015 (1)	19.0%	27.2%	22.0%	21.3%

(1) Revenue growth rates from our non-U.S. operations have been calculated by translating revenue from our non-U.S. operations for the three months ended August 31, 2015 into U.S. dollars using the average foreign currency exchanges rates for the three months ended August 31, 2014.

As we expand further within each region, we anticipate revenue growth rates in local currencies to become more similar among our geographic regions due to the similarity of products and services offered and the similarity in customer types or classes.

Gross profit margin

Gross profit margin increased to 85.4% for the three months ended August 31, 2016 from 84.9% for the three months ended August 31, 2015. A slight increase in cost to deliver our subscription revenue was more than offset by a higher mix of subscription revenue relative to training and services revenue for the three months ended August 31, 2016 from the three months ended August 31, 2015. Subscription revenue was 88.6% and 87.6% of total revenue for the three months ended August 31, 2016 and August 31, 2015, respectively.

Gross profit margin by geography

Gross profit margins by our geographic regions for the three months ended August 31, 2016 and August 31, 2015 were as follows:

	Americas	EMEA	Asia Pacific	Consolidated (1)
Three Months Ended August 31, 2016	86.0%	87.1%	84.8%	85.4%
Three Months Ended August 31, 2015	85.8%	86.8%	83.6%	84.9%

(1) Consolidated gross margin includes corporate (non-allocated) share-based compensation expense for the three months ended August 31, 2016 and August 31, 2015 of $4.1 million and $4.2 million, respectively. For additional information, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

Regional year-over-year variations in gross profit margins are primarily due to slight product mix shifts between subscriptions and services.

As we continue to expand our sales and support services within our geographic regions, we expect gross profit margins across geographic regions to further converge over the long run due to the similarity of products and services offered, similarity in production and distribution methods and the similarity in customer types or classes. These geographic profit margins exclude the impact of share-based compensation expense, which was not allocated to our geographic regions.

Income from operations

Operating income as a percentage of revenue decreased to 13.7% for the three months ended August 31, 2016 from 15.2% for the three months ended August 31, 2015. The decrease was primarily driven by an increase in operating expenses related to accelerated hiring to support our Application Development-related and other emerging technologies and the closing and integration of our recent business acquisitions.

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Income from operations by geography

Operating income as a percentage of revenue generated by our geographic regions for the three months ended August 31, 2016 and the three months ended August 31, 2015 was as follows:

	Americas	EMEA	Asia Pacific	Consolidated (1)
Three Months Ended August 31, 2016	18.6%	22.1%	31.6%	13.7%
Three Months Ended August 31, 2015	22.3%	24.9%	25.3%	15.2%

(1) Consolidated operating income as a percentage of revenue includes corporate (non-allocated) share-based compensation expense for the three months ended August 31, 2016 and August 31, 2015 of $45.4 million and $40.5 million, respectively. For additional information, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

Operating margin for Americas and EMEA decreased for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015 primarily as a result of an increase in operating expenses related to accelerated hiring to support our Application Development-related and other emerging technologies and closing and integrating the 3scale and Ansible acquisitions. APAC operating margin increased for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015 primarily as a result of growing revenue, which increased 36.7%.

These geographic operating margins exclude the impact of share-based compensation expense, which was not allocated to our geographic segments.

Cash, cash equivalents, investments in debt securities and cash flow from operations

Cash, cash equivalents and short-term and long-term available-for-sale investments in debt securities balances at August 31, 2016 totaled $2.04 billion. Cash generated from operating activities for the three months ended August 31, 2016 totaled $96.8 million, which represents a decrease of 21.4% in operating cash flow as compared to the three months ended August 31, 2015. This decrease is primarily due to (i) an increase in operating expenses related to accelerated hiring to support our Application Development-related and other emerging technologies and (ii) the timing of our billings, of which a larger dollar value of transactions were executed during the last weeks of the quarter ended August 31, 2016 as compared to the quarter ended August 31, 2015, which affected our ability to bill and collect cash from our customers in such transactions.

Our significant cash and investment balances give us a measure of flexibility to take advantage of opportunities such as acquisitions, increasing investment in our international operations and repurchasing our common stock.

Foreign currency exchange rates impact on results of operations

Approximately 42.7% of our revenue for the three months ended August 31, 2016 came from sales outside the U.S. 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 of net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions results in increased revenue and operating expenses from operations for our non-U.S. operations. Similarly, our revenue and operating expenses will decrease for our non-U.S. operations if the U.S. dollar strengthens against foreign currencies.

Three months ended August 31, 2016

Using the average foreign currency exchange rates from the second quarter of our prior fiscal year ended February 29, 2016, our revenue and operating expenses from non-U.S. operations for the three months ended

August 31, 2016 would have been lower and higher than we reported by approximately $3.5 million and $2.3 million, respectively, which would have resulted in income from operations being lower by $5.8 million.

Six Months Ended August 31, 2016

Using the average foreign currency exchange rates for the six months ended August 31, 2015, our revenue and operating expenses from non-U.S. operations for the six months ended August 31, 2016 would have been lower and higher than we reported by approximately $4.9 million and $5.1 million, respectively, which would have resulted in income from operations being lower by $10.0 million.

Business combinations

Acquisition of 3scale

On June 22, 2016, we completed our acquisition of all of the shares of 3scale for $29.1 million. 3scale is a provider of application programming interface (API) management technology. The acquisition is intended to extend our existing portfolio, including Red Hat JBoss Middleware, Red Hat OpenShift and Red Hat Mobile Application Platform, and strengthen our enablement of the API economy with simplified cloud integration and microservices-based architectures.

We incurred approximately $1.8 million in transaction costs, including legal and accounting fees, relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on our Consolidated Statement of Operations for the three and six months ended August 31, 2016.

Acquisition of Ansible

On October 16, 2015, we completed our acquisition of all of the shares of Ansible for approximately $126.0 million. Ansible is a provider of IT automation solutions that allows its users to manage applications across hybrid cloud environments. The acquisition is intended to augment our management portfolio and help customers to deploy and manage applications across private and public clouds, speed service delivery through development and operations initiatives, streamline OpenStack installations and upgrades and accelerate container adoption by simplifying orchestration and configuration.

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RESULTS OF OPERATIONS

Three months ended August 31, 2016 and August 31, 2015

The following table is a summary of our results of operations for the three months ended August 31, 2016 and August 31, 2015 (in thousands):

	Three Months Ended (Unaudited)			
	August 31, 2016	August 31, 2015	$ Change	% Change
Revenue:				
Subscriptions	$ 531,209	$ 441,526	$ 89,683	20.3%
Training and services	68,596	62,622	5,974	9.5
Total subscription and training and services revenue	599,805	504,148	95,657	19.0
Cost of subscription and training and services revenue:				
Cost of subscriptions	39,678	30,996	8,682	28.0
As a % of subscription revenue	7.5%	7.0%		
Cost of training and services	47,993	44,968	3,025	6.7
As a % of training and services revenue	70.0%	71.8%		
Total cost of subscription and training and services revenue	87,671	75,964	11,707	15.4
As a % of total revenue	14.6%	15.1%		
Total gross profit	512,134	428,184	83,950	19.6
Operating expense:				
Sales and marketing	253,255	205,101	48,154	23.5
Research and development	121,265	102,488	18,777	18.3
General and administrative	55,730	44,125	11,605	26.3
Total operating expense	430,250	351,714	78,536	22.3
Income from operations	81,884	76,470	5,414	7.1
Interest income	3,392	2,895	497	17.2
Interest expense	5,925	5,733	192	3.3
Other income (expense), net	84	(1,245)	1,329	106.7
Income before provision for income taxes	79,435	72,387	7,048	9.7
Provision for income taxes (1)	20,663	20,992	(329)	(1.6)
Net income	$ 58,772	$ 51,395	$ 7,377	14.4%
Gross profit margin-subscriptions	92.5%	93.0%		

Gross profit margin-training and services	30.0%	28.2%
Gross profit margin	85.4%	84.9%
As a % of total revenue:		
Subscription revenue	88.6%	87.6%
Training and services revenue	11.4%	12.4%
Sales and marketing expense	42.2%	40.7%
Research and development expense	20.2%	20.3%
General and administrative expense	9.3%	8.8%
Total operating expenses	71.7%	69.8%
Income from operations	13.7%	15.2%
Income before provision for income taxes	13.2%	14.4%
Net income	9.8%	10.2%
Estimated annual effective income tax rate (1)	27.0%	29.0%

(1) Provision for income taxes for the three months ended August 31, 2016 includes net discrete tax benefits of $0.8 million, of which $1.0 million are related to net excess tax benefits from share-based compensation. Our estimated annual effective tax rate is 27%. Our calculated tax rate for the three months ended August 31, 2016, including net discrete tax benefits, is 26%. See NOTE 5 Income Taxes to our Consolidated Financial Statements for further discussion.

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Revenue

Subscription revenue

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat offerings, increased by 20.3%, or $89.7 million, to $531.2 million for the three months ended August 31, 2016 from $441.5 million for the three months ended August 31, 2015.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 17.7%, or $64.1 million, to $427.0 million for the three months ended August 31, 2016 from $362.9 million for the three months ended August 31, 2015. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion and the continued migration of customers to our open source Linux platform from proprietary operating systems.

Revenue derived from the sale of subscriptions supporting our Application development-related and other emerging technology offerings increased by 32.5%, or $25.6 million, to $104.2 million for the three months ended August 31, 2016 from $78.6 million for the three months ended August 31, 2015. The increase is primarily due to additional subscriptions for Red Hat JBoss Middleware offerings. We expect the growth rate of revenue derived from our Application development-related and other emerging technology offerings to exceed the growth rate of revenue derived from our Infrastructure-related offerings as our Application development-related and other emerging technology offerings continue to gain broader market acceptance in the enterprise IT environment.

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 technologies and for delivery of added functionality to Red Hat technologies for our major customers and OEM partners. Total training and services revenue increased by 9.5%, or $6.0 million, to $68.6 million for the three months ended August 31, 2016 from $62.6 million for the three months ended August 31, 2015. The increase is due to both services and training. Services revenue increased by 8.5%, or $4.0 million, as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Training revenue increased by 12.8%, or $2.0 million as a result of increased adoption of our Red Hat Learning Subscriptions (RHLS). Combined training and services revenue as a percentage of total revenue was 11.4% and 12.4%, respectively, for the three months ended August 31, 2016 and August 31, 2015.

Cost of revenue

Cost of subscription revenue

The cost of subscription revenue primarily consists of expenses we incur to support, distribute and package Red Hat offerings. These costs include labor-related costs to provide technical support, security updates and fixes, as well as costs for fulfillment. Cost of subscription revenue increased by 28.0%, or $8.7 million, to $39.7 million for the three months ended August 31, 2016 from $31.0 million for the three months ended August 31, 2015. The increase is primarily due to the expansion of our technical staff in order to meet the demands of our growing subscriber base for support, security updates and fixes, and includes additional compensation of $5.4 million. The remaining increase was driven primarily by incremental amortization expense related to the acquisitions of Ansible and 3scale. Gross profit margin on subscriptions was 92.5% and 93.0%, respectively, for the three months ended August 31, 2016 and August 31, 2015. As the number of our open source technology subscriptions continues to increase, we expect associated support costs will continue to increase, although we anticipate this will occur at a rate slower than that of subscription revenue growth due to economies of scale.

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 types of customers. Cost of training and services revenue increased by 6.7%, or $3.0 million, to $48.0 million for the three months ended August 31, 2016 from $45.0 million for the three months ended August 31, 2015. Costs to deliver our services revenue increased by 7.1%, or $2.6 million, and relate to additional employee compensation and travel associated with additions to our emerging technologies staff. Total costs to deliver training and services as a percentage of training and services revenue decreased to 70.0% for the three months ended August 31, 2016 from 71.8% for the three months ended August 31, 2015 primarily as a result of increased revenue generated from our RHLS offering.

Gross profit margin

Gross profit margin increased to 85.4% for the three months ended August 31, 2016 from 84.9% for the three months ended August 31, 2015. A slight increase in cost to deliver our subscription revenue was more than offset by a higher mix of subscription revenue relative to training and services revenue for the three months ended August 31, 2016 from the three months ended August 31, 2015. Subscription revenue was 88.6% and 87.6% of total revenue for the three months ended August 31, 2016 and August 31, 2015, respectively.

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 23.5%, or $48.2 million, to $253.3 million for the three months ended August 31, 2016 from $205.1 million for the three months ended August 31, 2015. This increase was primarily due to a $37.2 million increase in selling costs, which includes $30.2 million of additional employee compensation expense attributable to the expansion of our sales force from the prior year. The remaining increase relates to marketing costs, which grew 20.5%, or $11.0 million, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015 and includes incremental employee compensation and marketing program costs of $8.0 million and $1.6 million, respectively. Sales and marketing expense increased as a percentage of revenue to 42.2% for the three months ended August 31, 2016 from 40.7% for the three months ended August 31, 2015.

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 18.3%, or $18.8 million, to $121.3 million for the three months ended August 31, 2016 from $102.5 million for the three months ended August 31, 2015. The increase in research and development costs primarily resulted from the expansion of our engineering group as a result of both direct hires and business combinations as we continue investing in our Application Development-related and other emerging technologies. Employee compensation increased by $17.2 million. Research and development expense was 20.2% and 20.3% of total revenue for the three months ended August 31, 2016 and August 31, 2015, 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 26.3%, or $11.6 million, to $55.7 million for the three months ended August 31, 2016 from $44.1 million for the three months ended August 31, 2015. General and

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administrative expenses include increased compensation-related expense of $3.2 million, infrastructure and facilities costs of $4.2 million and outside professional services of $3.8 million. General and administrative expense as a percentage of revenue was 9.3% and 8.8% for the three months ended August 31, 2016 and August 31, 2015, respectively. We expect general and administrative costs to decrease relative to revenue as we leverage benefits from investments made during the current fiscal year to expand and enhance our corporate processes and technology infrastructure.

Interest income

Interest income increased by 17.2%, or $0.5 million, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015. The increase in interest income for the three months ended August 31, 2016 is attributable to slightly higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $0.2 million, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015. Interest expense is primarily attributable to the issuance of convertible notes, which is described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

Other income (expense), net

Other income (expense), net increased by $1.3 million, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015. The increase is primarily due to net losses recognized from the settlement of foreign currency transactions during the three months ended August 31, 2015.

Income taxes

During the three months ended August 31, 2016, we recorded $20.7 million of income tax expense, which is based on an estimated annual effective tax rate of 27%. Our estimated annual effective tax rate of 27% was less than the U.S. federal statutory rate of 35% primarily due to foreign income taxed at lower rates, research tax credits and the domestic production activities deduction. Tax expense for the three months ended August 31, 2016 included a discrete tax benefit of $1.0 million, related to excess tax benefits from share-based compensation resulting from the early adoption of ASU 2016-09. See NOTE 2 Summary of Significant Accounting Policies to our Consolidated Financial Statements for additional information.

During the three months ended August 31, 2015, we recorded $21.0 million of income tax expense, which was based on a then estimated annual effective tax rate of 29%. Our estimated annual effective tax rate of 29% was less than the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates, state income taxes net of federal benefits and the domestic production activities deduction.

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Six months ended August 31, 2016 and August 31, 2015

The following table is a summary of our results of operations for the six months ended August 31, 2016 and August 31, 2015 (in thousands):

	Six Months Ended (Unaudited)			
	August 31, 2016	August 31, 2015	$ Change	% Change
Revenue:				
Subscriptions	$ 1,032,874	$ 866,319	$ 166,555	19.2%
Training and services	134,829	118,830	15,999	13.5
Total subscription and training and services revenue	1,167,703	985,149	182,554	18.5
Cost of subscription and training and services revenue:				
Cost of subscriptions	76,222	60,843	15,379	25.3
As a % of subscription revenue	7.4%	7.0%		
Cost of training and services	95,496	86,519	8,977	10.4
As a % of training and services revenue	70.8%	72.8%		
Total cost of subscription and training and services revenue	171,718	147,362	24,356	16.5
As a % of total revenue	14.7%	15.0%		
Total gross profit	995,985	837,787	158,198	18.9
Operating expense:				
Sales and marketing	496,503	403,973	92,530	22.9
Research and development	236,281	199,919	36,362	18.2
General and administrative	105,954	86,496	19,458	22.5
Total operating expense	838,738	690,388	148,350	21.5
Income from operations	157,247	147,399	9,848	6.7
Interest income	6,821	5,611	1,210	21.6
Interest expense	11,811	11,448	363	3.2
Other income (expense), net	(468)	(1,448)	980	67.7
Income before provision for income taxes	151,789	140,114	11,675	8.3
Provision for income taxes	31,832	40,633	(8,801)	(21.7)
Net income	$ 119,957	$ 99,481	$ 20,476	20.6%
Gross profit margin-subscriptions	92.6%	93.0%		
Gross profit margin-training and services	29.2%	27.2%		

Gross profit margin	85.3%	85.0%
As a % of total revenue:		
Subscription revenue	88.5%	87.9%
Training and services revenue	11.5%	12.1%
Sales and marketing expense	42.5%	41.0%
Research and development expense	20.2%	20.3%
General and administrative expense	9.1%	8.8%
Total operating expenses	71.8%	70.1%
Income from operations	13.5%	15.0%
Income before provision for income taxes	13.0%	14.2%
Net income	10.3%	10.1%
Estimated annual effective income tax rate (1)	27.0%	29.0%

(1) Provision for income taxes for the six months ended August 31, 2016 includes net discrete tax benefits of $9.2 million, of which $8.9 million are related to net excess tax benefits from share-based compensation. Our estimated annual effective tax rate is 27%. Our calculated tax rate for the six months ended August 31, 2016, including net discrete tax benefits, is 21%. See NOTE 5 Income Taxes to our Consolidated Financial Statements for further discussion.

Revenue

Subscription revenue

Subscription revenue increased by 19.2%, or $166.6 million, to $1,032.9 million for the six months ended August 31, 2016 from $866.3 million for the six months ended August 31, 2015.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 15.8%, or $113.5 million, to $830.2 million for the six months ended August 31, 2016 from $716.7 million for the six months ended August 31, 2015. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion and the continued migration of customers to our open source Linux platform from proprietary operating systems.

Revenue derived from the sale of subscriptions supporting our Application development-related and other emerging technology offerings increased by 35.4%, or $53.0 million, to $202.7 million for the six months ended August 31, 2016 from $149.7 million for the six months ended August 31, 2015. The increase is primarily due to additional subscriptions for Red Hat JBoss Middleware offerings. We expect the growth rate of revenue derived from our Application development-related and other emerging technology offerings to exceed the growth rate of revenue derived from our Infrastructure-related offerings as our Application development-related and other emerging technology offerings continue to gain broader market acceptance in the enterprise IT environment.

Training and services revenue

Total training and services revenue increased by 13.5%, or $16.0 million, to $134.8 million for the six months ended August 31, 2016 from $118.8 million for the six months ended August 31, 2015. The increase is due to both services and training. Services revenue increased by 12.3%, or $11.1 million as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Training revenue increased by 17.2%, or $4.9 million as a result of increased adoption of our RHLS. Combined training and services revenue decreased as a percentage of total revenue to 11.5% for the six months ended August 31, 2016 from 12.1% for the six months ended August 31, 2015.

Cost of revenue

Cost of subscription revenue

Cost of subscription revenue increased by 25.3%, or $15.4 million, to $76.2 million for the six months ended August 31, 2016 from $60.8 million for the six months ended August 31, 2015. The increase is primarily due to the expansion of our technical staff in order to meet the demands of our growing subscriber base for support, security updates and fixes, and includes additional compensation of $9.8 million. The remaining increase was driven primarily by incremental amortization expense related to the acquisitions of Ansible and 3scale. Gross profit margin on subscriptions was 92.6% and 93.0%, respectively, for the six months ended August 31, 2016 and August 31, 2015. As the number of our open source technology subscriptions continues to increase, we expect associated support costs will continue to increase, although we anticipate this will occur at a rate slower than that of subscription revenue growth due to economies of scale.

Cost of training and services revenue

Cost of training and services revenue increased by 10.4%, or $9.0 million, to $95.5 million for the six months ended August 31, 2016 from $86.5 million for the six months ended August 31, 2015. Costs to deliver our services revenue increased by 10.7%, or $7.6 million, and relate to additional employee compensation and travel associated with additions to our emerging technologies staff. Total costs to deliver training and services as a percentage of training and services revenue was 70.8% and 72.8%, respectively, for the six months ended August 31, 2016 and August 31, 2015.

Gross profit margin

Gross profit margin increased to 85.3% for the six months ended August 31, 2016 from 85.0% for the six months ended August 31, 2015. A slight increase in cost to deliver our subscription revenue was more than offset by a higher mix of subscription revenue relative to training and services revenue for the six months ended August 31, 2016 from the six months ended August 31, 2015. Subscription revenue was 88.5% and 87.9% of total revenue for the six months ended August 31, 2016 and August 31, 2015, respectively.

Operating expenses

Sales and marketing

Sales and marketing expense increased by 22.9%, or $92.5 million, to $496.5 million for the six months ended August 31, 2016 from $404.0 million for the six months ended August 31, 2015. This increase was primarily due to a $73.7 million increase in selling costs, which includes $56.9 million of additional employee compensation expense attributable to the expansion of our sales force from the prior year. The remaining increase relates to marketing costs, which grew 18.9%, or $18.8 million, for the six months ended August 31, 2016 as compared to the six months ended August 31, 2015 and includes incremental employee compensation and marketing program costs of $13.3 million and $2.5 million, respectively. Primarily as a result of expanded sales and marketing staffing, sales and marketing expense increased as a percentage of revenue to 42.5% for the six months ended August 31, 2016 from 41.0% for the six months ended August 31, 2015.

Research and development

Research and development expense increased by 18.2%, or $36.4 million, to $236.3 million for the six months ended August 31, 2016 from $199.9 million for the six months ended August 31, 2015. The increase in research and development costs primarily resulted from the expansion of our engineering group as a result of both direct hires and business combinations as we continue investing in our Application Development-related and other emerging technologies. Employee compensation increased by $33.1 million. Research and development expense was 20.2% and 20.3% of total revenue for the six months ended August 31, 2016 and August 31, 2015, respectively.

General and administrative

General and administrative expense increased by 22.5%, or $19.5 million, to $106.0 million for the six months ended August 31, 2016 from $86.5 million for the six months ended August 31, 2015. General and administrative expenses include increased compensation-related expense of $5.8 million, infrastructure and facilities costs of $7.5 million and outside professional services of $6.1 million. General and administrative expense increased as a percentage of revenue to 9.1% for the six months ended August 31, 2016 from 8.8% for the six months ended August 31, 2015. We expect general and administrative costs to decrease relative to revenue as we leverage benefits from investments made during the current fiscal year to expand and enhance our corporate processes and technology infrastructure.

Interest income

Interest income increased by 21.6%, or $1.2 million, for the six months ended August 31, 2016 as compared to the six months ended August 31, 2015. The increase in interest income for the six months ended August 31, 2016 is attributable to slightly higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $0.4 million, for the six months ended August 31, 2016 as compared to the six months ended August 31, 2015. Interest expense is primarily attributable to the issuance of convertible notes, which is described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

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Other income (expense), net

Other income (expense), net increased by $1.0 million, for the six months ended August 31, 2016 as compared to the six months ended August 31, 2015. The increase is primarily due to miscellaneous losses recognized during the six months ended August 31, 2015 not repeated during the six months ended August 31, 2016.

Income taxes

During the six months ended August 31, 2016, we recorded $31.8 million of income tax expense, which is based on an estimated annual effective tax rate of 27%. Our estimated annual effective tax rate of 27% was less than the U.S. federal statutory rate of 35% primarily due to foreign income taxed at lower rates, research tax credits and the domestic production activities deduction. Tax expense for the six months ended August 31, 2016 included a discrete tax benefit of $8.9 million, related to excess tax benefits from share-based compensation resulting from the early adoption of ASU 2016-09. See NOTE 2 Summary of Significant Accounting Policies to our Consolidated Financial Statements for additional information.

During the six months ended August 31, 2015, we recorded $40.6 million of income tax expense, which was based on a then estimated annual effective tax rate of 29%. Our estimated annual effective tax rate of 29% was less than the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates, state income taxes net of federal benefits and the domestic production activities deduction.

LIQUIDITY AND CAPITAL RESOURCES

We derive our liquidity and operating capital primarily from cash flows from operations. Historically, we also received cash from 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, and the issuance of convertible notes, including our issuance of convertible notes with par value totaling $805.0 million described in detail in NOTE 15 Convertible Notes to our Consolidated Financial Statements. At August 31, 2016, we had total cash and investments of $2.04 billion, which was comprised of $970.6 million in cash and cash equivalents, $365.1 million of short-term, available-for-sale, fixed-income investments and $706.9 million of long-term, available-for-sale fixed-income investments. This compares to total cash and investments of $2.00 billion at February 29, 2016.

With $970.6 million in cash and cash equivalents on hand, we believe our cash and cash equivalent balances, together with our ability to generate additional cash from operations, should be sufficient to satisfy our cash requirements for the next twelve months and for the foreseeable future. However, we may take advantage of favorable capital market conditions that may arise from time to time to raise additional capital. 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 liquidate these investments prior to their scheduled maturities and there are 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 those investments. At August 31, 2016, net accumulated unrealized gains on our available-for-sale debt securities totaled $0.5 million, versus accumulated unrealized losses of $1.4 million as of February 29, 2016.

Cash flows for six months ended August 31, 2016

Cash flows overview

At August 31, 2016, cash and cash equivalents totaled $970.6 million, an increase of $42.8 million as compared to February 29, 2016. The increase in cash and cash equivalents for the six months ended August 31, 2016 is primarily the result of cash provided by operations, which generated $329.1 million for the six months ended August 31, 2016. Partially offsetting cash provided by operations was the repurchase of 2,654,265 shares

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of our common stock for $193.9 million, payments made in return for common shares received from employees to satisfy employees minimum tax withholding obligations related to share awards vesting of $37.5 million, investments in property and equipment of $33.2 million and the acquisition of 3scale, net of cash acquired, of $28.7 million.

Cash flows from operations

Cash provided by operations of $329.1 million during the six months ended August 31, 2016 includes net income of $120.0 million, adjustments to exclude the impact of non-cash income and expenses, which totaled a $147.2 million net source of cash, and changes in operating assets and liabilities, which totaled a $62.0 million net source of cash. Cash provided by changes in operating assets and liabilities for the six months ended August 31, 2016 was primarily the result of collections on our billings.

Cash flows from investing

Cash used in investing activities of $71.3 million for the six months ended August 31, 2016 includes net purchases of available-for-sale debt securities of $2.9 million, investments in property and equipment of $33.2 million, which primarily relate to information technology infrastructure and leasehold improvements and the acquisition of 3scale, which used $28.7 million of cash during the six months ended August 31, 2016. Investments in other intangible assets, primarily patents, totaled $6.4 million during the six months ended August 31, 2016.

Cash flows from financing

Cash used in financing activities of $229.3 million for the six months ended August 31, 2016 includes $193.9 million to repurchase 2,654,265 shares of our common stock and $37.5 million of 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 six months ended August 31, 2016. Partially offsetting financing activities using cash were proceeds from employees exercise of common stock options, which totaled $2.1 million.

Investments in debt securities

Our investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. At August 31, 2016 and February 29, 2016, the vast majority of our investments were priced with the assistance of 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 values, 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 technologies, the expansion of our services operations and our acquisition activity. Our capital requirements during the fiscal year ending February 28, 2017 will depend on numerous factors, including the amount of resources we devote to:

funding the continued development of our technology offerings;

improving and extending our services and the technologies used to market and deliver these services to our customers and support our business;

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pursuing strategic acquisitions and alliances;

investing in or acquiring businesses, products and technologies; and

investing in enhancements to the systems we use to run our business and the expansion of our office facilities.

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, purchases of intangible assets (primarily patents) and mergers and acquisitions. Given our historically strong operating cash flow and the $2.04 billion of cash and investments held at August 31, 2016, we believe our cash and cash equivalent balances, together with our ability to generate additional cash from operations, should be sufficient to satisfy our cash requirements for the next twelve months and for the foreseeable future. However, we may take advantage of favorable capital market conditions that may arise from time to time to raise additional capital.

We believe that our ability to generate additional cash from operations will continue; however, there can be no assurances that we will be able to generate cash from operations at a level equal to the current rate or that such cash flows will be adequate to fund other investments or acquisitions that we may choose to make or that cash may be located in or generated in the appropriate geographic region where we can effectively use such cash. 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.

As of August 31, 2016, our cash, cash equivalents and available-for-sale investment securities totaled $2.04 billion, of which $991.6 million was held outside the U.S. Our intent is to reinvest the earnings of foreign subsidiaries indefinitely outside the U.S. to fund both organic growth and acquisitions. From time to time, however, we may remit a portion of these earnings to the extent it is economically prudent. For further discussion related to geographic segments, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

With $1.05 billion, or 51.5%, of our available cash, cash equivalents and available-for-sale investments held within the U.S. as of August 31, 2016, we do not anticipate a need to repatriate any foreign earnings for the foreseeable future. However, if cash held outside the U.S. were needed to fund our U.S. operations, under current tax law we would be subject to additional taxes on the portion related to repatriated earnings of our foreign subsidiaries. As of February 29, 2016, cumulative undistributed foreign earnings totaled $537.7 million. For further discussion, see NOTE 11 Income Taxes to our Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended February 29, 2016.

Off-balance sheet arrangements

As of August 31, 2016 and February 29, 2016, we have no off-balance sheet financing arrangements and do not utilize any structured debt , special purpose or similar unconsolidated entities for liquidity or financing purposes.

RECENT ACCOUNTING PRONOUNCEMENTS

For discussion of accounting pronouncements recently adopted and accounting pronouncements being evaluated, and the impact of these pronouncements on our consolidated financial statements, see NOTE 2 Summary of Significant Accounting Policies to our Consolidated Financial Statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest rate risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of short-term and long-term investments in a variety of available-for-sale fixed and floating rate debt 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 related to these securities may fall short of expectations due to changes in interest rates, or we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates or perceived credit risk related to the securities issuers. A hypothetical one-half percentage point change in interest rates, assuming a parallel shift of all interest rates, would result in an approximate $0.6 million change in annual interest income derived from investments in our portfolio as of August 31, 2016. For further discussion related to our investments as of August 31, 2016 and February 29, 2016, see NOTE 6 Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Investment risk

The fair market value of our available-for-sale 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 $10.4 million decrease in the fair value of our available-for-sale investment securities as of August 31, 2016. For further discussion related to our investments as of August 31, 2016 and February 29, 2016, see NOTE 6 Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Credit risk

Investments in debt and equity securities

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

Accounts receivable

At August 31, 2016, the Company had two customers whose accounts receivable balance individually represented 10% and 11%, respectively, of total accounts receivable. As of February 29, 2016, no individual customer accounted for 10% or more of our total accounts receivable.

Foreign currency risk

Approximately 42.7% of our revenue for the three months ended August 31, 2016 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 of 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.

Using the average foreign currency exchange rates from the second quarter of our prior fiscal year ended February 29, 2016, our revenue and operating expenses from non-U.S. operations for the three months ended August 31, 2016 would have been lower and higher than we reported by approximately $3.5 million and $2.3 million, respectively, which would have resulted in income from operations being lower by $5.8 million.

Using the average foreign currency exchange rates for the six months ended August 31, 2015, our revenue and operating expenses from non-U.S. operations for the six months ended August 31, 2016 would have been lower and higher than we reported by approximately $4.9 million and $5.1 million, respectively, which would have resulted in income from operations being lower by $10.0 million.

Convertible notes

In October 2014, we issued $805.0 million of 0.25% convertible notes due 2019. The convertible notes have a fixed annual interest rate of 0.25%, and therefore we do not have economic interest rate exposure on the convertible notes. However, the fair market value of the convertible notes is exposed to interest rate risk. Generally, the fair market value of the convertible notes will increase as interest rates fall and decrease as interest rates rise. For further discussion regarding the fair value of the convertible notes, see NOTE 15 Convertible Notes to our Consolidated Financial Statements.

In connection with the sale of the convertible notes, we entered into convertible note hedge transactions and warrant transactions. The convertible note hedge transactions are expected to offset the potential dilution with respect to shares of our common stock upon any conversion of the convertible notes and/or offset any cash payments that we are required to make in excess of the principal amount of the converted notes, as the case may be. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the market price per share of our common stock, as measured under the terms of the warrant transactions, exceeds the applicable strike price of the warrants. However, subject to certain conditions, we may elect to settle all of the warrants in cash. The initial strike price of the warrants is $101.65 per share. The number of shares of our common stock underlying the warrants is 10,965,630 shares, subject to anti-dilution adjustments. The convertible note hedge and warrants are both considered indexed to our common stock and classified as equity; therefore, the convertible note hedge and warrants are not accounted for as derivative instruments.

Derivative instruments

We transact business in various foreign countries and are, therefore, subject to risk of foreign currency exchange rate fluctuations. From time to time we 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. We have elected not to prepare and maintain the documentation required to qualify our forward contracts for hedge accounting treatment and, therefore, changes in fair value are recorded in our Consolidated Statements of Operations. For further discussion related to our management of foreign currency risk see NOTE 7 Derivative Instruments to our Consolidated Financial Statements.

The aggregate notional amount of outstanding forward contracts at August 31, 2016 was $34.0 million. The fair value of these outstanding contracts at August 31, 2016 was a gross less than $0.1 million asset and a gross less than $0.1 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively, on our Consolidated Balance Sheets. The forward contracts generally expire within three

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months of the period ended August 31, 2016. The forward contracts will settle in Euros, Hong Kong dollars, Japanese yen, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs and U.S. dollars.

The aggregate notional amount of outstanding forward contracts at February 29, 2016 was $72.6 million. The fair value of these outstanding contracts at February 29, 2016 was a gross $0.6 million asset and a gross $0.5 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively, on our Consolidated Balance Sheets. The forward contracts generally expired within three months of the period ended February 29, 2016. The forward contracts settled in Australian dollars, Hong Kong dollars, Japanese yen, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs and U.S. dollars.

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ITEM 4. CONTROLS AND PROCEDURES

Role of Controls and Procedures

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) or our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of the controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error and mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Also projections of any evaluation of effectiveness of controls and procedures to future periods are subject to the risk that the controls and procedures may become inadequate because of changes in conditions, or that the degree of compliance with the controls and procedures may have deteriorated.

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

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

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PART II

ITEM 1. LEGAL PROCEEDINGS

The Company 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, results of operations or cash flows.

ITEM 1A. RISK FACTORS

Set forth below are certain risks and cautionary statements, which supplement other disclosures in this report. Please carefully consider the following risks and cautionary statements. If any event related to the following risk factors occurs, our business, financial condition, operating results and cash flows could be materially adversely affected.

RISKS RELATED TO BUSINESS UNCERTAINTY

We face intense competition.

The enterprise software industry is rapidly evolving and intensely competitive, and is subject to changing technologies, shifting customer needs, and frequent introductions of new products and services. We compete based on our ability to provide our customers with enterprise software and related service offerings that best meet their needs at a compelling price. We expect that competition will continue to be intense, and there is a risk that our competitors products may provide better performance or include additional features when compared to our offerings. Competitive pressures could also affect the prices we may charge or the demand for our offerings, resulting in reduced profit margins and loss of market share.

Our current and potential competitors range from large and well-established companies to emerging start-ups. Some of our competitors have significantly greater financial resources and name recognition, larger development and sales staffs and more extensive marketing and distribution capabilities. Certain competitors also bundle hardware and software offerings, making it more difficult for us to penetrate their customer bases. As the enterprise software industry evolves, the competitive pressure for us to innovate encompasses a wider range of products and services, including new offerings that require different expertise than our current offerings. Some competitors may be able to innovate and provide products and services faster than we can. Moreover, if we are unable to effectively communicate the value of our subscription model, we may not compete effectively in attracting new, and maintaining existing, customers.

Given the rapid evolving nature of the enterprise software industry, the competitive landscape and the nature of the competition is constantly changing. Industry consolidation may affect competition by creating larger and potentially stronger competitors in the markets in which we compete. Moreover, other companies may currently be planning to or are under pressure by stockholders to divest businesses. These divestitures may result in additional competitors that may have an advantage by focusing on a single product or service. We also compete in certain areas with our partners and potential partners, and this may adversely impact our relationship with an individual partner or a number of partners.

Our efforts to compete effectively may not be sufficient, which may adversely affect our business, financial condition, operating results and cash flows.

Our continued success depends on our ability to adapt to a rapidly changing industry. Investment in new offerings, business strategies and initiatives could disrupt our ongoing business and may present risks not originally contemplated.

We operate in highly competitive markets that are characterized by rapid technological change, such as the transition of many of our enterprise customers to cloud computing environments and frequent new product and service announcements. Our continued success will depend on our ability to adapt to rapidly changing technologies and user preferences, to adapt our offerings to evolving industry standards, to predict user preferences and industry changes and to improve the performance and reliability of our offerings. Our failure to adapt to such changes could harm our business, and our efforts to adapt to such changes could require substantial expenditures on our part to modify our offerings or infrastructure. Delays in developing, completing or delivering new or enhanced offerings and technologies could result in delayed or reduced revenue for those offerings and could also adversely affect customer acceptance of those offerings and technologies. The success of new and enhanced offering introductions depends on several factors, including our ability to invest significant resources in research and development in order to enhance our existing offerings and introduce new offerings in a timely manner, successfully promote the offerings, manage the risks associated with the offerings, make sufficient resources available to support the offerings and address any quality or other defects in the early stages of introduction. Even if we are able to enhance our existing offerings or introduce new offerings that are well perceived by the market, if our marketing or sales efforts do not generate interest in or sales for these offerings they may be unsuccessful.

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

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

Our success depends in part on our ability to continue to establish and maintain strategic relationships with industry-leading cloud service providers, hardware original equipment manufacturers, independent software vendors (ISVs) and system integrators, such as Amazon.com, Inc., Cisco Systems, Inc., Dell Inc., Fujitsu Limited, Hewlett Packard Enterprise Company, International Business Machines Corporation, Microsoft Corporation, NEC Corporation, Oracle Corporation, SAP AG and others. Many of these strategic partners have engineered and certified that their technologies run on or with our offerings and, in some cases, have built their products and solutions using our offerings. We may not be able to maintain these relationships or replace them on attractive terms in the future. Some of our strategic partners offer competing products and services. As a result of these factors, many of the companies with which we have strategic alliances may choose to pursue alternative technologies and develop alternative products and services in addition to or in lieu of our offerings, either on their own or in collaboration with others, including our competitors. Moreover, we cannot guarantee that the companies with which we have strategic relationships will market our offerings effectively or continue to devote the resources necessary to provide us with effective sales, marketing and technical support. As our agreements with strategic partners terminate or expire, we may be unable to renew or replace these agreements on comparable terms, or at all.

We rely, to a significant degree, on indirect sales channels for the distribution of our offerings, and disruption within these channels could adversely affect our business, financial condition, operating results and cash flows.

We use a variety of different indirect distribution methods for our offerings, including channel partners, such as certified cloud service providers, distributors, embedded technology partners, hardware original equipment manufacturers, ISVs, system integrators and value added resellers. A number of these partners in turn distribute via their own networks of channel partners with whom we have no direct relationship. These relationships allow us to offer our technologies to a much larger customer base than we would otherwise be able through our direct sales and marketing efforts.

We rely, to a significant degree, on each of our channel partners to select, screen and maintain relationships with its distribution network and to distribute our offerings in a manner that is consistent with applicable law and regulatory requirements and our quality standards. If our channel partners or a partner in its distribution network violate applicable law or regulatory requirements or misrepresent the functionality of our offerings, our reputation could be damaged and we could be subject to potential liability. Furthermore, our channel partners may offer their own products and services or the products and services of other companies that compete with our offerings or may not distribute and market our offerings effectively. Moreover, our existing channel partner relationships do not, and any future channel partner relationships may not, provide for any exclusivity regarding marketing or distribution. In addition, if a channel partner is acquired by a competitor, its business units are reorganized or divested or its financial conditions were to weaken, our revenue derived from that partner may be adversely impacted.

Recruiting and retaining qualified channel partners and training them in the use of our enterprise technologies requires significant time and resources. If we fail to devote sufficient resources to support and expand our network of channel partners, our business may be adversely affected. In addition, because we rely on channel partners for the indirect distribution of our enterprise technologies, we may have little or no contact with the ultimate end-users of our technologies, thereby making it more difficult for us to establish brand awareness, ensure proper delivery and installation of our software, support ongoing customer requirements, estimate end-user demand, respond to evolving customer needs and obtain subscription renewals from end-users.

A portion of our sales to government entities have been made indirectly through our channel partners. Government entities may have statutory, contractual, or other legal rights to terminate contracts with our channel partners for convenience or due to a default, and any such termination may adversely impact our future operating results. Governments routinely investigate and audit government contractors administrative processes, and any unfavorable audit could result in the government refusing to continue buying our offerings, a reduction of revenue or fines or civil or criminal liability if the audit uncovers improper or illegal activities.

If our indirect distribution channel is disrupted, we may be required to devote more resources to distribute our offerings directly and support our customers, which may not be as effective and could lead to higher costs, reduced revenue and growth that is slower than expected.

The duration and extent of economic downturns, regional financial instability, and economic and market conditions in general could adversely affect our business, financial condition, operating results and cash flows.

Economic weakness and uncertainty, tightened credit markets and constrained IT spending from time to time contribute to slowdowns in the technology industry, as well as in the industries of our customers and the geographic regions in which we operate, which may result in reduced demand and increased price competition for our offerings. Our operating results in one or more geographic regions or customer industries may also be affected by uncertain or changing economic conditions within that region or industry. Continuing uncertainty about future economic conditions may, among other things, negatively impact our current and prospective customers and result in delays or reductions in technology purchases or lengthen our sales cycle. Adverse economic conditions also may negatively impact our ability to obtain payment for outstanding debts owed to us by our customers or other parties with whom we do business. In addition, such conditions may impact our investment portfolio, and we could determine that some of our investments have experienced an other-than-temporary decline in fair value, requiring an impairment charge that could adversely impact our financial condition and operating results. Also, such conditions may make it more difficult to forecast operating results. If global economic conditions, or economic conditions in the U.S., Europe, Asia or in other key geographic regions or customer industries, were to remain uncertain or persist, spread or deteriorate further, current and prospective customers may delay or reduce their IT spending, which could adversely affect our business, financial condition, operating results and cash flows.

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

As part of our business strategy, we have in the past entered into business combinations and acquisitions, and we may continue to do so in the future. These types of transactions can increase the expense of running our business and present significant challenges and risks, including:

- identifying acquisition targets that complement our strategic direction and technology road map;
- integrating the acquired business accounting, financial reporting, management, information and information security, human resource and other administrative systems to permit effective management and reporting, and the lack of control if such integration is delayed or not implemented;
- gathering full information regarding a business or technology prior to a transaction, including the identification and assessment of liabilities, claims or other circumstances that could result in litigation or regulatory exposure, unfavorable accounting treatment, unexpected tax implications and other adverse effects on our business;
- increasing or additional operating expenses related to the acquired business or technology;
- maintaining or establishing acceptable standards, controls, procedures and policies;
- disrupting of our ongoing business and distraction of management;
- impairing relationships with our employees, partners or customers as a result of any integration of new management and other personnel, products or technology or as a result of the changes in the competitive landscape affected by the transaction;
- maintaining good relationships with customers or business partners of the acquired business;
- effectively evaluating talent at an acquired business or cultural challenges associated with integrating employees from the acquired business into our organization;
- losing key employees of the acquired business;

incorporating and further developing acquired products or technology into our offerings and maintaining quality standards consistent with our brands;

achieving the expected benefits of the transaction, which may include generating greater market acceptance of our technologies, increasing our revenues or integrating the assets acquired into one or more of our current offerings;