SOURCEFIRE INC
Form 10-K
February 28, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO**

Commission File Number 1-33350

SOURCEFIRE, INC.
(Exact name of Registrant as Specified in its Charter)

Delaware *(State or Other Jurisdiction of Incorporation or Organization)*	**52-2289365** *(I.R.S. Employer Identification No.)*
9770 Patuxent Woods Drive **Columbia, Maryland** *(Address of Principal Executive Offices)*	**21046** *(Zip Code)*

Registrant s telephone number, including area code:
(410) 290-1616

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Exchange on Which Registered
Common Stock, $0.001 par value	Nasdaq Global Market

Securities registered pursuant to Section 12(g) of the Act: none

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o   No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o   No þ

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 þ   No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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. (Check one):

Large Accelerated Filer o	Accelerated Filer o
Non-Accelerated Filer þ (Do not check if smaller reporting company)	Smaller reporting Company o

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

As of June 30, 2007, there were 24,108,428 shares of the registrant s Common Stock outstanding. The aggregate market value of such shares held by non-affiliates of the registrant, based upon the closing sale price ($13.99) of such shares on the Nasdaq Global Market for such date, was approximately $183.4 million.

As of February 25, 2008, there were outstanding 24,647,719 shares of the registrant s Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the definitive Proxy Statement to be used in connection with the registrant s 2008 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K to the extent stated. That Proxy Statement will be filed within 120 days of registrant s fiscal year ended December 31, 2007.

SOURCEFIRE, INC.

ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 2007

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References in this Annual Report on Form 10-K to Sourcefire, we, us , our or the Company refer to Sourcefire, I and its subsidiaries, taken as a whole, unless a statement specifically refers to Sourcefire, Inc.

FORWARD-LOOKING STATEMENTS

This annual report contains both historical and forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. For example, statements concerning projections, predictions, expectations, estimates or forecasts and statements that describe our objectives, plans or goals are or may be forward-looking statements. These forward-looking statements reflect management s current expectations concerning future results and events and generally can be identified by use of expressions such as may, will, should, could, would, predict, potential, continue, expect, anticipate, future, intend, plar estimate, and similar expressions, as well as statements in future tense. These forward-looking statements include, but are not limited to, the following:

- expected growth in the markets for network security products;
- our plans to continue to invest in and develop innovative technology and products for our existing markets and other network security markets;
- the timing of expected introductions of new or enhanced products;
- our expectation of growth in our customer base and increasing sales to existing customers;
- our plans to increase revenue through more relationships with original equipment manufacturers, resellers, distributors, government suppliers and co-marketeers;
- our plans to grow international sales;
- our plans to acquire and integrate new businesses and technologies;
- our plans to hire more network security professionals and broaden our knowledge base; and
- our plans to hire additional sales personnel and the additional revenue we expect them to generate.

The forward-looking statements included in this annual report are made only as of the date of this annual report. We expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be different from any future results, performance and achievements expressed or implied by these statements. These risks and uncertainties include, but are not limited to, those discussed in Item 1A. Risk Factors of this annual report.

We operate in an industry in which it is difficult to obtain precise industry and market information. Although we have obtained some industry data from outside sources that we believe to be reliable, in certain cases we have based certain statements contained in this annual report regarding our industry and our position in the industry on our estimates concerning, among other things, our customers and competitors. These estimates are based on our experience in the industry, conversations with our principal suppliers and customers and our own investigations of market conditions. The statistical data contained in this annual report regarding the network security software industry are our statements, which are based on data we obtained from industry sources.

SOURCEFIRE®, SNORT®, the Sourcefire logo, the Snort and Pig logo, SECURITY FOR THE REAL WORLD™, SOURCEFIRE DEFENSE CENTER™, SOURCEFIRE 3D™, RNA™, ClamAV™ and certain other trademarks and logos are trademarks or registered trademarks of Sourcefire, Inc. in the United States and other countries. This annual report also refers to the products or services of other companies or persons by the trademarks and trade names used and owned by those companies or persons.

PART I

BUSINESS

Item 1. *BUSINESS*

Overview

We are a leading provider of Enterprise Threat Management (ETM) solutions for information technology (IT) infrastructures of commercial enterprises (e.g., healthcare, financial services, manufacturing, energy, education, retail, telecommunications) and federal and state government organizations. The Sourcefire 3D™ System comprised of multiple Sourcefire hardware and software product offerings provides a comprehensive, intelligent network defense that unifies intrusion prevention system (IPS), network behavior analysis (NBA), network access control (NAC) and vulnerability assessment (VA) solutions under a common management framework. This ETM approach equips our customers with an efficient and effective layered security defense protecting computer network assets before, during and after an attack.

Since 2001, Sourcefire has garnered a reputation in the network security industry of being a staunch advocate for open source. Over the years, this has developed into a key competitive distinction for Sourcefire as we now manage two of the security industry s leading open source initiatives, Snort® and ClamAV™, in addition to two new open source or freely available entrants, OfficeCat™ and Daemonlogger™. First published in 1998 by Sourcefire founder and Chief Technology Officer, Martin Roesch, open source Snort has rapidly become the de facto standard for intrusion detection and prevention. With over 170,000 registered users, 3 million downloads, and embraced by more than 100 network security providers, more organizations use Snort than any other IPS engine in the world. Further, open source ClamAV is a widely successful anti-malware engine and is most commonly used for email scanning on mail servers. Established in 2001 and acquired by Sourcefire in 2007, the ClamAV malware database incorporates more than 200,000 signatures, downloaded by more than 1 million unique IP addresses per day from more than 130 mirror sites in 44 countries.

Sourcefire embraces open source security as a foundation, but extends that foundation by adding enterprise-class manageability, scalability, and performance. Many Sourcefire 3D System customers, for example, start out using open source Snort, but graduate to Sourcefire s commercial offerings to gain more efficient and effective network security capabilities. By incorporating open source security as a foundation in Sourcefire s commercial product offerings, Sourcefire can:

- Seed the market by offering high quality, low cost network security solutions while providing a migration path for customers that require enterprise-class manageability, scalability and performance.
- Ensure product quality as many eyes inspect the open code base that forms the foundation for Sourcefire commercial product offerings.
- Maximize protection as Snort rules and ClamAV signatures are provided by Sourcefire and a variety of third-party sources, and customers can create their own custom rules and signatures.
- Embrace a community of open source evangelists willing to contribute time and effort in inspecting, evaluating, and ultimately using Sourcefire s open source security solutions.

Sourcefire sells its network security solutions to a diverse customer base that includes 29 of the Fortune 100 companies and over half of the 30 largest U.S. government agencies. For the years ended December 31, 2007, 2006 and 2005, we generated approximately 75%, 81% and 82% of our revenue from customers in the United States and 25%, 19% and 18% from customers outside of the United States, respectively. We have expanded our international and indirect distribution channels and, in the future, we expect to increase sales outside of the United States and to source additional customer prospects and generate an increasing portion of product revenues through alliances with original equipment manufacturers, or OEMs, such as Nokia, Inc. We increased our total revenue from $44.9 million in 2006 to $55.9 million in 2007, representing a growth rate of 24%. For the year ended December 31, 2007, product revenue represented 61% and services revenue represented 39% of our total revenue. We manage our operations on a consolidated basis for purposes of assessing performance and making operating decisions. Accordingly, we do not have reportable segments of our business.

2007 Developments

2007 was an eventful year for Sourcefire. We took our company public, we introduced the industry s first-ever Adaptive IPS technology, and we completed our first acquisition. The following is a list of key Sourcefire company developments that occurred in 2007:

January 16th Sourcefire announced its position as a Leader in Gartner IPS Magic Quadrant report

March 8th Sourcefire Initial Public Offering

March 22nd Sourcefire announced exercise of over-allotment option in connection with Initial Public Offering

April 16th Sourcefire launched Enterprise Threat Management (ETM) strategy

May 2nd Sourcefire announced Real-time User Awareness (RUA) product

June 26th Sourcefire added to Russell 3000 Index

July 9th Sourcefire launched 10Gbps 3D9800 Sensor

August 10th Sourcefire named Douglas McNitt as General Counsel

August 17th Sourcefire acquired ClamAV open source network anti-virus project

September 17th Sourcefire launched 3D System 4.7, including Adaptive IPS and NetFlow Analysis

September 23rd Sourcefire increased international growth with Australian expansion

October 1st Sourcefire joined the PCI Security Standards Council

December 12th Sourcefire announced Certified ClamAV Support

Initial Public Offering

In March 2007, we completed the initial public offering, or IPO, of our common stock in which we sold and issued 6,185,500 shares of our common stock, including 865,500 shares sold by us pursuant to the underwriters full exercise of their over-allotment option, at an issue price of $15.00 per share. We raised a total of $92.8 million in gross proceeds from the IPO, or approximately $83.9 million in net proceeds after deducting underwriting discounts and commissions of $6.5 million and other offering costs of $2.4 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into an aggregate of 14,302,056 shares of common stock.

Acquisition of ClamAV

In August 2007, we closed on our acquisition of the intellectual property assets of ClamAV, an open source anti-malware project. We paid $3.5 million in cash to the former owners, and deposited an additional $1.0 million in cash into escrow, to be paid to the sellers upon the completion of certain additional source code, which is currently expected to be completed in the first quarter of 2008. We allocated $2.9 million of the purchase price to in-process research and development and allocated the remaining $634,000 to certain marketing-related intangible assets. The amounts allocated to in-process research and development were immediately expensed, as there is no anticipated alternative future use for the acquired technology. As of December 31, 2007, we determined that it was probable that the additional source code would be completed in 2008 and the contingent payment would be made; therefore, the $1.0 million placed into escrow was accrued as a liability and recorded as a compensation expense as the sellers are now our employees and the payment is for services rendered.

Our Industry

We believe, based on our review of various industry sources, that the entire network security industry was an $18.7 billion market in 2006 and is projected to grow to $33.8 billion in 2011, representing a compound annual growth rate of approximately 13%. Our core market, intrusion prevention, was $0.9 billion in 2006 and is projected to grow to $2.0 billion in 2011, representing a compound annual growth rate of 16%. Other addressable markets that we serve, or intend to serve, include network behavior analysis (NBA), network access control (NAC), vulnerability assessment (VA), and unified threat management (UTM). We expect that demand for security solutions will continue to grow as organizations seek to address various growing and evolving security challenges, including:

Greater Sophistication, Severity and Frequency of Network Attacks. The growing use of the Internet as a business tool has required organizations to increase the number of access points to their networks, which has made vast amounts of critical information more vulnerable to attack. Theft of sensitive information for financial gain motivates network attackers, who derive profit through identity theft, credit card fraud, money laundering, extortion, intellectual property theft and other illegal means. These profit-motivated attackers, in contrast to the hobbyist hackers of the past, are employing much more sophisticated tools and techniques to generate profits for themselves and their well-organized and well-financed sponsors. Their attacks are increasingly difficult to detect and their tools often establish footholds on compromised network assets with little or no discernible effect, facilitating future access to the assets and the networks on which they reside.

Increasing Risks from Unknown Vulnerabilities. Vulnerabilities in computer software that are discovered by network attackers before they are discovered by security and software vendors represent a tremendous risk. These uncorrected flaws can leave networks largely defenseless and open to exploitation. According to the CERT Coordination Center (CERT-CC), the trends in the rate of vulnerability disclosure are particularly alarming, with approximately 5,990 vulnerabilities cataloged in 2005 and 8,064 vulnerabilities cataloged in 2006. During 2007, Microsoft alone issued 43 patches designated as critical for its various software products. Many vulnerabilities have existed since the original release of the affected software products some dating back to the 1990s but were not corrected until recently.

Diverse Demands on Security Administrators. The proliferation of targeted security solutions such as firewalls, intrusion prevention systems, URL filters, spam filters and anti-spyware solutions, while critical to enhancing network security, create significant administrative burdens on personnel who must manage numerous disparate technologies that are seldom integrated and often difficult to use. Most network security products require manual, labor intensive incident response and investigation by security administrators, especially when false positive results are generated. Compounding these resource constraint issues, many organizations are increasingly challenged by the loss of key personnel as the demand for security experts has risen dramatically in traditional corporate settings, government agencies and the growing number of start-up security companies.

Increasing Visibility of Negligence Lawsuits. Faced with an ever-growing list of laws and regulations, organizations can no longer plead ignorance when defending corporate negligence lawsuits resulting from internal and external security breaches. Today s enterprises must comply with a series of government and/or industry regulations defining best practices for network security. Achieving compliance with all manner of regulations is a complex and costly issue for nearly every organization.

Heightened Government and Industry Regulation. Rapidly growing government regulation is forcing compliance with increased requirements for network security, which has escalated demand for security solutions that both meet compliance requirements and reduce the burden of compliance reporting and enforcement. Examples of these laws include:

The Payment Card Industry Data Security Standard, or PCI DSS, which provides guidelines to help organizations that process credit card payments prevent credit card fraud, hacking and various other security vulnerabilities and threats. A company processing, storing, or transmitting payment card data must be PCI DSS compliant or risk losing its ability to process credit card payments.

The Health Insurance Portability and Accountability Act of 1996, or HIPAA, and its related rules, which establish requirements for safeguards to protect the confidentiality, integrity and availability of electronic protected health information.

The Financial Services Modernization Act of 1999, commonly known as the Gramm-Leach-Bliley Act, which includes provisions to protect consumers personal financial information held by financial institutions.

The Sarbanes-Oxley Act of 2002, which mandates that public companies demonstrate due diligence in the disclosure of financial information and maintain internal controls and procedures for the communication, storage and protection of such data.

The Federal Information Security Management Act, or FISMA, which requires federal agencies, including contractors and other organizations that work with the agencies, to develop, document and implement an agency-wide information security program.

State privacy laws that regulate the privacy of personal information. California s SB1386, for example, requires notification to any California resident whose unencrypted personal information was, or is reasonably believed to have been, acquired by an unauthorized person.

Our Products

Sourcefire manufactures a number of open source and commercial security products. Sourcefire s key open source product offerings include:

Snort® The traffic inspection engine used in our intrusion prevention system is the open source technology called Snort. Martin Roesch, our founder and Chief Technology Officer, created Snort in 1998 and assigned his rights to Sourcefire upon its incorporation. Our employees, including Mr. Roesch, have authored all major components of Snort, and we maintain control over the Snort project, including the principal Snort community forum, Snort.org. Snort, which has rapidly become a de facto industry standard for intrusion prevention, has been downloaded over 3 million times. We believe that a majority of the Fortune 100 companies and all of the 30 largest U.S. government agencies use Snort technology to monitor network traffic and that Snort is the most widely deployed intrusion prevention technology worldwide. The ubiquitous nature of the Snort user community represents a significant opportunity to sell our proprietary products to customers that require a complete enterprise solution.

Sourcefire Vulnerability Research Team (VRT) Subscriptions The Sourcefire VRT is a team of experienced network security professionals responsible for writing, testing and publishing Snort rules to defend against both known and zero-day exploits. Snort rules published by the Sourcefire VRT are made available to open source Snort users at no charge on a 30-day delayed basis. Real-time VRT rules updates are made available to Sourcefire commercial IPS customers with an active customer support agreement and to open source Snort users on a subscription basis.

ClamAV™ Founded in 2001, ClamAV is one of the most commonly-used open source anti-malware products in the world. More than one million unique IP addresses download ClamAV updates daily from over 130 mirror servers located in 44 countries. Renowned for its speed and accuracy, ClamAV has been adopted by network security solution and service providers worldwide and is currently integrated within leading enterprise solutions to identify deeply embedded threats such as viruses, trojans, spyware, and other forms of malware. Like Snort, ClamAV s cutting edge security technology is a product of our open source model. In addition to continual innovations to the ClamAV anti-virus engine, the ClamAV core team and ClamAV community deliver daily signature updates to its growing virus database of over 200,000 signatures.

Certified ClamAV Support As with many open source products, support options available to end users have been limited to user mailing lists and message boards. While the community that provides this support is made up of experts who have contributed code and signatures, it does not satisfy the needs of businesses and government agencies that require 24x7 commercial support. This common obstacle to open source adoption is why Sourcefire introduced Certified ClamAV Support. With Certified ClamAV Support, we believe that our customers get the best of both worlds, the hallmark rapid pace of innovation, cost savings and transparency of the open source model combined with the reliable, high quality support provided by a commercial software company.

Sourcefire s commercial hardware and software products are marketed and sold as components of the Sourcefire 3D System. Our 3D System is comprised of the following hardware and software product offerings:

Sourcefire Defense Center^{tm} The nerve center of the Sourcefire 3D System, Defense Center unifies critical network security functions including event monitoring, correlation, and prioritization with network and user intelligence for forensic analysis, trends analysis, reporting and alerting. Defense Center is highly extensible, providing application programming interfaces (APIs) to interoperate with a variety of third-party systems (e.g., firewalls, routers, Security Information Event Management, or SIEMs, trouble ticketing and patch management systems). Using Defense Center, customers can control multiple Sourcefire 3D Sensors from a single management console while aggregating and analyzing security and compliance events from across the organization.

Sourcefire 3D^tm Sensors Scaling from 5 Mbps to 10 Gbps, Sourcefire 3D Sensors are highly scalable, fault-tolerant appliances responsible for processing Sourcefire IPS, RNA, RUA and NetFlow Analysis software applications. Sourcefire 3D Sensors are available with a variety of copper and fiber interfaces to meet the connectivity needs of virtually any organization.

Sourcefire IPS^tm (Intrusion Prevention System) Built on the foundation of Snort, Sourcefire IPS uses a rules-based language a powerful combination of signature-, protocol-, and vulnerability-based inspection methods to examine network packets for threats. Sourcefire IPS allows users to create, edit, and view detection rules, and full packet payloads are logged for every event so users can see exactly what threatening traffic has been detected. Sourcefire 3D Sensors equipped with Sourcefire IPS software can be placed in passive intrusion detection, or IDS, mode to notify users of incoming threats or in inline IPS mode to block incoming threats.

Sourcefire RNA^tm (Real-time Network Awareness) At the heart of the Sourcefire 3D System is RNA, Sourcefire s network intelligence product that provides persistent visibility into the composition, behavior, topology (the relationship of network components) and risk profile of the network. Network intelligence derived by RNA provides a platform for Defense Center s automated decision-making and network policy compliance enforcement. The ability to continuously discover characteristics and vulnerabilities of virtually any computing device communicating on a network enables Sourcefire IPS to more precisely identify and block threatening traffic and to more efficiently classify threatening and/or suspicious behavior.

Sourcefire RUA^tm (Real-time User Awareness) Sourcefire RUA enables customers to link user identity to security and compliance events. RUA leverages existing investments in Active Directory or Lightweight Directory Access Protocol (LDAP) systems by pairing usernames with host IP addresses involved in security and compliance events. This enables Sourcefire customers to resolve security and compliance events more quickly and easily.

Sourcefire NetFlow Analysis Sourcefire NetFlow Analysis aggregates data from Cisco routers and switches, thus extending the reach of Sourcefire s network behavior analysis, or NBA, solution to corners of the network where Sourcefire 3D technology has not yet been employed. The combination of RNA and NetFlow data provides customers with the ability to baseline normal network traffic across the enterprise, enabling security analysts to detect suspicious deviations, such as worm propagation, from established baselines. Further, the ability to analyze NetFlow also provides network managers with the network usage intelligence required to identify performance bottlenecks and/or areas of the network where too much bandwidth has been allocated.

Sourcefire Intrusion Agent for Snort Many Sourcefire commercial customers start out as open source Snort users. To initiate the migration from Snort to the more scalable and manageable Sourcefire 3D System, Sourcefire offers Intrusion Agent software that can be placed on open source Snort Sensors. This enables customers with Defense Center to aggregate and analyze intrusion events from both open source Snort Sensors and commercial Sourcefire 3D Sensors.

Our Services

In addition to our open source and commercial product offerings, we also offer the following services to aid our customers with installing and supporting our ETM solutions:

Sourcefire Customer Support Sourcefire s customer support is designed to ensure customer satisfaction with Sourcefire products. Sourcefire s comprehensive support services include online technical support, over-the-phone support, hardware repair/advanced replacement, and ongoing software updates to Sourcefire products.

Sourcefire Product Services Sourcefire offers a variety of professional services solutions to provide customers with best practices for planning, installing, configuring, and managing all components of the Sourcefire

3D System. The Sourcefire Product Services Team provides customers with individualized, highly concentrated attention that gives organizations a running start and lasting knowledge transfer.

Sourcefire Education & Certification Sourcefire offers a variety of training programs to help security professionals using Sourcefire commercial or open source security solutions get the most out of their investment. Sourcefire training includes instructor-led and custom classes delivered at various locations around the world, onsite at customer premises, and online. In addition, Sourcefire provides a path for interested candidates to distinguish themselves through a certification program. Certification can be achieved on both Sourcefire products and open source Snort, including an expert-level exam for those security professionals who want to obtain certification on both technologies. Through training and testing, certification provides customers and their employees with an understanding of individual skills and experience with Snort and Sourcefire products.

Our Competitive Strengths

We are a leading provider of intelligence driven, open source network security solutions that enable our customers to protect their computer networks in an effective, efficient and highly automated manner. We apply the Sourcefire 3D Systems solution Discover, Determine, Defend to network security through our comprehensive family of integrated products. Our competitive strengths include:

Real-Time Approach to Network Security. Our approach to network security enables our customers to secure their networks by providing real-time defense against both known and unknown threats. Our solution is designed to support a continuum of network security functions that span pre-attack hardening of assets, high fidelity attack identification and disruption and real-time compromise detection and incident response. In addition, our ability to confidently classify and prioritize threats in network traffic and determine the composition, behavior and relationships of network devices, or endpoints, allows us to reliably automate what are otherwise manual, time-intensive processes. For example, our 3D Sensor may trigger an alert upon identifying a Microsoft Windows-specific threat. The Defense Center would collect this alert, or security event, and classify and prioritize the event based upon a number of factors, including whether any other 3D Sensor generated the same alert, whether the network endpoints are vulnerable to that specific attack based on intelligence collected by RNA and whether the threat is against a high-priority target, such as an e-commerce server. The response to any given security event is predicated upon this automated, real-time intelligent analysis and could range from no action (as in the case where the Defense Center has determined that the network or the individual asset is not vulnerable to the observed threat) to blocking the threat in real time, dynamically modifying firewall policy, and/or launching configuration management software to correct a vulnerability condition.

Comprehensive Network and User Intelligence. Our innovative network security solution incorporates RNA, which provides persistent visibility into the composition, behavior, topology and risk profile of the network and serves as a platform for automated decision-making and network security policy enforcement. RNA performs passive, or non-disruptive, network discovery. This enables network behavior analysis (NBA) and real-time compositional cataloging of network assets, including their configuration, thereby significantly increasing the network intelligence available to IT and security administrators. RNA also provides the foundation for Sourcefire s innovative new Adaptive IPS strategy, which maximizes efficiency and effectiveness of the IPS by ensuring Snort rules are consistently enabled to protect actual network assets present on the protected network. With our RUA offering, Sourcefire is the first network security provider to incorporate user identity as a part of a comprehensive IPS solution. By pairing usernames with host IP addresses, Sourcefire customers can evaluate and mitigate security and compliance events in less time than it takes with an IP address alone.

The Open Source Community. The open source Snort user community, with over 170,000 registered users and over 3 million downloads to date, has enabled us to establish a strong market footprint. We believe that a majority of the Fortune 100 companies and all of the top 30 U.S. government agencies use Snort technology to monitor network traffic and that Snort is the most widely deployed intrusion prevention technology worldwide. With more than one million unique IP addresses downloading signature updates daily, ClamAV is a leading tool in the anti-malware market. We believe that the combined user communities of both Snort and ClamAV provide us with significant benefits, including a broad threat awareness network, significant research and development leverage, and a large pool of security experts that are skilled in the use of our technologies. These communities enable us to more cost-effectively test new algorithms and concepts on a vast number of diverse networks and significantly expedite the process of product innovation. We believe that the broad acceptance of Snort and ClamAV makes us one of the most trusted sources of network security solutions.

Leading-Edge Performance. Our solutions are built to maintain high performance across the network while also providing high levels of network security. Specifically, our solutions have the ability to process up to 10 gigabits of traffic with latency as low as 100 microseconds. Our IPS technology incorporates advanced traffic processing functionality, including packet acquisition, protocol normalization and target-based traffic inspection, which yields increased inspection precision and efficiency and enables more granular inspection of network traffic. The Defense Center supports event loads as high as 1,300 events per second, which we believe meets or exceeds the requirements of the most demanding enterprise customers.

Significant Security Expertise. Our senior management team has extensive network security industry experience gained from past service in leading enterprises and government organizations, including Symantec, McAfee, the Department of Defense and the National Security Agency. Our founder and CTO, Martin Roesch, invented Snort and the core RNA technology and is widely regarded as a network security visionary. In addition, our senior management team averages 16 years of experience in the networking and security industries. Our employees have authored all major components of the Snort source code and maintain the Snort project. Our Vulnerability Research Team, or VRT, is comprised of highly experienced security experts who research new vulnerabilities and create innovative methods for preventing attempts to exploit them. Tomasz Kojm, ClamAV founder, and the core ClamAV team bring valuable experience to Sourcefire in defending against viruses, trojans, spyware and other forms of malware. By combining the strengths of our Sourcefire, Snort and ClamAV development teams with the breadth of the open source community, we believe our domain knowledge places us at the leading edge of the network security industry.

Broad Industry Recognition. We have received numerous industry awards and certifications including recognition as a leader in the network IPS market, supporting our position as one of a select few companies that best combines completeness of vision with ability to execute. Sourcefire is currently the only major IPS provider to hold Network Intrusion Prevention certification from ICSA Labs, and RNA is one of only five network security products to receive the NSS Gold award, which is awarded by The NSS Group only to those products that are distinguished in terms of advanced or unique features, and which offer outstanding value. In addition, our technology has achieved Common Criteria Evaluation Assurance Level 2, or EAL2, which is an international evaluation standard for information technology security products sanctioned by, among others, the International Standards Organization, the National Security Agency and the National Institute for Standards and Technology.

Our Growth Strategy

We intend to become the preeminent provider of open source and commercial network security solutions on a global basis. The key elements of our growth strategy include:

Continue to Develop Innovative Network Security Technology. We intend to maintain and enhance our technological leadership position in network security. We will continue to invest significantly in internal development and product enhancements and to hire additional experienced network security professionals to broaden our proprietary knowledge base. We believe our platform is capable of expanding into new markets such as unified threat management, security management, network behavior analysis and compliance and network management and, over time, we expect to penetrate these markets with innovative products and technologies.

Grow Our Customer Base. We have an opportunity to grow our customer base as our products become more widely adopted. With over 3 million downloads of Snort and over 170,000 registered users, we believe Snort is the most ubiquitous network intrusion detection and prevention technology and represents a significant customer conversion and up-sell opportunity for Sourcefire. We seek to monetize the Snort installed base by targeting enterprises that implement Snort but have not yet purchased any of the components of our Sourcefire 3D system. Through December 31, 2007, over 1,700 customers have purchased our products and services. Further, Sourcefire seeks to build upon its recent investment in ClamAV by affording ClamAV users with new-found improvements in support, manageability, scalability and performance. We will continue to target enterprises and government agencies that require advanced security technology and high levels of network availability and performance in sectors including finance, technology, healthcare, manufacturing and defense. Furthermore, we may create new customer conversion and sales opportunities by releasing select future product features and enhancements under an open source form of license, similar to the sales opportunity we created for our current 3D system products by releasing Snort under an open form of license.

Further Penetrate Our Existing Customer Base. We believe our strong customer relationships provide us the opportunity to sell both additional quantities of existing products and new products. We intend to sell additional products to existing customers and expand our footprint in the networks of our customers to include branch offices, remote locations and data centers. In addition, we believe we have a significant opportunity to up-sell our higher margin RNA and RUA products to existing customers because of the significant incremental benefit that increased network intelligence can bring to their security systems.

Expand Our OEM Alliances and Distribution Relationships. We believe we have a significant opportunity to drive revenue growth through our OEM and distribution relationships. We currently have OEM relationships in place with Nokia and Nortel, and we have a partnership with Crossbeam in which our software is preinstalled on their hardware. In addition, we seek to expand our strategic reseller arrangements and increasingly use this channel to generate additional inbound customer prospects. For example, we have reseller agreements with True North Solutions, which has been acquired by American Systems Corporation, and Pentura Limited, a UK information technology security company, through which we expect to derive additional revenue growth in the future. We also intend to utilize our relationships with managed security service providers such as Symantec, BT Counterpane, SecureWorks, VeriSign and Verizon, to derive incremental revenue. In 2007, we generated approximately 11% of our revenue from governmental organizations and, in the future, we believe we will generate an increasing amount of revenue from government suppliers such as Lockheed Martin, Northrop Grumman and Immix Technology, who resell our products to government agencies.

Strengthen Our International Presence. We believe the network security needs of many enterprises located outside of North America are not being adequately served and therefore represent a significant potential market opportunity. In 2007, we generated approximately 25% of our revenue from international customers, up from 19% in 2006. We have distribution agreements with several resellers having significant foreign presence, through which we now offer the Sourcefire 3D security solution. Beyond these growing reseller relationships, we are also investing in the capacity of our international sales and channel personnel who will provide expanded levels of support to regions throughout Europe, Latin America, and the Asia Pacific.

Selectively Pursue Acquisitions of Complementary Businesses and Technologies. To accelerate our expected growth, enhance the capabilities of our existing products and broaden our product and service offerings, we intend to selectively pursue acquisitions of businesses, technologies and products that would complement our existing operations. We continually seek to enhance and expand the breadth of our products and services and in the future we may pursue acquisitions that will enable us to better satisfy our customers rigorous and evolving network security needs.

Awards and Certifications

We received numerous industry awards and certifications since January 1, 2007, including:

> *Gartner Magic Quadrant.* In January 2007 and again in February 2008, Sourcefire announced it was recognized by Gartner, Inc. as being a Leader in the Magic Quadrant for Network Intrusion Prevention System Appliances report.

ICSA Certification. Our 3D3800 Sensor achieved Network Intrusion Prevention certification from ICSA Labs. Sourcefire is currently the only major IPS vendor to hold this certification.

IT Executive of the Year. Sourcefire founder and CTO, Martin Roesch, was named Commercial IT Executive of the Year by the Tech Council of Maryland.

Bossie Awards. InfoWorld named Snort and ClamAV as Bossie (Best in Open Source Security) winners, recognizing Sourcefire s open source leadership.

SC Awards Finalist. Sourcefire was named a finalist in four categories in the 2007 SC Awards.

Customers

We provide products and services to a variety of end users worldwide. Our customers represent a broad spectrum of organizations within diverse sectors, including some of the world s largest financial institutions, defense contractors, health care providers, IT companies, telecommunication companies and retailers, as well as U.S. and other national, state and local government agencies. Through December 31, 2007, over 1,700 customers have purchased our products and services. We view our primary customers as enterprises generally having annual revenue exceeding $500 million, though we are increasingly pursuing the sale of products and services to the mid-tier market, targeting organizations with annual revenue ranging from $250-$500 million.

In 2007, 2006 and 2005, no single customer accounted for over 10% of our revenues.

Sales and Marketing

We market and sell our appliances, software and services directly to our customers through our direct sales organization and indirectly through our resellers, distributors and original equipment manufacturers (OEMs).

Sales. As of December 31, 2007, our sales organization was comprised of approximately 89 full-time individuals organized into two geographic regions: North America and International. The North America sales force was divided into three groups: East, West and Federal. We maintain sales offices in Columbia, Maryland; Vienna, Virginia; Livonia, Michigan; Wokingham, United Kingdom; Tokyo, Japan; Singapore; Courbevoie Cedex, France; Hoofddorp, The Netherlands and Espoo, Finland. Our sales personnel are responsible for market development, including managing our relationships with resellers and distributors, assisting them in winning and supporting key customer accounts and acting as liaisons between the end customers and our marketing and product development organizations. We are also investing in the capacity of our international sales and channel personnel who will provide expanded levels of support to regions throughout Europe, Latin America, and the Asia/Pacific region.

Each sales organization is supported by experienced security engineers who are responsible for providing pre-sales technical support and technical training for the sales team and for our resellers and distributors. All of our sales personnel are responsible for lead follow-up and account management. Our sales personnel have quota requirements and are compensated with a combination of base salary and earned commissions.

Our indirect sales channel, comprised primarily of resellers and distributors, is supported by our sales force, including dedicated channel managers, with substantial experience in selling network security products to, and through, resellers. We maintain a broad network of value-added resellers throughout the United States and Canada, and distributors in Europe, Latin America and Asia/Pacific. Our arrangements with our resellers are non-exclusive, generally cover all of our products and services, and provide for appropriate discounts based on a variety of factors, including their transaction volume. These agreements are generally terminable at will by either party by providing the other party at least 90 days written notice. Our arrangements with distributors also are non-exclusive, are generally territory-specific, and provide discounts generally based upon the annual volume of their orders. We also provide our resellers and distributors with marketing assistance, technical training, and support.

Strategic Relationships. We have established commercial relationships with networking and security companies to provide alternative distribution channels for our products. Sourcefire has OEM relationships with Nokia and Nortel, and a meet-in-the-middle channel relationship with Crossbeam.

Marketing. Our marketing activity consists primarily of product marketing, product management and sales support programs. Marketing also includes advertising, our corporate website, trade shows, direct marketing and public relations. Our marketing program is designed to build the Sourcefire, Snort and ClamAV brands, increase customer awareness, generate leads and communicate our product advantages. We also use our marketing program to support the sale of our products through new channels and to new markets.

Research and Development

Our research and development efforts are focused both on improving and enhancing our existing network security products and on developing new features and functionality. We communicate with our customers and the open source community when considering product improvements and enhancements, and we regularly release new versions of our products incorporating these improvements and enhancements.

Vulnerability Research Team. Our Vulnerability Research Team is a group of leading edge network security experts working to proactively discover, assess and respond to the latest trends in network threats and security vulnerabilities. By gathering and analyzing this information, our Vulnerability Research Team creates and updates Snort rules, ClamAV signatures, and security tools that are designed to identify, characterize and defeat attacks. This team comprises full-time employees and operates from our corporate headquarters in Columbia, Maryland. Our Vulnerability Research Team participates in extensive collaboration with hundreds of network security professionals in the open source Snort community to learn of new vulnerabilities and exploits. The Vulnerability Research Team also coordinates and shares information with other security authorities such as The SANS Institute, CERT-CC (Computer Emergency Response Team), iDefense (Verisign), SecurityFocus (Bugtraq; Symantec) and Common Vulnerabilities and Exposures (Mitre). Because of the knowledge and experience of our personnel comprising the Vulnerability Research Team, as well as its extensive coordination with the open source community, we believe that we have access to one of the largest and most sophisticated groups of IT security experts researching vulnerability and threats on a real-time basis.

Our research and development expense was $11.9 million, $8.6 million and $6.8 million for the years ended December 31, 2007, 2006 and 2005, respectively.

Manufacturing and Suppliers

We rely primarily on contract equipment manufacturers to assemble, integrate and test our appliances and to ship those appliances to our customers. We typically hold little inventory, relying instead on a just-in-time manufacturing philosophy. We rely on three primary integrators. We have contracted with Patriot Technologies, Inc. and Intelligent Decisions Inc., or IDI, to assemble, integrate and test all our product offerings operating on an Intel platform. Our agreement with Patriot expires on December 12, 2008, and will automatically renew for successive one-year periods unless either we or Patriot notify the other of an intent not to renew at least 90 days prior to expiration. Our agreement with IDI expires on January 31, 2009 and will automatically renew for successive one-year periods unless either party notifies the other party of its intent not to renew at least 30 days prior to the end of the term. Finally, we have contracted with Bivio Networks, Inc. to manufacture select high performance models of our appliances. Bivio is our sole supplier of these high performance models, such as our 3D3800, 3D5800 and 3D9800, which are the highest priced 3D Sensors that we offer. Our agreement with Bivio expires on February 10, 2010. All of these agreements are non-exclusive. We would be faced with the burden, cost and delay of having to qualify and contract with a new supplier if any of these agreements terminate or expire for any reason.

Intellectual Property

To protect our intellectual property, both domestically and abroad, we rely primarily on patent, trademark, copyright and trade secret laws. We hold three issued patents and have 33 patent applications pending for examination in the U.S. and foreign jurisdictions. The claims for which we have sought patent protection relate to methods and systems we have developed for intrusion detection and prevention used in our RNA, IPS and Defense Center products. In addition, we utilize contractual provisions, such as non-disclosure and non-compete agreements with our employees and consultants, as well as confidentiality procedures to strengthen our protection.

Despite our efforts to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. While we cannot determine the extent to which piracy of our software products occurs, we expect software piracy to be a persistent problem. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States, and many foreign countries do not enforce these laws as diligently as U.S. government agencies and private parties.

Seasonality

Our business is subject to seasonal fluctuations. For a discussion of seasonality affecting our business, see Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Seasonality.

Competition

The market for network security monitoring, detection, prevention and response solutions is intensely competitive and we expect strong competition to continue in the future. Our chief competitors generally fall within the following categories:

- large companies, including Cisco Systems, Inc., IBM Corporation, Juniper Networks, Inc., 3Com Corporation, Check Point Software Technologies, Ltd. and McAfee, Inc., that sell competitive products and offerings, as well as other large software companies that have the technical capability and resources to develop competitive products;

- software or hardware network infrastructure companies, including Cisco Systems, Inc., 3Com Corporation and Juniper Networks, Inc., that could integrate features that are similar to our products into their own products;

- smaller software companies offering relatively limited applications for network and Internet security monitoring, detection, prevention or response; and

- small and large companies offering point solutions that compete with components of our product offerings.

Mergers or consolidations among these competitors, or acquisitions of our competitors by large companies, present competitive challenges to our business. For example, during the past several years IBM Corporation, Cisco Systems, Inc., McAfee, Inc., 3Com Corporation and Juniper Networks, Inc. have acquired smaller companies that have intrusion detection and prevention technologies. These acquisitions will potentially make these combined entities more formidable competitors to us if such products and offerings are effectively integrated. Large companies may have advantages over us because of their longer operating histories, greater brand name recognition, larger customer bases or greater financial, technical and marketing resources. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. They also have greater resources to devote to the promotion and sale of their products. In addition, these companies have reduced and could continue to reduce, the price of their security monitoring, detection, prevention and response products and managed security services, which intensifies pricing pressures within our market.

Several companies currently sell security software products (such as encryption, firewall, operating system security and virus detection software) that our customers and potential customers have broadly adopted. Some of these companies sell products that perform the same functions as some of our products. In addition, the vendors of operating system software or networking hardware may enhance their products to include functions similar to those that our products currently provide.

We believe that the principal competitive factors affecting the market for information security solutions include security effectiveness, manageability, technical features, performance, ease of use, price, scope of product offerings, professional services capabilities, distribution relationships and customer service and support. We believe that our solutions generally compete favorably with respect to such factors.

Employees

As of December 31, 2007, we had 240 employees, of whom 72 were engaged in product research and development, 103 were engaged in sales and marketing, 15 were engaged in customer service and support, 10 were engaged in professional services and 40 were engaged in administrative functions. Our current employees are not represented by a labor union and are not the subject of a collective bargaining agreement. We believe that we have good relations with our employees.

Corporate Information

Sourcefire, Inc. was organized in Delaware in January 2001. We completed our initial public offering in March 2007. Our executive offices are located at 9770 Patuxent Woods Drive, Columbia, Maryland 21046, and our main telephone number is (410) 290-1616.

Available Information

Our internet address is www.sourcefire.com. We provide free of charge on the Investor Relations page of our web site access to our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after they are electronically filed with or furnished to the Securities and Exchange Commission (SEC). Information appearing on our website is not incorporated by reference in and is not a part of this report.

Item 1A. ***RISK FACTORS***

Set forth below and elsewhere in this Annual Report on Form 10-K, and in other documents we file with the Securities and Exchange Commission, are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this Annual Report on Form 10-K. Because of the following factors, as well as other variables affecting our operating results, past financial performance should not be considered as a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

We have had operating losses since our inception, we expect operating expenses to increase in the foreseeable future and we may never reach or maintain profitability.

We have incurred operating losses each year since our inception in 2001. Our net loss was approximately $932,000 for the year ended December 31, 2006 and $5.6 million for the year ended December 31, 2007. Our accumulated deficit as of December 31, 2007 is approximately $44.5 million. Becoming profitable will depend in large part on our ability to generate and sustain increased revenue levels in future periods. Although our revenue has generally been increasing, there can be no assurances that we will become profitable in the near future or at any other time. We may never achieve profitability and, even if we do, we may not be able to maintain or increase our level of profitability. We expect that our operating expenses will continue to increase in the foreseeable future as we seek to expand our customer base, increase our sales and marketing efforts, continue to invest in research and development of our technologies and product enhancements and incur significant costs associated with being a public company. These efforts may be more costly than we expect and we may not be able to increase our revenue enough to offset our higher operating expenses. In addition, if our new products and product enhancements fail to achieve adequate market acceptance, our revenue will suffer. If we cannot increase our revenue at a greater rate than our expenses, we will not become or remain profitable.

We face intense competition in our market, especially from larger, better-known companies, and we may lack sufficient financial or other resources to maintain or improve our competitive position.

The market for network security monitoring, detection, prevention and response solutions is intensely competitive, and we expect competition to increase in the future. We may not compete successfully against our current or potential competitors, especially those with significantly greater financial resources or brand name recognition. Our chief competitors include large software companies, software or hardware network infrastructure companies, smaller software companies offering relatively limited applications for network and Internet security monitoring, detection, prevention or response and small and large companies offering point solutions that compete with components of our product offerings.

Mergers or consolidations among these competitors, or acquisitions of our competitors by large companies, present heightened competitive challenges to our business. For example, Cisco Systems, Inc., McAfee, Inc., 3Com Corporation, Juniper Networks, Inc. and IBM have acquired, during the past several years, smaller companies that have intrusion detection or prevention technologies. These acquisitions may make these combined entities more formidable competitors to us if such products and offerings are effectively integrated. Large companies may have advantages over us because of their longer operating histories, greater brand name recognition, larger customer bases or greater financial, technical and marketing resources. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. They also have greater resources to devote to the promotion and sale of their products than we have. In addition, these companies have reduced and could continue to reduce, the price of their security monitoring, detection, prevention and response products and managed security services, which intensifies pricing pressures within our market.

Several companies currently sell software products (such as encryption, firewall, operating system security and virus detection software) that our customers and potential customers have broadly adopted. Some of these companies sell products that perform functions comparable to some of our products. In addition, the vendors of operating system software or networking hardware may enhance their products to include functions similar to those that our products currently provide. The widespread inclusion of comparable features comparable to our software in operating system software or networking hardware could render our products less competitive or obsolete, particularly if such features are of a high quality. Even if security functions integrated into operating system software or networking hardware are more limited than those of our products, a significant number of customers may accept more limited functionality to avoid purchasing additional products such as ours.

One of the characteristics of open source software is that anyone can offer new software products for free under an open source licensing model in order to gain rapid and widespread market acceptance. Such competition can develop without the degree of overhead and lead time required by traditional technology companies. It is possible for new competitors with greater resources than ours to develop their own open source security solutions, potentially reducing the demand for our solutions. We may not be able to compete successfully against current and future competitors. Competitive pressure and/or the availability of open source software may result in price reductions, reduced revenue, reduced operating margins and loss of market share, any one of which could seriously harm our business.

New competitors could emerge or our customers or distributors could internally develop alternatives to our products, and either such development could impair our sales.

We may face competition from emerging companies as well as established companies who have not previously entered the market for network security products. Established companies may not only develop their own network intrusion detection and prevention products, but they may also acquire or establish product integration, distribution or other cooperative relationships with our current competitors. Moreover, our large corporate customers and potential customers could develop network security software internally, which would reduce our potential revenue. New competitors or alliances among competitors may emerge and rapidly acquire significant market share due to factors such as greater brand name recognition, a larger installed customer base and significantly greater financial, technical, marketing and other resources and experience.

Our quarterly operating results are likely to vary significantly and be unpredictable, in part because of the purchasing and budget practices of our customers, which could cause the trading price of our stock to decline.

Our operating results have historically varied significantly from period to period, and we expect that they will continue to do so as a result of a number of factors, most of which are outside of our control, including:

- the budgeting cycles, internal approval requirements and funding available to our existing and prospective customers for the purchase of network security products;

- the timing, size and contract terms of orders received, which have historically been highest in the fourth quarter (representing more than one-third of our total revenue in recent years), but may fluctuate seasonally in different ways;

- the level of perceived threats to network security, which may fluctuate from period to period;

the level of demand for products sold by original equipment manufacturers, or OEMs, resellers and distributors that incorporate and resell our technologies;

the market acceptance of open-source software solutions;

the announcement or introduction of new product offerings by us or our competitors, and the levels of anticipation and market acceptance of those products;

price competition;

general economic conditions, both domestically and in our foreign markets;

the product mix of our sales; and

the timing of revenue recognition for our sales.

In particular, the network security technology procurement practices of many of our customers have had a measurable influence on the historical variability of our operating performance. Our prospective customers usually exercise great care and invest substantial time in their network security technology purchasing decisions. As a result, our sales cycles are long, generally between six and twelve months and often longer, which further impacts the variability of our results. Additionally, many of our customers have historically finalized purchase decisions in the last weeks or days of a quarter. A delay in even one large order beyond the end of a particular quarter can substantially diminish our anticipated revenue for that quarter. In addition, many of our expenses must be incurred before we generate revenue. As a result, the negative impact on our operating results would increase if our revenue fails to meet expectations in any period.

The cumulative effect of these factors will likely result in larger fluctuations and unpredictability in our quarterly operating results than in the operating results of many other software and technology companies. This variability and unpredictability could result in our failing to meet the revenue or operating results expectations of securities industry analysts or investors for a particular period. If we fail to meet or exceed such expectations for these or any other reasons, the market price of our shares could fall substantially, and we could face costly securities class action suits as a result. Therefore, you should not rely on our operating results in any quarter as being indicative of our operating results for any future period, nor should you rely on other expectations, predictions or projections of our future revenue or other aspects of our results of operations.

Economic, market and political conditions may adversely affect our revenue growth and our efforts to achieve profitability.

Our business is influenced by a range of factors that are beyond our control. These include:

general economic and business conditions;

the overall demand for network security products and services; and

constraints on budgets and changes in spending priorities of corporations and government agencies.

A general weakening of the economy in the United States or of the global economy, or a curtailment in corporate spending due to factors that affect one or more of the industries to which we sell our products and services, could delay and decrease customer purchases, which could adversely affect our revenue growth and results of operations. For example, the decline in operating performance of financial institutions associated with the problems in the subprime mortgage industry could cause our current or potential financial institution customers to delay or forego purchases of our products and services. Our customers include, but are not limited to, financial institutions, defense contractors, health care providers, IT companies, telecommunications companies and retailers. Similarly, a reduction in the budgets or spending priorities of government agencies could adversely affect our revenue growth and results of operations.

The market for network security products is rapidly evolving, and the complex technology incorporated in our products makes them difficult to develop. If we do not accurately predict, prepare for and respond promptly to technological and market developments and changing customer needs, our competitive position and prospects will be harmed.

The market for network security products is relatively new and is expected to continue to evolve rapidly. Moreover, many customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated new techniques to gain access to and attack systems and networks. Customers look to our products to continue to protect their networks against these threats in this increasingly complex environment without sacrificing network efficiency or causing significant network downtime. The software in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, without impeding the high network performance demanded by our customers. Although the market expects speedy introduction of software to respond to new threats, the development of these products is difficult and the timetable for commercial release of new products is uncertain. Therefore, we may in the future experience delays in the introduction of new products or new versions, modifications or enhancements of existing products. If we do not quickly respond to the rapidly changing and rigorous needs of our customers by developing and introducing on a timely basis new and effective products, upgrades and services that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

If our new products and product enhancements do not achieve sufficient market acceptance, our results of operations and competitive position will suffer.

We spend substantial amounts of time and money to research and develop new products and enhanced versions of Snort, the Defense Center and our 3D Sensor and RNA products to incorporate additional features, improved functionality or other enhancements in order to meet our customers rapidly evolving demands for network security in our highly competitive industry. When we develop a new product or an advanced version of an existing product, we typically expend significant money and effort upfront to market, promote and sell the new offering. Therefore, when we develop and introduce new or enhanced products, they must achieve high levels of market acceptance in order to justify the amount of our investment in developing and bringing the products to market.

Our new products or enhancements could fail to attain sufficient market acceptance for many reasons, including:

- delays in introducing new, enhanced or modified products;
- defects, errors or failures in any of our products;
- inability to operate effectively with the networks of our prospective customers;
- inability to protect against new types of attacks or techniques used by hackers;
- negative publicity about the performance or effectiveness of our intrusion prevention or other network security products;
- reluctance of customers to purchase products based on open source software; and
- disruptions or delays in the availability and delivery of our products, which problems are more likely due to our just-in-time manufacturing and inventory practices.

If our new products or enhancements do not achieve adequate acceptance in the market, our competitive position will be impaired, our revenue will be diminished and the effect on our operating results may be particularly acute because of the significant research, development, marketing, sales and other expenses we incurred in connection with the new product.

If existing customers do not make subsequent purchases from us or if our relationships with our largest customers are impaired, our revenue could decline.

In 2005, 2006 and 2007, existing customers that purchased additional products and services from us, whether for new locations or additional technology to protect existing networks and locations, generated a majority of our total revenue for each respective period. Part of our growth strategy is to sell additional products to our existing customers and, in particular, to sell our RNA products to customers that previously bought our Intrusion Sensor products. We may not be effective in executing this or any other aspect of our growth strategy. Our revenue could decline if our current customers do not continue to purchase additional products from us. In addition, as we deploy new versions of our existing Snort, 3D Sensor and RNA products or introduce new products, our current customers may not require the functionality of these products and may not purchase them.

We also depend on our installed customer base for future service revenue from annual maintenance fees. Our maintenance and support agreements typically have durations of one year. No single customer contributed greater than 10% of our recurring maintenance and support revenues in 2005, 2006 or 2007. If customers choose not to continue their maintenance service, our revenue may decline.

If we cannot attract sufficient government agency customers, our revenue and competitive position will suffer.

Contracts with the U.S. federal and state and other national and state government agencies accounted for 11% of our total revenue for both of the years ended December 31, 2006 and December 31, 2007. We lost many government agency customers when a foreign company tried unsuccessfully to acquire us in late 2005 and early 2006. Since then, we have been attempting to regain government customers, which subjects us to a number of risks, including:

Procurement. Contracting with public sector customers is highly competitive and can be expensive and time-consuming, often requiring that we incur significant upfront time and expense without any assurance that we will win a contract;

Budgetary Constraints and Cycles. Demand and payment for our products and services are impacted by public sector budgetary cycles and funding availability, with funding reductions or delays adversely impacting public sector demand for our products, including delays caused by continuing resolutions or other temporary funding arrangements;

Modification or Cancellation of Contracts. Public sector customers often have contractual or other legal rights to terminate current contracts for convenience or due to a default. If a contract is cancelled for convenience, which can occur if the customer s product needs change, we may only be able to collect for products and services delivered prior to termination. If a contract is cancelled because of default, we may only be able to collect for products and alternative products and services delivered to the customer;

Governmental Audits. National governments and state and local agencies routinely investigate and audit government contractors administrative processes. They may audit our performance and pricing and review our compliance with applicable rules and regulations. If they find that we improperly allocated costs, they may require us to refund those costs or may refuse to pay us for outstanding balances related to the improper allocation. An unfavorable audit could result in a reduction of revenue, and may result in civil or criminal liability if the audit uncovers improper or illegal activities; and

Replacing Existing Products. Many government agencies already have installed network security products of our competitors. It can be very difficult to convince government agencies or other prospective customers to replace their existing network security solutions with our products, even if we can demonstrate the superiority of our products.

We are subject to risks of operating internationally that could impair our ability to grow our revenue abroad.

We market and sell our software in North America, South America, Europe, Asia and Australia, and we plan to establish additional sales presence in these and other parts of the world. Therefore, we are subject to risks associated with having worldwide operations. Sales to customers located outside of the United States accounted for 19% of our total revenue for the year ended December 31, 2006 and 25% for the year ended December 31, 2007. The expansion of our existing operations and entry into additional worldwide markets will require significant management attention and financial resources. We are also subject to a number of risks customary for international operations, including:

economic or political instability in foreign markets;

greater difficulty in accounts receivable collection and longer collection periods;

unexpected changes in regulatory requirements;

difficulties and costs of staffing and managing foreign operations;

import and export controls;

the uncertainty of protection for intellectual property rights in some countries;

costs of compliance with foreign laws and laws applicable to companies doing business in foreign jurisdictions;

management communication and integration problems resulting from cultural differences and geographic dispersion;

multiple and possibly overlapping tax structures; and

foreign currency exchange rate fluctuations.

To date, a substantial portion of our sales have been denominated in U.S. dollars, and we have not used risk management techniques or hedged the risks associated with fluctuations in foreign currency exchange rates. In the future, if we do not engage in hedging transactions, our results of operations will be subject to losses from fluctuations in foreign currency exchange rates.

In the future, we may not be able to secure financing necessary to operate and grow our business as planned.

In the future, we may need to raise additional funds to expand our sales and marketing and research and development efforts or to make acquisitions. Additional equity or debt financing may not be available on favorable terms, if at all. If adequate funds are not available on acceptable terms, we may be unable to fund the expansion of our sales and marketing and research and development efforts or take advantage of acquisition or other opportunities, which could seriously harm our business and operating results. If we issue debt, the debt holders would have rights senior to common stockholders to make claims on our assets and the terms of any debt could restrict our operations, including our ability to pay dividends on our common stock. Furthermore, if we issue additional equity securities, stockholders would experience dilution, and the new equity securities could have rights senior to those of our common stock.

Our inability to acquire and integrate other businesses, products or technologies could seriously harm our competitive position.

In order to remain competitive, we intend to acquire additional businesses, products or technologies. If we identify an appropriate acquisition candidate, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product or technology into our existing business and operations. Any acquisitions we are able to complete may not be accretive to earnings or result in the realization of any expected strategic benefits. Further, completing a potential acquisition and integrating an acquired business could significantly divert management s time and resources from the operation of our business.

If other parties claim commercial ownership rights to Snort or ClamAV, our reputation, customer relations and results of operations could be harmed.

While we created a majority of the current Snort code base and the current ClamAV code base, a portion of the current code for both Snort and ClamAV was created by the combined efforts of Sourcefire and the open source software community, and a portion was created solely by the open source community. We believe that the portions of the Snort code base and the ClamAV base code created by anyone other than by us are required to be licensed by us pursuant to the GNU General Public License, or GPL, which is how we currently license Snort and ClamAV. There is a risk, however, that a third party could claim some ownership rights in Snort or ClamAV, attempt to prevent us from commercially licensing Snort or ClamAV in the future (rather than pursuant to the GPL as currently licensed) or claim a right to licensing royalties. Any such claim, regardless of its merit or outcome, could be costly to defend, harm our reputation and customer relations or result in our having to pay substantial compensation to the party claiming ownership.

Our products contain third party open source software, and failure to comply with the terms of the underlying open source software licenses could restrict our ability to sell our products.

Our products are distributed with software programs licensed to us by third party authors under open source licenses, which may include the GPL, the GNU Lesser Public License, or LGPL, the BSD License and the Apache License. These open source software programs include, without limitation, Snort®, ClamAVtm, Linux, Apache, Openssl, Etheral, IPTables, Tcpdump and Tripwire. These third party open source programs are typically licensed to us for a minimal fee or no fee at all, and the underlying license agreements generally require us to make available to the open source user community the source code for such programs, as well as the source code for any modifications or derivative works we create based on these third party open source software programs. With the exception of Snort and ClamAV, we have not created any modifications or derivative works to any other open source software programs referenced above. We regularly release updates and upgrades to the Snort and ClamAV software programs under the terms and conditions of the GNU GPL version 2.

Included with our software and/or appliances are copies of the relevant source code and licenses for the open source programs. Alternatively, we include instructions to users on how to obtain copies of the relevant open source code and licenses. Additionally, if we combine our proprietary software with third party open source software in a certain manner, we could, under the terms of certain of these open source license agreements, be required to release the source code of our proprietary software. This could also allow our competitors to create similar products, which would result in a loss of our product sales. We do not provide end users with a copy of the source code to our proprietary software because we believe that the manner in which our proprietary software is aligned with the relevant open source programs does not create a modification or derivative work of that open source program requiring the distribution of our proprietary source code. Our ability to commercialize our products by incorporating third party open source software may be restricted because, among other reasons:

- the terms of open source license agreements may be unclear and subject to varying interpretations, which could result in unforeseen obligations regarding our proprietary products;

- it may be difficult to determine the developers of open source software and whether such licensed software infringes another party s intellectual property rights;

- competitors will have greater access to information by obtaining these open source products, which may help them develop competitive products; and

- open source software potentially increases customer support costs because licensees can modify the software and potentially introduce errors.

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

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

The software program Linux is included in our products and is licensed under the GPL. The GPL is the subject of litigation in the case of The SCO Group, Inc. v. International Business Machines Corp., pending in the United States District Court for the District of Utah. It is possible that the court could rule that the GPL is not enforceable in such litigation. Any ruling by the court that the GPL is not enforceable could have the effect of limiting or preventing us from using Linux as currently implemented.

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

If we were to undertake actions to protect and maintain ownership and control over our proprietary intellectual property, including patents, copyrights, trademark rights and trade secrets, our standing in the open source community could be diminished which could result in a limitation on our ability to continue to rely on this community as a resource to identify and defend against new viruses, threats and techniques to attack secure networks, explore new ideas and concepts and further our research and development efforts.

Our proprietary rights may be difficult to enforce, which could enable others to copy or use aspects of our products without compensating us.

We rely primarily on copyright, trademark, patent and trade secret laws, confidentiality procedures and contractual provisions to protect our proprietary rights. As of the date hereof, we have three patents issued and 33 applications pending for examination in the U.S. and foreign jurisdictions. We also hold numerous registered United States and foreign trademarks and have a number of trademark applications pending in the United States and in foreign jurisdictions. Valid patents may not be issued from pending applications, and the claims allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate protection or competitive advantages to us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our technologies or products is difficult. Our products incorporate open source Snort and ClamAV software, which is readily available to the public. To the extent that our proprietary software is included by others in what are purported to be open source products, it may be difficult and expensive to enforce our rights in such software. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States, and many foreign countries do not enforce these laws as diligently as U.S. government agencies and private parties. It is possible that we may have to resort to litigation to enforce and protect our copyrights, trademarks, patents and trade secrets, which litigation could be costly and a diversion of management resources. If we are unable to protect our proprietary rights to the totality of the features in our software and products (including aspects of our software and products protected other than by patent rights), we may find ourselves at a competitive disadvantage to others who need not incur the additional expense, time and effort required to create products similar to ours.

In limited instances we have agreed to place, and in the future may place, source code for our software in escrow, other than the Snort and ClamAV source code, which are publicly available. In most cases, the source code may be made available to certain of our customers and OEM partners in the event that we file for bankruptcy or materially fail to support our products. Release of our source code may increase the likelihood of misappropriation or other misuse of our software. We have agreed to source code escrow arrangements in the past only rarely and usually only in connection with prospective customers considering a significant purchase of our products and services.

Claims that our products infringe the proprietary rights of others could harm our business and cause us to incur significant costs.

Technology products such as ours, which interact with multiple components of complex networks, are increasingly subject to infringement claims as the functionality of products in different industry segments overlaps. In particular, our RNA technology is a new technology for which we have yet be issued a patent. It is possible that other companies have patents with respect to technology similar to our technology, including RNA. 10 of our 33 pending patent applications relate to our RNA technology and were filed in 2004 and 2005. If others filed patent applications before us, which contain allowable claims within the scope of our RNA technology, then we may be found to infringe on such patents, if and when they are issued. We are aware of at least one company that has filed an application for a patent that, on its face, contains claims that may be construed to be within the scope of the same broad technology area as our RNA technology. That company, NetClarity, previously filed a suit against us for misappropriation and incorporation in our products of its proprietary rights, as well as making claims that our RNA technology and 3D security solutions are covered by claims in its pending patent application. This pending patent application has not issued as a patent. On June 7, 2007, we reached a definitive agreement with NetClarity, Inc. to settle this lawsuit and on June 13, 2007, the Superior Court of Suffolk County, Massachusetts entered a Stipulation of Dismissal with prejudice.

Unless and until the U.S. Patent and Trademark Office, or PTO, issues a patent to an applicant, there can be no way to assess a potential patentee s right to exclude. Depending on the timing and substance of these patents and patent applications, our products, including our RNA technology, may be found to infringe the proprietary rights of others, and we may be subject to litigation with respect to any alleged infringement. The application of patent law to the software industry is particularly uncertain, as the PTO has only recently begun to issue software patents in large numbers, and there is a backlog of software-related patent applications pending claiming inventions whose priority dates may pre-date development of our own proprietary software. Additionally, in our customer contracts we typically agree to indemnify our customers if they incur losses resulting from a third party claim that their use of our products infringes upon the intellectual property rights of a third party. Any potential intellectual property claims against us, with or without merit, could:

- be very expensive and time consuming to defend;
- require us to indemnify our customers for losses resulting from such claims;
- cause us to cease making, licensing or using software or products that incorporate the challenged intellectual property;
- cause product shipment and installation delays;
- require us to redesign our products, which may not be feasible;
- divert management s attention and resources; or
- require us to enter into royalty or licensing agreements in order to obtain the right to use a necessary product or component.

Royalty or licensing agreements, if required, may not be available on acceptable terms, or at all. A successful claim of infringement against us and our failure or inability to license the infringed or similar technology could prevent us from distributing our products and cause us to incur great expense and delay in developing non-infringing products.

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

We utilize various types of software licensed from unaffiliated third parties. For example, we license database software from MySQL that we use in our 3D Sensors, our RNA Sensors and our Defense Centers. Our Agreement with MySQL permits us to distribute MySQL software on our products to our customers worldwide until December 31, 2010. We amended our MySQL agreement on December 29, 2006 to give us the unlimited right to distribute MySQL software in exchange for a one-time lump-sum payment. We believe that the MySQL agreement is material to our business because we have spent a significant amount of development resources to allow the MySQL software to function in our products. If we were forced to find replacement database software for our products, we would be required to expend resources to implement a replacement database in our products, and there would be no guarantee that we would be able to procure the replacement on the same or similar commercial terms.

In addition to MySQL, we rely on other open source software, such as the Linux operating system, the Apache web server and OpenSSL, a secure socket layer implementation. These open source programs are licensed to us under various open source licenses. For example, Linux is licensed under the GNU General Public License Version 2, while Apache and OpenSSL are licensed under other forms of open source license agreements. If we could no longer rely on these open source programs, the functionality of our products would be impaired, and we would be required to expend significant resources to find suitable alternatives.

Our business would be disrupted if any of the software we license from others or functional equivalents of this software were either no longer available to us, no longer offered to us on commercially reasonable terms or offered to us under different licensing terms and conditions. For example, our business could be disrupted if the widely-used Linux operating system were to be released under the new Version 3 of the GNU General Public License, as we could be required to expend significant resources to ensure that our use of Linux, as well as the manner in which our proprietary and other third party software work with Linux, complies with the new version of the GNU General Public License. Additionally, we would be required to either redesign our products to function with software available from other parties or develop these components ourselves, which would result in increased costs and could result in delays in our product shipments and the release of new product offerings. Furthermore, we might be forced to limit the features available in our current or future products. If we fail to maintain or renegotiate any of these software licenses, we could face significant delays and diversion of resources in attempting to license and integrate a functional equivalent of the software.

Defects, errors or vulnerabilities in our software products would harm our reputation and divert resources.

Because our products are complex, they may contain defects, errors or vulnerabilities that are not detected until after our commercial release and installation by our customers. We may not be able to correct any errors or defects or address vulnerabilities promptly, or at all. Any defects, errors or vulnerabilities in our products could result in:

- expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;
- loss of existing or potential customers;
- delayed or lost revenue;
- delay or failure to attain market acceptance;
- increased service, warranty, product replacement and product liability insurance costs; and
- negative publicity, which would harm our reputation.

In addition, because our products and services provide and monitor network security and may protect valuable information, we could face claims for product liability, tort or breach of warranty. Anyone who circumvents our security measures could misappropriate the confidential information or other valuable property of customers using our products, or interrupt their operations. If that happens, affected customers or others may sue us. In addition, we may face liability for breaches of our product warranties, product failures or damages caused by faulty installation of our products. Provisions in our contracts relating to warranty disclaimers and liability limitations may be deemed by a court to be unenforceable. Some courts, for example, have found contractual limitations of liability in standard computer and software contracts to be unenforceable in some circumstances. Defending a lawsuit, regardless of its merit, could be costly and divert management attention. Our business liability insurance coverage may be inadequate or future coverage may be unavailable on acceptable terms or at all.

Our networks, products and services are vulnerable to, and may be targeted by, hackers.

Like other companies, our websites, networks, information systems, products and services may be targets for sabotage, disruption or misappropriation by hackers. As a leading network security solutions company, we are a high profile target and our networks, products and services may have vulnerabilities that may be targeted by hackers. Although we believe we have sufficient controls in place to prevent disruption and misappropriation, and to respond to such situations, we expect these efforts by hackers to continue. If these efforts are successful, our operations, reputation and sales could be adversely affected.

We utilize a just-in-time contract manufacturing and inventory process, which increases our vulnerability to supply disruption.

Our ability to meet our customers demand for certain of our products depends upon obtaining adequate hardware platforms on a timely basis, which must be integrated with our software. We purchase hardware platforms through our contract manufacturers from a limited number of suppliers on a just-in-time basis. In addition, these suppliers may extend lead times, limit the supply to our manufacturers or increase prices due to capacity constraints or other factors. Although we work closely with our manufacturers and suppliers to avoid shortages, we may encounter these problems in the future. Our results of operations would be adversely affected if we were unable to obtain adequate supplies of hardware platforms in a timely manner or if there were significant increases in the costs of hardware platforms or problems with the quality of those hardware platforms.

We depend on a single source to manufacture our enterprise class intrusion sensor product; if that sole source were to fail to satisfy our requirements, our sales revenue would decline and our reputation would be harmed.

We rely on one manufacturer, Bivio Networks, to build the hardware platform for three models of our intrusion sensor products that are used by our enterprise class customers. These enterprise class intrusion sensor products are purchased directly by customers for their internal use and are also utilized by third party managed security service providers to provide services to their customers. Revenue resulting from sales of these enterprise class intrusion sensor products accounted for approximately 4% of our product revenue in the year ended December 31, 2005, approximately 21% of our product revenue in the year ended December 31, 2006 and approximately 22% of our product revenue in the year ended December 31, 2007. The unexpected termination of our relationship with Bivio Networks would be disruptive to our business and our reputation, which could result in a material decline in our revenue as well as shipment delays and possible increased costs as we seek and implement production with an alternative manufacturer.

Our expected transition to a new chief executive officer could be disruptive to our business, and our inability to hire or retain other key personnel would also slow our growth.

On February 27, 2008, we announced that we and E. Wayne Jackson III, our Chief Executive Officer, had agreed not to renew the term of Mr. Jackson s employment contract with us, which is scheduled to expire at the close of business on May 5, 2008. Our board of directors has initiated an external search process for a new Chief Executive Officer to succeed Mr. Jackson, who will remain in his current role as Chief Executive Officer until we hire a successor.

While Mr. Jackson is fully cooperating with the search process, there can be no assurances that the transition to a new Chief Executive Officer will be smooth. Our success depends in part on having a successful Chief Executive Officer, yet we face significant competition for such an executive. We may not be able to find a suitable successor for the Chief Executive Officer position in a timely manner, and there are also no assurances that a new Chief Executive Officer would lead us in a successful manner. Any failure to implement a smooth transition to such a successor could have a material adverse effect on our business, results of operations or financial condition.

In addition to the transition of our Chief Executive Officer position, our business is also dependent on our ability to hire, retain and motivate highly qualified personnel, including other senior management, sales and technical professionals. In particular, as part of our growth strategy we intend to expand the size of our direct sales force domestically and internationally and to hire additional customer support and professional services personnel. However, competition for qualified services personnel is intense, and if we are unable to attract, train or retain the number of highly qualified sales and services personnel that our business needs, our reputation, customer satisfaction and potential revenue growth could be seriously harmed. To the extent that we hire personnel from competitors, we may also be subject to allegations that they have been improperly solicited or divulged proprietary or other confidential information.

In light of the transition arrangement with Mr. Jackson as our Chief Executive Officer, our future success will depend to a significant extent on the continued services of Martin Roesch, our founder. The loss of the services of this or other individuals could adversely affect our business and could divert other senior management time in searching for their replacements.

We depend on resellers and distributors for our sales; if they fail to perform as expected, our revenue will suffer.

Part of our business strategy involves entering into additional agreements with resellers and distributors that permit them to resell our products and service offerings. Revenue resulting from our resellers and distributors accounted for approximately 49% of our total revenue in the year ended December 31, 2005, approximately 49% of our total revenue in the year ended December 31, 2006 and approximately 56% of our total revenue in the year ended December 31, 2007. For the years ended December 31, 2005, 2006 and 2007, no single reseller, distributor, customer or OEM accounted for more than ten percent of our total revenue. There is a risk that our pace of entering into such agreements may slow, or that our existing agreements may not produce as much business as we anticipate. There is also a risk that some or all of our resellers or distributors may be acquired, may change their business models or may go out of business, any of which could have an adverse effect on our business.

If we do not continue to establish and effectively manage our OEM relationships, our revenue could decline.

Our ability to sell our network security software products in new markets and to increase our share of existing markets will be impaired if we fail to expand our indirect distribution channels. Our sales strategy involves the establishment of multiple distribution channels domestically and internationally through strategic resellers, system integrators and OEMs. We have alliances with OEMs such as Nortel and Nokia and we cannot predict the extent to which these companies will be successful in marketing or selling our software. Our agreements with these companies could be terminated on short notice, and they do not prevent our OEMs, systems integrators, strategic resellers or other distributors from selling the network security software of other companies, including our competitors. Nortel and Nokia, or any other OEM, system integrator, strategic reseller or distributor, could give higher priority to other companies software or to their own software than they give to ours, which could cause our revenue to decline.

Our inability to effectively manage our expected headcount growth and expansion and our additional obligations as a public company could seriously harm our ability to effectively run our business.

Our historical growth has placed, and our intended future growth is likely to continue to place, a significant strain on our management, financial, personnel and other resources. We will likely not continue to grow at our historical pace due to limits on our resources. We have grown from 107 employees at December 31, 2004 to 240 employees at December 31, 2007. Since January 1, 2005, we have opened additional sales offices and have significantly expanded our operations. This rapid growth has strained our facilities and required us to lease additional space at our headquarters. In several recent quarters, we have not been able to hire sufficient personnel to keep pace with our growth. In addition to managing our expected growth, we have substantial additional obligations and costs as a result of becoming a public company in March 2007. These obligations include investor relations, preparing and filing periodic SEC reports, developing and maintaining internal controls over financial reporting and disclosure controls, compliance with corporate governance rules, Regulation FD and other requirements imposed on public companies by the SEC and the NASDAQ Global Market that we did not experience as a private company. Fulfilling these additional obligations will make it more difficult to operate a growing company. Any failure to effectively manage growth or fulfill our obligations as a public company could seriously harm our ability to respond to customers, the quality of our software and services and our operating results. To effectively manage growth and operate a public company, we are in the process of implementing an enterprise-wide information management system that includes new accounting, finance, management information and human resource systems and controls. Any failure by us to implement this system as planned, including any failure to adequately train personnel to use the new system, complete the implementation on schedule, complete the implementation within our budget or successfully transition our existing systems to the new system, could require us to devote significant additional management attention and financial resources, which could negatively affect the operation of our business.

The price of our common stock may be subject to wide fluctuations.

Prior to our IPO in March 2007, there was not a public market for our common stock. The market price of our common stock is subject to significant fluctuations. Among the factors that could affect our common stock price are the risks described in this Risk Factors section and other factors, including:

- quarterly variations in our operating results compared to market expectations;
- changes in expectations as to our future financial performance, including financial estimates or reports by securities analysts;
- changes in market valuations of similar companies;
- liquidity and activity in the market for our common stock;
- actual or expected sales of our common stock by our stockholders;
- strategic moves by us or our competitors, such as acquisitions or restructurings;
- general market conditions; and
- domestic and international economic, legal and regulatory factors unrelated to our performance.

Stock markets in general have experienced extreme volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the trading price of our common stock, regardless of our operating performance.

We and certain of our officers and directors have been named as co-defendants in, and are the subject of, certain legal proceedings which may result in substantial costs and divert management s attention and resources.

As described in Legal Proceedings below, multiple federal securities class action lawsuits have been filed naming our company and certain of our officers and directors as co-defendants. We are not able to predict the ultimate outcome of this litigation. It is possible that these matters could be resolved adversely to us, could result in substantial costs and could divert management s attention and resources, which could harm our business.

Risks associated with legal liability often are difficult to assess or quantify, and their existence and magnitude can remain unknown for significant periods of time. While we maintain director and officer insurance, the amount of insurance coverage may not be sufficient to cover a claim, and the continued availability of this insurance cannot be assured. We may in the future be the target of additional proceedings, and these proceedings may result in substantial costs and divert management s attention and resources.

Sales of substantial amounts of our common stock in the public markets, or the perception that they might occur, could reduce the price that our common stock might otherwise attain.

As of February 25, 2008, we had 24,647,719 outstanding shares of common stock. This number includes 6,185,500 shares of our common stock that we sold in our IPO, which has been and may in the future be resold at any time in the public market. This number also includes an aggregate of approximately 12.0 million shares held by directors, officers and venture capital funds that invested in Sourcefire prior to our initial public offering, and who may sell such shares at their discretion subject to certain volume limitations. Sales of substantial amounts of our common stock in the public market, as a result of the exercise of registration rights or otherwise, or the perception that such sales could occur, could adversely affect the market price of our common stock and may make it more difficult for you to sell your common stock at a time and price that you deem appropriate.

As a result of becoming a public company, we are obligated to develop and maintain proper and effective internal controls over financial reporting and are subject to other requirements that will be burdensome and costly. We may not complete our analysis of our internal controls over financial reporting in a timely manner, or these internal controls may not be determined to be effective, which may adversely affect investor confidence in our company and, as a result, the value of our common stock.

Beginning with our Annual Report on Form 10-K for the year ending December 31, 2008, we will be required, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404), to furnish a report by management on, among other things, the effectiveness of our internal control over financial reporting. This assessment will need to include disclosure of any material weaknesses identified by our management in our internal control over financial reporting. Our auditors may also be required to issue an attestation report on the effectiveness of our internal controls over financial reporting for the year ended December 31, 2008.

We are continuing the challenging process of compiling the system and processing documentation before we perform the evaluation needed to comply with Section 404. We may not be able to complete our evaluation, testing and any required remediation in a timely fashion. During the evaluation and testing process, if we identify one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that our internal control is effective. If we are unable to assert that our internal control over financial reporting is effective, or if our auditors are unable to attest that our internal control over financial reporting is effective, we could lose investor confidence in the accuracy and completeness of our financial reports, which could have a material adverse effect on the price of our common stock. Failure to comply with these rules might make it more difficult for us to obtain certain types of insurance, including director and officer liability insurance, and we might be forced to accept reduced policy limits and coverage and/or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, on committees of our board of directors, or as executive officers.

In addition, as a public company, we have and will continue to incur significant additional legal, accounting and other expenses that we did not incur as a private company, and our administrative staff has been and will continue to be required to perform additional tasks. For example, we have created and/or revised the roles and duties of our board committees, adopted disclosure controls and procedures, retained a transfer agent and adopted an insider trading policy and bear all of the internal and external costs of preparing and distributing periodic public reports in compliance with our obligations under the securities laws. In addition, changing laws, regulations and standards relating to corporate governance and public disclosure, and related regulations implemented by the Securities and Exchange Commission and the NASDAQ Global Market, are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time-consuming. These laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. We intend to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management s time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, regulatory authorities may initiate legal proceedings against us and our business may be harmed.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.

Our amended and restated certificate of incorporation and our amended and restated bylaws, each of which became effective in March 2007 upon completion of our IPO, contain provisions that may delay or prevent an acquisition of us or a change in our management. These provisions include a classified board of directors, a prohibition on actions by written consent of our stockholders, and the ability of our board of directors to issue preferred stock without stockholder approval. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which prohibits stockholders owning in excess of 15% of our outstanding voting stock from merging or combining with us. Although we believe these provisions collectively provide for an opportunity to receive higher bids by requiring potential acquirors to negotiate with our board of directors, they would apply even if the offer may be considered beneficial by some stockholders. In addition, these provisions may frustrate or prevent attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management.

Item 1B. ***UNRESOLVED STAFF COMMENTS***

Not applicable.

Item 2. ***PROPERTIES***

Our principal executive offices are located in Columbia, Maryland. We also lease sales offices in Vienna, Virginia; Livonia, Michigan; Wokingham, United Kingdom; Tokyo, Japan; Singapore; Courbevoie Cedex, France; Hoofddorp, The Netherlands and Espoo, Finland. Our lease in Columbia, Maryland expires on May 31, 2010; our lease in Vienna, Virginia expires on January 31, 2012; our lease in Livonia, Michigan expires on August 31, 2008; our lease in Wokingham, United Kingdom expires on January 24, 2012; our lease in Singapore expires on September 30, 2008; our leases in Tokyo, Japan; Courbevoie Cedex, France; Hoofddorp, The Netherlands; and Espoo, Finland run month-to-month. We believe that our facilities are generally suitable to meet our needs for the foreseeable future; however, we will continue to seek additional space as needed to satisfy our growth.

Item 3. ***LEGAL PROCEEDINGS***

Consolidated IPO Class Action Litigation

On May 8, 2007, a putative class action lawsuit was filed in the United States District Court for the District of Maryland, against the Company and certain of its officers and directors, captioned *Howard Katz v. Sourcefire, Inc., et al.*, Case No. 1:07-cv-01210-WMN. Since then, two other putative class action lawsuits were filed in the United States District Court of Maryland against the Company and certain of its officers and directors and other parties making similar allegations, captioned *Mark Reaves v. Sourcefire, Inc. et al*, Case No. 1:07-cv-01351-JFM and *Raveill v. Sourcefire, Inc. et al*, Case No. 1:07-cv-01425-WMN. In addition, a fourth putative class action lawsuit was filed in the United States District Court for the Southern District of New York against the Company and certain of its officers and directors and other parties making similar allegations, captioned *Barry Pincus v. Sourcefire, Inc., et al.*, Case No. 1:07-cv-04720-RJH. Pursuant to a stipulation of the parties, and an order entered on or about June 29, 2007, the United States District Court of the Southern District of New York has transferred the *Pincus* case to the United States District Court for the District of Maryland.

These actions claim to be filed on behalf of all persons or entities who purchased the Company s common stock pursuant to an allegedly false and misleading registration statement and prospectus issued in connection with the Company s March 9, 2007 initial public offering (the IPO). These lawsuits allege violations of Section 11, Section 12 and Section 15 of the Securities Exchange Act of 1933, as amended, in connection with allegedly material misleading statements and/or omissions contained in the Company s registration statement and prospectus issued in connection with the IPO. The plaintiffs seek, among other things, a determination of class action status, compensatory and rescission damages, a rescission of the initial public offering, as well as fees and costs on behalf of a putative class.

On September 4, 2007, the Court granted a motion to consolidate the four putative class action lawsuits into a single civil action. In that same order, the Court also appointed Sandra Amrhein as lead plaintiff, the law firm of Kaplan Fox & Kilsheimer LLP as lead counsel, and Tydings & Rosenberg LLP as liaison counsel. On October 4, 2007, Ms. Amrhein filed an Amended Consolidated Class Action Complaint asserting legal claims that previously had been asserted in one or more of the four original actions.

On November 20, 2007, the defendants moved to dismiss the Amended Consolidated Class Action Complaint. The parties are currently in the process of briefing that motion to dismiss; no hearing date on those motions has been set by the Court.

From time to time, we are involved in other disputes and litigation in the normal course of business.

Item 4. ***SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS***

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

PART II

Item 5. ***MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES***

Market Information

Our common stock is publicly traded on the NASDAQ Global Market under the symbol FIRE. Our stock began trading on the NASDAQ Global Market on March 9, 2007. The following table sets forth, for the periods indicated, the high and low sales prices of our common stock as reported by the NASDAQ Global Market.

	High	Low
Year ended December 31, 2007:		
First Quarter (from March 9, 2007)	**$ 18.83**	**$ 14.75**
Second Quarter	**$ 17.61**	**$ 10.71**
Third Quarter	**$ 15.00**	**$ 7.96**
Fourth Quarter	**$ 10.50**	**$ 7.23**

As of February 25, 2008, there were approximately 144 holders of record of our common stock. The number of holders of record of our common stock does not reflect the number of beneficial holders whose shares are held by depositories, brokers or other nominees.

Dividend Policy

We have never declared or paid any cash dividends on our common stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future.

Stock Performance Graph

The following graph illustrates a comparison of the total cumulative stockholder return on our common stock (traded under the symbol FIRE) since March 9, 2007, the date our stock commenced public trading, through December 31, 2007 to two indices: the Russell 2000 Index and the RDG Software Composite Index. The graph assumes an initial investment of $100 on March 9, 2007. The comparisons in the graph are required by the Securities and Exchange Commission and are not intended to forecast or be indicative of possible future performance of our common stock.

COMPARISON OF 9 MONTH CUMULATIVE TOTAL RETURN*
Among Sourcefire, Inc., The Russell 2000 Index
And The RDG Software Composite Index

* $100 invested on 3/9/07 in stock or 2/28/07 in index-including reinvestment of dividends. Fiscal year ending December 31.

3/9/07	**3/07**	**4/07**	**5/07**	**6/07**	**7/07**	**8/07**	**9/07**	**10/07**	**11/07**
100.00	113.75	77.28	88.27	90.32	78.44	61.85	58.62	63.27	52.3
100.00	101.07	102.89	107.10	105.53	98.32	100.54	102.27	105.20	97.6
100.00	101.26	106.17	110.27	107.74	104.49	105.72	110.02	124.97	114.3

Use of Proceeds

In March 2007, we completed the initial public offering of shares of our common stock. On March 9, 2007, we offered and sold 5,320,000 shares of our common stock, and certain of our stockholders offered and sold an aggregate of 450,000 shares of our common stock at a public offering price of $15.00 per share. The offer and sale of these shares were registered under the Securities Act of 1933, as amended, pursuant to our Registration Statement on Form S-1, as amended (File No. 333-138199), which was declared effective by the SEC on March 8, 2007. The managing underwriters of this offering were Morgan Stanley & Co. Incorporated, Lehman Brothers Inc., UBS Securities LLC and Jefferies & Company. On March 23, 2007, we offered and sold an additional 865,500 shares of our common stock at a price of $15.00 per share pursuant to the underwriters exercise in full of their over-allotment option.

Our portion of the net proceeds from the initial public offering was approximately $83.9 million after deducting underwriting discounts and commissions of approximately $1.05 per share, or $6.5 million in the aggregate, and $2.4 million in offering expenses. We did not receive any proceeds for the sale of the 450,000 shares by selling stockholders.

We intend to use the net proceeds from the offering for working capital and other general corporate purposes, including financing our growth, developing new products and funding capital expenditures. Pending such usage, we have invested the net proceeds in short-term, interest-bearing investment grade securities.

Item 6. ***SELECTED FINANCIAL DATA***

The consolidated statement of operations data for the three years ended December 31, 2007 and the consolidated balance sheet data as of December 31, 2006 and 2007 have been derived from our audited consolidated financial statements appearing elsewhere in this report. The consolidated statement of operations data for the years ended December 31, 2003 and 2004 and the consolidated balance sheet data as of December 31, 2003, 2004 and 2005 have been derived from our audited consolidated financial statements that do not appear in this report. The selected consolidated financial data set forth below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations set forth below and our consolidated financial statements and related notes included elsewhere in this report. The historical results are not necessarily indicative of the results to be expected in any future period.

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(In thousands, except share, per share and other operating data)				
Consolidated statement of operations data:					
Revenue:					
Products	34,332	30,219	23,589	12,738	8,153
Services	21,527	14,707	9,290	3,955	1,328
Total revenue	55,859	44,926	32,879	16,693	9,481
Cost of revenue:					
Products	9,523	8,440	6,610	4,533	2,570
Services	3,360	2,632	1,453	872	436
Total cost of revenue	12,883	11,072	8,063	5,405	3,006
Gross profit	42,976	33,854	24,816	11,288	6,475
Operating expenses:					
Research and development	11,902	8,612	6,831	5,706	3,751
Sales and marketing	25,860	20,652	17,135	12,585	9,002
General and administrative	10,599	5,017	5,120	2,905	2,141
Depreciation and amortization	1,649	1,230	1,103	752	441
In-process research and development	2,947				
Total operating expenses	52,957	35,511	30,189	21,948	15,335
Loss from operations	(9,981)	(1,657)	(5,373)	(10,660)	(8,860)
Other income (expense), net	4,604	792	(85)	164	16
Loss before income taxes	(5,377)	(865)	(5,458)	(10,496)	(8,844)
Income tax expense	(244)	(67)			
Net loss	(5,621)	(932)	(5,458)	(10,496)	(8,844)
Accretion of preferred stock	(870)	(3,819)	(2,668)	(2,451)	(1,262)

Net loss attributable to common stockholders	(6,491)	(4,751)	(8,126)	(12,947)	(10,106)
Net loss attributable to common stockholders per common share:					
Basic and diluted	(0.32)	(1.40)	(2.54)	(4.97)	(4.69)
Shares used in per common share calculations:					
Basic and diluted	20,434,792	3,389,527	3,200,318	2,602,743	2,156,725

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(In thousands, except share, per share and other operating data)				
Other operating data:					
Number of sales in excess of $500,000	15	14	9	5	2
Number of new 3D customers	266	273	149	136	161
Cumulative number of Fortune 100 3D customers at end of period	29	26	24	17	10
Number of full-time employees at end of period	240	182	135	107	84

Consolidated Balance Sheet Data

	Year Ended December 31,				
	2007	2006	2005	2004	2003
Cash and cash equivalents	33,071	13,029	1,106	3,563	5,315
Held-to-maturity investments	73,956	13,293	2,005	5,751	
Total assets	141,678	49,952	21,250	20,016	10,316
Long-term debt		1,312	990	461	345
Total liabilities	32,484	22,104	16,340	10,177	5,166
Total convertible preferred stock		66,747	40,007	37,339	19,958
Total stockholders equity (deficit)	109,194	(38,899)	(35,097)	(27,500)	(14,808)

Item 7. *MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*

Introduction

Management s discussion and analysis of financial condition, changes in financial condition and results of operations is provided as a supplement to the accompanying consolidated financial statements and notes to help provide an understanding of Sourcefire, Inc. s financial condition and results of operations. This item of our Annual Report on Form 10-K is organized as follows:

Overview. This section provides a general description of our business, the performance indicators that management uses in assessing our financial condition and results of operations, and anticipated trends that management expects to affect our financial condition and results of operations.

Results of Operations. This section provides an analysis of our results of operations for the three years ended December 31, 2007.

Liquidity and Capital Resources. This section provides an analysis of our cash flows for the year ended December 31, 2007 and a discussion of our capital requirements and the resources available to us to meet those requirements.

Critical Accounting Policies and Estimates. This section discusses accounting policies that are considered important to our financial condition and results of operations, require significant judgment or require estimates on the part of management in application. Our significant accounting policies, including those considered to be critical accounting policies, are summarized in Note 2 to the accompanying consolidated financial statements.

Overview

We are a leading provider of Enterprise Threat Management (ETM) solutions for information technology (IT) infrastructures of commercial enterprises (e.g., healthcare, financial services, manufacturing, energy, education, retail, telecommunications) and federal and state government organizations. The Sourcefire 3D^{tm} System comprised of multiple Sourcefire hardware and software product offerings provides a comprehensive, intelligent network defense that unifies intrusion prevention system (IPS), network behavior analysis (NBA), network access control (NAC) and vulnerability assessment (VA) solutions under a common management framework. This ETM approach equips our customers with an efficient and effective layered security defense protecting computer network assets before, during and after an attack.

We sell our network security solutions to a diverse customer base that includes 29 of the Fortune 100 and over half of the 30 largest U.S. government agencies. We also manage two of the security industry s leading open source initiatives, Snort and ClamAV.

2007 Developments

Initial Public Offering

In March 2007, we completed the initial public offering, or IPO, of our common stock in which we sold and issued 6,185,500 shares of our common stock, including 865,500 shares sold by us pursuant to the underwriters full exercise of their over-allotment option, at an issue price of $15.00 per share. We raised a total of $92.8 million in gross proceeds from the IPO, or approximately $83.9 million in net proceeds after deducting underwriting discounts and commissions of $6.5 million and other offering costs of $2.4 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into an aggregate of 14,302,056 shares of common stock.

Acquisition of ClamAV

In August 2007, we closed on our acquisition of the intellectual property assets of ClamAV, an open source gateway anti-virus and anti-malware project. We paid $3.5 million in cash to the former owners, and deposited an additional $1.0 million in cash into escrow, to be paid to the sellers upon the delivery of certain additional source code, which is currently expected to be completed in the first quarter of 2008. We allocated $2.9 million of the purchase price to in-process research and development and allocated the remaining $634,000 to certain marketing related intangible assets. The estimated fair value of the in-process research and development project was determined by the use of a discounted cash flow model, using a discount rate that took into account the stage of completion and the risks surrounding the successful development and commercialization of the technology and product. The amount allocated to in-process research and development was immediately expensed, as there is no anticipated alternative future use for the acquired technology. The estimated fair value of the marketing-related intangible assets was determined using the relief from royalty method. As of December 31, 2007, we determined that it was probable that the additional source code would be completed in 2008 and the contingent payment would be made; therefore, the $1.0 million placed into escrow was accrued as a liability and recorded as a compensation expense as the sellers are now our employees and the payment is for services rendered.

Key Financial Metrics and Trends

Pricing and Discounts

We maintain a standard price list for all of our products. Additionally, we have a corporate policy that governs the level of discounts our sales organization may offer on our products, based on factors such as transaction size, volume of products, federal or state programs, reseller or distributor involvement and the level of technical support commitment. Our total product revenue and the resulting cost of revenue and gross profit percentage are directly affected by our ability to manage our product pricing policy. Although to date we have not experienced pressure to reduce our prices, competition is increasing and, in the future, we may be forced to reduce our prices to remain competitive.

Revenue

We currently derive revenue from product sales and services. Product revenue is principally derived from the sale of our network security solutions. Our network security solutions include a perpetual software license bundled with a third-party hardware platform. Services revenue is principally derived from technical support and professional services. We typically sell technical support to complement our network security product solutions. Technical support entitles a customer to product updates, new rule releases and both telephone and web-based assistance for using our products. Our professional services revenue includes optional installation, configuration and tuning (network security deployment services). These network security deployment services typically occur on-site after delivery has occurred.

Product sales are typically recognized as revenue at shipment of the product to the customer, whether sold directly or through resellers. For sales made through distributors and original equipment manufacturers, or OEMs, we do not recognize revenue until we receive the monthly sales report which indicates the sell-through volume to end user customers. Revenue from services is recognized when the services are performed. For technical support services, revenue is recognized ratably over the term of the support arrangement, which is usually a 12-month agreement providing for payment in advance and automatic renewals as evidenced by customer payment.

We sell our network security solutions globally. However, 81% of our revenue for 2006 and 75% of our revenue for 2007 was generated by sales to U.S.-based customers. We expect that our revenue from customers based outside of the United States will increase in amount and as a percentage of total revenue as we strengthen our international presence. We also expect that our revenue from sales through OEMs and distributors will increase in amount and as a percentage of total revenue as we expand such relationships.

Revenue from product sales has historically been highly seasonal, with more than one-third of our total product revenue in recent fiscal years generated in the fourth quarter and more than 60% in the second half of the year. The timing of our year-end shipments could materially affect our fourth quarter product revenue in any fiscal year and sequential quarterly comparisons. Revenue from our government customers has occasionally been influenced by the September 30th fiscal year-end of the U.S. federal government, which has historically resulted in our revenue from government customers being highest in the third quarter. Although we do not expect these general seasonal patterns to change substantially in the future, our revenue within a particular quarter is often affected significantly by the unpredictable procurement patterns of our customers. Our prospective customers usually spend a long time evaluating and making purchase decisions for network security solutions. Historically, many of our customers have not finalized their purchasing decisions until the final weeks or days of a quarter. We expect these purchasing patterns to continue in the future. Therefore, a delay in even one large order beyond the end of the quarter could materially reduce our anticipated revenue for a quarter. Because many of our expenses must be incurred before we expect to generate revenue, delayed orders could negatively impact our results of operations for a particular period and cause us to fail to meet the financial performance expectations of securities industry research analysts or investors.

Cost of Revenue

Cost of product revenue includes the cost of the hardware platform bundled into our network security solution, royalties for third-party software included in our network security solution, materials and labor that are incorporated in the quality assurance of our products, logistics, warranty, shipping and handling costs and, in the limited instance where we lease our network security solutions to our customers, depreciation and amortization. For the years ended December 31, 2007 and 2006, cost of product revenue was 28% of total product revenue for both periods. Hardware costs, which are our most significant cost item, generally have not fluctuated materially as a percentage of revenue in recent years because competition among hardware platform suppliers has remained strong and, therefore, per unit hardware cost has remained consistent. Because of the competition among hardware suppliers and our outsourcing of the manufacture of our products to three separate domestic contract manufacturers, we currently have no reason to expect that our cost of product revenue as a percentage of total product revenue will change significantly in the foreseeable future due to hardware pricing increases. However, hardware or other costs of manufacturing may increase in the future. We incur labor and associated overhead expenses, such as occupancy costs and fringe benefits costs, as part of managing our outsourced manufacturing process. These costs are included as a component of our cost of product revenue, but they have not been material to date.

Cost of services revenue includes the direct labor costs of our employees and outside consultants engaged to furnish those services, as well as their travel and associated direct material costs. Additionally, we include in cost of services revenue an allocation of overhead expenses such as occupancy costs, fringe benefits and supplies as well as the cost of time and materials to service or repair the hardware component of our products covered under a renewed support arrangement beyond the manufacturer s warranty. For the years ended December 31, 2007 and 2006, cost of services revenue was 16% and 18%, respectively, of total services revenue. We anticipate incurring an increasing amount of these services costs in the future for additional personnel to support and service our growing customer base.

Gross Profit

Our gross profit is affected by a variety of factors, including competition, the mix and average selling prices of our products, our pricing policy, technical support and professional services, new product introductions, the cost of hardware platforms, the cost of labor to generate such revenue and the mix of distribution channels through which our products are sold. Although we have not had to reduce the prices of our products or vary our pricing policy in recent years, our gross profit would be adversely affected by price declines if we are unable to reduce costs on existing products and fail to introduce new products with higher margins. Currently, product sales typically have a lower gross profit as a percentage of revenue than our services due to the cost of the hardware platform. Our gross profit for any particular quarter could be adversely affected if we do not complete a sufficient level of sales of higher-margin products by the end of the quarter. As discussed above, many of our customers do not finalize purchasing decisions until the final weeks or days of a quarter, so a delay in even one large order of a higher-margin product could reduce our total gross profit percentage for that quarter. For the years ended December 31, 2007 and 2006, gross profit was 77% and 75%, respectively, of total revenue. Based on current market conditions, we do not expect these percentages to change significantly in the foreseeable future, although unexpected pricing pressures or an increase in hardware or other costs would cause our gross profit percentage to decline.

Operating Expenses

Research and Development. Research and development expenses consist primarily of payroll, benefits and related occupancy and other overhead for our engineers, costs for professional services to test our products, and costs associated with data used by us in our product development.

We have significantly expanded our research and development capabilities and expect to continue to expand these capabilities in the future. We are committed to increasing the level of innovative design and development of new products as we strive to enhance our ability to serve our existing commercial and federal government markets as well as new markets for security solutions. To meet the changing requirements of our customers, we will need to fund investments in several development projects in parallel. Accordingly, we anticipate that our research and development expenses will continue to increase in absolute dollars for the foreseeable future, but should decline moderately as a percentage of total revenue as we expect to grow our revenues more rapidly than our research and development expenditures. For the years ended December 31, 2007 and 2006, research and development expense was $11.9 million and $8.6 million, or 21% and 19% of total revenue, respectively.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, incentive compensation, benefits and related costs for sales and marketing personnel; trade show, advertising, marketing and other brand-building costs; marketing consultants and other professional services; training, seminars and conferences; travel and related costs; and occupancy and other overhead costs.

As we focus on increasing our market penetration, expanding internationally and continuing to build brand awareness, we anticipate that selling and marketing expenses will continue to increase in absolute dollars, but decrease as a percentage of our revenue, in the future.

For the years ended December 31, 2007 and 2006, sales and marketing expense was $25.9 million and $20.7 million, or 46% of total revenue for both periods.

General and Administrative. General and administrative expenses consist primarily of salaries, incentive compensation, benefits and related occupancy and other overhead costs for executive, finance, information system, human resources and administrative personnel; legal, accounting and tax preparation and advisory fees; travel and related costs; information systems and infrastructure costs; and corporate insurance.

Weighted average common shares outstanding	182,850	185,039	183,054	187,533
Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares	2,854	2,635	3,011	2,548
Dilutive effect of convertible notes	390		349	
Diluted shares	186,094	187,674	186,414	190,081

Diluted net income per share				
	$0.25	$0.26	$0.78	$0.70

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 to the Company s Consolidated Financial Statements 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 nine months ended November 30, 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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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(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		Nine Months Ended	
	November 30, 2015	November 30, 2014	November 30, 2015	November 30, 2014
Number of shares considered anti-dilutive for calculating diluted EPS	19	39	160	151

NOTE 10 Share Repurchase Programs

On March 25, 2015, the Company announced that its Board of Directors has authorized the repurchase of up to $500.0 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program commenced on April 1, 2015, and will expire on the earlier of (i) March 31, 2017, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program.

As of November 30, 2015, the Company had repurchased 1,882,115 shares of its common stock for $148.3 million under this repurchase program.

As of November 30, 2015, the amount available under the program for the repurchase of the Company s common stock was $351.7 million.

Accelerated share repurchase

During the fiscal year ended February 28, 2015, the Company entered into an accelerated share repurchase program (the ASR Agreement). On October 7, 2014, under the ASR Agreement, the Company paid $375.0 million to the ASR Agreement counterparty and received 5,312,555 shares of its common stock from the ASR Agreement counterparty, which represented 80 percent of the shares deliverable to the Company under the ASR Agreement assuming an average share price of $56.47 (the Company s closing share price at October 1, 2014). The ASR Agreement was completed on February 27, 2015. On March 4, 2015, the ASR Agreement counterparty delivered 720,101 additional shares of the Company s common stock to the Company in settlement of the ASR Agreement.

The Company initially accounted for the ASR Agreement as two separate transactions: (i) the 5,312,555 shares of common stock initially delivered to the Company were accounted for as a treasury stock transaction with $300.0 million, or 80 percent, of the $375.0 million upfront payment being recorded in Treasury stock in the Company s Consolidated Balance Sheet at February 28, 2015 and (ii) the unsettled portion of the ASR Agreement of $75.0

million was recorded in Additional paid-in capital on the Company s Consolidated Balance Sheet as of February 28, 2015. The $75.0 million representing the unsettled portion of the ASR originally recorded in Additional paid-in capital was reclassified upon settlement to Treasury stock during the nine months ended November 30, 2015.

The total number of shares of common stock the Company repurchased under the ASR Agreement was 6,032,656 shares with a weighted average share price of $62.16.

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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 nine months ended November 30, 2015 and November 30, 2014 and total cash, cash equivalents and available-for-sale investment securities and total assets as of November 30, 2015 and November 30, 2014, by geographic segment (in thousands):

	Americas	EMEA	Asia Pacific	Corporate (1)	Consolidated
			Three Months Ended November 30, 2015		
Revenue from unaffiliated customers	$ 342,368	$ 114,909	$ 66,303	$	$ 523,580
Income (loss) from operations	$ 73,377	$ 23,824	$ 15,083	$ (43,407)	$ 68,877
			Three Months Ended November 30, 2014		
Revenue from unaffiliated customers	$ 290,525	$ 105,755	$ 59,615	$	$ 455,895
Income (loss) from operations	$ 68,620	$ 19,805	$ 12,395	$ (33,623)	$ 67,197
			Nine Months Ended November 30, 2015		
Revenue from unaffiliated customers	$ 996,405	$ 320,836	$ 191,487	$	$ 1,508,728
Income (loss) from operations	$ 222,851	$ 67,243	$ 46,648	$ (120,466)	$ 216,276
Total cash, cash equivalents and available-for-sale investment securities	$ 1,162,302	$ 488,003	$ 221,151	$	$ 1,871,456
Total assets	$ 2,787,555	$ 785,844	$ 325,806	$	$ 3,899,205
			Nine Months Ended November 30, 2014		
Revenue from unaffiliated customers	$ 838,757	$ 310,025	$ 176,766	$	$ 1,325,548
Income (loss) from operations	$ 170,093	$ 70,056	$ 41,180	$ (98,942)	$ 182,387
Total cash, cash equivalents and available-for-sale investment securities	$ 1,078,060	$ 383,972	$ 184,489	$	$ 1,646,521
Total assets	$ 2,546,504	$ 717,611	$ 283,756	$	$ 3,547,871

(1) Amounts represent share-based compensation expense for each of the three and nine months ended November 30, 2015 and November 30, 2014, which was not allocated to geographic segments.

Supplemental information about geographic areas

The following table lists, for each of the three and nine months ended November 30, 2015 and November 30, 2014, 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		Nine Months Ended	
	November 30, 2015	November 30, 2014	November 30, 2015	November 30, 2014
United States, the Company s country of domicile	$ 306,762	$ 264,242	$ 894,872	$ 746,105
Foreign	216,818	191,653	613,856	579,443
Total revenue from unaffiliated customers	$ 523,580	$ 455,895	$ 1,508,728	$ 1,325,548

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(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 November 30, 2015 and February 28, 2015 (in thousands):

	As of November 30, 2015	As of February 28, 2015
United States, the Company s country of domicile	$ 123,196	$ 131,792
Foreign	37,819	40,359
Total tangible long-lived assets	$ 161,015	$ 172,151

Supplemental information about major customers

For each of the three and nine months ended November 30, 2015 and November 30, 2014, the U.S. government and its agencies represented approximately 10% of the Company s total revenue.

Supplemental information about products and services

The following table, for each of the three and nine months ended November 30, 2015 and November 30, 2014, provides further detail, by type, of our 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 Enterprise Virtualization. Subscription revenue generated from our Application development-related and other emerging technology offerings includes Red Hat JBoss Middleware, Red Hat Storage Technologies and Red Hat cloud offerings such as Red Hat Enterprise Linux OpenStack Platform and OpenShift by Red Hat (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2015	November 30, 2014	November 30, 2015	November 30, 2014
Subscription revenue:				
Infrastructure-related offerings	$ 373,091	$ 332,897	$ 1,089,758	$ 983,915
Application development-related and other emerging technology offerings	84,397	61,802	234,049	172,246
Total subscription revenue	457,488	394,699	1,323,807	1,156,161

Training and services revenue:				
Consulting services	50,746	44,588	141,211	125,578
Training	15,346	16,608	43,710	43,809
Total training and services revenue	66,092	61,196	184,921	169,387
Total subscription and training and services revenue	$ 523,580	$ 455,895	$ 1,508,728	$ 1,325,548

NOTE 12 Commitments and Contingencies

Operating leases

As of November 30, 2015, 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 November 30,

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2015 and November 30, 2014 was $8.1 million and $8.0 million, respectively. Rent expense under operating leases for the nine months ended November 30, 2015 and November 30, 2014 was $23.7 million and $23.0 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 Ansible, Inc.

On October 15, 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 deploy and manage applications across private and public clouds, speed service delivery through development/operations initiatives, streamline OpenStack installations and upgrades and accelerate container adoption by simplifying orchestration and configuration.

The consideration paid was $126.3 million and includes $125.5 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 $126.3 million has been allocated to the Company s assets and liabilities on a preliminary basis as follows: $91.9 million to goodwill, $42.4 million to identifiable intangible assets and $8.0 million to working capital as a net current liability.

The Company incurred approximately $3.8 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 Statement of Operations for the three and nine months ended November 30, 2015.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Acquisition of FeedHenry Ltd.

On October 8, 2014 the Company completed its acquisition of all of the shares of FeedHenry Ltd. (FeedHenry). FeedHenry is a provider of cloud-based enterprise mobile application platforms. The acquisition is intended to expand the Company s portfolio of application development, integration and platform-as-a-service solutions, enabling the Company to support mobile application development in public and private environments.

The consideration paid was $80.2 million and has been allocated to the Company s assets and liabilities as follows: $68.5 million to goodwill, $9.0 million to identifiable intangible assets and the remaining $2.7 million to net working capital.

Acquisition of eNovance, SAS

On June 24, 2014, the Company completed its acquisition of all of the shares of eNovance, SAS (eNovance), a provider of open source cloud computing services. The acquisition is intended to assist in advancing the Company s market position in OpenStack, and the addition of eNovance s systems integration capabilities and engineering talent is expected to help meet growing demand for enterprise OpenStack consulting, design and deployment.

The consideration paid was $67.6 million and has been allocated to the Company s assets and liabilities as follows: $60.8 million to goodwill, $5.3 million to identifiable intangible assets and the remaining $1.5 million to net working capital.

In addition to the cash consideration transferred, the Company issued a total of 529,057 restricted common shares to certain employee-shareholders. The vesting of these restricted shares is conditioned on continued employment with the Company. As a result of the employment condition, the transfer of these shares has been accounted for apart from the business combination. The shares effectively vest 25% per year, with the closing-date fair value of the shares being amortized, on a straight-line basis, to share-based compensation expense in the Company s Consolidated Statement of Operations.

Acquisition of Inktank Storage, Inc.

On April 30, 2014, the Company completed its acquisition of all of the shares of Inktank Storage, Inc. (Inktank), a provider of scale-out, open source storage systems, whose technology, Inktank Ceph Enterprise, delivers object and block storage software to enterprises deploying public or private clouds. The acquisition is intended to complement the Company s existing GlusterFS-based storage and Red Hat Enterprise Linux OpenStack Platform offerings.

The consideration paid was $152.5 million and has been allocated to the Company s assets and liabilities as follows: $131.4 million to goodwill, $10.8 million to identifiable intangible assets and the remaining $10.3 million to net working capital.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 nine months ended November 30, 2015 and November 30, 2014 (in thousands, except per share amounts) as if the acquisitions of Ansible, FeedHenry, eNovance and Inktank had closed on March 1, 2014, 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.

	Three Months Ended		Nine Months Ended	
	November 30, 2015	November 30, 2014	November 30, 2015	November 30, 2014
Revenue	$ 524,360	$ 456,280	$ 1,511,556	$ 1,331,424
Net income	$ 44,635	$ 45,851	$ 138,634	$ 116,697
Basic net income per common share	$ 0.24	$ 0.25	$ 0.76	$ 0.62
Diluted net income per common share	$ 0.24	$ 0.24	$ 0.74	$ 0.61

Post-acquisition financial information

The following is a summary of the post-acquisition revenue, expenses and losses of Ansible that are included in the Company s Consolidated Statement of Operations for the three and nine months ended November 30, 2015 (in thousands):

	Three Months Ended November 30, 2015	Nine Months Ended November 30, 2015
Revenue	$ 198	$ 198
Operating expenses	(2,248)	(2,248)
Operating loss	(2,050)	(2,050)
Other loss	(2)	(2)
Loss before tax benefit	(2,052)	(2,052)
Tax benefit	595	595
Net loss	$ (1,457)	$ (1,457)

Goodwill

The following is a summary of changes in goodwill for the nine months ended November 30, 2015 (in thousands):

Balance at February 28, 2015	$ 927,060
Acquisition of Ansible	91,943
Impact of foreign currency fluctuations and other adjustments	(5,801)
Balance at November 30, 2015	$ 1,013,202

The excess of purchase price paid for Ansible, FeedHenry, eNovance, Inktank 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

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 note 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, as described in NOTE 10 Share Repurchase Programs to the Company s Consolidated Financial Statements.

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 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.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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.

As of November 30, 2015, the convertible notes consisted of the following (in thousands):

	As of November 30, 2015	As of February 28, 2015
Liability component		
Principal	$ 805,000	$ 805,000
Less: debt discount	(75,715)	(89,598)
Net carrying amount	$ 729,285	$ 715,402
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 November 30, 2015. Additionally, the Company recorded a deferred tax asset of $0.7 million related to the $1.8 million equity component of transactional costs which are deductible for tax purposes.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table includes total interest expense recognized related to the convertible notes for the three and nine months ended November 30, 2015 and November 30, 2014 (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2015	November 30, 2014	November 30, 2015	November 30, 2014
Coupon rate 0.25% per year, payable semiannually	$ 503	$ 302	$ 1,509	$ 302
Amortization of convertible note issuance costs liability component	615	351	1,813	351
Accretion of debt discount	4,664	2,734	13,884	2,734
Total interest expense related to convertible notes	$ 5,782	$ 3,387	$ 17,206	$ 3,387

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 November 30, 2015	
	Fair Value	Carrying Value
Convertible notes	$ 738,477	$ 729,285

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.

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, middleware, storage and cloud 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, reliability, scalability, flexibility, stability 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 have focused on introducing and gaining acceptance for Red Hat technologies that comprise our open source architecture. Red Hat Enterprise Linux (RHEL) and Red Hat JBoss Middleware offerings have gained widespread independent software vendor (ISV) and independent hardware vendor (IHV) support. We have continued to build our open source architecture by expanding our enterprise operating system and middleware offerings and introducing virtualization, storage, cloud and other offerings.

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 28, 2015.

In our fiscal year ended February 28, 2015, we focused on and expect in our fiscal year ending February 29, 2016 to continue to focus on, among other things, (i) promoting the widespread adoption of Red Hat offerings by customers globally, (ii) expanding our portfolio of virtualization, storage, management and other technology offerings that enable cloud computing, (iii) investing in the development of open source technologies, (iv) pursuing strategic acquisitions and alliances, (v) increasing revenue from our existing customer base, (vi) increasing 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.

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Revenue

For the three months ended November 30, 2015, total revenue increased 14.8%, or $67.7 million, to $523.6 million from $455.9 million for the three months ended November 30, 2014. Excluding the impact of foreign currency exchange rate fluctuations, total revenue increased by 21.1% for the three months ended November 30, 2015, as detailed in the following table.

The growth rates of subscription revenue by offering type and training and services revenue, as reported and excluding the impact of foreign currency exchange rate fluctuations, for the three and nine months ended November 30, 2015 versus the three and nine months ended November 30, 2014 are as follows (in thousands):

	Three Months Ended			Nine Months Ended		
	November 30, 2015	November 30, 2014	Year-Over-Year Growth Rate	November 30, 2015	November 30, 2014	Year-Over-Year Growth Rate
Infrastructure-related subscription revenue, as reported	$ 373,091	$ 332,897	12.1%	$ 1,089,758	$ 983,915	10.8%
Adjustment for foreign currency exchange rates	18,550			68,781		
Infrastructure-related subscription revenue, excluding foreign currency impact	391,641	332,897	17.6%	1,158,539	983,915	17.7%
Application development-related and other emerging technology subscription revenue, as reported	84,397	61,802	36.6%	234,049	172,246	35.9%
Adjustment for foreign currency exchange rates	5,330			18,212		
Application development-related and other emerging technology subscription revenue, excluding foreign currency impact	89,727	61,802	45.2%	252,261	172,246	46.5%
Total subscription revenue, as reported	457,488	394,699	15.9%	1,323,807	1,156,161	14.5%
Adjustment for foreign currency exchange rates	23,880			86,993		
Total subscription revenue, excluding foreign currency	481,368	394,699	22.0%	1,410,800	1,156,161	22.0%

impact						
Total training and services revenue, as reported	66,092	61,196	8.0%	184,921	169,387	9.2%
Adjustment for foreign currency exchange rates	4,603			15,487		
Total training and services revenue, excluding foreign currency impact	70,695	61,196	15.5%	200,408	169,387	18.3%
Total subscription and training and services revenue, as reported	523,580	455,895	14.8%	1,508,728	1,325,548	13.8%
Adjustment for foreign currency exchange rates	28,483			102,480		
Total subscription and training and services revenue, excluding foreign currency impact	$ 552,063	$ 455,895	21.1%	$ 1,611,208	$ 1,325,548	21.6%

Revenue from our non-U.S. operations has been translated into U.S. dollars using the average exchange rates for each month of the three and nine months ended November 30, 2015. In an effort to provide a comparable framework for assessing how our business performed when compared to the three and nine months ended November 30, 2014 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 each of the three and nine months ended November 30, 2015 using the average foreign currency exchanges rates for each of the three and nine months ended November 30, 2014.

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 new versions of the software, security updates, fixes, functionality enhancements, upgrades to the technology, if and when available, and compatibility with an ecosystem of certified hardware and software. Subscription revenue increased sequentially for the first, second and third quarters of fiscal 2016 and for each quarter of fiscal 2015 and fiscal 2014 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 15.9%, or $62.8 million, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014. Excluding the impact of foreign currency exchange rate fluctuations, subscription revenue increased by 22.0% for the three months ended November 30, 2015. The increase in subscription revenue is driven primarily by additional subscriptions related to our principal RHEL and Red Hat JBoss Middleware offerings, which continue to gain broader market acceptance in mission-critical areas of computing, and the expansion of our sales channels and our 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 8.0%, or $4.9 million, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014. Excluding the impact of foreign currency exchange rates, training and services revenue increased by 15.5%. The increase is driven primarily by customer interest in new products and increased demand for our open source solutions.

We believe our success is influenced by:

- the extent to which we can expand the breadth and depth of our offerings;
- our ability to enhance the value of Red Hat offerings through frequent and continuing innovation while maintaining stable platforms over multi-year periods;

our involvement and leadership in key open source communities which enables us to develop, enhance and maintain our offerings;

our ability to generate increasing revenue from partners and other strategic relationships, including CCSPs, distributors, embedded technology partners, IHVs, ISVs, original equipment manufacturers (OEMs), systems integrators, and value added resellers;

our ability to generate new and recurring revenue for Red Hat offerings;

the widespread and increasing deployment of open source technologies by enterprises and similar institutions, such as government agencies and universities; and

our ability to provide customers with consulting and training services that generate additional revenue.

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Deferred revenue and billings proxy

Year-to-date deferred revenue

Our deferred revenue, current and long-term, balance at November 30, 2015 was $1.49 billion. Total deferred revenue at November 30, 2015 increased 0.3%, or $4.8 million, as compared to the balance of $1.48 billion at February 28, 2015. The slight increase in deferred revenue is primarily attributable to our typically-lower, seasonal first and second quarter billings and the year-to-date impact of foreign currency exchange rate fluctuations as discussed in the following paragraph. 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 increase in deferred revenue reported on our Consolidated Balance Sheets of $4.8 million differs from the increase of $40.1 million we reported on our Consolidated Statements of Cash Flows for the nine months ended November 30, 2015 as the amount reported on our Consolidated Statements of Cash Flows for the nine months ended November 30, 2015 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 business combinations.

Year-over-year deferred revenue

Total deferred revenue increased by 14.4%, or $187.0 million, to $1.49 billion at November 30, 2015 from $1.30 billion at November 30, 2014. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue increased by 20.4%, or $265.0 million, from November 30, 2014 to November 30, 2015. This increase in deferred revenue of $265.0 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 November 30, 2015, plus $0.2 million related to deferred revenue acquired from business combinations during the same period.

Current deferred revenue increased by 14.8%, or $139.1 million, to $1.08 billion at November 30, 2015 from $941.4 million at November 30, 2014 and long-term deferred revenue increased by 13.3%, or $47.9 million, to $406.6 million at November 30, 2015 from $358.7 million at November 30, 2014. Excluding the impact of foreign currency exchange rate fluctuations, current deferred revenue increased by 20.1%, or $189.2 million, and long-term deferred revenue increased by 21.1%, or $75.8 million, from November 30, 2014 to November 30, 2015.

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 November 30, 2015, our rolling average billings proxy increased by 14.8%, or $72.3 million, to $559.4 million from $487.1 million for the four-fiscal-quarter period ended November 30, 2014. Using the average foreign currency exchange rates for each quarter of our four-fiscal-quarter period ended

November 30, 2014, our rolling average billings proxy for the four-fiscal-quarter period ended November 30, 2015 would have increased by approximately 21.3%, or $103.7 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 28, 2015.

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Revenue by geography

For the three months ended November 30, 2015, approximately $216.8 million, or 41.4%, of our revenue was generated outside the United States compared to approximately $191.7 million, or 42.0%, for the three months ended November 30, 2014. The relative decrease in the percentage of revenue generated outside of the United States for the three months ended November 30, 2015 compared to the percentage of revenue generated outside of the United States for the three months ended November 30, 2014 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 or expand our presence in existing locations. As of November 30, 2015, 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 November 30, 2015 and the three months ended November 30, 2014 was as follows (in thousands):

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended November 30, 2015	$ 342,368	$ 114,909	$ 66,303	$ 523,580
Three Months Ended November 30, 2014	$ 290,525	$ 105,755	$ 59,615	$ 455,895

Year-over-year revenue growth rates in U.S. dollars for our three geographical regions were as follows for the three months ended November 30, 2015 and three months ended November 30, 2014:

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended November 30, 2015	17.8%	8.7%	11.2%	14.8%
Three Months Ended November 30, 2014	16.3%	12.7%	12.5%	15.0%

Excluding the impact of foreign currency exchange rate fluctuations, Americas, EMEA, Asia Pacific and Consolidated revenue grew 19.3%, 24.8%, 23.0% and 21.1%, respectively, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014.

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

Gross profit

Gross profit margin was 84.5% and 84.3% for each of the three months ended November 30, 2015 and November 30, 2014, respectively. A favorable mix shift, as subscription revenue increased relative to services, was partially offset by increased costs to deliver our services. Such increases in costs to deliver our consulting services result from investments in personnel, infrastructure and processes to support our emerging technologies.

Gross profit margin by geography

Gross profit margins by our geographic regions for the three months ended November 30, 2015 and November 30, 2014 were as follows:

	Americas	EMEA	Asia Pacific	Consolidated (1)
Three Months Ended November 30, 2015	85.5%	86.3%	82.5%	84.5%
Three Months Ended November 30, 2014	85.5%	86.0%	82.4%	84.3%

(1) Consolidated gross margin includes corporate (non-allocated) share-based compensation expense for the three months ended November 30, 2015 and November 30, 2014 of $4.1 million and $3.9 million, respectively. For additional information, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

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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 13.2% for the three months ended November 30, 2015 from 14.7% for the three months ended November 30, 2014. The decrease was primarily driven by the integration of our recent business combinations.

Income from operations by geography

Operating income as a percentage of revenue generated by our geographic regions for the three months ended November 30, 2015 and the three months ended November 30, 2014 was as follows:

	Americas	EMEA	Asia Pacific	Consolidated (1)
Three Months Ended November 30, 2015	21.4%	20.7%	22.7%	13.2%
Three Months Ended November 30, 2014	23.6%	18.7%	20.8%	14.7%

(1) Consolidated operating income as a percentage of revenue includes corporate (non-allocated) share-based compensation expense for the three months ended November 30, 2015 and November 30, 2014 of $43.4 million and $33.6 million, respectively. For additional information, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

Operating margin for Americas decreased for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014 primarily as a result of closing and integrating the Ansible acquisition.

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 November 30, 2015 totaled $1.87 billion. Cash generated from operating activities for the three months ended November 30, 2015 totaled $139.6 million which represents an increase of 5.0% in operating cash flow as compared to the three months ended November 30, 2014. This increase is due to increases in subscription revenue and services revenues, billings and collections during the same periods.

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 41.4% of our revenue for the three months ended November 30, 2015 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-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 November 30, 2015

Using the average foreign currency exchange rates from the third quarter of our prior fiscal year ended February 28, 2015, our revenue and operating expenses from non-U.S. operations for the three months ended November 30, 2015 would have been higher than we reported by approximately $28.5 million and $24.1 million, respectively, which would have resulted in income from operations being higher by $4.4 million.

Nine Months Ended November 30, 2015

Using the average foreign currency exchange rates for the nine months ended November 30, 2014, our revenue and operating expenses from non-U.S. operations for the nine months ended November 30, 2015 would have been higher than we reported by approximately $102.5 million and $78.5 million, respectively, which would have resulted in income from operations being higher by $24.0 million.

Business combinations

Ansible

On October 15, 2015 we completed our acquisition of all of the shares of Ansible for total consideration of $126.3 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 deploy and manage applications across private and public clouds, speed service delivery through development/operations initiatives, streamline OpenStack installations and upgrades and accelerate container adoption by simplifying orchestration and configuration.

FeedHenry

On October 8, 2014, we completed our acquisition of all of the shares of FeedHenry for approximately $80.2 million. FeedHenry is a provider of cloud-based enterprise mobile application platforms. The acquisition is intended to expand our portfolio of application development, integration and platform-as-a-service (Paas) solutions, enabling us to support mobile application development in public and private environments.

eNovance

On June 24, 2014, we completed our acquisition of all of the shares of eNovance, a provider of open source cloud computing services, for $67.6 million. The acquisition is intended to assist in advancing our market position in OpenStack, and the addition of eNovance s systems integration capabilities and engineering talent is expected to help meet growing demand for enterprise OpenStack consulting, design and deployment.

Inktank

On April 30, 2014, we completed our acquisition of all of the shares of Inktank, a provider of scale-out, open source storage systems, whose flagship technology, Inktank Ceph Enterprise, delivers object and block storage software to enterprises deploying public or private clouds for consideration of $152.5 million. The acquisition is intended to complement our existing GlusterFS-based storage and Red Hat Enterprise Linux OpenStack Platform offerings.

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Convertible note offering

On October 7, 2014, we completed our offering of $805.0 million aggregate principal amount of our 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 us 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, for resale to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended.

We 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 in NOTE 15 Convertible Notes to our Consolidated Financial Statements. Proceeds of $79.8 million were received by us from the sale of warrants pursuant to the warrant transactions also described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

In addition, we used $375.0 million of the net proceeds from the offering of the convertible notes to repurchase shares of our common stock under an accelerated share repurchase program pursuant to an agreement that we entered into on October 1, 2014, as described in NOTE 10 Share Repurchase Programs to our Consolidated Financial Statements.

We intend 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.

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RESULTS OF OPERATIONS

Three months ended November 30, 2015 and November 30, 2014

The following table is a summary of our results of operations for the three months ended November 30, 2015 and November 30, 2014 (in thousands):

	Three Months Ended (Unaudited)			
	November 30, 2015	November 30, 2014	$ Change	% Change
Revenue:				
Subscriptions	$ 457,488	$ 394,699	$ 62,789	15.9%
Training and services	66,092	61,196	4,896	8.0
Total subscription and training and services revenue	523,580	455,895	67,685	14.8
Cost of subscription and training and services revenue:				
Cost of subscriptions	32,246	28,574	3,672	12.9
As a % of subscription revenue	7.0%	7.2%		
Cost of training and services	48,802	42,791	6,011	14.0
As a % of training and services revenue	73.8%	69.9%		
Total cost of subscription and training and services revenue	81,048	71,365	9,683	13.6
As a % of total revenue	15.5%	15.7%		
Total gross profit	442,532	384,530	58,002	15.1
Operating expense:				
Sales and marketing	215,784	187,218	28,566	15.3
Research and development	104,906	90,613	14,293	15.8
General and administrative	52,965	39,502	13,463	34.1
Total operating expense	373,655	317,333	56,322	17.7
Income from operations	68,877	67,197	1,680	2.5
Interest income	2,874	2,196	678	30.9
Interest expense	5,817	3,441	2,376	69.0
Other income (expense), net	49	1,559	(1,510)	(96.9)
Income before provision for income taxes	65,983	67,511	(1,528)	(2.3)
Provision for income taxes	19,135	19,578	(443)	(2.3)
Net income	$ 46,848	$ 47,933	$ (1,085)	(2.3)%

Gross profit margin-subscriptions	93.0%	92.8%
Gross profit margin-training and services	26.2%	30.1%
Gross profit margin	84.5%	84.3%
As a % of total revenue:		
Subscription revenue	87.4%	86.6%
Training and services revenue	12.6%	13.4%
Sales and marketing expense	41.2%	41.1%
Research and development expense	20.0%	19.9%
General and administrative expense	10.1%	8.7%
Total operating expenses	71.4%	69.6%
Income from operations	13.2%	14.7%
Income before provision for income taxes	12.6%	14.8%
Net income	8.9%	10.5%
Estimated annual effective income tax rate	29.0%	29.0%

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Revenue

Subscription revenue

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat offerings, increased by 15.9%, or $62.8 million, to $457.5 million for the three months ended November 30, 2015 from $394.7 million for the three months ended November 30, 2014.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 12.1%, or $40.2 million, to $373.1 million for the three months ended November 30, 2015 from $332.9 million for the three months ended November 30, 2014. 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 36.6%, or $22.6 million, to $84.4 million for the three months ended November 30, 2015 from $61.8 million for the three months ended November 30, 2014. 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 8.0%, or $4.9 million, to $66.1 million for the three months ended November 30, 2015 from $61.2 million for the three months ended November 30, 2014. The increase is due to services revenue which increased by 13.8%, or $6.2 million, as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Training revenue decreased by 7.6%, or $1.3 million. Training revenue in the current year decreased relative to the prior year s training revenue which included incremental revenue related to the then recently released RHEL 7 offering. Combined training and services revenue decreased as a percentage of total revenue to 12.6% for the three months ended November 30, 2015 from 13.4% for the three months ended November 30, 2014.

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, physical media, literature, packaging and shipping. Cost of subscription revenue increased by 12.9%, or $3.7 million, to $32.2 million for the three months ended November 30, 2015 from $28.6 million for the three months ended November 30, 2014. 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 $2.7 million. The remaining increase is driven primarily by incremental travel and outside services costs. Gross profit margin on subscriptions was 93.0% and 92.8%, respectively, for each of the three months ended

November 30, 2015 and November 30, 2014. As the number of our open source technology subscriptions continues to increase, we expect associated support cost 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 14.0%, or $6.0 million, to $48.8 million for the three months ended November 30, 2015 from $42.8 million for the three months ended November 30, 2014. Costs to deliver our services revenue increased by 17.6%, or $6.0 million, and relate to additional third-party consulting costs incurred to meet a surge in demand for and 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 73.8% and 69.9% for each of the three month periods ended November 30, 2015 and November 30, 2014, respectively.

Gross profit

Gross profit margin was 84.5% and 84.3% for the three months ended November 30, 2015 and November 30, 2014, respectively. A favorable mix shift, as subscription revenue increased relative to services, was partially offset by increased costs to deliver our services. Such increases in costs to deliver our consulting services result from investments in personnel, infrastructure and processes to support our emerging technologies.

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 15.3%, or $28.6 million, to $215.8 million for the three months ended November 30, 2015 from $187.2 million for the three months ended November 30, 2014. This increase was partially due to a $17.1 million increase in selling costs, which includes $12.3 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 25.5%, or $11.5 million, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014 and includes incremental employee compensation and marketing program costs of $4.4 million and $6.5 million, respectively. Sales and marketing expense increased as a percentage of revenue to 41.2% for the three months ended November 30, 2015 from 41.1% for the three months ended November 30, 2014.

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 15.8%, or $14.3 million, to $104.9 million for the three months ended November 30, 2015 from $90.6 million for the three months ended November 30, 2014. 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 cloud management and our other emerging technologies. Employee compensation and travel costs increased by $12.2 million and $0.4 million, respectively. Research and development expense was 20.0% and 19.9% of total revenue for the three months ended November 30, 2015 and November 30, 2014, 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 34.1%, or $13.5 million, to $53.0 million for the three months ended November 30, 2015 from $39.5 million for the three months ended November 30, 2014. General and

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administrative expenses include increased compensation-related expense of $6.0 million, transaction costs related to business combinations of $2.7 million and infrastructure and facilities costs of $2.2 million. General and administrative expense increased as a percentage of revenue to 10.1% for the three months ended November 30, 2015 from 8.7% for the three months ended November 30, 2014. Although general and administrative expense increased as a percentage of total revenue for the three months ended November 30, 2015, we expect such costs to decrease relative to revenue as we begin to leverage benefits from investments made during the current year to expand and enhance our corporate processes and technology infrastructure.

Interest income

Interest income increased by 30.9%, or $0.7 million, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014. The increase in interest income for the three months ended November 30, 2015 is attributable to slightly higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $2.4 million, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014. The increase in interest expense for the three months ended November 30, 2015 is attributable to the issuance of convertible notes during the three months ended November 30, 2014 which is described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

Other income (expense), net

Other income (expense), net decreased by $1.5 million, for the three months ended November 30, 2015 as compared to the three months ended November 30, 2014. The decrease is primarily due to net gains recognized from the settlement of foreign currency transactions during the three months ended November 30, 2014 that were not repeated during the three months ended November 30, 2015.

Income taxes

During the three months ended November 30, 2015, we recorded $19.1 million of income tax expense, which is based on an estimated annual effective tax rate of 29%. Our estimated annual effective tax rate of 29% is less than the U.S. federal statutory rate of 35% primarily due to foreign income taxed at lower rates, state income taxes net of federal benefits and the domestic production activities deduction.

During the three months ended November 30, 2014, we recorded $19.6 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% primarily due to foreign income taxed at lower rates.

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Nine months ended November 30, 2015 and November 30, 2014

The following table is a summary of our results of operations for the nine months ended November 30, 2015 and November 30, 2014 (in thousands):

	Nine Months Ended (Unaudited)			
	November 30, 2015	November 30, 2014	$ Change	% Change
Revenue:				
Subscriptions	$ 1,323,807	$ 1,156,161	$ 167,646	14.5%
Training and services	184,921	169,387	15,534	9.2
Total subscription and training and services revenue	1,508,728	1,325,548	183,180	13.8
Cost of subscription and training and services revenue:				
Cost of subscriptions	93,088	84,125	8,963	10.7
As a % of subscription revenue	7.0%	7.3%		
Cost of training and services	135,321	118,857	16,464	13.9
As a % of training and services revenue	73.2%	70.2%		
Total cost of subscription and training and services revenue	228,409	202,982	25,427	12.5
As a % of total revenue	15.1%	15.3%		
Total gross profit	1,280,319	1,122,566	157,753	14.1
Operating expense:				
Sales and marketing	619,757	538,576	81,181	15.1
Research and development	304,824	275,817	29,007	10.5
General and administrative	139,462	125,786	13,676	10.9
Total operating expense	1,064,043	940,179	123,864	13.2
Income from operations	216,276	182,387	33,889	18.6
Interest income	8,484	6,048	2,436	40.3
Interest expense	17,265	3,591	13,674	380.8
Other income (expense), net	(1,398)	1,777	(3,175)	(178.7)
Income before provision for income taxes	206,097	186,621	19,476	10.4
Provision for income taxes	59,768	54,120	5,648	10.4
Net income	$ 146,329	$ 132,501	$ 13,828	10.4%
Gross profit margin-subscriptions	93.0%	92.7%		

Gross profit margin-training and services	26.8%	29.8%
Gross profit margin	84.9%	84.7%
As a % of total revenue:		
Subscription revenue	87.7%	87.2%
Training and services revenue	12.3%	12.8%
Sales and marketing expense	41.1%	40.6%
Research and development expense	20.2%	20.8%
General and administrative expense	9.2%	9.5%
Total operating expenses	70.5%	70.9%
Income from operations	14.3%	13.8%
Income before provision for income taxes	13.7%	14.1%
Net income	9.7%	10.0%
Estimated annual effective income tax rate	29.0%	29.0%

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Revenue

Subscription revenue

Subscription revenue increased by 14.5%, or $167.6 million, to $1.32 billion for the nine months ended November 30, 2015 from $1.16 billion for the nine months ended November 30, 2014.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 10.8%, or $105.8 million, to $1.09 billion for the nine months ended November 30, 2015 from $983.9 million for the nine months ended November 30, 2014 and includes a favorable revenue adjustment of $5.3 million related to cloud-usage revenues through our CCSP program, as described further in NOTE 2 Summary of Significant Accounting Policies to our Consolidated Financial Statements. The remaining 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 35.9%, or $61.8 million, to $234.0 million for the nine months ended November 30, 2015 from $172.2 million for the nine months ended November 30, 2014. The increase is primarily due to additional subscriptions for Red Hat JBoss Middleware offerings.

Training and services revenue

Total training and services revenue increased by 9.2%, or $15.5 million, to $184.9 million for the nine months ended November 30, 2015 from $169.4 million for the nine months ended November 30, 2014. The increase is due to services revenue which increased by 12.4%, or $15.6 million, as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Training revenue decreased by 0.2%, or $0.1 million. Combined training and services revenue decreased as a percentage of total revenue to 12.3% for the nine months ended November 30, 2015 from 12.8% for the nine months ended November 30, 2014.

Cost of revenue

Cost of subscription revenue

Cost of subscription revenue increased by 10.7%, or $9.0 million, to $93.1 million for the nine months ended November 30, 2015 from $84.1 million for the nine months ended November 30, 2014. 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 $6.9 million. The remaining increase is driven primarily by incremental travel, outside services and equipment costs of $1.2 million. Gross profit margin on subscriptions was 93.0% and 92.7%, respectively, for each of the nine months ended November 30, 2015 and November 30, 2014. Excluding the favorable revenue adjustment of $5.3 million related to cloud-usage revenue, gross profit margin on subscriptions for the nine months ended May 31, 2015 was 92.9%.

Cost of training and services revenue

Cost of training and services revenue increased by 13.9%, or $16.5 million, to $135.3 million for the nine months ended November 30, 2015 from $118.9 million for the nine months ended November 30, 2014. Costs to deliver our services revenue increased by 16.7%, or $16.0 million, and relate to additional third-party consulting costs incurred to meet a surge in demand for and 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 73.2% and 70.2% for each of the nine months ended November 30, 2015 and November 30, 2014, respectively.

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Gross profit

Excluding the favorable revenue adjustment of $5.3 million described previously, gross profit margin increased slightly to 84.8% for the nine months ended November 30, 2015 from 84.7% for the nine months ended November 30, 2014. The increase was due to a favorable mix shift as subscription revenue increased relative to services and was partially offset by increased costs to deliver our services due to additions to our emerging technologies staff.

Operating expenses

Sales and marketing

Sales and marketing expense increased by 15.1%, or $81.2 million, to $619.8 million for the nine months ended November 30, 2015 from $538.6 million for the nine months ended November 30, 2014. This increase was partially due to a $53.0 million increase in selling costs, which includes $43.4 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 22.0%, or $28.1 million, for the nine months ended November 30, 2015 as compared to the nine months ended November 30, 2014 and includes incremental employee compensation and marketing program costs of $12.2 million and $14.9 million, respectively. Primarily as a result of expanded sales and marketing staffing, sales and marketing expense increased as a percentage of revenue to 41.1% for the nine months ended November 30, 2015 from 40.6% for the nine months ended November 30, 2014.

Research and development

Research and development expense increased by 10.5%, or $29.0 million, to $304.8 million for the nine months ended November 30, 2015 from $275.8 million for the nine months ended November 30, 2014. 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 cloud management and our other emerging technologies. Employee compensation increased by $26.2 million and travel costs increased by $1.2 million. Research and development expense was 20.2% and 20.8% of total revenue for the nine months ended November 30, 2015 and November 30, 2014, respectively.

General and administrative

General and administrative expense increased by 10.9%, or $13.7 million, to $139.5 million for the nine months ended November 30, 2015 from $125.8 million for the nine months ended November 30, 2014. General and administrative expenses include increased compensation-related expense of $9.2 million and infrastructure and facilities costs of $2.6 million. General and administrative expense decreased as a percentage of revenue to 9.2% for the nine months ended November 30, 2015 from 9.5% for the nine months ended November 30, 2014.

Interest income

Interest income increased by 40.3%, or $2.4 million, for the nine months ended November 30, 2015 as compared to the nine months ended November 30, 2014. The increase in interest income for the nine months ended November 30, 2015 is attributable to slightly higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $13.7 million, for the nine months ended November 30, 2015 as compared to the nine months ended November 30, 2014. The increase in interest expense for the nine months ended November 30, 2015 is attributable to the issuance of convertible notes during the nine months ended November 30, 2014 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 decreased by $3.2 million, for the nine months ended November 30, 2015 as compared to the nine months ended November 30, 2014. The decrease is primarily due to net gains realized on the sale of non-marketable, cost-basis investments in equity securities during the nine months ended November 30, 2014 that were not repeated during the nine months ended November 30, 2015.

Income taxes

During the nine months ended November 30, 2015, we recorded $59.8 million of income tax expense, which is based on an estimated annual effective tax rate of 29%. Our estimated annual effective tax rate of 29% is less than the U.S. federal statutory rate of 35% primarily due to foreign income taxed at lower rates, state income taxes net of federal benefits and the domestic production activities deduction.

During the nine months ended November 30, 2014, we recorded $54.1 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% primarily due to foreign income taxed at lower rates.

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 recent issuance of convertible notes with par value totaling $805.0 million described previously in Overview Convertible note offering and in detail in NOTE 15 Convertible Notes to our Consolidated Financial Statements. At November 30, 2015, we had total cash and investments of $1.87 billion, which was comprised of $942.0 million in cash and cash equivalents, $194.0 million of short-term, available-for-sale, fixed-income investments and $735.4 million of long-term, available-for-sale fixed-income investments. This compares to total cash and investments of $1.81 billion at February 28, 2015.

With $942.0 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 November 30, 2015, net accumulated unrealized losses on our available-for-sale debt securities totaled $2.2 million, versus accumulated unrealized gains of $0.2 million as of February 28, 2015.

Nine months ended November 30, 2015

Cash flows overview

At November 30, 2015, cash and cash equivalents totaled $942.0 million, a decrease of $105.4 million as compared to February 28, 2015. The decrease in cash and cash equivalents for the nine months ended November 30, 2015 is primarily the result of net purchases of available-for-sale debt securities of $194.4 million, business combinations which included net cash consideration paid of $126.7 million, the repurchase of 1,882,115 shares of our common stock for $148.3 million and payments made in return for common shares received from employees to satisfy employees minimum tax withholding obligations related to share awards vesting of $60.8 million. Partially offsetting cash used in investing and financing activities was cash provided by operations which generated $468.6 million for the nine months ended November 30, 2015.

Cash flows from operations

Cash provided by operations of $468.6 million during the nine months ended November 30, 2015 includes net income of $146.3 million, adjustments to exclude the impact of non-cash revenues and expenses, which totaled a $208.6 million net source of cash, and changes in operating assets and liabilities, which totaled a $113.7 million net source of cash. Cash provided by changes in operating assets and liabilities for the nine months ended November 30, 2015 was primarily the result of collections on our billings.

Cash flows from investing

Cash used in investing activities of $361.9 million for the nine months ended November 30, 2015 includes net purchases of available-for-sale debt securities of $194.4 million and net cash of $126.7 million used to acquire businesses. Investments in property and equipment totaled $29.5 million and primarily relate to information technology infrastructure and leasehold improvements. Investments in other intangible assets, primarily patents, totaled $8.1 million during the nine months ended November 30, 2015.

Cash flows from financing

Cash used in financing activities of $189.1 million for the nine months ended November 30, 2015 includes $148.3 million to repurchase 1,882,115 shares of our common stock and payments made in return for common shares received from employees to satisfy employees minimum tax withholding obligations related to restricted share awards vesting during the nine months ended November 30, 2015 of $60.8 million. Partially offsetting financing activities using cash were proceeds from excess tax benefits related to share-based employee compensation, which totaled $18.0 million and proceeds from employees exercise of common stock options, which totaled $3.3 million. Payments on other borrowings totaled $1.4 million for the nine months ended November 30, 2015.

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 November 30, 2015 and February 28, 2015, 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 29, 2016 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;

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.

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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 $1.87 billion of cash and investments held at November 30, 2015, 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 cash flows from operations will continue to increase; however, there can be no assurances that we will increase our cash flows from operations from the current rate or that such cash flows will be adequate to fund other investments or acquisitions that we may choose to make 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 November 30, 2015, our cash, cash equivalents and available-for-sale investment securities totaled $1.87 billion, of which $761.5 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 $1.11 billion, or 59.3%, of our available cash, cash equivalents and available-for-sale investments held within the U.S. as of November 30, 2015, 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 28, 2015, cumulative undistributed foreign earnings totaled $420.0 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 28, 2015.

Off-balance sheet arrangements

As of November 30, 2015 and February 28, 2015, we have no off-balance sheet financing arrangements and do not utilize any structured debt , special purpose or similar unconsolidated entities for liquidity or financing purposes.

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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 which 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 $0.5 million change in annual interest income derived from investments in our portfolio as of November 30, 2015. For further discussion related to our investments as of November 30, 2015 and February 28, 2015, 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 $17.7 million decrease in the fair value of our available-for-sale investment securities as of November 30, 2015. For further discussion related to our investments as of November 30, 2015 and February 28, 2015, 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

As of November 30, 2015 and February 28, 2015, no individual customer accounted for 10% or more of our total accounts receivable.

Foreign currency risk

Approximately 41.4% of our revenue for the three months ended November 30, 2015 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 third quarter of our prior fiscal year ended February 28, 2015, our revenue and operating expenses from non-U.S. operations for the three months ended November 30, 2015 would have been higher than we reported by approximately $28.5 million and $24.1 million, respectively, which would have resulted in income from operations being higher by $4.4 million.

Using the average foreign currency exchange rates for the nine months ended November 30, 2014, our revenue and operating expenses from non-U.S. operations for the nine months ended November 30, 2015 would have been higher than we reported by approximately $102.5 million and $78.5 million, respectively, which would have resulted in income from operations being higher by $24.0 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 November 30, 2015 was $38.1 million. The fair value of these outstanding contracts at November 30, 2015 was a gross $0.1 million asset and a gross $0.4 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 months of the period ended November 30, 2015. The forward contracts will settle in Euros, Japanese yen, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs and U.S. dollars.

The aggregate notional amount of outstanding forward contracts at February 28, 2015 was $108.1 million. The fair value of these outstanding contracts at February 28, 2015 was a gross $0.1 million asset and a gross $0.7 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 28, 2015. The forward contracts settled in Australian dollars, Euros, Hong Kong dollars, Japanese yen, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs and U.S. dollars.

RECENT ACCOUNTING PRONOUNCEMENTS

In November 2015, the FASB issued Accounting Standards Update 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes* (ASU 2015-17). ASU 2015-17 removes the requirement that deferred tax assets and liabilities be classified as either current or noncurrent in a classified statement of financial position and instead considers deferred tax assets and liabilities to be classified as noncurrent. This guidance is effective for us as of the first quarter of our fiscal year ending February 28, 2018. We do not believe that this updated standard will have a material impact on our consolidated financial statements.

In September 2015, the FASB issued Accounting Standards Update 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments* (ASU 2015-16). The FASB issued ASU 2015-16 to simplify US GAAP to require that the acquirer record, in the same period s financial statements, the effect of changes to provisional, measurement period amounts calculated as if the accounting had been completed at the acquisition date and disclose the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. This guidance is effective for us as of the first quarter of our fiscal year ending February 28, 2017. We do not believe that this updated standard will have a material impact on our consolidated financial statements.

In April 2015, the FASB issued Accounting Standards Update 2015-03, *Interest Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs* (ASU 2015-03). The FASB issued ASU 2015-03 to simplify the presentation of debt issuance costs related to a recognized debt liability to present the debt issuance costs as a direct deduction from the carrying value of the debt liability rather than showing the debt issuance costs as a deferred charge on the balance sheet. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, and is effective for us as of the first quarter of the fiscal year ending February 28, 2017. We do not believe that this updated standard will have a material impact on the Company s 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 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 fiscal years and interim periods within those years beginning after December 15, 2017, which is effective for us as of the first quarter of the fiscal year ending February 28, 2019. We are evaluating the impact that the implementation of this standard will have on our consolidated financial statements.

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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 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.

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 and frequent new product and service announcements. Our continued success will depend on our ability to adapt to rapidly changing technologies, 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. In addition, the widespread adoption of other technological changes could require substantial expenditures on our part to modify or adapt 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.

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 and system integrators, such as Amazon.com, Inc., Cisco Systems, Inc., Dell Inc., Fujitsu Limited, Hewlett-Packard Co., International Business Machines Corporation, NEC Corporation, Oracle Corporation, SAP AG and others. Many of these strategic partners have engineered and certified that their products and services run on or with our offerings, and in some cases have built their products 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 cloud service providers, distributors, embedded technology partners, hardware original equipment manufacturers, independent software vendors, 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 that are competitive 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, afford us any exclusive marketing or distribution rights. In addition, if a channel partner is acquired by a competitor or its business units are reorganized or divested, 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.

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 of 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 of talent at an acquired business or cultural challenges associated with integrating employees from the acquired business into our organization;
- Losing of 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;
- Incurring expenses related to the transaction;
- Assuming claims and liabilities we may assume from the acquired business or technology, or that are otherwise related to the transaction;
- Entering into new markets in which we have little or no experience or in which competitors may have stronger market positions;
- Impairing of intangible assets and goodwill acquired in transactions; and
- For foreign transactions, managing additional risks related to the integration of operations across different cultures and languages, and the economic, political, compliance and regulatory risks associated with specific countries.

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

The duration and extent of economic downturns, regional financial instability, and economic and market conditions generally 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 customer segments and 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 segments may also be affected by uncertain or changing economic conditions within that region or segment. 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, these conditions may impact our investment portfolio, and we could determine that some of our investments have experienced an other-than-temporary decline in fair value, requiring an impairment charge that could adversely impact our financial condition and operating results. Also, these 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 segments, 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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If we fail to effectively manage our growth, our business, financial condition, operating results and cash flows could be adversely affected.

We have expanded our operations rapidly in recent years. For example, our total revenue increased from $1.53 billion for the fiscal year ended February 28, 2014 to $1.79 billion for the fiscal year ended February 28, 2015. Moreover, the total number of our employees increased from approximately 6,300 as of February 28, 2014 to approximately 7,300 as of February 28, 2015. In addition, we continue to explore ways to extend our offerings and geographic reach. Our growth has placed and will likely continue to place a strain on our management systems, information systems, resources and internal controls. Our ability to successfully provide our offerings and implement our business plan requires adequate information systems and resources, internal controls and oversight from our senior management. As we expand in international markets, these challenges increase as a result of the need to support a growing business in an environment of multiple languages, cultures, customs, legal systems, dispute resolution systems, regulatory systems and commercial practices. As we grow, (i) we may not be able to adequately screen and hire or adequately train, supervise, manage or develop sufficient personnel, and (ii) we may not be able to develop or effectively manage our controls, oversight functions or information systems. If we are unable to effectively manage our growth, our business, financial condition, operating results and cash flows could be adversely affected.

Industry consolidation and divestitures may lead to increased competition and may adversely affect our business, financial condition, operating results and cash flows.

There has been a trend of both consolidation and divestitures in the technology industry. We expect these trends to continue as companies attempt to strengthen or hold their market positions in an evolving industry. For example, as the computing, networking, storage, and software technologies that comprise the enterprise data center converge, many companies seek to position themselves as key or single-source vendors providing end-to-end technology solutions for the data center. Also, some of our current and potential competitors have made acquisitions or announced new strategic alliances designed to position them as a key or single-source vendor. As a result of these developments, we face greater competition, including competition from entities that are among our key business partners. This increased competition could adversely affect our business, financial condition, operating results and cash flows.

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

One of the characteristics of open source software is that anyone may modify and redistribute the existing open source software and use it to compete with us. Such competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. It is possible for competitors with greater resources than ours to develop their own open source solutions, potentially reducing the demand for, and putting price pressure on, our offerings. In addition, some competitors make their open source software available for free download and use on an ad hoc basis or may position their open source software as a loss leader. We cannot guarantee that we will be able to compete successfully against current and future competitors or that competitive pressure and/or the availability of open source software will not result in price reductions, reduced operating margins and loss of market share, any one of which could adversely affect our business, financial condition, operating results and cash flows.

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

Our future success depends on the continued services and effectiveness of a number of key management personnel, including our CEO. The loss of these individuals, particularly to a competitor, some of which may be in a position to offer greater compensation, could adversely affect our business or stock price.

Our ability to retain key management personnel or hire capable new management personnel as we grow may be challenged to the extent that other companies are able to offer more attractive opportunities to the individuals we seek to hire or retain. In addition, historically we have used share-based compensation as a key component of

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our compensation packages. Changes in the accounting for share-based compensation could adversely affect our earnings or make it more beneficial for us to use more cash compensation to attract and retain capable personnel. If the price of our common stock falls, the value of our share-based awards to recipients is reduced. Such events, or if we are unable to secure stockholder approval for increases in the number of shares eligible for share-based compensation grants, could adversely affect our ability to successfully attract and retain key management personnel. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key management personnel could hinder our strategic planning and execution.

We depend on our key non-management employees, and our inability to attract and retain such employees could adversely affect our business or diminish our brands.

Competition in our industry for qualified employees, especially technical employees, is intense and our competitors directly target our employees. Our inability to attract and retain key employees could hinder our influence in open source projects and seriously impede our success. Moreover, the loss of these individuals, particularly to a competitor, some of which may be in a position to offer greater compensation, and any resulting loss of customers could reduce our market share and diminish our brands. We have from time to time in the past experienced, and we may experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Also, to the extent we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited, that they have divulged proprietary or other confidential information, or that their former employers own their inventions or other work product.

A number of our key employees have become, or will become, vested in a significant amount of their equity compensation awards. Employees may be more likely to leave us after a significant portion of their equity compensation awards fully vest, especially if the shares underlying the equity awards have significantly appreciated in value. Additionally, as we grow, there may be less equity compensation to award per employee. If we do not succeed in attracting and retaining key personnel, our business, financial performance, operating results and cash flows may be adversely affected.

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

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity and collaboration. As our organization grows, our employees (including remote workers) and our resources become more globally dispersed and our organizational management structures become more complex, we may find it increasingly difficult to maintain these beneficial aspects of our corporate culture. If we are unable to maintain our corporate culture, we may find it difficult to attract and retain motivated employees, continue to perform at current levels or execute on our business strategy. As a result, our business, financial condition, operating results and cash flows could be adversely affected.

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

We provide Red Hat enterprise technologies primarily under annual or multi-year subscriptions. A subscription generally entitles a customer to, among other things, a specified level of support, as well as new versions of the software, security updates, fixes, functionality enhancements and upgrades to the technology, if and when available, and compatibility with an ecosystem of certified hardware and software. While we believe this practice complies with the requirements of the GNU General Public License, and while we have reviewed this practice with the Free

Software Foundation, the organization that maintains and provides interpretations of the GNU General Public License, we may still encounter customer resistance to this distribution model or customers may fail to honor the terms of our subscription agreements. To the extent we are unsuccessful in promoting or defending this distribution model, our business, financial condition, operating results and cash flows could be adversely affected.

Demand for our offerings depends substantially on the general demand for enterprise software, which fluctuates based on numerous factors, including the spending levels and growth of our current and prospective customers, and general economic conditions. In addition, our customers generally undertake a significant evaluation process that may result in a lengthy sales cycle. We spend substantial time, effort, and money on our sales efforts, including developing and implementing appropriate go-to-market strategies and training our sales force and channel partners in order to effectively market new offerings, without any assurance that our efforts will produce any sales. The purchase of our offerings may be discretionary and can involve significant expenditures. If our current and prospective customers cut costs, then they may significantly reduce their enterprise software expenditures.

As technologies and the markets for our enterprise offerings change, our subscription-based business model may no longer meet the needs of our customers. For example, a business model based on annual or multi-year subscriptions may no longer be competitive in an environment where disruptive technologies (such as virtualization and cloud) enable customers to consume computing resources on an hourly basis or for free. We also develop and offer these disruptive technologies with consumption-based pricing, which may have an effect on the demand for our subscription-based offerings.

An increased focus on developing and providing virtualization, storage and cloud offerings may require a greater focus on marketing more holistic solutions, rather than individual offerings. Consequently, we may need to develop appropriate marketing and pricing strategies for our offerings, our customers purchasing decisions may become more complex and require additional levels of approval and the duration of sales cycles for our offerings may increase.

If we are unable to adapt our business model to changes in the marketplace or if demand for our offerings declines, our business, financial condition, operating results and cash flows could be adversely affected.

If our customers do not renew their subscription agreements with us, or if they renew on less favorable terms, our business, financial results, operating results and cash flows may be adversely affected.

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

If third-party enterprise hardware and software providers do not continue to make their products and services compatible with our offerings, our software may cease to be competitive and our business, financial condition, operating results and cash flows may be adversely affected.

The competitive position of our offerings is dependent on their compatibility with products and services of third-party enterprise hardware and software companies. To the extent that a hardware or software vendor might have or develop products and services that compete with ours, the vendor may have an incentive to seek to limit the performance, functionality or compatibility of our offerings when used with one or more of the vendor s offerings. In addition, these vendors may fail to support or issue statements of compatibility or certification of our offerings when used with their offerings. We intend to encourage the development of additional applications that operate on both current and new versions of our offerings by, among other means, attracting third-party developers to our offerings, providing open source tools to create these applications and maintaining our existing developer relationships through marketing and technical support. We intend to encourage the compatibility of our software with various third-party hardware and software offerings by maintaining and expanding our relationships, both business and technical, with relevant independent hardware and software vendors. If we are not successful in achieving these goals, however, our offerings may not be competitive and our business, financial condition, operating results and cash flows may be adversely affected.

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

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

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

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

In addition, errors in our technologies could cause system failures, loss of data or other adverse effects for our customers who may assert warranty and other claims for substantial damages against us. Although our agreements with our customers often contain provisions which seek to limit our exposure to potential product liability claims, it is possible that these provisions may not be effective or enforceable under the laws of some jurisdictions. While we seek to insure against these types of claims, our insurance policies may not adequately limit our exposure to such claims. These claims, even if unsuccessful, could be costly and time-consuming to defend and could adversely affect our business, financial conditions, operating results and cash flows.

Our virtualization, storage and cloud offerings are based on emerging technologies and business models, and the potential market for these offerings remains uncertain.

Our virtualization, storage and cloud offerings are based on emerging technologies and business models, the success of which will depend on the perceived technological and operational benefits and cost savings associated with the adoption of these technologies. Virtualization, storage and cloud technologies are rapidly evolving, and their development is a complex and uncertain process requiring high levels of innovation and investment as well as the accurate anticipation of technology trends, market demand and customer needs. We expect competition to remain intense and, as with many emerging IT sectors, these technologies may be subject to a first mover effect pursuant to which certain product offerings rapidly capture a significant portion of market share and developer attention. Moreover, we may make errors in reacting to relevant business trends and predicting which technologies are successful or otherwise develop into industry standards.

Adoption of virtualization, storage and cloud offerings may occur more slowly or less pervasively than we expect and the revenue growth associated with these offerings may be slower than currently expected. Moreover, even if virtualization, storage and cloud technologies are adopted widely by enterprises, our offerings in these areas may not attract a sufficient number of users or generate attractive financial results. We incur expenses associated with these offerings in advance of our ability to generate associated revenue. Demand for our virtualization, storage and cloud offerings may unfavorably impact demand for our other offerings, including software subscriptions and related professional services. If the market for our virtualization, storage and cloud offerings fails to develop adequately, it could have an adverse effect on our business, financial condition, operating results and cash flows.

Our continued success depends on our ability to maintain and enhance strong brands.

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

If our growth rate slows, our stock price could be adversely affected.

As the markets for our offerings mature and the scale of our business increases, our rate of revenue growth will likely be lower than the growth rates we experienced in earlier periods. In addition, to the extent that the adoption of our offerings occurs more slowly or is less pervasive than we expect, our revenue growth rates may slow or our revenue may decline, which could adversely affect our stock price.

Security breaches and data loss may expose us to liability, harm our reputation and adversely affect our business.

Our business involves the production and distribution of enterprise software technologies, as well as hosting applications. As part of our business, we (or third parties with whom we contract) receive, store and process our data, as well as our customers and partners data. While we take security and testing measures relating to our offerings and operations, those measures may not prevent security breaches and data loss that could harm our business or the businesses of our customers and partners. Advances in computer capabilities, new discoveries in the field of cryptography, inadequate technology or facility security measures or other factors may result in data loss or a compromise or breach of our systems and the data we receive, store and process (or systems and the data received, stored and processed by third parties with whom we contract). These security measures may be breached or data lost as a result of actions by third parties, employee error (such as weak passwords or unencrypted devices), malfeasance or vulnerabilities or security bugs found in software code. A party who is able to circumvent security measures or exploit inadequacies in security measures, could, among other things, misappropriate proprietary information (including information about our employees, customers and partners, our customers information, financial data and data that others could use to compete against us), cause the loss or disclosure of some or all of this information, cause interruptions or denial of service in our or our customers operations, cause delays in development efforts or expose customers (and their customers) to computer viruses or other disruptions or vulnerabilities. A compromise to these systems could remain undetected for an extended period of time, exacerbating the impact of that compromise. These risks may increase as we continue to grow our cloud and services offerings and as we receive, store and process more of our customers data. Actual or perceived vulnerabilities may lead to regulatory investigations, claims against us by customers, partners or other

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third parties, or costs, such as those related to providing customer notifications and fraud monitoring. While our customer agreements typically contain provisions that seek to limit our liability, there is no assurance these provisions will be enforceable and effective under applicable law. In addition, the cost and operational consequences of implementing further data protection measures could be significant. Moreover, because the techniques used to obtain unauthorized access, disable or degrade service or sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. Any loss of data or compromise of our systems or the data we receive, store or process (or systems and the data received, stored and processed by third parties with whom we contract) could result in a loss of confidence in the security of our offerings, damage our reputation, loss of channel or strategic partners, lead to legal liability and adversely affect our business, financial condition, operating results and cash flows.

We are vulnerable to technology infrastructure failures, which could harm our reputation and adversely affect our business.

We rely on our technology infrastructure, and the technology infrastructure of third parties, for many functions, including selling our offerings, supporting our partners, fulfilling orders and billing, collecting and making payments. This technology infrastructure may be vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, terrorist attacks, computer intrusions, vulnerabilities and viruses, software errors, computer denial-of-service attacks and other events. A significant number of the systems making up this infrastructure are not redundant, and our disaster recovery planning may not be sufficient for every eventuality. This technology infrastructure may fail or be vulnerable to damage or interruption because of actions by third parties or employee error or malfeasance. We may not carry business interruption insurance sufficient to protect us from all losses that may result from interruptions in our services as a result of technology infrastructure failures or to cover all contingencies. Any interruption in the availability of our websites and on-line interactions with customers or partners may cause a reduction in customer or partner satisfaction levels, which in turn could cause additional claims, reduced revenue or loss of customers or partners. Despite any precautions we may take, such problems could result in, among other consequences, a loss of data, loss of confidence in the stability and reliability of our offerings, damage to our reputation, and legal liability, all of which may adversely affect our business, financial condition, operating results and cash flows interruptions.

A decline in or reprioritization of funding in the U.S. or foreign government budgets or delays in the budget process could adversely affect our business, financial condition, operating results and cash flows.

We derive, and expect to continue to derive, a portion of our revenue from U.S. and foreign governments. Government deficit reduction and austerity measures, along with continued economic challenges, continue to place pressure on U.S. and foreign government spending. The termination of, or delayed or reduced funding for, government-sponsored programs and contracts from which we derive revenue could adversely affect our business, financial condition, operating results and cash flows.

We may be unable to predict the future course of open source technology development, which could reduce the market appeal of our offerings, damage our reputation and adversely affect our business, financial condition, operating results and cash flows.

We do not exercise control over many aspects of the development of open source technology. Different groups of open source software programmers compete with one another to develop new technology. Typically, the technology developed by one group will become more widely used than that developed by others. If we acquire or adopt new technology and incorporate it into our offerings but competing technology becomes more widely used or accepted, the market appeal of our offerings may be reduced and that could harm our reputation, diminish our brands and adversely affect our business, financial condition, operating results and cash flows.

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We include software licensed from other parties in our offerings, the loss of which could increase our costs and delay availability of our offerings.

We utilize various types of software licensed from unaffiliated third parties in our offerings. Aspects of our business could be disrupted if any of the software we license from others or functional equivalents of this software were no longer available to us, no longer offered to us on commercially reasonable terms or changed in ways or included defects that made the third-party software unsuitable for our use. In these cases, we would be required to either redesign our technologies to function with software available from other parties, develop these components ourselves or eliminate the functionality, which could result in increased costs, the need to mitigate customer issues, delays in delivery of our offerings and the release of new offerings and limit the features available in our current or future offerings.

RISKS RELATED TO LEGAL UNCERTAINTY

If our technologies are found or alleged to infringe third-party intellectual property rights, we may be required to take costly and time-consuming actions to meet our commitments to customers.

We regularly commit to our subscription customers that if portions of our offerings are found to infringe third-party intellectual property rights we will, at our expense and option: (i) obtain the right for the customer to continue to use the technology consistent with their subscription agreement with us; (ii) modify the technology so that its use is non-infringing; or (iii) replace the infringing component with a non-infringing component, and indemnify them against specified infringement claims. Although we cannot predict whether we will need to satisfy these commitments and we often have limitations on these commitments, satisfying the commitments could be costly, be time-consuming, divert the attention of technical and management personnel, and adversely affect our business, financial condition, operating results and cash flows. In addition, our insurance policies would likely not adequately cover our exposure to this type of claim. Finally, because we have agreed to indemnify our subscription customers against specified infringement claims arising from the use of our offerings, we could become involved in litigation brought against such customers if our services and technology are allegedly implicated.

We are vulnerable to claims that our technologies infringe third-party intellectual property rights and an unfavorable legal decision affecting our intellectual property could adversely affect our business.

We are vulnerable to claims that our technologies infringe third-party intellectual property rights, including patents, copyrights, trademarks and trade secrets, because our technologies are comprised of software components, many of which are developed by numerous independent parties. We are also unlikely to be able to assess adequately the relevance of patents to our technologies, and may be unable to take appropriate responsive action in a timely or economic manner because, among other reasons, the scope of software patent protection is often not well defined or readily determinable, patent applications in the U.S. are not publicly disclosed at the time of filing, and the number of software patents that are issued each year is significant and growing. Our exposure to risks associated with the use of intellectual property may increase as a result of acquisitions. In addition, third parties may make infringement and similar or related claims after we have acquired technology that had not been asserted prior to our acquisition of such technology.

In the past, our technologies have been subject to intellectual property infringement claims. Some of these claims have been brought by entities that do not design, manufacture, or distribute products or services or that acquire intellectual property like patents for the sole purpose of monetizing their acquired intellectual property through asserting claims of infringement. As these entities do not have operating businesses of their own and therefore have limited risk of counterclaims for damages or injunctive relief, it may be difficult to deter them from bringing intellectual property infringement claims. We expect to face the possibility of more intellectual property infringement claims as our prominence increases, business activities expand, market share and revenue grow, the number of products and competitors in our industry grows and the functionality of products in different portions of the industry overlap. We may not be able to accurately assess the risk related to these suits, and we may be unable to accurately assess our level of exposure.

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Defending patent and other intellectual property claims, even claims without significant merit, can be time-consuming, costly and can divert the attention of technical and management personnel. We may receive unfavorable preliminary or interim rulings in the course of litigation, and there can be no assurances that favorable final outcomes will be obtained in all cases. We may decide to settle certain lawsuits and disputes on terms that are disadvantageous to us. Similarly, if any litigation to which we are a party is resolved adversely, we may be subject to an unfavorable judgment that may not be reversed upon appeal. The terms of such a settlement or judgment may require us to cease offering certain of our technologies or pay substantial amounts to the other party. In addition, we may have to seek a license to continue offering technologies found to be in violation of a third party s rights, which may not be available on reasonable terms, or at all, and may significantly increase our operating costs and expenses. As a result, we may also be required to develop alternative non-infringing technology or practices or discontinue the practices. The development of alternative non-infringing technology or practices could require significant effort and expense or may not be feasible.

An unfavorable legal decision regarding the intellectual property in and to our technology and other offerings could adversely affect our business, financial condition, operating results and cash flows. See Part II, Item 1, Legal Proceedings for additional information.

Our activities, or the activities of our partners, may violate anti-corruption laws and regulations that apply to us.

In many foreign countries, particularly in certain developing economies, it is not uncommon to engage in business practices that are prohibited by regulations that may apply to us, such as the U.S. Foreign Corrupt Practices Act and similar laws. Although we have policies and procedures designed to help promote compliance with these laws, our employees, contractors, partners and agents, as well as those companies to which we outsource certain of our business operations, may take actions in violation of our policies and procedures. Any violation of these laws and regulations could result in fines, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation.

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

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

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

Our collection of trademarks is valuable and important to our business. The protective steps we have taken in the past may have been, and may in the future continue to be, inadequate to protect and deter misappropriation of our trademark rights. We may be unable to detect the unauthorized use of, or take appropriate steps to enforce, our trademark rights in a timely manner. We have registered some of our trademarks in countries in North America, South America, Europe, Asia, Africa and Australia and have other trademark applications pending in various countries around the world. Effective trademark protection may not be available in every country in

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which we offer or intend to distribute our offerings. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon, or diminish the value of our trademarks and other proprietary rights. Failure to adequately protect our trademark rights could damage or even destroy one or more of our brands and impair our ability to compete effectively. Furthermore, defending or enforcing our trademark rights could result in the expenditure of significant financial and managerial resources.

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

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

Our Patent Promise on software patents limits our ability to enforce our patent rights in certain circumstances.

As part of our commitment to the open source community, we provide our Patent Promise on software patents. Under our Patent Promise, we agree, subject to certain limitations, not to enforce our patent rights against users of open source software covered by certain open source licenses, including the GNU General Public License version 2.0 and version 3.0, GNU Lesser General Public License version 2.1 and version 3.0, IBM Public License version 1.0, Common Public License version 1.0, Q Public License version 1.0, Open Software License version 3.0 and any other open source license granted by Red Hat. While we may be able to claim protection of our intellectual property under other rights, such as trade secrets or contractual rights, our Patent Promise effectively limits our ability to assert our patent rights against these third parties (even if we were to conclude that their use infringes our patents with competing offerings), unless any such third party asserts its patent rights against us. This limitation on our ability to assert our patent rights against others could harm our business and ability to compete.

We are, and may become, involved in disputes and lawsuits that could adversely affect our business.

Lawsuits or legal proceedings may be commenced against us. These disputes and proceedings may involve significant expense and divert the attention of management and other employees. If we do not prevail in these matters, we could be required to pay substantial damages or settlement costs, which could adversely affect our business, financial condition, operating results and cash flows. See Part II, Item 1, Legal Proceedings for additional information.

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

Our business is subject to federal, state and international laws regarding privacy and protection of user data. We post, on our website, our privacy policies and practices concerning the use and disclosure of user data. As Internet commerce continues to evolve, increasing regulation by federal, state or foreign agencies becomes more likely. The introduction of new offerings by us may cause new and different regulations to apply to our business. New or increased laws and regulations applying to the solicitation, collection, processing, protection, use or other treatment of information could affect our ability to use and share data, or the adoption of our cloud offerings by customers.

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

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Any failure or perceived failure by us to comply with our posted privacy policies or other federal, state or international privacy-related or data protection laws, government regulations or directives, or industry self-regulatory principles, or a requirement to change our data practices could have an adverse effect on our business, financial condition, operating results and cash flows.

If we fail to comply with our customer contracts or government contracting regulations, our business could be adversely affected.

Our contracts with our customers may include specialized performance requirements. In particular, our contracts with federal, state, provincial and local governmental customers are subject to various government certification requirements, procurements regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us or our channel partners to comply with the specific provisions in our customer contracts or any violation of government contracting regulations by us or our channel partners could result in the imposition of various civil and criminal penalties, which may include termination of contracts, forfeiture of profits, suspension of payments and, in the case of our government contracts, fines and suspension from future government contracting. In addition, we may be subject to *qui tam* litigation, the process by which a private individual sues or prosecutes on behalf of the government relating to government contracts and shares in the proceeds of any successful litigation or settlement, which could include claims for up to treble damages. Further, any negative publicity related to our customer contracts or any proceedings surrounding them, regardless of its accuracy, may damage our business and affect our ability to compete for new contracts. There is increased pressure for governments and their agencies, both domestically and internationally, to reduce spending. If our customer contracts are terminated, if we are suspended from government work, if we are unable to meet government certification requirements, or if our ability to compete for new contracts is adversely affected, we could suffer an adverse effect on our business, financial condition, operating results and cash flows.

We may be subject to legal liability associated with providing online services or content.

We provide offerings, such as OpenShift by Red Hat, that enable users to exchange information, advertise products and services, conduct business, and engage in various online activities. The law relating to the liability of providers of these online offerings for activities of their users is relatively unsettled and still developing both in the U.S. and internationally and may be significantly different from jurisdiction to jurisdiction. Claims could be brought against us based on the nature and content of information that we publish or to which we provide links or that may be posted online or generated by us or by third parties, including our customers. In addition, we could be subject to domestic or international actions alleging that certain content we have generated or third-party content that we have made available within our services violates applicable law.

RISKS RELATED TO FINANCIAL UNCERTAINTY

Our quarterly and annual operating results may not be a reliable indicator of our future financial performance.

Due to the unpredictability of the IT spending environment, among other reasons, our revenue and operating results have fluctuated and may continue to fluctuate. We base our current and projected future expense levels, in part, on our estimates of future revenue. Our expenses are, to a large extent, fixed in the short term. Accordingly, we may not be able to adjust our spending quickly enough to protect our projected operating results for a quarter if our revenue in that quarter falls short of our expectations. If, among other considerations, our future financial performance falls below the expectations of securities analysts or investors or we are unable to increase or maintain profitability, the market price of our common stock may decline.

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We may not be able to meet the financial and operational challenges that we will encounter as our international operations, which represented approximately 42.8% of our total revenue for the fiscal year ended February 28, 2015, continue to expand.

Our international operations accounted for approximately 42.8% of total revenue for the fiscal year ended February 28, 2015. As we expand our international operations, we may have difficulty managing and administering a globally dispersed business and we may need to expend additional funds to, among other activities, reorganize our sales force and technical support services team, outsource or supplement general and administrative functions, staff key management positions, obtain additional information technology infrastructure and successfully localize offerings for a significant number of international markets, which may adversely affect our operating results. Additional challenges associated with the conduct of our business globally that may adversely affect our operating results include:

- Fluctuations in exchange rates;
- Pricing environments;
- Longer payment cycles and less financial stability of customers;
- Economic, political, compliance and regulatory risks associated with specific countries;
- Laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, loans, and taxes;
- Difficulty selecting and monitoring channel partners;
- Lower levels of availability or use of the Internet, through which our software is often delivered;
- Difficulty protecting our intellectual property rights globally due to, among other reasons, the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property rights;
- Difficulty in staffing, developing and managing foreign operations as a result of distance, language, legal, cultural and other differences;
- Different employee/employer relationships and the existence of works councils and labor unions;
- Difficulty maintaining quality standards consistent with the our brands;

Export and import laws and regulations that could prevent us from delivering our offerings into and from certain countries;

Public health risks and natural disasters, particularly in areas in which we have significant operations;

Limitations on the repatriation and investment of funds and foreign currency exchange restrictions;

Changes in import/export duties, quotas or other trade barriers that could affect the competitive pricing of our offerings and reduce our market share in some countries; and

Economic or political instability or terrorist acts in some international markets that could adversely affect our business in those markets or result in the loss or forfeiture of some foreign assets and the loss of sums spent developing and marketing those assets and the revenue associated with them.

Any failure by us to effectively manage the challenges associated with the international expansion of our operations could adversely affect our business, financial condition, operating results and cash flows.

A substantial portion of our revenue is derived from our Red Hat Enterprise Linux platform.

During our fiscal year ended February 28, 2015, a substantial portion of our subscription revenue was derived from our Red Hat Enterprise Linux offerings. Although we are continuing to develop other offerings, we expect that revenue from Red Hat Enterprise Linux will constitute a majority of our revenue for the foreseeable future. Declines and variability in demand for Red Hat Enterprise Linux could occur as a result of:

competitive products and pricing;

failure to release new or enhanced versions of Red Hat Enterprise Linux on a timely basis, or at all;

technological change that we are unable to address with Red Hat Enterprise Linux; or

future economic conditions.

Additionally, as more customers and potential customers virtualize their data centers and move computing projects to cloud environments, demand for operating systems such as Red Hat Enterprise Linux may decline. Moreover, as data centers become more virtualized and move to cloud environments, we may experience a decline in growth if we are unsuccessful in adapting our business model and offerings accordingly. Due to the concentration of our revenue from Red Hat Enterprise Linux, our business, financial condition, operating results and cash flows could be adversely affected by a decline in demand for Red Hat Enterprise Linux.

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

A portion of our business is conducted in currencies other than the U.S. dollar. Changes in exchange rates among other currencies and the U.S. dollar may affect our revenue, operating expenses and operating margins, which are reported in U.S. dollars. We cannot predict the impact of future exchange rate fluctuations. As we expand international operations, our exposure to exchange rate fluctuations may increase. We use financial instruments, primarily forward purchase contracts, to economically hedge currency commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations. If these hedging activities are not successful or we change or reduce these hedging activities in the future, we may experience significant unexpected expenses from fluctuations in exchange rates. For information regarding our hedging activity, see Part I, Item 3, Quantitative and Qualitative Disclosures About Market Risk .

We may be subject to greater tax liabilities.

We are subject to income and other taxes in the U.S. and in numerous foreign jurisdictions. Our domestic and foreign tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions. Additionally, the amount of taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we operate. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly subject to audits by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes more difficult. The results of an audit or litigation could adversely affect our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions may result in higher effective tax rates for the company. In addition, there have been proposals to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form this proposed legislation may pass, if enacted it could adversely affect our tax expense and cash flows.

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

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

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additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term.

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

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

We may be exposed to potential risks if we do not have an effective system of disclosure controls or internal controls.

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

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

Changes in accounting principles and guidance, or their interpretation, could result in unfavorable accounting charges or effects, including changes to previously filed financial statements, which could cause our stock to decline.

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the U.S. These principles are subject to interpretation by the Securities and Exchange Commission and various bodies formed to interpret and create appropriate accounting principles and guidance. A change in these principles or guidance, or in their interpretations, may have a significant effect on our reported results and may retroactively affect previously reported results.

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

We maintain an investment portfolio of various holdings, types and maturities. Our portfolio as of February 28, 2015 consisted primarily of money market funds, U.S. government and agency securities, European sovereign and agency securities with a rating of AA or higher, certificates of deposit, and corporate securities. Although we follow an established investment policy and seek to minimize the risks associated with our investments by investing primarily in investment grade, highly liquid securities and by limiting the amounts invested with any one institution, type of security or issuer, we cannot give assurances that the assets in our investment portfolio will not lose value or become impaired, or that our interest income will not decline.

A significant part of our investment portfolio consists of U.S. government and agency securities. If global credit and equity markets experience prolonged periods of decline, or if there is a default or downgrade of U.S. government or agency debt, our investment portfolio may be adversely impacted and we could determine that some of our investments have experienced an other-than-temporary decline in fair value, requiring impairment charges that could adversely affect our financial condition and operating results.

Future fluctuations and uncertainty in economic and market conditions could adversely affect the market value of our investments, and we could record additional impairment charges and lose some or all of the principal value of investments in our portfolio. A total loss of an investment or a significant decline in the value of our investment portfolio could adversely affect our financial condition and operating results. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, see Part I, Item 3, Quantitative and Qualitative Disclosures About Market Risk .

Our investments in private companies are subject to risk of loss of investment capital. Some of these investments may have been made to further our strategic objectives and support our key business initiatives. Our investments in private companies are inherently risky because the markets for the technologies they have under development are typically in the early stages and may never materialize. We could lose the value of our entire investment in these companies.

Epidemics, geo-political events, Internet and power outages or natural disasters could adversely affect our business, financial condition, operating results and cash flows.

The occurrence of one or more epidemics, geo-political events (such as civil unrest or terrorist attacks), Internet and power outages or natural disasters in a country in which we operate or in which technology industry suppliers or our customers are located, could adversely affect our business, financial condition, operating results and cash flows. Such events could result in physical damage to, or the complete loss of, one or more of our facilities, the lack of an adequate work force in a market, the inability of our customers to access our offerings, the inability of our associates to reach or have transportation to our facilities directly affected by such events, the evacuation of the populace from areas in which our facilities are located, changes in the purchasing patterns of our customers, the temporary or long-term disruption in the supply of computer hardware and related components, the disruption or delay in the manufacture and transport of goods globally, the disruption of utility services to our facilities or to suppliers, partners or customers, or disruption in our communications with our customers.

RISKS RELATED TO THE CONVERTIBLE NOTES

The convertible notes are effectively subordinated to any secured debt we incur in the future and to any liabilities of our subsidiaries.

In October 2014, we issued $805.0 million of 0.25% Convertible Senior Notes due 2019 (the convertible notes). The convertible notes will rank senior in right of payment to any of our indebtedness that is expressly subordinated in right of payment to the convertible notes; equal in right of payment to any of our existing and future indebtedness and other liabilities that are not so subordinated; effectively junior in right of payment to any of our secured indebtedness to the extent of the value of the assets securing such indebtedness; and structurally junior to all existing and future indebtedness and other liabilities of our subsidiaries (including trade payables). In the event of our bankruptcy, liquidation, reorganization or other winding up, our assets that secure debt ranking senior in right of payment to the convertible notes will be available to pay obligations on the convertible notes only after the secured debt has been repaid in full from these assets, and the assets of our subsidiaries will be available to pay obligations on the convertible notes only after all claims senior to the convertible notes have been repaid in full. There may not be sufficient assets remaining to pay amounts due on any or all of the convertible notes then outstanding.

We may still incur substantially more debt or take other actions that could diminish our ability to make payments on the convertible notes.

We and our subsidiaries may be able to incur substantial additional debt in the future, subject to the restrictions contained in our future debt instruments, some of which may be secured debt. We are not restricted under the terms of the indenture governing the convertible notes from incurring additional debt, securing existing or future debt, recapitalizing our debt or taking a number of other actions that are not limited by the terms of the indenture governing the convertible notes that could have the effect of diminishing our ability to make payments on the convertible notes when due.

We may not have the ability to raise the funds necessary to settle conversions of the convertible notes in cash, repay the convertible notes at maturity or repurchase the convertible notes upon a fundamental change, and our future debt may contain limitations on our ability to pay cash upon conversion or repurchase of the convertible notes.

Holders of the convertible notes will have the right to require us to repurchase all or a portion of their convertible notes upon the occurrence of a fundamental change at a repurchase price equal to 100% of the principal amount of the convertible notes to be repurchased, plus accrued and unpaid interest, if any. In addition, upon conversion of the convertible notes, unless we elect to deliver solely shares of our common stock to settle such conversion (other than paying cash in lieu of delivering any fractional share), we will be required to make cash payments in respect of the convertible notes being converted. However, we may not have enough available cash or be able to obtain financing at the time we are required to make repurchases of the convertible notes surrendered therefor or pay cash with respect to the convertible notes being converted or at their maturity.

In addition, our ability to repurchase or to pay cash upon conversions of the convertible notes may be limited by law, regulatory authority or agreements governing our future indebtedness and is dependent on our future performance, which is subject to economic, financial, competitive and other factors beyond our control. Our failure to repurchase the convertible notes at a time when the repurchase is required by the indenture or to pay any cash payable on future conversions of the convertible notes as required by the indenture would constitute a default under the indenture. A fundamental change under the indenture or a default under the indenture could also lead to a default under agreements governing our future indebtedness. If the repayment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness and repurchase the convertible notes or make cash payments upon conversions thereof.

The conditional conversion feature of the convertible notes, if triggered, may adversely affect our financial condition and operating results.

In the event the conditional conversion feature of the convertible notes is triggered, holders of the convertible notes will be entitled to convert the convertible notes at any time during specified periods at their option. If one or more holders elect to convert their convertible notes, unless we elect to satisfy our conversion obligation by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share), we would be required to settle a portion or all of our conversion obligation through the payment of cash, which could adversely affect our liquidity. In addition, even if holders do not elect to convert their convertible notes, we could be required under applicable accounting rules to reclassify all or a portion of the outstanding principal of the convertible notes as a current rather than long-term liability, which would result in a material reduction of our net working capital.

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The accounting method for convertible debt securities that may be settled in cash, such as the convertible notes, could have a material effect on our reported financial results.

Accounting Standards Codification Subtopic 470-20, Debt with Conversion and Other Options (ASC 470-20), requires an entity to separately account for the liability and equity components of convertible debt instruments (such as the convertible notes) that may be settled entirely or partially in cash upon conversion in a manner that reflects the issuer s non-convertible debt interest rate. Accordingly, the equity component of the convertible notes is required to be included in the additional paid-in capital section of stockholders equity on our consolidated balance sheet, and the value of the equity component is treated as original issue discount for purposes of accounting for the debt component of the convertible notes. As a result, we are required to recognize a greater amount of non-cash interest expense in our consolidated income statements in the current and future periods presented as a result of the amortization of the discounted carrying value of the convertible notes to their principal amount over the term of the convertible notes. We will report lower net income (or greater net losses) in our consolidated financial results because ASC 470-20 will require interest to include both the current period s amortization of the original issue discount and the instrument s non-convertible interest rate. This could adversely affect our reported or future consolidated financial results, the trading price of our common stock and the trading price of the convertible notes.

In addition, under certain circumstances, in calculating earnings per share, convertible debt instruments (such as the convertible notes) that may be settled entirely or partly in cash are currently accounted for utilizing the treasury stock method, the effect of which is that the shares of common stock issuable upon conversion of the convertible notes, if any, are not included in the calculation of diluted earnings per share except to the extent that the conversion value of the convertible notes exceeds their principal amount. Under the treasury stock method, diluted earnings per share is calculated as if the number of shares of common stock that would be necessary to settle such excess, if we elected to settle such excess in shares, were issued. We cannot be sure that the accounting standards in the future will continue to permit the use of the treasury stock method. If we are unable to use the treasury stock method in accounting for the shares issuable upon conversion of the convertible notes, if any, then our diluted consolidated earnings per share would be adversely affected.

The convertible note hedge and warrant transactions may affect the value of our common stock.

In connection with the sale of the convertible notes, we entered into convertible note hedge transactions with institutions that we refer to as the option counterparties. We also entered into warrant transactions with the option counterparties pursuant to which we sold warrants for the purchase of our common stock. The convertible note hedge transactions are expected to offset the potential dilution to our common stock upon any conversion of convertible notes and/or offset any cash payments we are required to make in excess of the principal amount upon conversion of any convertible notes. The warrant transactions could separately have a dilutive effect to the extent that the market price per share of our common stock exceeds the strike price of the relevant warrants, unless, subject to certain conditions, we elect to settle the warrants in cash.

The option counterparties or their respective affiliates may modify their hedge positions by entering into or unwinding various derivatives with respect to our common stock and/or purchasing or selling our common stock or other securities of ours in secondary market transactions prior to the maturity of the convertible notes (and are likely to do so during any observation period related to a conversion of convertible notes or following any repurchase of convertible notes by us in connection with any fundamental change repurchase date or otherwise). This activity could suppress or inflate the market price of our common stock.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the price of the convertible notes or our common stock. In addition, we do not make any representation that the option counterparties or their respective affiliates will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

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We are subject to counterparty risk with respect to the convertible note hedge transactions.

The option counterparties are financial institutions or affiliates of financial institutions, and we will be subject to the risk that these option counterparties may default under the convertible note hedge transactions. Our exposure to the credit risk of the option counterparties will not be secured by any collateral. If one or more of the option counterparties to one or more of our convertible note hedge transactions becomes subject to insolvency proceedings, we will become an unsecured creditor in those proceedings with a claim equal to our exposure at the time under those transactions. Our exposure will depend on many factors but, generally, the increase in our exposure will be correlated to the increase in the market price of our common stock and in the volatility of the market price of our common stock. In addition, upon a default by one of the option counterparties, we may suffer dilution with respect to our common stock as well as adverse financial consequences. We can provide no assurances as to the financial stability or viability of any of the option counterparties.

RISKS RELATED TO OWNERSHIP OF OUR COMMON STOCK

Our stock price has been volatile historically and may continue to be volatile.

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

The sale of our common stock by significant stockholders may cause the price of our common stock to decrease.

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

We may issue additional shares of our common stock or instruments convertible into shares of our common stock and thereby materially and adversely affect the market price of our common stock.

We are not restricted from issuing additional shares of our common stock or other instruments convertible into, or exchangeable or exercisable for, shares of our common stock. If we issue additional shares of our common stock or instruments convertible into shares of our common stock, it may materially and adversely affect the market price of our common stock.

In addition, a substantial number of shares of our common stock is reserved for instruments issued under our equity compensation plans, including for the issuance upon the exercise of stock options and the vesting of performance share units, restricted stock, restricted stock units and deferred stock units, upon conversion of the convertible notes, and in relation to the convertible note hedge and warrant transactions entered into in connection with the convertible notes. We may not be able to predict the size of future issuances or the effect, if any, that they may have on the market price for our common stock. The issuance and sale of substantial amounts of common stock, or the perception that such issuances and sales may occur, could adversely affect the market price of our common stock and impair our ability to raise capital through the sale of equity or equity-linked securities.

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We do not currently expect to pay dividends on our common stock, so any returns may be limited to changes in the value of our common stock.

We have never declared or paid any cash dividends on our common stock. We currently anticipate that we will retain future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. In addition, our ability to pay cash dividends on our common stock may be prohibited or limited by the terms of any future debt financing arrangement. Any return to stockholders will therefore be limited to the increase, if any, of our stock price.

Conversion of the convertible notes may dilute the ownership interest of existing stockholders, including holders who had previously converted their convertible notes, or may otherwise depress the price of our common stock.

The conversion of the convertible notes into shares of our common stock, to the extent that we choose not to deliver all cash for the conversion value, will dilute the ownership interests of existing stockholders. Any sales in the public market of the common stock issuable upon conversion of the convertible notes could adversely affect prevailing market prices of our common stock. In addition, the existence of the convertible notes may encourage short selling by market participants due to this dilution or may facilitate trading strategies involving the convertible notes and our common stock.

Provisions of our certificate of incorporation, by-laws, Delaware law and the convertible notes may have anti-takeover effects that could prevent a change in control even if the change in control would be beneficial to our stockholders.

Provisions of our certificate of incorporation, by-laws and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. These provisions include:

- our Board of Directors has the right to elect directors to fill a vacancy created by the expansion of the Board of Directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our Board of Directors;

- stockholders must provide advance notice to nominate individuals for election to the Board of Directors or to propose matters that can be acted upon at a stockholders meeting; such provisions may discourage or deter a potential acquirer from conducting a solicitation of proxies to elect the acquirer s own slate of directors or otherwise attempting to obtain control of our company; and

- our Board of Directors may issue, without stockholder approval, shares of undesignated preferred stock; the ability to issue undesignated preferred stock makes it possible for our Board of Directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to acquire us.

Further, as a Delaware corporation, we are also subject to certain Delaware law anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the Board of Directors has approved the transaction. Our Board of Directors could rely on Delaware law to prevent or delay an acquisition of us. Additionally, certain provisions of the convertible notes could make it more difficult or more expensive for a third party to acquire us or could also have the effect of delaying or reducing the likelihood of a change in control of us even if such acquisition or change of control may be favorable to our stockholders.

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

The table below sets forth information regarding the Company s purchases of its common stock during its third fiscal quarter ended November 30, 2015:

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (1)	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (2)
September 1, 2015 September 30, 2015		$		$ 429.9 million
October 1, 2015 October 31, 2015	767,325	$ 77.68	409,400	$ 398.2 million
November 1, 2015 November 30, 2015	577,800	$ 80.40	577,800	$ 351.7 million
Total	1,345,125		987,200	

(1) During the three months ended November 30, 2015, the Company withheld an aggregate of 357,925 shares of its common stock (with a weighted average share price of $77.89) from employees to satisfy minimum tax withholding obligations relating to the vesting of share awards. These shares were not withheld pursuant to the program described in Note (2) below.

(2) On March 25, 2015, the Company announced that its Board of Directors has authorized the repurchase of up to $500.0 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program commenced on April 1, 2015, and will expire on the earlier of (i) March 31, 2017, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program.

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ITEM 6. EXHIBITS

(a) List of Exhibits

Exhibit No.	Exhibit
31.1	Certification of the registrant s Chief Executive Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the registrant s Chief Financial Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the registrant s principal executive officer and principal financial officer pursuant to 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

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SIGNATURES

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

	RED HAT, INC.	
Date: January 8, 2016	By:	/s/ JAMES M. WHITEHURST **James M. Whitehurst** **President and Chief Executive Officer** **(Duly Authorized Officer on Behalf of the Registrant)**
	RED HAT, INC.	
Date: January 8, 2016	By:	/s/ FRANK A. CALDERONI **Frank A. Calderoni** **Executive Vice President, Operations and** **Chief Financial Officer** **(Principal Financial Officer)**

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