RED HAT INC
Form 10-Q
January 09, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 30, 2006

OR

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

For the transition period from to .

Commission File Number: 000-26281

RED HAT, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

06-1364380

(I.R.S. Employer Identification No.)

1801 Varsity Drive, Raleigh, North Carolina 27606

(Address of principal executive offices, including zip code)

(919) 754-3700

(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

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

As of December 31, 2006, there were 192,174,875 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

RED HAT, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands except share and per share amounts)

	November 30, 2006 (unaudited)	February 28, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 795,992	$ 267,547
Investments in debt securities	180,873	537,324
Accounts receivable, net of allowances for doubtful accounts of $3,317 and $1,984, respectively	81,251	59,792
Prepaid expenses and other current assets	34,123	16,576
Total current assets	1,092,239	881,239
Property and equipment, net of accumulated depreciation and amortization of $46,780 and $35,443, respectively	42,278	35,822
Goodwill	327,264	75,942
Identifiable intangibles, net	97,574	13,467
Investments in debt securities	120,313	272,669
Other assets, net	33,238	35,102
Total assets	$ 1,712,906	$ 1,314,241
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 10,742	$ 5,627
Accrued expenses	40,370	31,960
Deferred revenue	227,786	162,934
Other current obligations	359	401
Total current liabilities	279,257	200,922
Deferred lease credits	5,329	4,994
Long term deferred revenue	83,909	60,554
Other long term obligations		213
Convertible debentures	570,000	570,000
Commitments and contingencies		
Stockholders equity:		
Minority interest		771
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, $0.0001 per share par value, 300,000,0000 shares authorized, 202,593,124 and 194,043,220 shares issued, and 191,471,492 and 183,115,666 shares outstanding at November 30, 2006 and February 28, 2006, respectively	20	19
Additional paid-in capital	1,015,376	763,906
Deferred compensation		(2,418)
Accumulated deficit	(112,579)	(152,113)

Treasury stock at cost, 11,121,632 and 10,927,554 shares at November 30, 2006 and February 28, 2006, respectively	(125,723)	(124,125)
Accumulated other comprehensive loss	(2,683)	(8,482)
Total stockholders equity	774,411	477,558
Total liabilities and stockholders equity	$ 1,712,906	$ 1,314,241

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	November 30, 2006	November 30, 2005	November 30, 2006	November 30, 2005
Revenue:				
Subscriptions	$ 88,860	$ 60,211	$ 245,300	$ 163,779
Training and services	16,966	12,901	44,202	35,831
Total revenue	105,826	73,112	289,502	199,610
Cost of revenue:				
Cost of subscriptions	6,741	4,952	20,123	15,788
Cost of training and services	10,699	6,905	27,183	20,291
Total cost of revenue	17,440	11,857	47,306	36,079
Gross profit	88,386	61,255	242,196	163,531
Operating expense:				
Sales and marketing	37,575	20,505	105,883	61,296
Research and development	19,200	9,644	51,084	29,846
General and administrative	18,024	12,357	49,579	34,067
Total operating expense	74,799	42,506	206,546	125,209
Income from operations	13,587	18,749	35,650	38,322
Other income and expense, net	11,113	6,645	31,388	22,601
Interest expense	(1,494)	(1,490)	(4,467)	(4,612)
Income before provision for income taxes	23,206	23,904	62,571	56,311
Provision for income taxes	8,586	701	23,151	3,942
Net income	$ 14,620	$ 23,203	$ 39,420	$ 52,369
Basic net income per common share	$ 0.08	$ 0.13	$ 0.21	$ 0.30
Diluted net income per common share	$ 0.07	$ 0.12	$ 0.19	$ 0.27
Weighted average shares outstanding				
Basic	191,298	177,615	188,379	177,200
Diluted	219,458	211,783	218,591	208,964

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	November 30, 2006	November 30, 2005	November 30, 2006	November 30, 2005
Cash flows from operating activities:				
Net income	$ 14,620	23,203	39,420	52,369
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	6,594	4,145	17,691	11,443
Deferred income taxes	3,501	293	13,003	(507)
Share-based compensation expense	8,495	1,299	24,421	3,794
Excess tax benefits from share-based payment arrangements	(2,368)		(5,243)	
Gain from repurchase of convertible debentures				(3,140)
Amortization of debt issuance costs	752	752	2,256	2,304
Provision for doubtful accounts	281	228	983	369
(Gain) Loss on disposal of property and equipment	(16)	128	(22)	1,125
Other		546	(283)	568
Changes in operating assets and liabilities net of effects of acquisitions:				
Accounts receivable	(10,446)	2,968	(10,628)	(6,274)
Prepaid expenses and other current assets	243	(1,731)	(2,002)	(2,521)
Accounts payable	3,030	337	3,539	(3,030)
Accrued expenses	9,595	3,966	9,438	11,521
Deferred revenue	25,486	17,983	63,565	68,229
Other	(91)	(4)	(206)	223
Net cash provided by operating activities	59,676	54,113	155,932	136,473
Cash flows from investing activities:				
Purchase of investment securities		(223,900)	(7,444)	(363,077)
Proceeds from sales and maturities of investment securities	166,810	221,956	522,862	332,972
Acquisitions of businesses, net of cash acquired	(302)	(303)	(149,864)	(2,803)
Purchase of other investments		(20,000)		(20,767)
Purchase of property and equipment	(5,766)	(4,401)	(14,751)	(12,389)
Net cash provided by (used in) investing activities	160,742	(26,648)	350,803	(66,064)
Cash flows from financing activities:				
Excess tax benefits from share-based payment arrangements	2,368		5,243	
Repurchase of convertible debentures				(26,301)
Proceeds from issuance of common stock under Employee Stock Purchase Plan		833	306	2,330
Proceeds from exercise of common stock options	2,966	6,978	14,650	14,102
Purchase of treasury stock	(66)		(1,598)	(16,688)
Structured stock repurchase	1,514		1,514	1,031
Other financing	(223)	470	(255)	553

Net cash provided by (used in) financing activities	6,559	8,281	19,860	(24,973)
Effect of foreign currency exchange rates on cash and cash equivalents	834	(1,856)	1,850	(3,659)
Net increase in cash and cash equivalents	227,811	33,890	528,445	41,777
Cash and cash equivalents at beginning of the period	568,181	148,056	267,547	140,169
Cash and cash equivalents at end of the period	$ 795,992	181,946	795,992	181,946

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries (Red Hat or the Company) is a global leader in providing open source software solutions to the enterprise. The Company is also the market leader in providing enterprise-ready open source operating system platforms. The Company applies its technology leadership to create its enterprise operating platform, Red Hat Enterprise Linux (Enterprise Linux) and other infrastructure technology solutions, based on open source technology. The Company s enterprise solutions are intended to meet the functionality requirements and performance demands of the enterprise and third-party computer hardware and software applications that are critical to the enterprise. The Company provides the chief information officers of the largest companies in the world with the choice of Enterprise Linux operating platforms for a range of application areas, including the technical/developer workstation, edge of the network applications, information technology infrastructure (applications such as database, ERP and large file systems), corporate desktop and data center. Red Hat Network (RHN) provides an integrated management service that allows various Red Hat enterprise technologies to be updated and configured and the performance of these and other technologies to be monitored in an automated fashion. These and other technology solutions reflect the Company s continuing commitment to provide an enterprise-wide infrastructure platform and developer solutions based on open source technology. The Company derives its revenues and generates its cash from customers primarily from two sources: (i) subscriptions for its enterprise technologies and (ii) training and services revenue, as further described below in NOTE 2, Summary of Significant Accounting Policies.

NOTE 2 Summary of Significant Accounting Policies

Unaudited Interim Financial Information

The unaudited interim consolidated financial statements as of and for the three months and nine months ended November 30, 2006 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the consolidated balance sheets, consolidated operating results and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three months and nine months ended November 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2007. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the SEC s rules and regulations for interim reporting. For further information, see the Company s Consolidated Financial Statements, including notes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2006.

Principles of Consolidation

The accompanying Consolidated Financial Statements include the accounts of the Company and all of its wholly-owned subsidiaries. Entities that are not wholly-owned, but for which a controlling financial interest is maintained by the Company are consolidated. The non-controlling interest of these entities is presented as a separate component of stockholders equity. All significant inter-company accounts and transactions are eliminated in consolidation. There are no foreign exchange restrictions on the Company s foreign subsidiaries.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported

amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from such estimates.

Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position No. 97-2, Software Revenue Recognition (SOP 97-2), as amended by Statement of Position No. 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, and Statement of Position No. 98-9, Modification of SOP 97-2, and Staff Accounting Bulletin No. 101, as amended by Staff Accounting Bulletin No. 104. The Company establishes persuasive evidence of an arrangement for each type of revenue transaction based on either a signed contract with the end customer, a click-through contract on the Company s website whereby the customer agrees to the Company s standard subscription terms, signed distribution contracts with original equipment manufacturers (OEMs) and other resellers, or, in the case of individual training seats, through receipt of payment which indicates acceptance of the Company s training agreement terms.

Subscription Revenue

Subscription revenue is comprised of direct and indirect sales of Red Hat enterprise technologies. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement for the purchase of a subscription, subscription services are made available to the customer and the customer is billed. The deferred revenue amount is amortized to revenue over the life of the subscription. Red Hat enterprise technologies are generally offered with either one or three-year base subscription periods; the majority of the Company s subscriptions have one-year terms. Under these subscription agreements, renewal rates are generally specified for one or three year renewal terms. The base subscription generally entitles the end user to the technology itself and post contract customer support (PCS) generally consisting of a specified level of customer support and security errata, bug fixes, functionality enhancements to the technology and upgrades to new versions of the technologies, each on a when-and-if available basis, during the term of the subscription. The Company sells its offerings through two principal channels: (1) direct, which includes sales by the Company s sales-force as well as web store sales, and (2) indirect, which includes distributors, resellers and OEMs. The Company recognizes revenue from the sale of Red Hat enterprise technologies ratably over the period of the subscription beginning on the commencement date of the subscription agreement.

Subscription arrangements with large enterprise customers often have contracts with multiple elements (e.g., software technology, maintenance, training, consulting and other services). The Company allocates revenue to each element of the arrangement based on vendor-specific objective evidence of its fair value when the Company can demonstrate sufficient evidence of the fair value of at least those elements that are undelivered. The fair value of each element in multiple element arrangements is created by either (i) providing the customer with the ability during the term of the arrangement to renew that element at the same rate paid for the element included in the initial term of the agreement or (ii) selling the services on a stand-alone basis.

In addition, the Company s subscription revenue is partially derived from sales of its RHN offerings. RHN is a Red Hat-hosted, internet-based set of services used to help promote the security, availability and management of most of the Company s Red Hat technology solutions as well as provide functionality for managing other technologies. RHN may be subscribed to at the time of, and in addition to, one of the Company s Enterprise Linux offerings or on a stand alone basis. Revenues are recognized ratably over the term of the subscription beginning on the commencement date of the subscription.

Training and Services Revenue

Training and services are comprised of revenue for consulting, engineering and customer training and education services. Consulting services consist of hourly arrangements, and revenue is recognized as these

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services are performed. Engineering services represent revenues earned under fixed fee arrangements with the Company s OEM partners and other customers to provide for significant modification and customization of the Company s Red Hat enterprise technologies. The Company recognizes revenues for these fixed fee engineering services using the percentage of completion basis of accounting, provided the Company has the ability to make reliable estimates of progress towards completion, the fee for such services is fixed or determinable and collection of the resulting receivable is probable. Under the percentage of completion method, earnings under the contract are recognized based on the progress toward completion as estimated using the ratio of labor hours incurred to total expected project hours. Changes in estimates are recognized in the period in which they are known. Revenue for customer training and education services is recognized on the dates the services are complete.

Deferred Commissions

Deferred commissions are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to the Company s sales force. The commissions are deferred and typically amortized over twelve months to match the period of the subscription term. The commission payments are paid in full subsequent to the month in which the customer s service commences. The deferred commission amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. In addition, the Company has the ability and intent under the commission plans with its sales force to recover commissions previously paid to its sales force in the event that customers breach the terms of their subscription agreements and do not pay fully for their subscription agreements. Amortization of deferred commissions is included in sales and marketing expense in the accompanying Consolidated Statements of Operations. Deferred commissions are included in prepaid expenses and other current assets on the accompanying Consolidated Balance Sheets.

Impairment of Long-Lived Assets

The Company evaluates the recoverability of its property and equipment and other assets in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). SFAS 144 requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired, and broadens the presentation of discontinued operations to include more disposal transactions. An impairment loss is recognized when the net book value of such assets exceeds the estimated future undiscounted cash flows attributable to the assets or the business to which the assets relate. The Company performs this assessment on an annual basis, typically during the fourth quarter of the fiscal year or whenever events or changes in circumstances indicate an impairment may have occurred. Impairment losses are measured as the amount by which the carrying value exceeds the fair value of the assets. No significant impairment losses were recognized by the Company during the three months and nine months ended November 30, 2006 and November 30, 2005.

Reclassifications

Certain prior period amounts were reclassified to conform with current period presentation. For example, prior to fourth quarter of fiscal 2006, the Company reported its results in two reportable segments aligned by product: enterprise technologies and embedded technologies. The embedded product is no longer significant in terms of revenue, no longer separately managed and no longer considered a separate business unit. Accordingly, the Company has reclassified its prior period financial results to conform with current period presentation.

Cash and Cash Equivalents

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

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Accounts Receivable and Allowance for Doubtful Accounts:

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company s estimate of the amount of probable credit losses in the Company s existing accounts receivable. The Company determines the allowance based on historical write-off experience by industry and regional economic data. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company feels it is probable the receivable will not be recovered. The Company does not have off-balance-sheet credit exposure related to its customers. Accounts receivable includes earnings in excess of billings of $1.8 million and $1.5 million at November 30, 2006 and February 28, 2006, respectively.

Investments in Debt Securities

The Company s investments at November 30, 2006 and February 28, 2006 are in debt securities which are classified as available for sale and carried at market value in accordance with Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. These investments are classified as either a cash equivalent, current asset (Investments in debt securities-current) or long-term asset (Investments in debt securities-long term) based on their time to maturity at date of purchase by the Company. Investments with a maturity date of one year or less from the balance sheet date are classified as a current asset and those with a maturity date of greater than one year are classified as a long-term asset. The average maturity period of the Company s investment in debt securities was 0.2 years at November 30, 2006 and 0.7 years at February 28, 2006. The Company s investments are considered available for sale as these securities could be sold at any time in response to needs for liquidity, changes in the availability of and the yield on alternative instruments or changes in funding sources or terms. The Company had unrealized gains of $2.2 million and $6.6 million related to these investments during the three and nine months ended November 30, 2006. The Company had unrealized losses of $1.3 million and $0.5 million related to these investments for the three months and nine months ended November 30, 2005, respectively.

Internal Use Software

In accordance with Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, the Company capitalized $2.4 million and $1.5 million in costs related to the development of internal use software for its website, enterprise resource planning system and systems management applications during the three months ended November 30, 2006 and November 30, 2005, respectively. For the nine months ended November 30, 2006 and 2005, the Company capitalized $6.4 million and $6.8 million of internal use software, respectively. The Company amortizes the costs of computer software developed for internal use on a straight-line basis over an estimated useful life of five years. The carrying value of internal use software is included in property and equipment on the Consolidated Balance Sheets.

Capitalized Software Costs

Capitalization of software development costs for products to be sold to third parties begins upon the establishment of technological feasibility and ceases when the product is available for general release. The establishment of technological feasibility and the ongoing assessment of recoverability of capitalized software development costs requires considerable judgment by management concerning certain external factors including, but not limited to, technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technologies. As a result of the Company s practice of releasing source code that it has developed on a weekly basis for unrestricted download on the Internet, there is generally no passage of time between achievement of technological feasibility and the availability of the Company s product for general release. Therefore, the Company has no capitalized software development costs at November 30, 2006 and February 28, 2006.

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Property and Equipment

Property and equipment is primarily comprised of furniture, computer equipment, computer software and leasehold improvements which are recorded at cost and depreciated or amortized using the straight-line method over their estimated useful lives as follows: furniture and fixtures, seven years; computer equipment, three years; computer software, five years; leasehold improvements, over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease. Expenditures for maintenance and repairs are charged to operations as incurred; major expenditures for renewals and betterments are capitalized and depreciated. Property and equipment acquired under capital leases are depreciated over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease.

Other Assets

Other assets include debt issue costs, security deposits which are expected to be refunded to the Company upon termination of certain leases, and investments in other companies accounted for using the equity and cost-basis methods of accounting.

The costs related to the issuance of the convertible debentures, which closed in January 2004, were capitalized and are being amortized to interest expense through January, 2009, the first scheduled date on which holders have the option to require the Company to repurchase the convertible debentures. Issuance costs related to the Company s convertible debentures totaled $15.8 million and primarily consisted of investment banking, legal and other professional fees. Amortized issuance cost was $0.8 million for each of the three months ended November 30, 2006 and November 30, 2005. Amortized issuance cost was approximately $2.3 million for each of the nine months ended November 30, 2006 and November 30, 2005.

Share-Based Compensation

Prior to March 1, 2006, the Company accounted for share-based compensation pursuant to the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and accordingly no compensation expense was recorded for stock options or other share-based awards to employees and non-employee directors that were granted with an exercise price equal to or above the market value per share of the Company s common stock on the grant date. For awards granted with an exercise price less than the market value of the Company s stock on the grant date, the award s intrinsic value was recorded as deferred compensation and reported as a separate component of stockholders equity. The deferred compensation was amortized to compensation expense over the vesting period of the award.

Effective March 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment (SFAS 123R), using the modified-prospective transition method. Under the modified-prospective method, compensation costs recognized in the three months and nine months ended November 30, 2006 includes (a) compensation cost for all share-based awards granted prior to, but not yet vested as of, March 1, 2006 based on the grant date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-based Compensation (SFAS 123) and (b) compensation costs for all share-based awards granted on or subsequent to March 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the provisions of the modified prospective transition method, results for prior periods have not been restated.

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The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the three months ended November 30, 2006 and November 30, 2005 (in thousands):

	Three Months Ended	
	November 30, 2006 (unaudited)	November 30, 2005 (unaudited)
Cost of revenue	$ 558	$
Sales and marketing	2,181	87
Research and development	1,882	99
General and administrative	3,874	1,113
Total share-based compensation	$ 8,495	$ 1,299

No share-based compensation was capitalized during the three months ended November 30, 2006 and 2005.

The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the nine months ended November 30, 2006 and November 30, 2005 (in thousands):

	Nine Months Ended	
	November 30, 2006 (unaudited)	November 30, 2005 (unaudited)
Cost of revenue	$ 1,607	$
Sales and marketing	6,753	117
Research and development	5,150	205
General and administrative	10,911	3,472
Total share-based compensation	$ 24,421	$ 3,794

No share-based compensation was capitalized during the nine months ended November 30, 2006 and 2005.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123, as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-based Compensation Transition and Disclosure, to stock based employee compensation (in thousands, except per share amounts):

	Three Months Ended November 30, 2005 (unaudited)	Nine Months Ended November 30, 2005 (unaudited)
Net income, as reported	$ 23,203	$ 52,369
Add: Recognized stock-based compensation expense, net of related tax effects	1,208	3,528
	(9,374)	(27,969)

Deduct: total stock-based compensation expense determined under the fair value based method for all awards, net of related tax effects				
Pro forma net income	$	15,037	$	27,928
Earnings per share data:				
Basic as reported	$	0.13	$	0.30
Basic pro forma	$	0.08	$	0.16
Diluted as reported	$	0.12	$	0.27
Diluted pro forma	$	0.08	$	0.15

Prior to the adoption of SFAS 123R, had the Company realized the tax benefits from deductions resulting from the exercise of share-based awards, it would have presented such tax benefits as a source of operating cash

flow in its Consolidated Statements of Cash Flows. SFAS 123R requires that the portion of benefits resulting from tax deductions in excess of the award s original grant date fair value (the excess tax benefits) be presented as a source of cash flow from financing activities. In the three and nine months ended November 30, 2006 the Company recognized $4.1 million and $9.1 million, respectively of income tax benefits from share-based awards exercised during the current period of which, for the same periods, $2.4 million and $5.2 million, respectively resulted from tax deductions in excess of the original fair value of the awards as previously reported on a pro-forma basis under SFAS 123. These excess tax benefits are reported on the Company s Consolidated Statements of Cash Flows as cash provided by financing activities.

The fair value of options granted during the three and nine months ended November 30, 2006 under the provisions of SFAS 123R and the three and nine months ended November 30, 2005 under the provisions of SFAS 123 was estimated on the date of grant using the Black-Scholes-Merton option-pricing model based on the following weighted average assumptions:

	Three Months Ended	
	November 30, 2006 (unaudited)	November 30, 2005 (unaudited)
Expected dividend yield	0.00%	0.00%
Risk-free interest rate	4.78%	4.01%
Expected volatility (1)	50.56%	59.86%
Expected life (in years) (2)	3.27	3.00
Weighted average fair value of options granted during the period	$ 8.01	$ 7.16

	Nine Months Ended	
	November 30, 2006 (unaudited)	November 30, 2005 (unaudited)
Expected dividend yield	0.00%	0.00%
Risk-free interest rate	4.81%	3.83%
Expected volatility (1)	50.25%	62.18%
Expected life (in years) (2)	3.27	3.00
Weighted average fair value of options granted during the period	$ 8.36	$ 6.57

(1) The expected volatility rate for options granted during the three and nine months ended November 30, 2006 was estimated based on an equal weighting of historical volatility of the Company s common stock over a period of approximately 3.27 years and the implied volatility of publicly traded options for the Company s common stock.

(2) The expected term for options granted during the three and nine months ended November 30, 2006 was determined by assuming a midpoint hypothetical settlement scenario which incorporates unsettled options into the term estimate by assuming all vested, outstanding options are settled mid-way between the date of review, May 22, 2006, and the options expiration. The Company will reassess its estimate of expected term annually or when new information indicates a change is appropriate.

Estimated annual forfeitures: SFAS 123R requires the application of an estimated forfeiture rate. An estimated forfeiture rate of 15% per annum, which approximates the Company s historical rate, was applied to (a) unvested options granted prior to adoption and (b) all options granted since adoption. Awards are adjusted to actual forfeiture rates at vesting. The Company expects to reassess its estimated forfeiture rate annually or when new information, including actual forfeitures indicate a change is appropriate.

Sales and Marketing Expenses

Sales and marketing expenses consist of costs, including salaries, sales commissions and related expenses, such as travel, of all personnel involved in the sales and marketing process. Sales and marketing expenses also

include costs of advertising, sales lead generation programs, cooperative marketing arrangements and trade shows. All costs of advertising, including cooperative marketing arrangements, are expensed as incurred. Advertising expense totaled $3.5 million and $2.7 million for the three months ended November 30, 2006 and November 30, 2005, respectively. For the nine months ended November 30, 2006 and November 30, 2005, advertising expense totaled $11.9 million and $8.5 million, respectively.

Research and Development Expenses

Research and development expenses include all direct costs, primarily salaries for Company personnel and outside consultants, related to the development of new software products, significant enhancements to existing software products, and the portion of costs of development of internal use software required to be expensed. Research and development costs are charged to operations as incurred with the exception of those software development costs that may qualify for capitalization.

Deferred Taxes

The Company accounts for income taxes using the liability method that requires the recognition of deferred tax assets or liabilities for the temporary differences between financial reporting and tax bases of its assets and liabilities and for tax loss carryforwards at enacted statutory tax rates in effect for the years in which the differences are expected to reverse. The Company has recorded a valuation allowance against the majority of its deferred tax assets due to uncertainty of realization of these deferred tax assets. For the three months and nine months ended November 30, 2006, the Company recorded a net tax expense of $8.6 million and $23.2 million, respectively. For the three months and nine months ended November 30, 2005, the Company recorded a net tax expense of $0.7 million and $3.9 million, respectively.

The Company continues to assess the realizability of its deferred tax assets, which primarily consist of net operating losses from deductions resulting from exercises of stock options by employees in the United States. In assessing the realizability of these deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. In making this assessment, management considers the historical trend of taxable losses, projected future taxable income and the reversal of deferred tax liabilities. As of November 30, 2006, the net deferred tax asset balance was approximately $160 million of which approximately $144 million is offset by a valuation allowance and is included in prepaid expenses and other current assets. The Company continues to provide a valuation allowance against its deferred tax assets arising from tax losses in the United States and Asia Pacific due primarily to (i) cumulative tax losses, (ii) uncertainty related to the amount of future stock option exercises and related tax deductions generated, and (iii) inherent difficulties in forecasting future taxable income as a result of rapidly changing technology and the Company s competitive environment.

Foreign Currency Translation

The Euro has been determined to be the functional currency for the Company s European operations and local currencies have been determined to be the functional currencies for the Company s Asian and South American operations.

Foreign exchange gains and losses, which result from the process of remeasuring foreign currency transactions into the appropriate functional currency, are included in other income and expense, net in the Company s Consolidated Statements of Operations. The translation of foreign currency financial statements into U.S. Dollars for financial reporting purposes is included in other comprehensive income, which is a separate component of stockholders equity. Net foreign exchange gains and losses, included in other income, were $0.3 million loss and $0.1 million loss for the three and nine months ended November 30, 2006, respectively. No significant net foreign exchange gains or losses were recognized for the three and nine months ended November 30, 2005.

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Significant Customers and Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of temporary cash investments and trade receivables. The Company primarily places its temporary cash investments with high-credit quality financial institutions which invest predominantly in U.S. Government instruments, investment grade corporate bonds and certificates of deposit guaranteed by banks which are members of the FDIC. Cash deposits are primarily in financial institutions in the United States. However, cash for monthly operating costs of international operations are deposited in banks outside the United States.

The Company performs credit evaluations to reduce credit risk and requires no collateral from its customers. Management estimates the allowance for uncollectible accounts based on their historical experience and credit evaluation. The Company s standard credit terms are net 30 days in the U.S., net 45 days in EMEA, and range from net 30 to net 60 days in Asia Pacific.

For the three months and nine months ended November 30, 2006 and November 30, 2005, there were no individually significant customers from which the Company generated revenue or receivables.

Net Income Per Common Share

The Company computes net income per common share in accordance with Statement of Financial Accounting Standards No. 128, Earnings Per Share (SFAS 128), SEC Staff Accounting Bulletin No. 98 (SAB 98) and Emerging Issues Task Force No. 04-8, The Effect of Contingently Convertible Instruments on Diluted EPS. Under the provisions of SFAS 128 and SAB 98, basic net income per common share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding. Diluted net income per common share is computed by dividing net income adjusted for interest expense and amortization of debt issuance costs associated with the convertible debentures, by the weighted average number of common shares and dilutive potential common share equivalents then outstanding. Potential common share equivalents consist of shares issuable upon the exercise of stock options and convertible securities such as the Company s convertible debentures. Diluted net income per share for the three months and nine months ended November 30, 2006 and November 30, 2005, assumes the conversion of the convertible debentures using the if converted method.

The following table reconciles the numerators and denominators of the earnings per share calculation for the three months ended November 30, 2006 and November 30, 2005 (in thousands, except per share amounts):

	Three Months Ended (unaudited)	
	November 30, 2006	**November 30, 2005**
Diluted net income per share computation:		
Net income	$ 14,620	$ 23,203
Interest expense on convertible debt, net of related tax	449	662
Amortization of debt issuance costs, net of related tax	474	700
Net income diluted	$ 15,543	$ 24,565
Weighted Average common shares outstanding	191,298	177,615
Incremental shares attributable to assumed exercise of outstanding options	5,887	11,895
Incremental shares attributable to assumed exercise of convertible debentures	22,273	22,273
Diluted shares	219,458	211,783
Diluted net income per share	$ 0.07	$ 0.12

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The following table reconciles the numerators and denominators of the earnings per share calculation for the nine months ended November 30, 2006 and November 30, 2005 (in thousands, except per share amounts):

	Nine Months Ended (unaudited)	
	November 30, 2006	November 30, 2005
Diluted net income per share computation:		
Net income	$ 39,420	$ 52,369
Interest expense on convertible debt, net of related tax	1,347	2,017
Amortization of debt issuance costs, net of related tax	1,422	2,143
Net income diluted	$ 42,189	$ 56,529
Weighted Average common shares outstanding	188,379	177,200
Incremental shares attributable to assumed exercise of outstanding options	7,939	9,083
Incremental shares attributable to assumed exercise of convertible debentures	22,273	22,681
Diluted shares	218,591	208,964
Diluted net income per share	$ 0.19	$ 0.27

The following shares are not included in the computation of diluted earnings per share because the option prices were greater than the average market price of the Company s stock during the related periods and the effect of including such options in the computation would be antidilutive:

For the three months each ended November 30, 2006 and November 30, 2005, options to purchase approximately 15.2 million shares and 11.7 million shares, respectively.

For the nine months each ended November 30, 2006 and November 30, 2005, options to purchase approximately 11.3 million shares and 12.7 million shares, respectively.

Segment Reporting

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

Previously the Company reported its results in two reportable segments aligned by product: enterprise technologies and embedded technologies. The embedded product is no longer significant in terms of revenue, no longer separately managed and no longer considered a separate business unit. Accordingly, the Company has reclassified its prior period financial results to conform with current period presentation.

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The Company has offices in more than 50 locations around the world. The Company manages its international business on an Americas-wide, EMEA-wide and Asia Pacific-wide basis. The following table aggregates individually immaterial international operations and separately discloses the significant international operations as of and for the three months ended November 30, 2006 and November 30, 2005 (in thousands):

	Americas	EMEA	Asia Pacific	Total
	Three Months Ended November 30, 2006			
	(unaudited)			
Revenue from unaffiliated customers	$ 71,618	$ 20,297	$ 13,911	$ 105,826
Net income	$ 13,698	$ 133	$ 789	$ 14,620
Total assets	$ 1,600,621	$ 69,000	$ 43,285	$ 1,712,906

	Americas	EMEA	Asia Pacific	Total
	Three Months Ended November 30, 2005			
	(unaudited)			
Revenue from unaffiliated customers	$ 48,764	$ 12,792	$ 11,556	$ 73,112
Net income	$ 20,211	$ 1,390	$ 1,602	$ 23,203
Total assets	$ 1,153,641	$ 41,937	$ 34,455	$ 1,230,033

Revenues from unaffiliated customers in the United States, the Company s country of domicile, were approximately $68.2 million and $48.8 million for the three months ended November 30, 2006 and November 30, 2005, respectively. Revenues in Japan totaled $8.0 million and $6.9 million for the three months ended November 30, 2006 and November 30, 2005, respectively. In terms of revenue, Japan was the only individually material country outside the United States.

The following table aggregates individually immaterial international operations and separately discloses the significant international operations as of and for the nine months ended November 30, 2006 and November 30, 2005 (in thousands):

	Americas	EMEA	Asia Pacific	Total
	Nine Months Ended November 30, 2006			
	(unaudited)			
Revenue from unaffiliated customers	$ 194,730	$ 53,254	$ 41,518	$ 289,502
Net income (loss)	$ 38,781	$ 1,244	$ (605)	$ 39,420
Total assets	$ 1,600,621	$ 69,000	$ 43,285	$ 1,712,906

	Americas	EMEA	Asia Pacific	Total
	Nine Months Ended November 30, 2005			
	(unaudited)			
Revenue from unaffiliated customers	$ 134,415	$ 34,973	$ 30,222	$ 199,610
Net income	$ 48,968	$ 2,364	$ 1,037	$ 52,369
Total assets	$ 1,153,641	$ 41,937	$ 34,455	$ 1,230,033

Revenues from unaffiliated customers in the United States, the Company s country of domicile, were approximately $185.5 million and $134.4 million for the nine months ended November 30, 2006 and November 30, 2005, respectively. Revenues in Japan totaled $24.1 million and $17.4 million for the nine months ended November 30, 2006 and November 30, 2005, respectively.

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Comprehensive Income

The Company s comprehensive income is comprised of net income, foreign currency translation adjustments and unrealized gains and losses on marketable securities classified as available-for-sale. Comprehensive income for the three months ended November 30, 2006 and November 30, 2005 was as follows (in thousands):

	Three Months Ended (unaudited)	
	November 30, 2006	November 30, 2005
Comprehensive income:		
Net income	$ 14,620	$ 23,203
Foreign currency translation adjustments, net of taxes	32	(372)
Change in unrealized loss on marketable securities, net of taxes	2,195	(1,320)
Total comprehensive income, net of taxes	$ 16,847	$ 21,511

Comprehensive income for the nine months ended November 30, 2006 and November 30, 2005 was as follows (in thousands):

	Nine Months Ended (unaudited)	
	November 30, 2006	November 30, 2005
Comprehensive income:		
Net income	$ 39,420	$ 52,369
Foreign currency translation adjustments, net of taxes	(752)	(513)
Change in unrealized losses on marketable securities, net of taxes	6,551	(489)
Total comprehensive income, net of taxes	$ 45,219	$ 51,367

As of November 30, 2006 and February 28, 2006, the Company held investments in debt securities with an unrealized loss of $3.2 million and $9.7 million, respectively.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for the Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a comprehensive model for recognizing, measuring, presenting and disclosing uncertain income tax positions taken or expected to be taken by the Company on its tax returns. The Company will adopt FIN 48 effective March 1, 2007. The cumulative effects, if any, of applying FIN 48 will be recorded to retained earnings as of the beginning of the period of adoption. The Company has begun evaluating the impact of FIN 48 on its consolidated financial statements, but is not yet in a position to determine such effects.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 provides guidance on the consideration of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The staff believes registrants must quantify the impact of correcting all misstatements, including both carryover and reversing effects of prior year misstatements, on the Company s current year consolidated financial statements. The staff prescribes two approaches to assessing the materiality of misstatements; the rollover approach, which quantifies misstatements based on the amount of error originating in the current year income statement and the iron curtain

approach , which quantifies misstatements based on the effects of correcting the cumulative effect existing in the balance sheet at the end of the current year. If under

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either approach, misstatements are deemed material, the Company is required to adjust its financial statements, including correcting prior year financial statements, even though such correction was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require the Company to amend previously filed reports, rather such corrections may be made the next time the Company files its prior year statements. The Company does not currently anticipate any adjustments resulting from the application of SAB 108.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (SFAS 157). SFAS 157 establishes a framework for measuring fair value within generally accepted accounting principles, clarifies the definition of fair value within that framework, and expands disclosures about the use of fair value measurements. SFAS 157 does not require any new fair value measurements in generally accepted accounting principles. However, the definition of fair value in SFAS 157 may affect assumptions used by companies in determining fair value. The Company has not completed its evaluation of the impact on the Company s financial statements of adopting SFAS 157, but currently believes the adoption of SFAS will not require significant modification of the Company s fair value measurements and will be substantially limited to expanded disclosures in the notes to the Company s consolidated financial statements. The Company will be required to adopt SFAS 157 on March 1, 2008.

NOTE 3 Goodwill

In accordance with Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, the Company completed the annual impairment test as of February 28, 2006 and no goodwill impairment was deemed necessary. The following is a summary of adjustments to goodwill for the nine months ended November 30, 2006 (in thousands):

	(unaudited)
Balance at February 28, 2006	$ 75,942
Add: acquisition of JBoss, Inc. (see NOTE 13)	254,919
Acquisition of other businesses (1)	7,731
Less: tax benefits related to acquired NOL carryforwards	(11,654)
Impact of foreign currency fluctuations and other	326
Balance at November 30, 2006	$ 327,264

(1) Goodwill additions represent the excess of purchase price over tangible and identifiable intangible assets of acquired businesses operating in India, Argentina and Brazil.

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NOTE 4 Identifiable Intangible Assets

Identifiable intangible assets consist primarily of purchased technologies, customer and reseller relationships, trademarks, copyrights and patents, which are amortized over the estimated useful life on a straight line basis. Useful lives range from three to five years for purchased technologies and customer and reseller relationships and generally three to ten years for trademarks, copyrights and patents. As of November 30, 2006, trademarks with an indefinite estimated useful life totaled $8.7 million. As of February 28, 2006, the Company had no identifiable intangible assets with an indefinite estimated useful life. Amortization expense associated with identifiable intangible assets was $2.9 million and $1.0 million for the three months ended November 30, 2006 and 2005, respectively. Amortization expense for the nine months ended November 30, 2006 was $7.1 million and $2.9 million, respectively. The following is a summary of identifiable intangible assets (in thousands):

	November 30, 2006 (unaudited)			February 28, 2006		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$ 17,178	$(4,415)	$ 12,763	$ 4,486	$(2,500)	$ 1,986
Purchased technologies	17,454	(8,004)	9,450	13,323	(4,561)	8,762
Customer and reseller relationships	79,535	(4,174)	75,361	3,700	(981)	2,719
Total identifiable intangible assets	$ 114,167	$ (16,593)	$ 97,574	$ 21,509	$ (8,042)	$ 13,467

Additions to identifiable intangible assets resulting from the Company s recent acquisition of JBoss, which closed June 2, 2006, totaled $79.2 million (see NOTE 13).

NOTE 5 Other Assets

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

	November 30, 2006 (unaudited)	February 28, 2006
Debt issue costs convertible debentures	$ 6,395	$ 8,652
Cost-basis investments	5,132	5,132
Equity-basis investment	20,114	20,013
Security deposits	1,593	1,305
Other	4	
	$ 33,238	$ 35,102

The Company reviews the non-marketable cost-basis investments in equity securities for other than temporary declines in fair value based on prices recently paid for shares in that company, as well as changes in market conditions. The carrying values are not necessarily representative of the amounts that the Company could realize in a current transaction.

Equity-basis investment represents $20.1 million related to the Company s previously announced investment in Open Inventions Network LLC (OIN) and the related cumulative share of OIN s earnings as of November 30, 2006.

NOTE 6 Accrued Expenses

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

	November 30, 2006 (unaudited)	February 28, 2006
Wages and other compensation related expenses	$ 17,295	$ 14,921
Other trade payables	14,941	8,799
Income and other taxes payable	7,330	7,319
Other	804	921
Total accrued expenses	$ 40,370	$ 31,960

NOTE 7 Convertible Debentures

In January 2004, the Company issued $600 million in convertible senior debentures (Debentures) to the initial purchaser, a sophisticated, accredited investor with a pre-existing relationship with the Company, in a private placement pursuant to Section 4(2) of the Securities Act of 1933, as amended (the Securities Act) and the debentures were resold by the initial purchaser to qualified institutional buyers under Rule 144A under the Securities Act. Pursuant to a previously announced common stock and convertible debenture repurchase program, the Company has repurchased certain Debentures. As of November 30, 2006, there was $570 million in principal amount of the Debentures outstanding. The Debentures mature on January 15, 2024 and bear interest at a rate of 0.5% per annum, payable semiannually on January 15 and July 15 of each year. The Debentures are senior unsecured obligations and rank equally in right of payment with all of the Company s other existing and future unsecured and unsubordinated debt. The Debentures are convertible into approximately 22,273,000 shares of the Company s common stock under certain circumstances prior to maturity at a conversion rate of 39.0753 shares per $1,000 principal amount of debentures (which represents a conversion price of approximately $25.59 per share) subject to adjustment under certain conditions. The holders of the Debentures may convert their Debentures into shares of the Company s common stock prior to stated maturity under the following circumstances: (1) during any fiscal quarter after the fiscal quarter ending February 29, 2004 if the closing sale price of the Company s common stock exceeds 120% of the then current conversion price for at least 20 consecutive trading days in the 30 consecutive trading-day period ending on the last trading day of the immediately preceding fiscal quarter; (2) during any five consecutive trading-day period immediately following any five consecutive trading-day period (the Debenture Measurement Period) in which the average trading price of the Debentures during that Debenture Measurement Period was less than 97% of the average conversion value for the Debentures during such period; however, the holders may not convert their Debentures after January 15, 2019 if on any trading day in such Debenture Measurement Period the closing sale price of shares of the Company s common stock was between the then current conversion price of the Debentures and 120% of the then current conversion price of the Debentures; (3) upon the occurrence of specified corporate transactions; or (4) if the Company has called the Debentures for redemption. Based upon the terms of the Debentures, the contingent conversion features were not triggered as of November 30, 2006. The Company may redeem the Debentures, in whole or in part, in cash at any time on or after January 15, 2009. Holders of the Debentures may require the Company to redeem the Debentures, in whole or in part, in cash on January 15 of 2009, 2014 and 2019. As of November 30, 2006, no Debentures were redeemed. Accrued interest to the redemption date will be

paid by the Company in any such redemption. Interest payments of $1.4 million were made during the nine months ended November 30, 2006. Accrued interest payable at November 30, 2006 was $1.1 million and is recorded in accrued expenses.

In connection with the issuance of the Debentures, the Company incurred $15.8 million of issuance costs, which primarily consisted of investment banking, legal and other professional fees. These costs are being amortized and are recorded as additional interest expense through January, 2009, the first scheduled date on which holders have the option to require the Company to repurchase the Debentures. Amortization expense

related to the issuance costs was $0.8 million for the three months each ended November 30, 2006 and November 30, 2005 and $2.3 million for the nine months each ended November 30, 2006 and November 30, 2005. At November 30, 2006 and February 28, 2006, net debt issuance costs associated with the Debentures was $6.4 million and $8.6 million, respectively, and is recorded in other assets, net.

NOTE 8 Income Taxes

During the three and nine months ended November 30, 2006, the Company recorded $8.6 million and $23.2 million of income tax expense, respectively, which resulted in an estimated annual effective tax rate of 37%. The Company s estimated annual effective tax rate differs from the U.S. federal statutory rate of 35% primarily due to the treatment of certain share-based awards which are included in the Company s Consolidated Statements of Operations for the three and nine months ended November 30, 2006 but are considered non-deductible for tax purposes. The provision for income tax expense for the three months and nine months ended November 30, 2005, was $0.7 million and $3.9 million and was based on a then estimated annual effective tax rate of 7%, primarily for domestic federal alternative minimum tax expense as well as foreign income tax expense. The then estimated annual effective tax rate of 7% differed from the U.S. federal statutory rate of 35% primarily due to U.S. net operating loss carryforwards.

As of November 30, 2006 the Company continues to provide a valuation allowance against the majority of its net deferred tax assets with respect to its net operating losses (NOLs) in the United States and Asia Pacific since realization of these benefits is not deemed more likely than not. Based on the valuation allowance as of November 30, 2006, if the Company concluded the reversal of the entire valuation allowance was appropriate, the following would be recorded: (1) approximately $5.8 million reduction in goodwill related to NOLs from acquisitions; (2) approximately $123.6 million increase to additional paid in capital related to NOLs from deductions with respect to stock options and warrants; and (3) an income tax benefit of approximately $14.6 million.

As of November 30, 2006, the Company had federal and state net operating loss carryforwards of approximately $411 million and $511 million respectively. These net operating loss carryforwards expire in varying amounts beginning in 2019 and 2007 for federal and state income tax purposes, respectively. A portion of the net operating loss carryforwards is reflected in additional paid-in capital with a full valuation allowance as these net operating loss carryforwards are generated by deductions related to stock options and warrants. The Company s research and development credits begin to expire in 2009.

NOTE 9 Share-based Awards

The Company s 2004 Long-Term Incentive Plan as amended (the 2004 Plan) provides for the granting of stock options, nonvested shares and deferred share units, among other awards. As of November 30, 2006, approximately 8 million shares of common stock were reserved for issuance upon exercise of future options to be granted to any employee, officer or director or consultant of the Company at terms and prices to be determined by the Board of Directors. The 2004 Plan provides that the purchase price per share for each option shall not be less than the fair market value of the common stock on the date of grant. Options granted under the 2004 Plan to date include contract terms of five years and generally vest 25% upon completion of one full year of service and 6.25% on the first day of each subsequent three-month period of service. The 1999 Stock Option and Incentive Plan (the 1999 Plan) provides that the purchase price per share for each non-qualified option should be set by the Board of Directors on the date of grant. The purchase price per share for each Incentive Stock Option (ISO) shall not be less than the fair market value of the common stock on the date of grant. The maximum contract term for an option granted under the 2004 Plan is seven years from the date of grant and under the 1999 Plan is ten years from the date of grant. Options granted under the 1999 Plan generally vest 25% upon completion of one full year of service and 6.25% on the first day of each subsequent three-month period of service.

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Stock Options

The activity for the stock option plans for the three and nine months ended November 30, 2006 is presented in the following table:

	Shares Underlying Options	Weighted Average Exercise Price Per Share
Outstanding at February 28, 2006	18,703,115	$ 13.43
Granted	172,300	28.34
Exercised	(737,277)	9.93
Forfeited	(118,743)	19.72
Outstanding at May 31, 2006	18,019,395	$ 13.68
Granted	448,799	26.38
Exercised	(450,179)	10.04
Forfeited	(159,024)	15.65
Converted JBoss options at acquisition	724,039	1.07
Outstanding at August 31, 2006	18,583,030	$ 13.46
Granted	3,286,950	16.89
Exercised	(350,671)	8.40
Forfeited	(427,853)	13.78
Outstanding at November 30, 2006	21,091,456	14.53

The following summarizes information, as of November 30, 2006 about the Company s outstanding and exercisable stock options:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.00 - $ 3.21	2,269,091	5.7	$ 0.70	1,821,383	$ 0.59
$ 3.22 - $ 6.41	3,102,730	5.0	$ 5.08	3,032,941	$ 5.05
$ 6.42 - $ 9.62	1,815,685	6.1	$ 7.42	1,549,232	$ 7.43
$ 9.63 - $12.03	682,657	3.3	$ 11.02	211,607	$ 11.10
$12.04 - $16.03	5,822,486	3.9	$ 13.99	2,007,064	$ 13.90
$16.04 - $19.24	727,740	5.5	$ 17.48	327,060	$ 17.63
$19.25 - $22.44	3,639,451	5.0	$ 20.09	479,067	$ 21.28
$22.45 - $28.86	2,583,788	4.5	$ 25.93	1,603,739	$ 26.48
$28.87 - $32.06	80,450	4.3	$ 29.22		$
$32.07 and over	367,378	2.9	$ 85.44	367,378	$ 85.44

Total	21,091,456	4.7	$ 14.53	11,399,471	$ 12.98

The intrinsic value of options outstanding and options exercisable at November 30, 2006 was $118.7 million and $92.0 million, respectively.

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The following summarizes information, as of November 30, 2006 about the Company s outstanding stock options expected to vest:

	Options Expected to Vest		
Exercise Prices	**Number Expected to Vest**		**Weighted Average Exercise Price**
$ 0.00 - $ 3.21	447,708	$	1.15
$ 3.22 - $ 6.41	67,120	$	6.11
$ 6.42 - $ 9.62	252,996	$	7.37
$ 9.63 - $12.03	390,547	$	10.98
$12.04 - $16.03	3,197,182	$	14.02
$16.04 - $19.24	327,257	$	17.40
$19.25 - $22.44	2,306,916	$	19.93
$22.45 - $28.86	774,683	$	25.05
$28.87 - $32.06	64,180	$	29.23
$32.07 and over		$	
Total	7,828,589	$	15.95

The intrinsic value at November 30, 2006 of options expected to vest was $24.0 million.

The total intrinsic value of stock options exercised during the three months ended November 30, 2006 and 2005 was $4.1 million and $15.7 million, respectively. The total intrinsic value of stock options exercised during the nine months ended November 30, 2006 and 2005 was $24.7 million and $26.8 million, respectively.

As of November 30, 2006, compensation cost related to unvested stock options not yet recognized in the Company s Consolidated Financial Statements totaled $73.8 million. The weighted average period over which these unvested stock options are expected to be recognized is approximately 2.2 years.

Nonvested Shares

The following summarizes information about the Company s outstanding nonvested shares at November 30, 2006:

	Nonvested Shares		**Weighted Average Grant-date Fair Value**
Nonvested at February 28, 2006	127,688	$	13.20
Granted			
Vested	(14,812)		11.03
Forfeited			
Nonvested at May 31, 2006	112,876	$	13.49
Granted	10,500		23.27
Vested	(20,030)		14.46

Forfeited

Nonvested at August 31, 2006	103,346	$	14.29
Granted	219,250		19.91
Vested	(8,136)		13.18
Forfeited			
Nonvested at November 30, 2006	314,460	$	18.24

The intrinsic value of nonvested shares outstanding at November 30, 2006 was $5.5 million.

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Nonvested shares granted under the 2004 Plan generally vest 25% on the first anniversary of the date of grant and 6.25% on the first day of each subsequent three-month period. Nonvested shares are generally amortized to expense on a straight-line basis over four years. The total fair value of nonvested shares recognized in the Consolidated Statements of Operations for the three months ended November 30, 2006 was $0.3 million. The total fair value of nonvested shares recognized in the Consolidated Statements of Operations for the nine months ended November 30, 2006 and 2005 was $0.6 million and $0.1 million, respectively. The intrinsic value of nonvested shares vesting in the three and nine months ended November 30, 2006 was $0.2 million and $1.1 million, respectively. The intrinsic value of nonvested shares vesting in the nine month period ended November 30, 2005 was $0.1 million.

As of November 30, 2006, compensation cost related to nonvested share awards not yet recognized in the Company s Consolidated Financial Statements totaled $5.5 million. The weighted average period over which these nonvested share awards are expected to be recognized is approximately 3.7 years.

Deferred Share Units

Deferred share units are generally awarded to Directors and vest immediately. Deferred share units awarded during the three and nine months ended November 30, 2006 totaled 2,191 and 17,156 shares, respectively with a weighted average fair value per share of $16.93 and $22.66, respectively. The total fair value of deferred share units recognized in the Company s Consolidated Financial Statements for the nine months ended November 30, 2006 and 2005 was $0.4 million and $0.1 million, respectively.

NOTE 10 Commitments and Contingencies

As of November 30, 2006, the Company leased office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases was $3.3 million and $2.0 million for the three months ended November 30, 2006 and November 30, 2005, respectively. For the nine months ended November 30, 2006 and November 30, 2005 rent expense under operating leases was $8.8 million and $5.8 million, respectively. As of November 30, 2006 the Company had no capital leases.

In January 2002, the Company assumed the lease obligation of an unrelated third party for an office building which serves as the Company s headquarters. This lease terminates in June 2020. As compensation to the Company for assuming this obligation, the third party paid rent on the Company s behalf from the commencement of the sublease until February 2003, is allowing the Company the use of all furniture and fixtures, including building improvements, that were in the building at the time of the commencement of the sublease, and paid the Company a certain monthly amount through October 2002 to offset the operating expenses of this building, all of which was valued in the aggregate at $5.9 million. Included in the aggregate amount was $3.6 million representing the fair value of furniture and fixtures. This credit balance began to amortize, as a reduction to related rent expense, in fiscal 2004 and will continue to do so until the lease terminates in June 2020. The furniture and fixtures are being depreciated over a period of seven years. As of November 30, 2006, the carrying amount of long-term deferred lease credit was $5.3 million.

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.

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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 insignificant.

NOTE 11 Legal Proceedings

Red Hat Professional Consulting, Inc., formerly PTI, a wholly owned subsidiary of the Company acquired in February 2001, together with its former directors and some of its former principal shareholders, is a defendant in a suit brought by a former employee in DeKalb County Superior Court in Georgia (Case No. 00-CV-5509-8). The plaintiff asserts, among other things, breach of various employment agreements and seeks monetary damages. Red Hat Professional Consulting, Inc. has filed an answer, affirmative defenses and counterclaims, denying all liability. All discovery in the matter is complete. On October 31, 2005, a hearing was held on defendants Third Motion for Partial Summary Judgment, and the Court granted summary judgment on three of the claims. A pre-trial order was entered in the matter, and it was set for trial on December 11, 2006. However, the Court elected to delay trial for purposes of rehearing plaintiff s motion for partial summary judgment, and that hearing was held on December 11, 2006. The Court has yet to rule on that motion, and a new trial date has not been set. The Company has been indemni