BION ENVIRONMENTAL TECHNOLOGIES INC
Form 10-K
September 21, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended: **June 30, 2011**

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 No. **000-19333**

BION ENVIRONMENTAL TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in its Charter)

Colorado	**84-1176672**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

Box 566/1774 Summitview Way

Crestone, Colorado 81131

(Address of Principal Executive Offices, Including Zip Code)

Registrant s Telephone Number, including area code: **(212) 758-6622**

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Exchange on Which Registered
None	**N/A**

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock, No Par Value

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. [ ] YES [X] NO

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 [X] NO

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.

[X] YES [ ] NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). N/A

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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. [X]

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act)

[ ] Yes [X] No

The aggregate market value of the approximately 6,600,000 shares of voting stock held by non-affiliates of the Registrant as of December 31, 2010 approximated $21.2 million. As of September 20, 2011, the Registrant had 13,918,601 shares of common stock issued and 13,214,292 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K (and the documents incorporated herein by reference) contain forward-looking statements, within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that involve substantial risks and uncertainties. Forward-looking statements generally can be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "project," "predict," "plan," "believe" or "continue" or the negative thereof or variations thereon or similar terminology. The expectations reflected in forward-looking statements may prove to be incorrect.

Important factors that could cause actual results to differ materially from our expectations include, but are not limited to, the following (not set forth in any order that ranks priority or magnitude):

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changes in political, legal, regulatory and economic climates, including without limitation those relating to funding of environmental clean-up and enforcement of environmental rules and regulations;

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changes in the public's perceptions of large scale livestock agriculture/CAFOs, environmental protection and other related issues;

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industry risks, including environmental related problems;

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the ability of the Company to implement its business strategy;

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the Company's limited financial and management resources and ability to raise additional needed funds and/or hire needed personnel;

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the ability of the Company to keep its existing personnel and their accumulated expertise including the risk of illness or death of one or more key personnel;

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the extent of the Company's success in the development and operation of Integrated Projects and retrofit/remediation of existing livestock facilities;

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engineering, mechanical or technological difficulties with operational equipment including potential mechanical failure or under-performance of equipment;

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operating variances from expectations;

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the substantial capital expenditures required for construction of the Company's proposed CAFO retrofit facilities and Integrated Projects and the related need to fund such capital requirements through commercial banks and/or public or private securities markets;

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the need to develop and re-develop technology and related applications;

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dependence upon key personnel;

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the limited liquidity of the Company's equity securities;

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operating hazards attendant to the environmental clean-up, CAFO and renewable energy production, food processing and biofuel industries;

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seasonal and climatic conditions;

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availability and cost of material and equipment;

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delays in anticipated permit approval and/or start-up dates;

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availability of capital in the current 'distressed' financial markets;

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the strength and financial resources of the Company's competitors; and

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general economic conditions, including the recent recession and its effects on the national and international capital markets.

We do not undertake and specifically disclaim any obligation to publicly release the results of any revisions that may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

PART I

ITEM 1. BUSINESS.

GENERAL

Bion Environmental Technologies, Inc.'s ("Bion," "Company," "We," "Us," or "Our") patented and proprietary technology provides a comprehensive environmental solution to a significant source of pollution in US agriculture, Confined Animal Feeding Operations ("CAFO's"). Bion's technology is "comprehensive" in that it surpasses current environmental regulations for both nutrient releases to water and air emissions from livestock waste streams based upon our research to date. Because Bion's technology reduces the harmful emissions from a CAFO on which it is utilized, a CAFO (existing or to be developed) can potentially increase its herd concentration while lowering or maintaining its level of nutrient releases and atmospheric emissions.

Bion is now actively pursuing business opportunities in two broad areas 1) retrofit and environmental remediation of existing CAFO s to reduce nutrient (primarily nitrogen and phosphorus) releases, gaseous emissions (ammonia, greenhouse gases, volatile organic compounds, etc.), and pathogens, hormones and other compounds in order to clean the air and water in the surrounding areas (as described below), and 2) development of "closed loop" Integrated Projects (as described below). Bion is pursuing these opportunities within the United States and internationally.

For several years, the Company focused on completion of the development of the next generation waste treatment systems and applications based on its patented and proprietary waste handling/renewable energy technology ("Bion System" or "System") and its technology platform based on its core technology. The re-development process is now substantially complete and the initial commercial system based on our updated technology has been constructed. Currently, Bion is focused on using applications of its patented waste management technology to pursue two main business opportunities: 1) environmental retrofit and remediation of the waste streams of existing CAFOs in selected markets where government policy supports such efforts (such as the Chesapeake Bay watershed) and expansion of such opportunities into other regional markets; and 2) development of Integrated Projects which will include large CAFOs, such as large dairies, beef cattle facilities and hog farms, with Bion waste treatment system modules processing the aggregate CAFO waste stream from the equivalent of 40,000 or more beef and/or dairy cows (or the waste stream equivalent of other species) while recovering cellulosic biomass (to be utilized for renewable energy production) and nutrient rich solids (that can potentially to be marketed as feed and/or fertilizer), integrated with an ethanol plant capable of producing 40 (or more) million gallons of ethanol per year and/or with CAFO end product processors (referred to as Project(s) or Integrated Project(s)). A substantial portion of our activities involve public policy initiatives (by the Company and other stakeholders) to encourage the establishment of appropriate public policies and regulations (at federal, regional, state and local levels) to support our business activities.

The Company began pursuing both of these opportunities within the United States during the later stages of technology re-development in 2008-2009 and has recently begun activities to pursue such opportunities internationally

as well.

During 2008, the Company reorganized its management and operational structure to pursue its business plan primarily through two operating subsidiaries in order to focus on its two related but distinct business opportunities: 1) Bion Services Group, Inc. ('Services Group') is focused on utilization of Bion's technology to provide environmental waste treatment (often with renewable energy production from the waste stream) to retrofit/remediate existing livestock facilities; and 2) Bion Integrated Projects Group, Inc. ('Projects Group') will utilize Bion's patented technology to develop new, state-of-the-art, 'closed loop' livestock/renewable energy facilities integrated with related agriculture activities such as food processing and biofuels production in Integrated Projects (as defined below). Services Group will also provide its services and utilize its personnel to provide design, engineering and construction and project management services to support the activities of Projects Group.

Services Group is proceeding with its initial projects at Kreider Farms in Pennsylvania as described below, including the recently constructed Kreider Farms System and is pursuing opportunities in other locations. Projects Group is moving forward with pre-development activities for its initial Integrated Project(s) in the Northeast United States (probably in Pennsylvania and/or upstate New York) and preliminary work on other potential projects. The Company has also recently initiated activities to pursue both of these opportunities internationally.

We believe that Bion's technology platform creates the opportunity to develop Integrated Projects that profitably integrate large-scale CAFO's and their end-product users, renewable energy production from the CAFO waste stream, on site utilization of the renewable energy generated and biofuel/ethanol production in an environmentally and economically sustainable manner while reducing the aggregate capital expense and operating costs for the entire integrated complex. In the context of our Integrated Projects, Bion's waste treatment technology, in addition to mitigating polluting releases to water and emissions to air, will recover cellulosic biomass from portions of the CAFO waste stream from which renewable energy can be produced to be utilized by integrated ethanol plants, CAFO end-product processors (including cheese, ice cream and /or bottling plants in the case of dairy CAFOs and/or slaughter and/or further processing facilities in the context of beef CAFOs) and/or other users as a replacement for fossil fuel energy or sold to unrelated purchasers. Also, an integrated ethanol plant's main by-product, called distillers grain, can be added to the feed of the animals in wet form thereby potentially lowering the: i)capital expenditures, ii) operating, marketing and shipping costs, and iii) energy/fossil fuel usage of the ethanol production process. Thus, integrated ethanol plants will act as a feed mill for the CAFO, thereby reducing the CAFO's feeding costs and both lowering costs and generating revenue to the ethanol plant(s), and also provide a market for the renewable energy from the cellulosic biomass that Bion's System (defined below) modules produce from the CAFO waste stream. As such, Bion Integrated Projects can be denominated "closed loop". We anticipate that the participants in our Integrated Projects will have substantially lower carbon footprints per unit of production compared to non-integrated producers of the same products. Bion, as developer of, and a participant in, its Integrated Projects, anticipates that it will share in the cost savings and revenue generated from these (and other) benefits of integrated activities.

We anticipate that most projects undertaken by the Company in which we retain ownership interests (whether retrofit or Integrated Projects) will be pursued through single project subsidiaries. Bion PA 1 LLC (PA-1), through which we developed the Bion System required by Phase 1 of the Kreider project and Bion PA 2 LLC (PA-2), through which we are developing the Kreider Renewable Energy Facility (see below), are the first two of what are likely to be many such entities.

The Company's consolidated financial statements for the years ended June 30, 2011 and 2010 included herein have been prepared assuming the Company will continue as a going concern. The Company has not recorded any revenue from operations for either of the years ended June 30, 2011 or June 30, 2010. The Company has incurred net losses of approximately $6,998,000 and $2,976,000 during the years ended June 30, 2011 and 2010, respectively. The Company had a working capital surplus and stockholders' deficit, respectively, of approximately $87,000 and $2,543,000 as of June 30, 2011. The report of the independent registered public accounting firm on the Company's consolidated financial statements as of and for the years ended June 30, 2011 and June 30, 2010 includes a "going concern" explanatory paragraph, which means that there are factors that raise substantial doubt about the Company's ability to continue as a going concern.

PRINCIPAL PRODUCTS AND SERVICES

Currently, Bion is focused on using applications of its patented waste management technology to pursue two large opportunities: 1) retrofit and environmental remediation of existing CAFOs (pursued through Services Group) and 2) development of Integrated Projects (pursued through Projects Group).

Bion's Services Group, building upon our redeveloped technology and Bion's 15 years' of experience providing waste treatment services to the livestock industry with its first generation technology applications, is pursuing the opportunity related to retrofit and environmental remediation of existing CAFOs. Our technology has evolved and been upgraded over the last five years to meet changing standards and requirements. Bion's re-developed technology platform creates a potentially profitable business opportunity to provide waste treatment services and systems and/or renewable energy production capability to existing large livestock operations (of which there are many) and potentially to smaller facilities through aggregation of waste streams. Early candidates for these solutions include individual CAFO facilities that face impending regulatory action, CAFOs that wish to expand or relocate, and operations located in regions that suffer severe and immediate environmental issues, such as the Chesapeake Bay watershed or the San Joaquin Valley, where financial incentives (such as nutrient reduction credit trading programs) are (or may become) available that encourage voluntary reductions of nutrient releases and/or atmospheric emissions from agricultural sources. The Company's Kreider Farms projects in Pennsylvania in the Chesapeake Bay watershed represent the Company's first new endeavors in this market segment. These installations, when completed, will reduce nitrogen and phosphorus releases and ammonia emissions from the dairy and poultry waste streams to generate tradable nutrient reduction credits as part of a nutrient credit trading program through the PA Department of Environmental Protection (PADEP). Phase 2 of the Kreider project, which is in its early development and permitting phase, will treat the recovered cellulosic solids recovered from Kreider's dairy waste by the Phase 1 Kreider System and the waste stream from Kreider's poultry operations to generate renewable energy and tradable credits.

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Bion's Projects Group is pursuing the opportunity related to development of Integrated Projects which will include large CAFOs (such as large dairies, beef cattle feed lots and/or hog farms) with Bion waste treatment System modules processing the aggregate CAFO waste stream from the equivalent of 20,000 to 80,000 (or more) beef or dairy cows (or the waste stream equivalent of other species) while recovering cellulosic biomass to be utilized for renewable energy production (and possibly high nutrient fine solids to be marketed as feed and/or fertilizer), integrated with CAFO end product users/processing facilities and/or a biofuel/ethanol plant capable of producing 40 million to 100 (or more) million gallons of ethanol per year. Such Integrated Projects will involve multiple CAFO modules of 10,000 or more beef or dairy cows (or waste stream equivalent of other species) with waste treatment modules on a single site and/or on sites within an approximately 30 mile radius. Bion believes its technology platform will allow integration of large-scale CAFO's with end product processors and/or ethanol production together with renewable energy production from cellulosic biomass recovered from the waste streams and on-site energy utilization in a 'closed loop' manner that will reduce the capital expenditures, operating costs and carbon footprint for the entire Integrated Project and each component facility. Some Projects may be developed from scratch while others may be developed in geographic proximity to (and in coordination with) existing participating CAFOs, ethanol plants and/or end product processors.

The Company anticipates selecting a site for its initial Integrated Project (and possibly additional Integrated Projects) during the 2012 calendar year. Bion intends to commence development of its initial Integrated Project by optioning land and beginning the permitting process during 2012.

Bion has begun pre-development work on an Integrated Project planned to include a large-scale beef cattle finishing operation, a beef processing facility and an ethanol production facility to be located in Pennsylvania. The Company has begun discussions with various state and regional agencies in Pennsylvania regarding this potential Project. Limited progress has been made in the pre-development process to date because the Company has primarily focused its efforts in Pennsylvania on its two projects at Kreider Farms. However, the Company currently believes there is a significant likelihood that it will option land in Pennsylvania for our initial Integrated Project during the current fiscal year and move into the development process during 2012. In addition to the Pennsylvania beef cattle project, Bion has considered a similar Project to be located in upstate New York and has been in discussions with various local and state governments and agencies in New York regarding such a Project. Additionally, the Company has been in discussions with various local and state agencies in Nebraska regarding potential development of a large scale integrated dairy/cheese Integrated Project (which would be integrated with one or more existing ethanol plant(s)). Other locations are also under consideration for the Company s Integrated Projects. It is not possible at this time to firmly predict where the initial Project will be developed or the order in which Projects will be developed. All of these potential Projects are in very early pre-development stages and may never progress to actual development or may be developed after other Projects not yet under active consideration.

Bion intends to choose sites for additional Projects through fiscal years 2012-13 to create a pipeline of Projects. Management has a 5-year development target (through calendar year 2017) of approximately 12-24 Integrated Projects. At the end of the 5-year period, Bion projects that 4-8 of these Integrated Projects will be in full operation in 3-6 states (and possibly one or more foreign countries), and the balance would be in various stages ranging from partial operation to early development stage. It is possible that one or more Integrated Projects will be developed in joint ventures specifically targeted to meet the growing animal protein demand outside of the United States (including without limitation Asia, Europe and/or the Middle East). No Integrated Project has been developed to date.

The Company's successful accomplishment of its business activities is dependent upon many factors (see 'Forward-Looking Statements' above) including without limitation the following, none of which can be assured at this date:

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Successful development and completion of the first Integrated Project to demonstrate the operation of a fully integrated, environmentally compliant, Bion-based CAFO/ethanol Project at a profitable level; and

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Our ability to raise sufficient funds to allow us to finance our activities and projects; and

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Regulatory and enforcement policies at the Federal, State and local levels.

INDUSTRY BACKGROUND

The traditional business model for CAFO's, regardless of livestock type, has relied on a combination of: 1) a passive environmental regulatory regime, and 2) access to a relatively unlimited supply of cheap land and water to serve as the basis for "environmental" treatment of animal waste. Such land and water resources have now become significantly more expensive while ongoing consolidation of the CAFO industry has produced substantially increased and more concentrated waste streams. At the same time, regulatory scrutiny of, and public concern about, the environmental impact from CAFO's has intensified greatly.

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The production of animal protein (meat and dairy) in the United States (and elsewhere) now faces substantial production constraints due to environmental pollution problems (primarily air and water), public health concerns, resource limitations (land, water and energy), input cost increases (feed, etc.) and, potentially, climate change each of which negatively affect both the current profit levels and the future activities of the industry as currently structured.

Agricultural release of nitrogen and phosphorus into rural watersheds negatively effect and create large remediation costs not only for local waterways and aquifers but also for downstream water bodies and urban areas. Bion s remediation business opportunity focuses on its ability to efficiently remove nutrients (primarily nitrogen and phosphorus) and prevent air emission at the CAFO source at far lower cost than such nutrients can be removed downstream in municipal waste water and storm water treatment facilities in urban areas.

Agricultural runoff (including re-deposition of nitrogen from ammonia off-gassing) is the largest water pollution problem in the United States. Over-application of animal waste to cropland has resulted in manure nutrients polluting surface and ground water systems, adversely impacting water quality throughout the country including the Chesapeake Bay, the Great Lakes and the Gulf of Mexico 'Dead Zone'. Clean-up initiatives for the Chesapeake Bay, the Great Lakes and elsewhere are requiring the expenditure of substantial sums of money to reduce excess nutrient pollution. In each such case, agriculture in general--and CAFO's in particular--have been identified among the main contributors of pollution. CAFO's are also significant emitters of pollutants to air, with dairy CAFO's having been identified as the largest contributor to airborne ammonia and other polluting gases in the San Joaquin Valley and elsewhere and among the largest contributors to nutrient pollution of the Chesapeake Bay. A substantial volume of the nitrogen released to the atmosphere from CAFO waste streams as ammonia and other nitrogen gases emitted by CAFOs is re-deposited to the ground and then adds to nitrogen pollution of surface and ground water systems. Further, untreated manure from CAFO s has been linked to pathogens on food and hormones in water supplies. Bion believes that its patented and proven technology offers the only comprehensive solution to the environmental impacts of these concentrated livestock waste streams.

We believe Bion's technology can enable animal protein production to take place in a manner which is both economically and environmentally sustainable because our technology removes nutrients from the waste streams generated by animal operations at the source and dramatically reduces releases to water and gaseous atmospheric emissions. The potential resulting herd concentration increase (due to lower pollution) will reduce marginal costs of production for the CAFO s. Also, it results in a core Bion technology platform that integrates environmental treatment and renewable energy production and utilization with ethanol production, thereby creating the Company's Integrated Projects business opportunity.

In the context of Integrated Projects, Bion's waste treatment technology and technology platform (and the resulting herd concentration), in turn, potentially provide the opportunity to integrate a number of revenue generating operations (thereby reducing unit production costs) while maximizing the realized value of the renewable energy production. The Bion Integrated Project model will access diversified revenue streams through a balanced integration of herd and technologies to provide a hedge of the commodity risks associated with any of the separate enterprises. We believe that Bion's Integrated Projects may generate revenues and profits for the Company from one or more of the following items:

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Waste processing and technology licensing fees;

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Fees and savings related to permanently integrated utilization of the wet distiller grains, which are a by-product of ethanol production;

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Renewable energy production from the cellulosic biomass recovered from the livestock waste streams combined with utilization of the energy produced within the Integrated Projects;

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Ethanol production cost savings;

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Various "environmental" credits; and

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Other items including feed products or fertilizers.

Exactly what fees and revenues accrue to Bion will depend on the nature of Bion's participation in each Integrated Project and on negotiations with other participants in such Projects. If Bion is simply the operator of its Waste System within an Integrated Project that it develops, it would probably generate revenue from: a) waste processing and

technology licensing fees charged to the CAFO, b) sales of renewable energy to the ethanol plant and/or other facilities, c) fees related to the utilization of the wet distillers grain made possible by the integration, d) fees for its "developer" role, and/or e) sales of the fertilizer and/or other products generated from the waste treatment process. If Bion also participates in the ownership and/or operation of the ethanol plant, it would further generate revenue from sales of ethanol and sales of feed products to the CAFO. Sales of distillers grain as feed products generally represent 14-20% of the total revenues of an ethanol plant if there is an available market for the distillers grain. If Bion participates in the ownership and/or operation of the integrated CAFO (and its facilities), we will also generate revenues from the sale of the CAFO's end products. While it is possible that Bion would have a uniform ownership interest throughout a Project, it is likely that in many cases Bion will have differing ownership interests (from 0% to 100%) in each component of an Integrated Project.

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We believe that our technology platform and the proposed Projects do not involve significant technology risk. Our waste handling technology is modular and scalable, has been utilized efficiently in the past and has been verified by peer-reviewed data. Our first new generation Bion System module (at the Kreider dairy farm in Pennsylvania) is now operational and performing up to (or exceeding) expectations for nutrient removal from the CAFO waste stream. The other Project components required for an integrated operation, such as CAFO facilities, ethanol plants and solids separation, drying and combustion equipment, all consist of available and fully-tested processes and equipment that do not pose any experimental challenges once properly sized, selected and installed. It is Bion's ability to integrate the component parts in a balanced proportion with large CAFO herds and ethanol production in an environmentally sustainable manner that creates this unique economic opportunity. Bion has a patent pending relating to the Bion integration model described herein.

Bion has identified three primary market opportunities to potentially develop Integrated Projects depending on the facilities that exist in a given geographic region:

Existing Processing: Our technology enables newly-permitted livestock herds to be located near existing beef or dairy processing plants. A dedicated herd with Bion s environmental treatment will potentially create the opportunity for the processor to brand finished products as being 'environmentally-responsible,' 'Green,' or 'locally-grown,' as well as provide single sourcing for inputs resulting in improved food safety, security and accountability. Locating the herd in close proximity to the existing processing plant will likely substantially reduce its transportation costs and carbon footprint and the processing plant can purchase and utilize the renewable energy Bion produces from the cellulosic biomass recovered by Bion from the CAFO wastes to reduce purchases of fossil fuel.

Existing Ethanol: Newly-permitted livestock herds can be located near existing ethanol plants that are struggling in the current economic environment. In Bion's closed-loop livestock/ethanol model, a corn ethanol plant serves as a feed mill for the livestock herd and the ethanol plant provides its distiller grain co-product on a wet basis to supplement the herd's ration, eliminating the ethanol plant's traditional costs to dry, market and ship its distiller grains. The ethanol plant becomes an onsite/local consumer of the renewable energy generated from the herd's waste that

replaces all of the remaining fossil fuel requirements of the ethanol plant. Efficiency can be significantly increased since integration enables three 'shots' at the corn: i) first ethanol is produced from it, then ii)it is fed to the cows, and finally iii) renewable energy is produced from the cellulosic biomass portion recovered from the livestock waste stream. Integration with Bion's technology platform has the potential to more than triple the energy efficiency of corn ethanol production, improving the generally-accepted net energy balance of 1.4 to 1 to approximately 3.5-5 to 1 range (based on the Argonne National Laboratories GREET model assessment of a similar integrated, closed-loop project) --similar to the efficiency targets publicly discussed for future cellulosic ethanol production--and thereby greatly reduce the carbon footprint.

Greenfield Projects: Bion will develop new state-of-the-art Projects in selected locations that maximize economic advantages of the Projects' participants. Bion's partners in these Projects will potentially realize increased productivity and profits by capitalizing on the operational and resource efficiencies of integration as described elsewhere herein. Additionally, the facilities and processes of Greenfield Project participants will be optimized to provide the greatest benefit to the Project as a cooperative enterprise. Further market advantages may result from strategic location, such as proximity to high-value product markets, product branding, and economic development incentives, subsidies and tax credits.

Bion anticipates that the output (meat or dairy) from one or more Integrated Projects (in any of the categories above) may be primarily dedicated international export markets designated by Project participants. Bion has recently commenced activities related to participation of international end users in our Projects.

Although we have developed the structure and basic design work related to Integrated Projects, we have not yet actually developed or operated an Integrated Project. Further, we have not completed the development of all of the System applications that will be necessary to address all targeted markets (such as swine, poultry, etc.) and all geographic areas and we anticipate a continuing need for the development of additional applications and more efficient integration.

The basic integration in a fully integrated Project will probably include:

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An ethanol plant and CAFO combination sized to balance the distillers grain by-product of the ethanol production with the feed requirements of the CAFO herd and to meet or exceed the energy needs of the ethanol plant with the renewable energy produced by Bion from the CAFO waste stream. Beyond the production of ethanol, the ethanol facility will function as a feed mill for the CAFO herd which will utilize the spent grain from ethanol production on a

wet basis in its feed ration, materially reducing the operating expenses (energy and transportation) and capital expenditure requirements (for items such as dryers) and increasing the net energy efficiency of ethanol production;

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Additionally, the ethanol plant is potentially a source of waste heat (which, if not productively utilized, would increase ethanol production costs for required disposal) to be used to maintain temperatures throughout the co-located Bion System or dry captured cellulosic solids or other byproducts from the waste stream. In colder climates, additional uses of this waste heat will potentially include heating some of the CAFO facilities or other integrated facilities;

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Processing, drying and combusting/gasifying the recovered cellulosic biomass portion of the CAFO's manure stream to produce heat used for solids drying and to replace natural gas usage by the ethanol production process and other co-located facilities;

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Drying and processing of the fine solids portion of the CAFO's waste stream (if any) into a value-added, marketable, organic fertilizer and/or high protein feed product ingredients; and

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Co-located end-product production facilities (cheese and/or other dairy processors, beef processing facilities, etc.) that will utilize the output of the CAFO and consume renewable energy produced from the CAFO waste stream.

In order to implement this plan, Bion will need to work with (and/or acquire) CAFO's, ethanol producers and/or end-product processors to generate multi-party agreements pursuant to which the Integrated Projects will be developed and which will provide that, at a minimum, the following take place: a) the CAFO and ethanol plant (and other facilities) agree to locate in geographic proximity to each other, b) Bion licenses, constructs and operates its Systems to process the CAFO's waste stream and produces renewable energy and other products from the waste stream, c) the CAFO agrees to purchase and utilize the wet distillers grain by-product of the ethanol plant in its feed ration and d) the ethanol plant and/or end product facilities agree to purchase and utilize the renewable energy produced by Bion from the CAFO waste stream in the place of natural gas or other energy purchases. These agreements could be in the form of joint ventures, in which all parties share the cost and ownership of all facilities in the Integrated Project (in negotiated uniform or varied manners across the various facilities), or in other forms of multi-party agreements including agreements pursuant to which Bion would bear the cost of construction of its System and the owners of the CAFO and the ethanol plant would bear the cost of construction of the CAFO facilities and ethanol plant, respectively, and negotiated contractual arrangements would set forth the terms of transfer of products (wet distillers grain, combustible dried solids, etc.), energy and dollars among the parties.

CORPORATE BACKGROUND

The Company is a Colorado corporation organized on December 31, 1987. Our principal executive offices are located at the residence of our President at 1774 Summitview Way, Crestone, Colorado 81131. Our primary telephone number is 212-758-6622. We have no additional offices at this time.

HISTORY AND DEVELOPMENT OF OUR BUSINESS

Substantially all of our business and operations to date has been conducted through wholly-owned subsidiaries, Bion Technologies, Inc. (a Colorado corporation organized September 20, 1989), Bion Integrated Projects Group, Inc. ("Projects Group") (formerly Bion Dairy Corporation through August 2008 and originally Bion Municipal, Inc., a Colorado corporation organized July 23, 1999) and Bion Services Group, Inc. ("Services Group") (formerly Bion International, Inc., a Colorado corporation organized July 23, 1999) and BionSoil, Inc. (a currently inactive Colorado corporation organized June 3, 1996). Bion is also the parent of Dairy Parks, LLC (an inactive Delaware entity organized July 25, 2001), Bion PA 1 LLC (a Colorado entity organized August 14, 2008) (PA-1) and Bion PA 2 LLC (a Colorado entity organized June 24, 2010) (PA-2). In January 2002, Bion entered into a series of transactions whereby the Company became a 57.7% (now 58.9%) owner of Centerpoint Corporation (a Delaware corporation organized August 9, 1995) ("Centerpoint").

Although we have been conducting business since 1989, we determined that we needed to redefine how we could best utilize our technology during 2003. From 2003 through early 2008, we primarily worked on technology improvements and applications and in furtherance of our business model of Integrated Project development. During 2008 we re-commenced pursuing active commercial transactions involving installation of our Systems for CAFO waste treatment and related environmental remediation and initiation of development of our initial Integrated Projects.

Our original systems were wastewater treatment systems for dairy farms and food processing plants. The basic design was modified in late 1994 to create Nutrient Management Systems ("NMS") that produced organic soil products as a byproduct of remediation of the waste stream when installed on large dairy or swine farms. Through June 30, 2002, we sold and subsequently installed, in the aggregate, approximately 30 of these first generation systems in 7 states, of which we believe approximately 5-10 are still in operation in 3 states. We discontinued marketing of our first generation NMS systems during fiscal year 2002 and turned control and ownership of the first generation systems over to the farms on which they were installed over the following two years. We were unable to produce a business

model based on the first generation systems that would generate sufficient revenues to create a profitable business. While continuing to market and operate the first generation systems, during the second half of calendar year 2000, we began to focus our activities on developing the next generation of the Bion technology. We no longer operate or own any of the first generation NMS systems.

As a result of our research and development efforts, the core of our current technology was re-developed during fiscal years 2001-2004. We designed and tested Systems that use state-of-the-art, computerized, real-time monitoring and system control with the potential to be remotely accessed for both reporting requirements and control functions. These Systems are smaller and faster than our first generation NMS systems. The initial versions of our new generation of Bion Systems were designed to harvest solids used to produce organic fertilizer and soil amendments or additives (the "BionSoil(R) products") in a few weeks as compared to six to twelve months with our first generation systems.

During 2003-4 we designed, installed and began testing a commercial scale, second generation Bion System as a temporary modification or retrofit to a waste lagoon on a 1,250 milking cow dairy farm in Texas known as the DeVries Dairy. In December 2004, Bion published an independently peer-reviewed report, a copy of which may be found on our website, www.biontech.com, with data from the DeVries project demonstrating a reduction in nutrients (nitrogen and phosphorus) of approximately 75% and air emissions of approximately 95%. More specifically, those published results indicated that the Bion System produced a 74% reduction of nitrogen and a 79% reduction of phosphorus. The air results show that the Bion System limited emissions from the waste stream as follows: (in pounds per 1,400 pound dairy cow per year):

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Ammonia

0.20

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Hydrogen Sulfide

0.56

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Volatile Organic Compounds

0.08

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Nitrogen Oxides

0.17

These emissions represented a reduction from published baselines of 95%-99%.

Through 2007 the demonstration project at the DeVries Dairy in Texas also provided Bion with the opportunity to explore mechanisms to best separate the processed manure into streams of coarse and fine solids, with the coarse cellulosic solids/biomass supporting generation of renewable energy and the fine solids potentially becoming the basis of organic fertilizer products and/or a high protein animal feed ingredients. On-going research was also carried out on various aspects of nutrient releases and atmospheric emissions.

Bion discontinued operation of the DeVries demonstration research system during 2008.

During the 2005-2008 period, Bion focused on completing development of its technology platform and business model. As such, we did not pursue near term revenue opportunities such as retrofitting existing CAFO's with interim versions of our waste management solutions, because such efforts would have diverted scarce management and financial resources and negatively impacted our ability to complete development of an integrated technology platform in support of large-scale sustainable Integrated Projects.

Bion is now actively pursuing business opportunities in two broad areas: 1) retrofit and environmental remediation of existing CAFO s to reduce nutrient (primarily nitrogen and phosphorus) releases, gaseous emissions (ammonia, greenhouse gases, volatile organic compounds, etc.), and pathogens, hormones and other compounds in order to clean the air and water in the surrounding areas, and 2) development of "closed loop" Integrated Projects (as described above. Bion is pursuing these opportunities within the United States and internationally.

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We believe significant remediation/retrofit opportunities exist that will enable us to generate additional future revenue streams from Bion's technology. The initial retrofit opportunities we are pursuing are related to the existing clean-up program for the Chesapeake Bay ('Chesapeake Bay Program' or 'CB Program'). The Company anticipates that further opportunities for our remediation/retrofit business will develop in other areas with CAFO s including the watersheds of the Great Lakes (from New York to Minnesota), the extended Mississippi River/Gulf of Mexico watershed (including its tributaries from Pennsylvania in the east to Montana/Wyoming/Colorado in the west), and other areas with excess nutrient pollution from agriculture in general and CAFO s in particular.

Chesapeake Bay Watershed: Kreider Farms Projects

The urgency and priority of the need to clean up nutrient (primarily nitrogen and phosphorus) pollution to the Chesapeake Bay was made clear with President Obama's 2009 Executive Order concerning clean-up of the Chesapeake Bay and the EPA issuance in December 2010 of the Chesapeake Bay Total Maximum Daily Load (TMDL) standard (http://www.epa.gov/reg3wapd/tmdl/ChesapeakeBay/tmdlexec.html) for nutrient pollution in Chesapeake Bay tributaries. In May 2010, the EPA published their overall strategy for remediating the Chesapeake Bay, and they have committed to reducing nitrogen and phosphorus flows to the Bay sufficiently to enable 60% of the Bay watershed segments to meet water quality standards by 2025. Today, 89 of the 92 Bay and tidal watershed segments are not in compliance with water quality standards (97% out of compliance). The EPA and associated state agencies have also committed to short term 3 year compliance milestones to enhance accountability and corrective actions, along with a host of definable and measurable goals, enhanced partnerships, and major environmental initiatives. Current EPA documents define the overall mission as requiring an approximately 65 million pound annual reduction from existing nitrogen (N) loading to the Chesapeake Bay by 2025. Importantly, the 3 year compliance milestones established as a part of the compliance program will add both short-term and long-term accountability to state actions associated with reduced nutrient and sediment flows to the Chesapeake Bay.

As a result of the host of both short and long-term specific commitments and compliance deadlines, Bion believes that its long-term opportunity related to the Chesapeake Bay clean-up has potentially been significantly expanded and accelerated.

During 2008 Bion executed an agreement to install a Bion System at the Kreider Dairy in Lancaster County, Pennsylvania to reduce nitrogen (including ammonia emissions which are re-deposited as nitrogen from the atmosphere) and phosphorus in the farm's effluent. Bion undertook this project due in large part to Pennsylvania's nutrient credit trading program, which was established to provide cost-effective reductions of the excess flow of nutrients (nitrogen and phosphorus) into the Chesapeake Bay watershed. Bion worked extensively with the Pennsylvania Department of Environmental Protection ('PADEP') over the past two years to establish nutrient credit calculation/ verification methodologies that are appropriate to Bion's proven technology and recognizes its 'multi-media' (both water and atmospheric) approach to nutrient reductions. Pennsylvania's nutrient credit trading program allows for voluntary credit trading between a 'non-point source' (such as a dairy or other agricultural sources) and a 'point source' polluter, such as a municipal waste water treatment plant or a housing development. For example, pursuant to this program, since Bion can reduce the nutrients from an existing dairy much more cost-effectively than a municipal wastewater treatment plant can reduce nutrients to meet its baseline, a municipal facility can purchase nutrient reduction credits (Credits) from Bion to offset its nutrient discharges, rather than spending significantly more money to make (and operate) the plant upgrades necessary to achieve its own reductions.

During May 2008, the PADEP approved Bion's initial protocols to determine how many tradable nutrient (nitrogen and phosphorus) credits Bion will receive for nutrient reductions achieved through installation of its comprehensive dairy waste management technology in Phase 1 of the Kreider project pursuant to Pennsylvania's efforts under the Chesapeake Bay Program mandates (Phase 2 protocols, related to the operation and development of a renewable energy production facility to utilize Kreider s poultry manure and the cellulosic solids recovered by the Phase 1 System, have been submitted to the PADEP). During April 2010, the PADEP issued an amended certification. The PADEP's approval includes the certification of credits both for ammonia air emission reductions and for significantly reducing the leaching and runoff potential of land applied nutrients. The PADEP has certified the Phase 1 System at Kreider dairy for 107 nitrogen and 13 phosphorus credits (each credit represents an annual pound of reduction) for

each of the 1,200 dairy cows (subject to testing and verification after operations have been stabilized).

On January 26, 2009 the Board of the Pennsylvania Infrastructure Investment Authority (Pennvest) approved a $7.75 million loan to PA-1, a wholly-owned subsidiary of the Company, for the initial stage of Bion's Kreider Farms project. After substantial unanticipated delays, on August 12, 2010 the Company received a permit for construction of the Phase 1 Kreider system. Construction activities commenced during November 2010. The closing/settlement of the Pennvest Loan took place on November 3, 2010, and as of our June 30, 2011 fiscal year end, PA-1 submitted five requests for drawdowns/reimbursements from Pennvest totaling $6,749,019 of which Pennvest has held $337,451 as retainage pending completion of the project and has loaned PA-1 $6,411,568. From July 1, 2011 through September 12, 2011, PA-1 received additional draws/reimbursements of approximately $884,433 pursuant to the Pennvest Loan bringing the total to $7,296,001. Bion has substantially finished the construction of the Phase 1 Kreider System and entered a period of system operational shakedown during May 2011. It is anticipated that the Phase 1 Kreider System will be in full, stabilized operation by sometime in October 2011. The PADEP recently re-certified the nutrient reduction credits for this project. The Company anticipates that these Credits will be verified by the PADEP during the current fiscal year and that the Company will be able to sell these Credits (under a long term contract(s)) during the 2012 calendar year subject to continuing annual verification by the PADEP based on operating data for the Phase 1 Kreider System.

Bion's agreements with Kreider Farms provide for the Phase 1 System to expand through-put to treat the waste from the Kreider dairy support herd after the PADEP has verified the operating results. It is anticipated that this expansion will commence during 2012 and lead to a proportionate increase in credits generated for sale.

Additionally, the Kreider agreements provide for Bion to develop a renewable energy production facility to treat the waste from Kreider's approximately 4.6 million chickens ('Kreider Renewable Energy Facility' or Phase 2 Kreider Project). It is anticipated that the 'Kreider Renewable Energy Facility' will generate renewable energy (and potentially related renewable energy credits) through the combustion of the poultry wastes and the cellulosic biomass captured by Bion in the Phase 1 System. The Company continues its development work related to the details of the Phase 2 Kreider project. During May 2011 the PADEP certified Phase 2 Kreider Project for 559,457 nutrient credits under the old EPA s Chesapeake Bay model. The Company anticipates that the Phase 2 Kreider Project will be certified for between 1.5-2 million nutrient reduction credits (for treatment of the waste stream from Kreider s poultry) when it makes reapplication later during the 2012 fiscal year pursuant to the recently completed new EPA Chesapeake Bay model. Note that this project may be expanded in the future to treat wastes from other local and regional CAFOs. The Company hopes to have Phase 2 Kreider Project operational during the 2012 calendar year and hopes to sell the credits (under a long term contract(s)) during 2012 subject to continuing annual verification by the PADEP based on operating data from the Kreider Renewable Energy Facility. The review process to clarify certain issues related to credit calculation and verification is under way. The Company does not yet have financing in place for the Kreider Renewable Energy Facility. This opportunity is being pursued through PA-2.

Bion anticipates that the Kreider System and Kreider Renewable Energy Facility will generate revenue from the sale of nutrient Credits, renewable energy (and related credits) and potentially, in time, credits for the reduction of greenhouse gas emissions.

A 2008 independent study commissioned by the Pennsylvania State Senate estimates that capital costs of $1.4 billion plus $60 million annual operating costs (which yields an amortized average cost of approximately $28 per lb of nitrogen reduction per year) will be required to upgrade the municipal wastewater treatment plants in Pennsylvania to meet the initial standards then in place to meet the US EPA s programmatic mandates set by the Chesapeake Bay Program (which mandates appear to have been accelerated). Bion anticipates that it will be able to profitably sell nutrient credits from its Kreider facilities (and subsequent projects) for an annual total cost in the range of $8-$10 per lb of nitrogen reduction (roughly the equivalent of the projected municipal wastewater upgrade annual operating costs alone) thereby creating potential savings to Pennsylvania ratepayers of most of the $1.4 billion capital cost required for wastewater treatment plant nitrogen reduction upgrades, if Bion's technology were utilized to offset all of the required nitrogen reductions (which is not likely) under the Pennsylvania portion of the Chesapeake Bay Program.

Bion estimates that the overall market opportunity for Bion in the Chesapeake Bay watershed is large and of long duration. Most (if not all) of the publicly proposed new (or upgraded) municipal waste water and storm water treatment facilities in the Chesapeake Bay watershed in Pennsylvania, Maryland, Virginia and Washington, DC have projected costs (capital and operating) far in excess of the costs involved in reducing nutrients using Bion s Systems to treat CAFO wastes at the source. While regulatory and enforcement policy is still evolving and, therefore, the impact of those future policies upon Bion's operations cannot be precisely predicted and/or fully quantified, Bion believes that the tremendous difference between its cost to remove nutrients from a concentrated livestock manure waste stream and the cost required for reduction of nutrients from diluted conventional waste water and storm water treatment technologies makes it reasonable to believe that Bion's potential profitability from projects in the Chesapeake Bay watershed should be significant. Based on the aggregate size of livestock operations in the Chesapeake Bay watershed, Bion believes that the potential market for reductions in nitrogen loadings to the Chesapeake Bay watershed from livestock can be reasonably anticipated to increase tenfold (or more) to total in excess of 65 million (or more) pounds annually (including airborne ammonia) over the next decade with certified tradable nutrient credits potentially generated equaling 50% to 60% of that aggregate required nitrogen reduction. Bion hopes that some significant portion of the nutrient reductions related to this clean-up mandate will be made by Bion Systems (which portion cannot be reasonably estimated at this time).

Once the credits from the Kreider Farms Project are verified by the PADEP, we believe will become the first nutrient credits from multi-media (air and water) reductions from an unregulated, non-point source (livestock) technology-based project to be verified (including ammonia reductions). These credits will be equivalent to municipal wastewater treatment plant reductions. Further, we believe this will provide the basis for credit trading throughout the Chesapeake Bay watershed basin-wide (beyond just Pennsylvania where the credits are being generated to the other states and Washington, DC). An established basin-wide trading program will broaden the market for credits from smaller local watersheds to the entire Chesapeake Bay Watershed.

Bion also believes that it is reasonable to assume that the Chesapeake Bay Program strategies developed by the US EPA and various state regulatory agencies to address the issue of excess nitrogen loadings to the Chesapeake Bay watershed clean-up will be subsequently applied to deal with the much larger nutrient pollution problems of the Mississippi River Basin that are a primary cause of the 'Dead Zone' in the Gulf of Mexico and similar problems in the Great Lakes and elsewhere. The US EPA has stated the intention that the strategies being developed for the Chesapeake Bay will be utilized in the Mississippi River Basin and other watersheds in the U.S. The Mississippi River Basin alone has been estimated to require more than 1 billion pounds of annual nitrogen reduction to remediate the dead zone in the Gulf of Mexico. Applying the same metrics as above (Bion s ability to profitably provide nitrogen reductions at a cost of $8-10 per pound per year compared to municipal wastewater and storm water removal costs of $25 or higher per pound per year), using Bion-type solutions would represent a potential benefit in excess of $25 billion annually to tax- and rate-payers of the 31 Mississippi River Basin states and the federal government. We believe that Bion will potentially have large business opportunities for utilization of its technology as efforts to clean up such polluted areas develop, but at present such opportunities are not quantifiable nor can a definitive timeline be predicted.

Integrated Projects

Bion is focused on implementation of its integrated technology platform as the basis for development of its large-scale Integrated Projects. Bion will pursue this opportunity through our Projects Group subsidiary (and project specific subsidiaries/entities) which will act as the developer and manager of, and a direct participant in and/or owner of components of, the Projects. As such, Bion will:

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locate, secure and develop appropriate sites;

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negotiate agreements with participants including both input providers and end-product users;

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secure required permits and other approvals based upon clear standards that establish acceptable environmental operating parameters for each component of the Integrated Projects;

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manage construction and operation of its Systems and, possibly, other facilities within the Projects; and

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provide its waste treatment services to CAFO operators in the Projects for a fee while producing renewable energy for on-site use (including sale to the integrated biofuel and/or end product facilities) and/or third party sale, and, possibly, fine solids products for sale.

In turn, the CAFO operator will use the wet distiller grains from the ethanol plant as a feed component for the herd at a long-term competitive price. The CAFO facilities, which will be subject to permits imposing standards limiting their emissions and releases, can be owned either by the CAFO operator or by an independent third party finance source and subsequently leased to the CAFO operator. The CAFO operator will be responsible to provide its herd and operate the CAFO.

In some instances, Bion will own direct interests in the CAFO herd, ethanol plant, end-product user and/or the related facilities in addition to its ownership interest in the Bion System(s).

Bion has begun pre-development work on an Integrated Project planned to include a large-scale beef cattle finishing operation (in modules), a beef processing facility and an ethanol production facility to be located in Pennsylvania. The Company has begun discussions with various state and regional agencies in Pennsylvania regarding this potential Project. Limited progress has been made in the pre-development process to date because the Company has primarily focused its efforts on its two projects at Kreider Farms in Pennsylvania. However, the Company currently believes there is a significant likelihood that the Company will option land for an initial Integrated Project during the 2012 calendar year and move into the development process. In addition to the Pennsylvania beef cattle project, Bion has engaged in activities related to development of a similar Project to be located in upstate New York and has been in discussions with various local and state agencies in Nebraska regarding potential development of a large scale integrated dairy/cheese Integrated Project (which would be integrated with one or more existing ethanol plant(s)). Other locations are also under consideration for the Company s Integrated Projects. It is not possible at this time to firmly predict where the initial Project will be developed or the order in which Projects will be developed. All of these potential Projects are in very early pre-development stages and may never progress to actual development or may be developed after other Projects not yet under active consideration.

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Bion's current preliminary plans call for an initial beef-based Project to include up to approximately 72,000 beef cattle (in modules) integrated with a dedicated (existing or new) slaughter and cooking (further processing) facility and an ethanol plant (existing or newly constructed). Bion anticipates that renewable energy produced from the cellulosic biomass that Bion's technology recovers from the livestock waste stream will replace most (if not all) of the fossil fuel needs of the ethanol production and other integrated facilities. Bion estimates that the basic capital expense

for the such a Project (if all integrated facilities are newly built) will be not less than $200 million and that the Project, if developed (in a greenfield manner), will result in the creation of 350 to 400 (or more) permanent long term jobs in the immediate region.

Note that our initial Project has not yet emerged from the pre-development phase, no land or permits for the Project have been acquired, Bion has no commitments from anyone related to financing or participation in this Project, and that no such Project has yet been developed by Bion (or others). Notwithstanding the foregoing items, Bion anticipates that it may option land and commence the actual development phase during 2012.

In addition to the initial beef cattle Projects described above, Bion has been in discussions with various local and state agencies in Nebraska and elsewhere regarding potential development of large scale integrated beef and/or dairy/cheese Integrated Projects that would require capital expense estimated to be in the range of $120 million to in excess of $750 million and would potentially generate 300 or more full time, permanent jobs for beef-based projects and 700 to 850 full time, permanent jobs for dairy/cheese based projects. A dairy/cheese-based Project would integrate multiple, newly constructed, very large-scale dairy complexes with a new dedicated milk processing/cheese production facility and, most likely, one or more existing ethanol production facilities. Preliminary plans under discussion involve up to 80,000 milking cows (requiring approximately 140,000 total head including the dairy support herd and steers) to be located on multiple satellite farms with waste treated by Bion's technology to assure environmental compliance and to produce renewable energy for use in the integrated facilities to replace fossil fuel requirements. Bion has been involved in very preliminary discussions regarding such a dairy/cheese project with Nebraska state development officials, as well as a large, international cheese producer/distributor and major dairy industry participants. These potential Projects are in very early discussion stages.

In addition, Bion has had preliminary discussions with several nationally and internationally-known food producers, processors, and distributors, regarding use of its technology to develop Projects which integrate new livestock herds with both existing and new processing facilities in order to improve their economic efficiencies, reduce environmental impacts and carbon footprint, produce branding opportunities and address food-safety concerns.

At present it is not possible to determine whether any of the Projects referred to above will move to the development phase, will actually be developed and constructed, or precisely what, if any, the economic returns and/or profitability for such Integrated Projects (and/or for Bion in connection therewith) will be, due to the early pre-development stage of each Project and numerous known and unknown variables related to future financing and partnering terms, as well as the availability of existing and proposed economic development incentive plans for which such Projects may qualify. However, Bion strongly believes that the economic efficiencies of these closed loop Integrated Projects will potentially increase the annual returns by 5 percentage points (or more) over the existing dairy/livestock/food industry metrics. In basic commodity businesses such as food products and ethanol production, such an increase, if realized, represents a very significant economic advantage which Bion believes will result in advantageous financing terms and in clearly superior profitability for its Integrated Projects.

RECENT FINANCINGS

Series B Convertible Preferred Stock (2009)

On July 29, 2009 the Company concluded a private offering in which we sold 28,170 shares of our Series B Convertible Preferred Shares ('Series B Preferred Shares') and received net proceeds of approximately $2,450,000 after commissions and offering expenses. The Company sold 21,320 Series B Preferred Shares through June 30, 2009 for net proceeds of approximately $1,854,840 with the balance sold thereafter. The Series B Preferred Shares pay a dividend of 2.5% per quarter (pro-rated), are convertible into our common shares at $2.00 per share and will be redeemed at 3 years if not previously converted.

Series C Convertible Preferred Stock (2010)

During April 2010 the Company concluded a private offering in which we sold 15,400 shares of its Series C Convertible Preferred Shares ('Series C Preferred Shares') and received net proceeds of approximately $1,339,800 after commissions and offering expenses. The Company sold 2,600 Series C Preferred Shares through June 30, 2010 in a second offering for net proceeds of approximately $226,200. Through final closing on September 17, 2010 an additional 4,800 shares of Series C Preferred Stock were sold for net proceeds of approximately $417,600 for total net proceeds of approximately $643,800 from the sale of 9,350 shares of Series C Preferred Stock in the second offering. The Company has 32,150 shares of Series C Preferred Stock outstanding as of September 20, 2011. The Series C Preferred Shares pay a dividend of 2.5% per quarter (pro-rated), are convertible into our common shares at $4.00 per share. The Company has the right to call for the redemption of the Preferred Shares one year after the issuance of the initial Series C Preferred Shares and, if Bion initiates such a call for redemption, the holders of the Preferred Shares have the right to convert the Preferred Shares to common stock prior to such redemption.

Sales of Common Stock during 2010 and 2011 Fiscal Years

During the fiscal year ended June 30, 2010 the Company sold 8,769 shares, in aggregate, of its restricted common stock for $13,153 of cash (net proceeds). Additionally the Company issued 306,990 shares of its restricted common stock, in aggregate, for $511,527 of services. The Company also issued 315,449 shares, in aggregate, of its restricted common stock in conversion of $255,010 of its debt to equity.

During the fiscal year ended June 30, 2011, the Company sold 311,746 shares of its common stock for net proceeds of $813,200. Also during the year ended June 30, 2011, the Company sold 306,000 units at $2.50 per unit, and received proceeds of $765,000. Each unit consisted of one share of the Company s restricted common stock and one warrant to purchase half of a share of the Company s restricted common stock at $3.00 per share until December 31, 2016. Additionally the Company issued 337,715 shares of its common stock, in aggregate, for $1,081,172 of services.

COMPETITION

There are a significant number of competitors in the waste treatment industry who are working on animal related pollution issues. This competition is increasing with the growing governmental and public concern focused on pollution due to CAFO wastes. Waste treatment lagoons which depend on anaerobic microorganisms ("anaerobic lagoons") are the most common traditional treatment process for animal waste on large farms within the swine and dairy industries. Additionally, many beef feedlots, poultry facilities and dairy farms simply scrape and accumulate manure for later field application. Both lagoon and scrape/pile manure storage approaches are coming under increasing regulatory pressure due to associated odor, nutrient management and water quality issues and are facing possible phase-out in some states. Although we believe that Bion has the most economically and technologically viable solution for the current problems, other alternative (though partial) solutions do exist including, for example, synthetic lagoon covers (which are placed on the top of the water in the lagoon to trap the gases), methane digesters (a tank which uses anaerobic microorganisms to break down the waste to produce methane), multistage anaerobic lagoons and solids separators (processes which separate large solids from fine solids). Additionally, many efforts are underway to develop and test new technologies.

Our ability to compete is dependent upon our ability to obtain required approvals and permits from regulatory authorities and upon our ability to introduce and market our Systems in the appropriate industry and geographic segments.

There is also extensive competition in the livestock, ethanol production, biomass renewable energy, organic soil amendment/fertilizer/ organic fertilizer and feed ingredient markets. There are many companies that are already selling products to satisfy demand in the sectors of these markets we are trying to enter. Many of these companies have established marketing and sales organizations and customer commitments, are supporting their products with advertising, sometimes on a national basis, and have developed brand name recognition and customer loyalty in many cases.

Additionally, a number of companies have discussed and/or attempted to implement some version of closed loop integrated projects , including without limitation, Panda Ethanol, E3 BioFuels and Prime BioSolutions, and are, or have in the past, pursued, with limited success to date, the development of various forms of such projects which combine CAFOs and ethanol plants and utilize the CAFO waste stream to produce energy for the ethanol plant and the CAFO herd to consume the distillers grain by-product of the ethanol production. While a very limited number of entities (including those named above) have announced projects and/or solutions that sound similar to the Company's

Integrated Projects with limited success to date, there appear to be significant differences including without limitation, the use of technology that is based on either manure 'gasification' or capturing methane from the waste stream using anaerobic digesters (ADs), which technologies do not reduce polluting nutrient releases and/or gaseous emissions in the manner or to the extent that Bion's technology reduces such negative environmental impacts. Further, although ADs do produce methane that can be used to replace some or all of the natural gas requirement of an ethanol plant, the AD process produces only about one third of the energy per animal that Bion believes will be produced by its technology platform from the biomass extracted from the CAFO waste stream based on Bion's internal analysis. None of the technologies of which the Company is aware appear to represent solutions to the nutrient and atmospheric environmental problems of CAFOs addressed by Bion's technology, or have any independent data supporting claimed environmental benefits, and, therefore, the Company believes that their potential projects will be limited to locations in which CAFOs have already been permitted and limited to the existing CAFO size.

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DEPENDENCE ON ONE OR A FEW MAJOR CUSTOMERS

In our Integrated Projects business segment, we will most likely be dependent upon one or a few major customers/partners/joint venturers since a limited number of Integrated Projects will be developed. We anticipate initially developing, owning interests in, and operating only one or a few fully Integrated Projects commencing during 2012, and, thereafter, developing a limited number of Projects at a time. Thus, at least for the near future, our revenues will be dependent on a relatively small number of major Projects, participants and/or customers.

In our CAFO retrofit/remediation business segment, we currently have only one operating System and contracts with only a single party. However, there are thousands of CAFO s in the United States and we anticipate that in the future we will have agreements with many CAFO customers.

PATENTS

We are the sole owner of five currently active United States patents (numbered below), one United States Patent granted awaiting issue/publication, one Australian patent, one Canadian patent, one patent from New Zealand and two patents from Mexico:

1*

U.S. Patent No. 6,689,274, Low Oxygen Waste Bioconversion System; expires June 2021.

2*

U.S. Patent No. 6,908,495, extension of Low Oxygen Waste Bioconversion System; expires May 2021.

3*

U.S. Patent No. 7,431,839 - 10/7/08: Low Oxygen Biologically Mediated Nutrient Removal; expires December 2021.

4*

U.S. Patent No. 7,575, 685 - 8/18/09: Low Oxygen Biologically Mediated Nutrient Removal; expires February 2021.

5*

U.S. Patent No. 7,879,589 2/1/11: Micro-Electron Acceptor Phosphorous Accumulating Organisms; expires February2021.

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U.S. Patent Application Granted (awaiting issue/publication) Application No. 13/016,121 7/21/11: Micro-Electron Acceptor Phosphorous Accumulating Organisms; expires February 2021.

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Australian Patent No. 2002227224, Low Oxygen Organic Waste Bioconversion System; expires November 8, 2021.

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Canadian Patent No. 1,336,623, Aqueous Stream Treatment Process; expires August 2012.

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New Zealand Patent No. 526,342, Low Oxygen Organic Waste Bioconversion System; expires November 8, 2021.

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Mexican Patent No. 240,124, Low Oxygen Organic Waste Bioconversion System; expires November 8, 2021.

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Mexican Patent No. 263,375, Low Oxygen Organic Waste Bioconversion System; expires November 8, 2021.

US Pending:

On November 3, 2006, we filed a patent application titled "Environmentally Compatible Integrated Food and Energy Production System." The application number is 11/592,511.

On February 25, 2010, we filed a patent application titled "Method for Treating Nitrogen in Waste Streams." The application number is 12/713,011.

Canadian Pending:

On November 8, 2001, we filed a patent application titled "Low Oxygen Organic Waste Bioconversion System." The application number is 2428417. First office action was received on April 9, 2010.

On April 18, 2005, we filed a patent application titled "Low Oxygen Biologically Mediated Nutrient Removal." The application number is 2503166. First office action was received on August 31, 2010.

European Union Pending:

On November 8, 2001, we filed a patent application titled "Low Oxygen Organic Waste Bioconversion System." The application number is 1993586.5. First office action was received on June 8, 2010.

In addition to such factors as innovation, technological expertise and experienced personnel, we believe that a strong patent position is increasingly important to compete effectively in the businesses on which we are focused. It is likely that we will file applications for additional patents in the future. There is, however, no assurance that any such patents will be granted.

It may become necessary or desirable in the future for us to obtain patent and technology licenses from other companies relating to technologies that may be employed in future products or processes. To date, we have not received notices of claimed infringement of patents based on our existing processes or products, but due to the nature of the industry, we may receive such claims in the future.

We generally require all of our employees and consultants, including our management, to sign a non-disclosure and invention assignment agreements upon employment with us.

RESEARCH AND DEVELOPMENT

During the years ended June 30, 2011 and June 30, 2010, respectively, we expended approximately $637,000 and $194,000 (including non-cash stock-based compensation) on research and development activities related to our technology platform applications in support of large-scale, economically and environmentally sustainable Integrated Projects and remediation activities. Bion's main efforts were directed at further refinement of our technology and its applications. In addition, substantial research and development activity was focused on design and refinement of all aspects of the technology and integration engineering related to the energy balances, renewable energy production and on-site utilization, related to Integrated Project issues and our business model. Research activities have focused on factors related to renewable energy production from CAFO waste including coarse solid recovery, drying and use for renewable energy production, as well as fine solids recovery, drying and utilization as fertilizer and/or animal feed. The sums expended on research and development were focused on substantially the same areas as in the prior year but were reduced compared to the years prior to 2009 due to the fact that during the subsequent years a greater portion of the Company's activities were focused on commercialization and business development based on our technology.

Environmental Protection/Regulation and Public Policy

In regards to development of Projects, we will be subject to extensive environmental (and other) regulations related to CAFO's, ethanol production and end product producers. To the extent that we are a provider of systems and services to others that result in the reduction of pollution, we are not under direct enforcement or regulatory pressure. However, we are involved in the business of CAFO waste treatment and are impacted by environmental regulations in at least four different ways:

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Our marketing and sales success depends, to a substantial degree, on the pollution clean-up requirements of various governmental agencies, from the Environmental Protection Agency (EPA) at the federal level to state and local agencies;

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Our System design and performance criteria must be responsive to the changes in federal, state and local environmental agencies' effluent and emission standards and other requirements;

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Our System installations and operations require governmental permits and/or other approvals in many jurisdictions; and

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To the extent we own or operate Integrated Projects including CAFO facilities and ethanol plants, those facilities will be subject to environmental regulations.

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Additionally, our activities are affected by many public policies and regulations (federal, state and local) related to other industries such as CAFO agriculture, municipal waste and storm water treatment, and others. For example, the differences in the regulatory requirements for agriculture and municipal waste water clean-up currently in place negatively impair the development of viable markets for nutrient reduction credits.

EMPLOYEES

As of September 15, 2011, we had 12 employees and primary consultants, 10 of whom are performing services for the Company on a full-time basis and 2 of whom provide consulting services to the Company on a part-time basis. Our future success depends in significant part on the continued service of our key technical and senior management personnel and the ability to hire additional qualified personnel. The competition for highly qualified personnel is intense, and there can be no assurance that we will be able to retain our key managerial and technical employees or that we will be able to attract and retain additional highly qualified technical and managerial personnel in the future. None of our employees is represented by a labor union, and we consider our relations with our employees to be good. None of our employees is covered by "key person" life insurance.

ITEM 1A. RISK FACTORS.

Not applicable.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

Not applicable.

ITEM 2. PROPERTIES.

The Company maintains its corporate office at Box 566/1774 Summitview Way, Crestone, Colorado 81131, the office of its President, and its main corporate telephone number is: (212) 758-6622. The Company remains responsible for its former corporate offices at 641 Lexington Ave, New York, New York 10022 which are currently subleased to Mr. Salvatore Zizza, former Chairman and director of the Company's Integrated Projects subsidiary. These offices are leased pursuant to a non-cancellable operating lease that became effective on August 1, 2006 and expires on November 30, 2013. The average monthly rental for the balance of the term of the lease is $15,820. The master sub-lease with Mr. Zizza, presently not an affiliate of the Company, pays the Company's entire obligations under this lease through November 30, 2013.

The Company is the sole owner of five currently active United States patents, one United States Patent granted awaiting issue/publication, one Australian patent, one Canadian patent, one patent from New Zealand and two patents from Mexico.

Two U.S. patent applications have been filed and are pending and two applications are pending in Canada and one application is pending in the European Union.

ITEM 3. LEGAL PROCEEDINGS.

The Company is not currently involved in any material litigation.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

PART II

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

(a) **Market Information**

Our common stock is quoted on the Over-The-Counter Electronic Bulletin Board under the symbol "BNET." The following quotations reflect inter dealer prices, without retail mark up, markdown or commissions and may not represent actual transactions.

	2011		2010	
Fiscal Year Ended June 30,	High	Low	High	Low
First Fiscal Quarter	$2.70	$1.25	$2.72	
Net increase (decrease) in cash and cash equivalents	110,914		(40,601)	
Cash and cash equivalents at beginning of the period	487,084		549,217	
Cash and cash equivalents at end of the period	$ 597,998		$ 508,616	

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries (Red Hat or the Company) is a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, middleware, virtualization, 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, the Company does not recognize revenue from the licensing of the code itself. The Company provides value to its customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of its Red Hat enterprise technologies, and by providing a level of performance, reliability, scalability, flexibility, stability and security for the enterprise technologies the Company packages and distributes. Moreover, because communities of developers not employed by the Company assist with the creation of the Company s open source offerings, opportunities for further innovation of the Company s offerings are supplemented by these communities.

The Company derives its revenue and generates cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat enterprise technologies. The arrangements with the Company s customers that produce this revenue and cash are explained in further detail in NOTE 2 Summary of Significant Accounting Policies contained in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2013.

NOTE 2 Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three months ended May 31, 2013 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, consolidated other comprehensive income and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three months ended May 31, 2013 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2014. 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, 2013.

There have been no changes to the Company s significant accounting policies from those described in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2013. These unaudited financial statements should be read in conjunction with such Annual Report on Form 10-K.

Certain reclassifications have been made to the prior year s financial statements to conform to the current year s presentation.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Consolidation Policy

The accompanying Consolidated Financial Statements include the accounts of the Company and all of its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. There are no significant foreign exchange restrictions on the Company s foreign subsidiaries.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from such estimates.

Recent Accounting Pronouncements

In March 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2013-05, *Foreign Currency Matters (Topic 830) Parent s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity* (ASU 2013-05), which requires a parent entity to release a related foreign entity s cumulative translation adjustment into net income only if its sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. ASU 2013-05 is effective prospectively for the Company in the first quarter of its fiscal year ending February 28, 2015. The Company does not believe that this updated standard will have a material impact on its consolidated financial statements.

NOTE 3 Changes in Equity

The following table summarizes the changes in the Company s stockholders equity, including other comprehensive income, during the three months ended May 31, 2013 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at February 28, 2013	$ 23	$ 1,802,899	$ 541,880	$ (816,674)	$ (7,967)	$ 1,520,161
Net income			40,391			40,391
Foreign currency translation adjustment					(3,617)	(3,617)
Unrealized gain (loss) on securities during period, net of tax					(359)	(359)
Reclassification for gain recognized in other income during period					(285)	(285)
Exercise of common stock options		453				453
Common stock repurchase (see NOTE 10)				(179,336)		(179,336)
Share-based compensation expense		23,131				23,131
Tax benefits related to share-based awards		3,751				3,751
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of		(10,983)				(10,983)

employee share-based awards

Balance at May 31, 2013	$ 23	$ 1,819,251	$ 582,271	$ (996,010)	$ (12,228)	$ 1,393,307

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity, including other comprehensive income, during the three months ended May 31, 2012 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at February 29, 2012	$ 23	$ 1,709,082	$ 391,676	$ (696,012)	$ (5,952)	$ 1,398,817
Net income			37,461			37,461
Foreign currency translation adjustment					(9,321)	(9,321)
Unrealized gain (loss) on securities during period, net of tax					46	46
Reclassification for gain recognized during period					(364)	(364)
Exercise of common stock options		3,890				3,890
Common stock repurchase (see NOTE 10)				(30,011)		(30,011)
Share-based compensation expense		22,206				22,206
Tax benefits related to share-based awards		11,829				11,829
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(18,832)				(18,832)
Balance at May 31, 2012	$ 23	$ 1,728,175	$ 429,137	$ (726,023)	$ (15,591)	$ 1,415,721

NOTE 4 Identifiable Intangible Assets

Identifiable intangible assets consist primarily of purchased technologies, customer and reseller relationships, trademarks, copyrights and patents and covenants not to compete which are amortized over the estimated useful life, generally on a straight-line basis with the exception of customer and reseller relationships which are generally amortized over the greater of straight-line or the related asset s pattern of economic benefit. Useful lives range from three to ten years. As of May 31, 2013 and February 28, 2013, trademarks with an indefinite estimated useful life totaled $9.2 million and $9.3 million, respectively. The following is a summary of identifiable intangible assets (in thousands):

	May 31, 2013			February 28, 2013		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$ 96,287	$ (29,535)	$ 66,752	$ 94,020	$ (27,412)	$ 66,608
Purchased technologies	79,157	(48,912)	30,245	79,201	(46,507)	32,694
Customer and reseller relationships	89,953	(55,541)	34,412	89,959	(53,391)	36,568
Covenants not to compete	10,483	(4,579)	5,904	10,516	(4,143)	6,373
Total identifiable intangible assets	$ 275,880	$ (138,567)	$ 137,313	$ 273,696	$ (131,453)	$ 142,243

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Amortization expense associated with identifiable intangible assets recognized in the Company s Consolidated Financial Statements for the three months ended May 31, 2013 and May 31, 2012 is summarized as follows (in thousands):

	Three Months Ended	
	May 31, 2013	May 31, 2012
Cost of revenue	$ 2,672	$ 669
Sales and marketing	1,958	2,076
Research and development	959	959
General and administrative	1,537	1,144
Total amortization expense	$ 7,126	$ 4,848

NOTE 5 Income Taxes

Income Tax Expense

The following table summarizes the Company s tax provision for the three months ended May 31, 2013 and May 31, 2012:

	Three Months Ended	
	May 31, 2013	May 31, 2012
Provision for income taxes:		
Income before provision for income taxes	$ 57,701	$ 55,089
Estimated annual effective tax rate on current year ordinary income	30%	32%
Provision for income taxes	$ 17,310	$ 17,628

For the three months ended May 31, 2013, the Company s estimated annual effective tax rate of 30% differs from the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates and the U.S. federal research tax credit. For the three months ended May 31, 2012, the Company s annual effective tax rate of 32% differed from the U.S. federal statutory rate of 35% principally due to foreign income taxed at lower rates.

Deferred Taxes

As of May 31, 2013, deferred tax assets (current and non-current) totaled $85.8 million, of which $0.5 million was offset by a valuation allowance. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign net operating loss (NOL) carryforwards.

As of May 31, 2013, the Company had U.S. federal and state NOL carryforwards of approximately $22.4 million and $111.9 million, respectively. As of May 31, 2013, the Company had U.S. federal and state research tax credit carryforwards of approximately $30.1 million and $9.3 million, respectively. The tax credit carryforwards are scheduled to expire in varying amounts beginning in the fiscal year ending February 28, 2019.

Unrecognized tax benefits

The Company s unrecognized tax benefits were $49.0 million as of May 31, 2013 and $48.3 million as of February 28, 2013. The Company s unrecognized tax benefits at May 31, 2013 and February 28, 2013, which, if recognized, would affect the Company s effective tax rate were $46.6 million and $45.3 million, respectively.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

During the three months ended May 31, 2013, the amount of unrecognized tax benefits increased $0.7 million, primarily as a result of increases with respect to tax positions taken during prior periods. The results and timing of the resolution of tax audits is highly uncertain and the Company is unable to estimate the range of possible changes to the balance of unrecognized tax benefits. However, the Company does not currently expect that within the next 12 months the total amount of unrecognized tax benefits will significantly increase or decrease. It is the Company s policy to recognize interest and penalties related to uncertain tax positions as income tax expense. Accrued interest and penalties related to unrecognized tax benefits totaled $4.9 million and $4.2 million as of May 31, 2013 and February 28, 2013, respectively.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The following table summarizes the tax years in the Company s major tax jurisdictions that remain subject to income tax examinations by tax authorities as of May 31, 2013. Due to NOL carryforwards, in some cases the tax years continue to remain subject to examination with respect to such NOLs.

Tax Jurisdiction	Years Subject to Income Tax Examination	
U.S. federal	1994	Present
North Carolina	1999	Present
Ireland	2008	Present
Japan	2012	Present

With respect to Japan, the Company has been examined for income tax for years through February 28, 2011. A tax examination was concluded in the fiscal year ended February 29, 2012 with no significant adjustments resulting. However, the statute of limitations remains open for five years.

The Company is currently undergoing an income tax examination by the U.S. Internal Revenue Service with respect to its fiscal year ended February 28, 2010. The Company is also undergoing an income tax examination in India.

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

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

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

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

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

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

Unrealized gains and temporary losses on investments classified as available for sale are included within accumulated other comprehensive income, net of any related tax effect. Upon realization, such amounts are reclassified from accumulated other comprehensive income to other income, net. Realized gains and losses and other than temporary impairments, if any, are reflected in the statements of operations as other income, net. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other-than-temporary. The vast majority of the Company s investments are 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, the Company assesses other factors to determine the security s market value, including broker quotes or model valuations. Independent price verifications of all holdings are performed by pricing vendors which are then reviewed by the Company. In the event a price fails a pre-established tolerance check, it is researched so that the Company can assess the cause of the variance to determine what the Company believes is the appropriate fair market value.

The Company minimizes its credit risk associated with investments by investing primarily in investment grade, liquid securities. The Company s policy is designed to limit exposures to any one issuer depending on credit quality. Periodic evaluations of the relative credit standing of those issuers are considered in the Company s investment strategy.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities at May 31, 2013 (in thousands):

	As of May 31, 2013	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money markets (1)	$ 183,694	$ 183,694	$	$
Interest-bearing deposits (1)	70,855		70,855	
Available-for-sale securities (1):				
Commercial paper	26,983		26,983	
U.S. agency securities	266,072		266,072	
Corporate securities	276,683		276,683	
Foreign government securities	16,680		16,680	
Foreign currency derivatives (2)	5		5	
Liabilities:				
Foreign currency derivatives (3)	(128)		(128)	
Total	$ 840,844	$ 183,694	$ 657,150	$

(1) Included in either Cash and cash equivalents or Investments in debt and equity securities in the Company s Consolidated Balance Sheet at May 31, 2013, in addition to $387.3 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet at May 31, 2013.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet at May 31, 2013.

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities at February 28, 2013 (in thousands):

	As of February 28, 2013	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money markets (1)	$ 143,680	$ 143,680	$	$
Interest-bearing deposits (1)	123,518		123,518	
Available-for-sale securities (1):				
Commercial paper	54,483		54,483	
U.S. agency securities	359,993		359,993	
Corporate securities	312,691		312,691	
Foreign government securities	26,869		26,869	

Equity securities (1)	274	274		
Foreign currency derivatives (2)	280		280	
Liabilities:				
Foreign currency derivatives (3)	(219)		(219)	
Total	$ 1,021,569	$ 143,954	$ 877,615	$

(1) Included in either Cash and cash equivalents or Investments in debt and equity securities in the Company s Consolidated Balance Sheet at February 28, 2013, in addition to $296.9 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet at February 28, 2013.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet at February 28, 2013.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table represents the Company s investments measured at fair value as of May 31, 2013 (in thousands):

	Amortized Cost	Gross Unrealized		Aggregate Fair Value	Balance Sheet Classification		
		Gains	Losses(1)		Cash Equivalent Marketable Securities	Short-term Marketable Securities	Long-term Marketable Securities
Money markets	$ 183,694	$	$	$ 183,694	$ 183,694	$	$
Interest-bearing deposits	70,855			70,855		70,855	
Commercial paper	26,983			26,983	26,983		
U.S. agency securities	266,760	66	(754)	266,072		23,479	242,593
Corporate securities	275,661	1,184	(162)	276,683		144,624	132,059
Foreign government securities	16,730		(50)	16,680		16,680	
Total	$ 840,683	$ 1,250	$ (966)	$ 840,967	$ 210,677	$ 255,638	$ 374,652

(1) As of May 31, 2013, there were less than $0.1 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

The following table represents the Company s investments measured at fair value as of February 28, 2013 (in thousands):

	Amortized Cost	Gross Unrealized		Aggregate Fair Value	Balance Sheet Classification		
		Gains	Losses(1)		Cash Equivalent Marketable Securities	Short-term Marketable Securities	Long-term Marketable Securities
Money markets	$ 143,680	$	$	$ 143,680	$ 143,680	$	$
Interest-bearing deposits	123,518			123,518		123,518	
Commercial paper	54,483			54,483	39,498	14,985	
U.S. agency securities	360,060	136	(203)	359,993	7,041	54,485	298,467
Corporate securities	311,561	1,262	(132)	312,691		172,250	140,441
Foreign government securities	26,902	2	(35)	26,869		26,869	
Equity securities	6	268		274		274	
Total	$ 1,020,210	$ 1,668	$ (370)	$ 1,021,508	$ 190,219	$ 392,381	$ 438,908

(1)

As of February 28, 2013, there were less than $0.1 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

NOTE 7 Derivative Instruments

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. The Company from time to time enters into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable,

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded on the Consolidated Balance Sheets at their respective fair market values. The Company has elected not to prepare and maintain the documentation required to qualify for hedge accounting treatment and, therefore, changes in fair value are recorded in the Consolidated Statements of Operations.

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of May 31, 2013 and for the three months then ended (in thousands):

	As of May 31, 2013			Three Months Ended May 31, 2013	
	Balance Sheet Location	Fair Value	Notional Value	Location of Gain (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 5	$ 16,045	Other income (expense), net	$ 325
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	$ (128)	$ 13,735	Other income (expense), net	$ (1,815)
TOTAL		$ (123)	$ 29,780		$ (1,490)

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of May 31, 2012 and for the three months then ended (in thousands):

	As of May 31, 2012			Three Months Ended May 31, 2012	
	Balance Sheet Location	Fair Value	Notional Value	Location of Gain (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 133	$ 13,747	Other income (expense), net	$ 279
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	$ (248)	$ 20,920	Other income (expense), net	$ (709)
TOTAL		$ (115)	$ 34,667		$ (430)

The aggregate notional amount of outstanding forward contracts at February 28, 2013 was $65.5 million. The fair value of these outstanding contracts at February 28, 2013 was a gross $0.3 million asset and a gross $0.2 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively, on the Consolidated Balance Sheets.

NOTE 8 Share-based Awards

The Company measures share-based compensation cost at grant date, based on the estimated fair value of the award and recognizes the cost over the employee requisite service period typically on a straight-line basis, net of estimated forfeitures. The Company estimates the fair value of stock options using the Black-Scholes-Merton valuation model. The fair value of nonvested share awards, nonvested share units and performance share units are measured at their underlying closing share price on the day of grant.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the three months ended May 31, 2013 and May 31, 2012 (in thousands):

	Three Months Ended	
	May 31, 2013	May 31, 2012
Cost of revenue	$ 2,840	$ 2,165
Sales and marketing	9,375	7,362
Research and development	6,881	6,812
General and administrative	4,035	5,867
Total share-based compensation	$ 23,131	$ 22,206

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months ended May 31, 2013 and May 31, 2012. Accordingly, no share-based compensation expense was capitalized during the three months ended May 31, 2013 and May 31, 2012.

Estimated annual forfeitures An estimated forfeiture rate of 10.0% per annum, which approximates the Company s historical rate, was applied to options and nonvested share units. Awards are adjusted to actual forfeiture rates at vesting. The Company reassesses its estimated forfeiture rate annually or when new information, including actual forfeitures, indicate a change is appropriate.

During the three months ended May 31, 2013, the Company granted the following share-based awards:

	Three Months Ended May 31, 2013	
	Shares and Shares Underlying Awards	Weighted Average Per Share Fair Value
Stock options	47,141	$ 13.74
Service-based shares and share units	945,325	$ 51.28
Performance share units target (1)	335,724	$ 47.86
Performance share awards (2)	138,330	$ 47.86
Total awards	1,466,520	$ 48.97

(1) On May 22, 2013, the Compensation Committee of the Company s Board of Directors (the Compensation Committee) approved the performance objectives to be used with, and authorized the grant of, performance share units (PSUs) in FY2014 with payouts based on the Company s financial performance according to a formula specified in, and subject to the terms and conditions of, the form of financial performance-based PSU award agreement approved by the Compensation Committee on May 22, 2013 (the Operating Performance PSU Agreement). On the same date, the Compensation Committee approved the performance objective to be used with, and authorized the grant of, PSUs in FY2014 with payouts based on the total shareholder return provided by the Company s common stock according to a

formula specified in, and subject to the terms and conditions of, the form of total shareholder return performance-based PSU award agreement approved by the Compensation Committee on May 22, 2013 (the TSR Performance PSU Agreement). Under the Operating Performance PSU Agreement, an executive will be granted an award for a target number of PSUs, and depending on the Company s financial performance measured against the financial performance of specified peer companies during the three-year performance period, the executive may earn up to 200% of the target number of PSUs (the Maximum PSUs) over a period with two separate performance segments. The first segment measures performance at the end of the second fiscal year within

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

the performance period against performance in the base year. The second segment measures performance at the end of the third fiscal year of the performance period against the base year. Up to 50% of the Maximum PSUs may be earned in respect of the first performance segment and up to 100% of the Maximum PSUs may be earned in respect of the second performance segment, less the amount earned in respect of the first performance segment. Under the TSR Performance PSU Agreement, an executive will be granted an award for a target number of PSUs, and depending on the Company s total shareholder return performance over a thirty-six month period beginning on March 1, 2013 (the TSR Performance Period), the executive may earn up to 200% of the target number of PSUs. The number of PSUs earned, according to the formula specified in the TSR Performance PSU Agreement, will be determined based on the Company s total shareholder return performance measured against the total shareholder return of specified peer companies during the TSR Performance Period. Stock price performance is measured by the change in the average price of common stock calculated over the ninety-day periods ending at both the beginning and the end of the TSR Performance Period. Total shareholder return is determined by measuring stock price performance plus any cash dividends payable with respect to a record date set, and not rescinded, within the TSR Performance Period.

(2) On May 22, 2013, the Compensation Committee approved the performance objective to be used with, and authorized the grant of, restricted stock awards (RSAs) in FY2014 subject to the terms and conditions of the form of RSA award agreement approved by the Compensation Committee on May 22, 2013 (the RSA Agreement). Under the RSA Agreement, an executive is awarded shares of the Company s common stock subject to achievement of a specified dollar amount of revenues established by the Committee as the performance objective for FY2014 (the RSA Performance Goal). If the Company fails to achieve the RSA Performance Goal for FY2014, then all shares of restricted stock subject to the award are forfeited. If the Company achieves the RSA Performance Goal for FY2014, 25% of the restricted stock vests on July 16, 2014, and the remainder vests ratably on a quarterly basis over the course of the subsequent three year period, provided that the executive s business relationship with the Company has not ceased.

NOTE 9 Earnings Per Share

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

The following table reconciles the numerators and denominators of the earnings per share calculation for the three months ended May 31, 2013 and May 31, 2012 (in thousands, except per share amounts):

	Three Months Ended	
	May 31, 2013	May 31, 2012
Net income, basic and diluted	$ 40,391	$ 37,461
Weighted average common shares outstanding	191,114	192,947
Incremental shares attributable to assumed vesting or exercise of outstanding equity awards shares	1,855	2,990
Diluted shares	192,969	195,937
Diluted net income per share	$ 0.21	$ 0.19

The following shares awards are not included in the computation of diluted earnings per share because the aggregate value of proceeds considered received upon either exercise or vesting were greater than the average

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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	
	May 31, 2013	May 31, 2012
Number of shares considered anti-dilutive for calculating diluted EPS	315	133

NOTE 10 Share Repurchase Program

Between March 1, 2013, and April 15, 2013, the Company repurchased an aggregate of 3,648,575 shares of its common stock for $179.3 million. These repurchases were made pursuant to the Company s repurchase program previously announced on March 28, 2012, and completed the repurchases authorized under such program.

On April 15, 2013, the Company announced that its Board of Directors has authorized the repurchase of up to $300.0 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program, which replaced the previously completed repurchase program, commenced on April 16, 2013, and will expire on the earlier of (i) March 31, 2015, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program.

As of May 31, 2013, the amount available under the program for the repurchase of the Company s common stock was $300.0 million.

NOTE 11 Segment Reporting

The following summarizes revenue from unaffiliated customers and income (loss) from operations for the three months ended May 31, 2013 and May 31, 2012 and total cash, cash equivalents and available-for-sale investment securities and total assets as of May 31, 2013 and May 31, 2012 by geographic segment (in thousands):

	Americas	EMEA	Asia Pacific	Corporate (1)	Total
	Three Months Ended May 31, 2013				
Revenue from unaffiliated customers	$ 233,426	$ 80,050	$ 49,783	$	$ 363,259
Income (loss) from operations	$ 47,006	$ 20,506	$ 12,242	$ (23,131)	$ 56,623
Cash, cash equivalents and available-for-sale investment securities	$ 668,269	$ 400,712	$ 159,307	$	$ 1,228,288
Total assets	$ 1,905,108	$ 539,259	$ 210,566	$	$ 2,654,933
	Three Months Ended May 31, 2012				
Revenue from unaffiliated customers	$ 203,994	$ 66,622	$ 44,115	$	$ 314,731
Income (loss) from operations	$ 43,353	$ 18,210	$ 11,551	$ (22,206)	$ 50,908
Cash, cash equivalents and available-for-sale investment securities	$ 901,426	$ 300,247	$ 98,426	$	$ 1,300,099
Total assets	$ 1,901,978	$ 409,919	$ 172,721	$	$ 2,484,618

(1) Amounts represent share-based compensation expense for each of the three months ended May 31, 2013 and May 31, 2012, which was not allocated to geographic segments.

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RED HAT, INC.

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(Unaudited)

Supplemental information about geographic areas

The following table lists, for each of the three months ended May 31, 2013 and May 31, 2012, 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	
	May 31, 2013	May 31, 2012
United States, the Company s country of domicile	$ 204,926	$ 178,015
Foreign	158,333	136,716
Total revenue from unaffiliated customers	$ 363,259	$ 314,731

Total tangible long-lived assets located in the United States, the Company s country of domicile, and similar tangible long-lived assets held outside the United States are summarized in the following table as of May 31, 2013 and February 28, 2013 (in thousands):

	As of May 31, 2013	As of February 28, 2013
United States, the Company s country of domicile	$ 123,234	$ 105,029
Foreign	35,642	36,557
Total tangible long-lived assets	$ 158,876	$ 141,586

Information about major customers

For the three months ended May 31, 2013 and May 31, 2012, the U.S. government and its agencies generated approximately 9% and 10% of our total revenue from unaffiliated customers, respectively.

NOTE 12 Commitments and Contingencies

Operating Leases

As of May 31, 2013, the Company leased office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases was $7.2 million and $6.4 million for the three months ended May 31, 2013 and May 31, 2012, respectively.

Facility Exit Costs

In December 2011, the Company entered into an agreement to sublease a building located in downtown Raleigh, North Carolina in which the Company s headquarters are currently located. In connection with the transition to the Company s new headquarters, the Company has endeavored to assign, sublease or otherwise dispose of its existing leases related to the two facilities that previously constituted the Company s headquarters in Raleigh, North Carolina.

In May 2012, the Company entered into a sublease agreement with an unrelated third-party to lease one of the two facilities. As a result, the Company recognized a loss of $3.1 million for the three months ended May 31, 2012 which represented the excess of the Company s remaining obligation on the space over the agreed sublease income.

The Company continues to market the remaining facility for sublease in an effort to mitigate further facility exit costs. However, to the extent the Company is unable to sublease or otherwise dispose of such space and recover the full amount of its remaining obligation, it will be required to recognize a loss at the date the

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Company ceases using this facility, currently estimated to be during the Company s fiscal second quarter ending August 31, 2013. At that time the Company s net loss with respect to the remaining facility is expected to be approximately $5.0 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.

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 ManageIQ, Inc.

On December 21, 2012, the Company completed its acquisition of ManageIQ, Inc. (ManageIQ), a provider of enterprise cloud management and automation solutions that enable organizations to deploy, manage and optimize private clouds, public clouds and virtualized infrastuctures. Under the terms of the purchase agreement, the consideration transferred by the Company totaled $104.5 million. The Company incurred approximately $0.5 million in transaction costs including legal and accounting fees relating to the acquisition. These costs have been expensed as incurred and included in general and administrative expense on the Consolidated Statement of Operations for the year ended February 28, 2013.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The table below represents the tangible and identifiable intangible assets and liabilities (in thousands) based on management s assessment of the acquisition date fair value of the assets acquired and liabilities assumed:

	Total Consideration Allocated
Estimated identifiable intangible assets (see detail below)	$ 17,340
Cash	222
Accounts receivable	570
Fixed assets	69
Deferred tax assets, net	3,446
Other assets	155
Accrued liabilities	(262)
Deferred revenue	(132)
Goodwill	83,074
Total consideration allocated	$ 104,482

The following table summarizes the allocation of identifiable intangible assets resulting from the acquisition. For purposes of this allocation, the Company has assessed a fair value of ManageIQ s identifiable intangible assets related to developed technology, employee covenants not to compete, customer relationships and tradenames and trademarks based on the net present value of the projected income stream of these identifiable intangible assets. The fair value of the identifiable intangible assets is being amortized over the estimated useful life of each intangible asset on a straight-line basis which approximates the economic pattern of benefits (in thousands):

	Amortization Expense Type	Estimated Life (Years)	Total
Developed technology	Cost of revenue	5	$ 13,500
Employee covenants not to compete	Research and development	4	2,800
Customer relationships	Sales and marketing	5	1,000
Tradenames and trademarks	General and administrative	2	40
Total identifiable intangible assets			$ 17,340

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Other acquisitions in fiscal 2013

During the year ended February 28, 2013, the Company entered into agreements to acquire two businesses operating in the middleware space. These acquisitions include technologies that are complementary to the Company s JBoss Middleware technology. One acquisition, which included certain assets and related operations acquired from Polymita Technologies S.L. (Polymita), closed on August 28, 2012. The second acquisition closed on September 7, 2012 and included certain assets and related operations acquired from FuseSource, a division of Progress Software Corporation (FuseSource). The total cash consideration for these two acquisitions was $31.2 million. The total cash consideration transferred of $31.2 million has been allocated to the Company s assets as follows: $17.5 million to goodwill, $13.2 million to identifiable intangible assets and the remaining $0.5 million to other current assets.

Pro forma consolidated financial information

The following unaudited pro forma consolidated financial information reflects the results of operations of the Company for the three months ended May 31, 2012 (in thousands, except per share amounts) as if the acquisitions of Polymita, FuseSource and ManageIQ had closed on March 1, 2012, 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 May 31, 2012	
Revenue	$	315,123
Net income		32,692
Basic net income per common share	$	0.17
Diluted net income per common share	$	0.17

Goodwill

The following is a summary of changes in goodwill for the three months ended May 31, 2013 (in thousands):

Balance at February 28, 2013	$ 690,911
Impact of foreign currency fluctuations	(381)
Balance at May 31, 2013	$ 690,530

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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, middleware, virtualization, 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 enterprise technologies, and by providing a level of performance, reliability, scalability, flexibility, stability and security for the enterprise 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 primarily offer our enterprise technologies in the form of annual or multi-year subscriptions, and we recognize revenue over the period of the subscription agreements with our customers. We market our offerings primarily to enterprise customers.

We have focused on introducing and gaining acceptance for Red Hat enterprise technologies that comprise our open source architecture. Our operating system, Red Hat Enterprise Linux (RHEL), has 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 enterprise 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 Policies and 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, 2013.

In our fiscal year ended February 28, 2013, we focused and expect in our fiscal year ending February 28, 2014 to continue to focus on, among other things, generating (i) widespread adoption of Red Hat enterprise technologies by enterprise customers globally, (ii) increased revenue from our existing user base by renewing existing subscriptions, converting users of free versions of our enterprise technologies to paying subscribers, providing additional value to our customers and growing the number of open source enterprise technologies we offer, (iii) increased revenue by providing additional consulting and other targeted services and (iv) increased revenue from strategic acquisitions and channel partner relationships, including distributors, original equipment manufacturers (OEMs), IHVs, ISVs, cloud computing providers, value-added resellers (VARs) and system integrators, and from our own international expansion, among other means.

Revenue. For the three months ended May 31, 2013, total revenue increased 15.4% or $48.5 million to $363.3 million from $314.7 million for the three months ended May 31, 2012. Subscription revenue increased

15.9% or $43.2 million, driven primarily by additional subscriptions related to our principal RHEL technologies, which continue to gain broader market acceptance in mission-critical areas of computing, and our expansion of 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 increased 12.5% or $5.3 million for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012. The increase is driven primarily by customer interest in new products and technologies.

We believe the success of our business model is influenced by:

- the extent to which we can expand the breadth and depth of our technology and service offerings;
- our ability to enhance the value of subscriptions for Red Hat enterprise technologies through frequent and continuing innovations to these technologies while maintaining stable platforms over multi-year periods;
- our ability to generate increasing revenue from channel partner and other strategic relationships, including distributors, OEMs, IHVs, ISVs, cloud computing providers, VARs and system integrators;
- the acceptance and widespread deployment of open source technologies by enterprises and similar institutions, such as government agencies;
- our ability to generate new and recurring subscription revenue for Red Hat enterprise technologies; and
- our ability to provide customers with consulting and training services that generate additional revenue.

Deferred Revenue. Our deferred revenue, current and long-term, balance at May 31, 2013 was $1.06 billion. 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. Total deferred revenue at May 31, 2013 decreased $30.1 million or 2.8% as compared to the balance at February 28, 2013 of $1.09 billion.

The decrease in deferred revenue reported on our Consolidated Balance Sheets of $30.1 million differs from the $16.9 million decrease in deferred revenue we reported on our Consolidated Statements of Cash Flows for the three months ended May 31, 2013 due to changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries functional currency into U.S. dollars.

Subscription revenue. Our enterprise technologies are sold 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 and upgrades to the technology, if and when available, and compatibility with an ecosystem of certified hardware and software applications. Our customers have the ability to purchase higher levels of subscriptions that increase the level of support the customer is entitled to receive. Subscription revenue increased sequentially for the first quarter of fiscal 2014 and for each quarter of fiscal 2013 and 2012 and is being driven primarily by the increased market acceptance and use of open source software by the enterprise and our expansion of sales channels and geographic footprint during these periods.

Revenue by geography. For the three months ended May 31, 2013, approximately $158.3 million or 43.6% of our revenue was generated outside the United States compared to approximately $136.7 million or 43.4% for the three months ended May 31, 2012. 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 May 31, 2013, we had offices in more than 80 locations throughout the world.

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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 Japan, Singapore, India, Australia, South Korea and China). Revenue generated by the Americas, EMEA and APAC for the three months ended May 31, 2013 totaled $233.4 million, $80.1 million and $49.8 million, respectively, which resulted in year-over-year revenue growth in the Americas, EMEA and APAC of 14.4%, 20.2% and 12.8% respectively. Excluding the impact of foreign currency exchange rates, Americas, EMEA and APAC revenue grew 14.8%, 20.9% and 24.1%, respectively for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012. The Americas continued to be affected by the uncertainty in Federal government spending while EMEA continued to perform well against a challenging European backdrop. Japan, which is the largest revenue producing country in our APAC region, also performed well despite a weakened yen.

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. Overall gross profit margin decreased to 84.6% for the three months ended May 31, 2013 from 85.4% for the three months ended May 31, 2012 as a result of both increased amortization expense related to prior fiscal year s complementary middleware and cloud-management technology acquisitions and increased headcount.

Gross profit margin by geography. Gross profit margins generated by our geographic segments for the three months ended May 31, 2013 were as follows: Americas 84.6%, EMEA 89.2% and APAC 82.5%. For the three months ended May 31, 2012, gross profit margins generated by our geographic segments were as follows: Americas 85.5%, EMEA 88.9% and APAC 84.2%. 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 segments, we expect gross profit margins 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 segments.

Income from operations. Operating income was 15.6% and 16.2% of total revenue for the three months ended May 31, 2013 and May 31, 2012, respectively. The decrease in operating income as a percentage of revenue was due to investments made to expand our sales and marketing and research and development functions as well as costs incurred to update our data processing systems and acquire three businesses. These investments are described further in our analysis of results of operations below.

Income from operations by geography. Operating income as a percentage of revenue generated by our geographic segments for the three months ended May 31, 2013 was as follows: Americas 20.1%, EMEA 25.6% and APAC 24.6%. For the three months ended May 31, 2012, income from operations as a percentage of revenue generated by our geographic segments was as follows: Americas 21.3%, EMEA 27.3% and APAC 26.2%. Operating margin for all of our geographic operating segments decreased for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012 primarily as a result of increased investments in research and development and sales and marketing to support new technologies such as cloud management.

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 and equity securities and cash flow from operations. Cash, cash equivalents and short-term and long-term available-for-sale investments in securities balances at May 31, 2013 totaled $1.23 billion. Cash generated from operating activities for the three months ended May 31, 2013 totaled $141.8 million which represents an increase of 14.0% in operating cash flow as compared to the three months

ended May 31, 2012. This increase is due to increases in subscription 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 international areas and repurchasing our common stock.

Foreign currency exchange rates impact on results of operations. Approximately 43.6% of our revenue for the three months ended May 31, 2013 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component in determining net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-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.

Using the average foreign currency exchange rates from the first quarter of our prior fiscal year ended February 28, 2013, our revenue and operating expenses from non-U.S. operations for the three months ended May 31, 2013 would have been higher than we reported by approximately $6.2 million and $2.7 million, respectively, which would have resulted in income from operations being higher by $3.5 million.

Business combinations. During the year ended February 28, 2013, we acquired two businesses operating in the middleware space. These acquisitions include technologies that are complementary to our JBoss middleware technology. One acquisition, which included certain assets and related operations acquired from Polymita Technologies S.L., closed on August 28, 2012. The second acquisition closed on September 7, 2012 and included certain assets and related operations acquired from FuseSource, a division of Progress Software Corporation. As a result of these acquisitions, operating expenses increased by approximately $3.8 million for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012.

Also, during the year ended February 28, 2013, we completed the acquisition of ManageIQ, Inc. (ManageIQ), a Delaware corporation, for approximately $104.5 million in cash. ManageIQ develops, distributes and provides support for enterprise cloud management and automation software. As a result of the acquisition of ManageIQ, operating expenses increased by approximately $3.0 million for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012.

Facility Exit Costs. In December 2011, we entered into an agreement to sublease a building located in downtown Raleigh, North Carolina in which our headquarters are currently located. In connection with the transition to our new headquarters, we have endeavored to assign, sublease or otherwise dispose of our existing leases related to the two facilities that previously constituted our headquarters in Raleigh, North Carolina. In May 2012, we entered into a sublease agreement with an unrelated third-party to lease one of the two facilities that previously constituted our headquarters. As a result, we recognized a loss of $3.1 million for the three months ended May 31, 2012 which represented the excess of our remaining obligation on the space over the agreed sublease income. We continue to market the remaining facility for sublease in an effort to mitigate further facility exit costs. However, to the extent we are unable to sublease or otherwise dispose of such space and recover the full amount of our remaining obligation, we will be required to recognize a loss at the date we cease using this facility, currently estimated to be during our fiscal second quarter ending August 31, 2013. At that time, our net loss with respect to the remaining facility is expected to be approximately $5.0 million.

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RESULTS OF OPERATIONS

Three months ended May 31, 2013 and May 31, 2012

The following table is a summary of our results of operations for the three months ended May 31, 2013 and May 31, 2012 (in thousands):

	Three Months Ended (Unaudited)			
	May 31, 2013	May 31, 2012	$ Change	% Change
Revenue:				
Subscriptions	$ 315,817	$ 272,571	$ 43,246	15.9%
Training and services	47,442	42,160	5,282	12.5
Total subscription and training and services revenue	363,259	314,731	48,528	15.4
Cost of subscription and training and services revenue:				
Cost of subscriptions	23,375	17,940	5,435	30.3
As a % of subscription revenue	7.4%	6.6%		
Cost of training and services	32,682	28,079	4,603	16.4
As a % of training and services revenue	68.9%	66.6%		
Total cost of subscription and training and services revenue	56,057	46,019	10,038	21.8
As a % of total revenue	15.4%	14.6%		
Total gross profit	307,202	268,712	38,490	14.3
Operating expense:				
Sales and marketing	142,444	120,870	21,574	17.8
Research and development	73,802	59,880	13,922	23.2
General and administrative	34,333	33,912	421	1.2
Facility exit costs		3,142	(3,142)	(100.0)
Total operating expense	250,579	217,804	32,775	15.0
Income from operations	56,623	50,908	5,715	11.2
Interest income	1,502	2,294	(792)	(34.5)
Other income (expense), net	(424)	1,887	(2,311)	(122.5)
Income before provision for income taxes	57,701	55,089	2,612	4.7
Provision for income taxes	17,310	17,628	(318)	(1.8)
Net income	$ 40,391	$ 37,461	$ 2,930	7.8%
Gross profit margin-subscriptions	92.6%	93.4%		
Gross profit margin-training and services	31.1%	33.4%		
Gross profit margin	84.6%	85.4%		
As a % of total revenue:				
Subscription revenue	86.9%	86.6%		
Training and services revenue	13.1%	13.4%		
Sales and marketing expense	39.2%	38.4%		
Research and development expense	20.3%	19.0%		
General and administrative expense	9.5%	10.8%		

Facility exit costs	%	1.0%
Total operating expenses	69.0%	69.2%
Income from operations	15.6%	16.2%
Income before provision for income taxes	15.9%	17.5%
Net income	11.1%	11.9%
Estimated annual effective income tax rate	30.0%	32.0%

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Revenue

Subscription revenue

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat enterprise technologies, increased by 15.9% or $43.2 million to $315.8 million for the three months ended May 31, 2013 from $272.6 million for the three months ended May 31, 2012. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion, and continuing innovation, which attracts new customers and helps to drive renewals from existing customers.

Training and services revenue

Training revenue includes fees paid by our customers for delivery of educational materials and instruction. Services revenue includes fees received from customers for consulting services regarding our offerings, deployment of Red Hat enterprise technologies and for delivery of added functionality to Red Hat enterprise technologies for our major customers and OEM partners. Total training and services revenue increased by 12.5% or $5.3 million to $47.4 million for the three months ended May 31, 2013 from $42.2 million for the three months ended May 31, 2012. Training revenue increased 7.9% or $1.0 million, as some enterprises increased overall spending on discretionary items such as training despite the current economic environment. Our services revenue increased by 14.4% or $4.3 million as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Combined training and services revenue decreased as a percentage of total revenue to 13.1% for the three months ended May 31, 2013 from 13.4% for the three months ended May 31, 2012.

Cost of revenue

Cost of subscription revenue

The cost of subscription revenue primarily consists of expenses we incur to support, distribute, manufacture, augment and package Red Hat enterprise technologies. These costs include labor related cost 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 30.3% or $5.4 million to $23.4 million for the three months ended May 31, 2013 from $17.9 million for the three months ended May 31, 2012. The increase is partially the result of continued additions to our technical support staff to meet the demands of our growing subscriber base for support, security updates and fixes, and includes additional compensation of $2.9 million. The remaining increase is driven primarily by incremental amortization expense of $2.0 million related to technology acquisitions. Gross profit margin on subscriptions decreased to 92.6% for the three months ended May 31, 2013 from 93.4% for the three months ended May 31, 2012. As the number of 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 16.4% or $4.6 million to $32.7 million for the three months ended May 31, 2013 from $28.1 million for the three months ended May 31, 2012. The cost to deliver training increased 4.7% or $0.3 million to $7.1 million for the three months ended May 31, 2013 compared to $6.8 million for the three months ended May 31, 2012. The cost to deliver training as a percentage of training revenue decreased to 54.4% for the three months ended May 31, 2013 from 56.1% for the three months ended May 31, 2012 due to better utilization of both instructors and class room space as we transition from an on-site, employee-based, fixed-cost delivery model to a variable-cost delivery model with a global training partner that provides training services on our behalf. Costs to deliver our services revenue

increased by 20.1% or $4.3 million and relate to additional employee compensation and travel associated with additions to our staff. Total costs to deliver training and services as a percentage of training and services revenue was 68.9% and 66.6% for each of the three month periods ended May 31, 2013 and May 31, 2012, respectively.

Gross profit

Gross profit margin decreased to 84.6% for the three months ended May 31, 2013 from 85.4% for the three months ended May 31, 2012 as a result of both increased amortization expense related to prior fiscal year s complementary middleware and cloud-management technology acquisitions and increased headcount.

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 17.8% or $21.6 million to $142.4 million for the three months ended May 31, 2013 from $120.9 million for the three months ended May 31, 2012. This increase was primarily due to a $16.1 million increase in selling costs, which includes $13.2 million of additional employee compensation expense attributable to the expansion of our sales force from the prior year and $0.4 million and $1.6 million related to professional services and travel, respectively. The remaining increase relates to marketing costs, which grew $5.5 million or 20.1% for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012. The increase in marketing costs includes $3.3 million and $1.6 million related to increased headcount and advertising expense, respectively, to support our expanding marketing efforts. Sales and marketing expense increased as a percentage of revenue to 39.2% for the three months ended May 31, 2013 from 38.4% for the three months ended May 31, 2012 as we continue to invest in our sales and marketing function to expand the breadth of our global sales coverage and depth of our product sales coverage.

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 23.2% or $13.9 million to $73.8 million for the three months ended May 31, 2013 from $59.9 million for the three months ended May 31, 2012. 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 such as Red Hat Open Stack infrastructure-as-a-service (IaaS) and OpenShift platform-as-a-service (PaaS) among others. Employee compensation increased by $10.5 million. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased $2.0 million. Research and development expense was 20.3% and 19.0% of total revenue for the three months ended May 31, 2013 and May 31, 2012, 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 1.2% or $0.4 million to $34.3 million for the three months ended May 31, 2013 from $33.9 million for the three months ended May 31, 2012. The increase in general and administrative expenses results from increased compensation-related expense of $0.6 million and increased facility and infrastructure enhancements of $1.6 million and offset by a reduction in professional service fees, which decreased $1.8 million. General and administrative expense decreased as a percentage of revenue to 9.5% for the three months ended May 31, 2013 from 10.8% for the three months ended May 31, 2012 as we begin to realize and leverage benefits from investments made during the prior fiscal year in process and technology infrastructure enhancements to support our corporate functions.

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Interest income

Interest income decreased by 34.5% for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012. The decrease in interest income for the three months ended May 31, 2013 is attributable to prevailing lower yields earned on our cash and investment balances.

Other income (expense), net

Other income (expense), net decreased $2.3 million for the three months ended May 31, 2013 as compared to the three months ended May 31, 2012. Other income (expense), net for the three months ended May 31, 2012 of $1.9 million included a $2.0 million share of income from a strategic investment accounted for under the equity method. For the three months ended May 31, 2013, our share from the strategic investment accounted for under the equity method resulted in a $0.4 million loss.

Income taxes

During the three months ended May 31, 2013, we recorded $17.3 million of income tax expense, which is based on an estimated annual effective tax rate of 30%. Our estimated annual effective tax rate of 30% is less than the U.S. federal statutory rate of 35% primarily due to foreign income taxed at lower rates and the U.S. federal research tax credit.

During the three months ended May 31, 2012, we recorded $17.6 million of income tax expense, which was based on a then estimated annual effective tax rate of 32%. Our estimated annual effective tax rate of 32% 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 have historically derived a significant portion of our liquidity and operating capital from cash flows from operations as well as the sale of equity securities, including private sales of preferred stock and the sale of common stock in our initial and follow-on public offerings, and the issuance of convertible debentures. At May 31, 2013, we had total cash and investments of $1.23 billion, which was comprised of $598.0 million in cash and cash equivalents, $184.8 million of short-term, available-for-sale, fixed-income investments, $70.9 million in interest-bearing deposit accounts with maturity dates greater than 30 days and $374.7 million of long-term, available-for-sale fixed-income investments. This compares to total cash and investments of $1.32 billion at February 28, 2013.

With $598.0 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. 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. At May 31, 2013 and February 28, 2013, net accumulated unrealized gains on our available-for-sale debt securities totaled $0.3 million and $1.0 million, respectively.

Three months ended May 31, 2013

Cash flows overview

At May 31, 2013, cash and cash equivalents totaled $598.0 million, an increase of $110.9 million as compared to February 28, 2013. The increase in cash and cash equivalents for the three months ended May 31, 2013 is primarily the result of cash provided by operations which generated $141.8 million and cash provided by

investing activities which includes net proceeds from available-for-sale debt securities of $196.2 million. Cash provided by operations and investing activities was partially offset by financing activities which included the repurchase of 3,648,575 shares of our common stock at a total cost of $179.3 million. Net cash generated by operating and investing activities and used for financing activities is further described below.

Cash flows from operations

Cash provided by operations of $141.8 million during the three months ended May 31, 2013 includes net income of $40.4 million, adjustments to exclude the impact of non-cash revenues and expenses, which totaled a $53.1 million net source of cash, and changes in operating assets and liabilities, which totaled a $48.4 million net source of cash. Cash provided by changes in operating assets and liabilities for the three months ended May 31, 2013 was primarily the result of collections on our prior quarter s significant billings which generated operating cash flow of $72.4 million. These collections were partially offset by a reduction in deferred revenue which reduced operating cash flow by $16.9 million and timing of disbursements settlement which reduced accounts payable and accrued expenses by $12.6 million.

Adjustments to exclude the impact of non-cash revenues and expenses related to deferred income taxes of $12.8 million was primarily due to share-based compensation deductions which were in excess of amounts originally recognized as expense in our consolidated statements of operations. Excess tax benefits from share-based compensation, which totaled $3.0 million, are considered a financing source of cash.

Cash flows from investing

Cash provided by investing activities of $167.4 million for the three months ended May 31, 2013 includes proceeds from net sales and maturities of available-for-sale securities of $196.2 million, which were partially offset by investments in property and equipment of $26.7 million, primarily related to leasehold improvements. Investments in other intangible assets, primarily patents, totaled $2.3 million for the three months ended May 31, 2013.

Cash flows from financing

Cash used in financing activities of $187.1 million for the three months ended May 31, 2013 includes $179.3 million used to repurchase 3,648,575 shares of our common stock. 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 three months ended May 31, 2013 totaled $11.0 million. Partially offsetting financing activities using cash were proceeds from excess tax benefits related to share-based employee compensation which totaled $3.0 million and proceeds from employees exercise of common stock options which totaled $0.5 million. Payments on other borrowings totaled $0.3 million for the three months ended May 31, 2013. See NOTE 10 Share Repurchase Program to our Consolidated Financial Statements for further discussion of our share repurchase program.

Investments in debt and equity securities

Our investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. At May 31, 2013 and February 28, 2013, 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 value, including broker quotes or model valuations. Independent price verifications of all of our holdings are performed by the pricing vendors, which we review. In the event a price fails a pre-established tolerance check, it is researched so that we can assess the cause of the variance to determine what we believe is the appropriate fair market value.

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Capital requirements

We have experienced a substantial increase in our operating expenses since our inception in connection with the growth of our operations, the development of our enterprise technologies, the expansion of our services operations and our acquisition activity. Our capital requirements during the year ending February 28, 2014 will depend on numerous factors, including the amount of resources we devote to:

- funding the continued development of our enterprise technology offerings;
- accelerating the development of our systems management offerings;
- improving and extending our services and the technologies used to deliver these services to our customers and support our business;
- pursuing strategic acquisitions and alliances;
- investing in businesses, products and technologies; and
- investing in enhancements to the systems we use to run our business and the expansion of our office facilities, including capital expenditures related to our current headquarters facility.

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 intellectual property and mergers and acquisitions. Given our historically strong operating cash flow and the $1.23 billion of cash and investments held at May 31, 2013, we do not presently anticipate the need to raise cash to fund our operations, either through the sale of additional equity or through the issuance of debt, in the foreseeable future. However, we may take advantage of favorable capital market situations that may arise from time to time to raise additional capital.

We believe that cash flow from operations will continue to improve; however, there can be no assurances that we will improve our cash flow from operations from the current rate or that such cash flows will be adequate to fund other investments or acquisitions that we may choose to make. We may choose to accelerate the expansion of our business from our current plans, which may require us to raise additional funds through the sale of equity or debt securities or through other financing means. There can be no assurances that any such financing would occur in amounts or on terms favorable to us, if at all.

As of May 31, 2013, our cash, cash equivalents and available-for-sale investment securities totaled $1.23 billion, of which $588.3 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. For further discussion related to geographic segments, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

With 52.1% of our available cash, cash equivalents and available-for-sale investments, as of May 31, 2013, held within the U.S., 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, 2013, undistributed foreign earnings totaled $200.5 million. For further discussion, see NOTE 11 Income Taxes contained in our Annual Report on Form 10-K for the year ended February 28, 2013.

Off-balance sheet arrangements

As of May 31, 2013 and February 28, 2013, 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 cash equivalents and short-term and long-term investments in a variety of fixed-income securities, including both government and corporate obligations, interest-bearing deposits and money market funds. Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in prevailing interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates, or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates or perceived credit risk related to the securities issuers. A hypothetical one-half percentage point change in interest rates, assuming a parallel shift of all interest rates, would result in an approximate $2.4 million change in annual interest income derived from investments in our portfolio as of May 31, 2013. For further discussion related to our investments as of May 31, 2013 and February 28, 2013, 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 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 $6.1 million decrease in the fair value of our available-for-sale investment securities as of May 31, 2013. For further discussion related to our investments as of May 31, 2013 and February 28, 2013, 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 May 31, 2013, one customer accounted for approximately 12% of the Company s accounts receivable. As of February 28, 2013, no individual customer accounted for 10% or more of the Company s accounts receivable.

Foreign Currency Risk

Approximately 43.6% of our revenue for the three months ended May 31, 2013 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component in determining net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decreases if the U.S. dollar strengthens against foreign currencies.

Using the average foreign currency exchange rates from the first quarter of our prior fiscal year ended February 28, 2013, our revenue and operating expenses from non-U.S. operations for the three months ended May 31, 2013 would have been higher than we reported by approximately $6.2 million and $2.7 million, respectively, which would have resulted in income from operations being higher by $3.5 million.

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 in accordance with FASB ASC Section 815. 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 May 31, 2013 was $29.8 million. The fair value of these outstanding contracts at May 31, 2013 was a gross less than $0.1 million asset and a gross $0.1 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively on our Consolidated Balance Sheets. The forward contracts generally expire within three months of the period ended May 31, 2013. The forward contracts will settle in Australian dollars, Brazilian reais, Chilean pesos, Colombian pesos, Danish krone, Euros, Israeli shekels, Japanese yen, Mexican pesos, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs, Taiwanese dollars and U.S. dollars.

The aggregate notional amount of outstanding forward contracts at February 28, 2013 was $65.5 million. The fair value of these outstanding contracts at February 28, 2013 was a gross $0.3 million asset and a gross $0.2 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, 2013. The forward contracts settled in Argentine pesos, Australian dollars, Chilean pesos, Czech koruna, Danish krone, Euros, Israeli shekels, Japanese yen, Korean won, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs, and U.S. dollars.

RECENT ACCOUNTING PRONOUNCEMENTS

In March 2013, the FASB issued Accounting Standards Update No. 2013-05, *Foreign Currency Matters (Topic 830) Parent s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity* (ASU 2013-05), which requires a parent entity to release a related foreign entity s cumulative translation adjustment into net income only if its sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. ASU 2013-05 is effective prospectively for us in the first quarter of our fiscal year ending February 28, 2015. We do not believe that this updated standard will have a material impact 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 Exchange Act) or our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of the controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error and mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Also projections of any evaluation of effectiveness of controls and procedures to future periods are subject to the risk that the controls and procedures may become inadequate because of changes in conditions, or that the degree of compliance with the controls and procedures may have deteriorated.

Evaluation of Disclosure Controls and Procedures

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

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 of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

RISKS RELATED TO BUSINESS UNCERTAINTY

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 specific 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 United States, 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.

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 hardware manufacturers, software vendors, cloud providers and enterprise solutions providers such as Amazon.com, Inc. (Amazon), Cisco Systems, Inc., Dell Inc., Fujitsu Limited, Hewlett-Packard Co. (HP), International Business Machines Corporation (IBM), NEC Corporation, Oracle Corporation (Oracle), 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.

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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 OEMs, distributors and 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 regulatory requirements and Red Hat s quality standards. 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 revenues 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.

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 and 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:

- Integrating the acquired business accounting, financial reporting, management, information and information security, human resource and other administrative systems to permit effective management, 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;
- Increased operating expenses related to the acquired business or technology;
- Maintaining or establishing acceptable standards, controls, procedures and policies;
- Disruption of our ongoing business and distraction of management;

- Impairment 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;

- Effective evaluation of talent at an acquired business or cultural challenges associated with integrating employees from the acquired business into our organization;

- Loss 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;

- Expenses related to the transaction;

- 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;

- Impairment of intangible assets and goodwill acquired in transactions; and

- For foreign transactions, 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.

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 $1.13 billion for the fiscal year ended February 29, 2012 to $1.33 billion for the fiscal year ended February 28, 2013. Moreover, the total number of our employees increased from over 4,500 as of February 29, 2012 to approximately 5,600 as of February 28, 2013 and is expected to generally increase in the foreseeable future. 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.

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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, we must also continue to hire, train, supervise and manage new employees. We may not be able to adequately screen and hire or adequately train, supervise and manage sufficient personnel or develop management, or effectively manage and develop our controls and oversight functions and information systems to adequately manage our growth effectively. If we are unable to effectively manage our growth, our business, financial condition, operating results and cash flows could be adversely affected.

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

There has been a trend of consolidation in the technology industry. We expect this trend 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 the technology sector performs well and/or if companies with more generous compensation packages or greater perceived growth opportunities compete for the same personnel. In addition, historically we have used share-based compensation as a key component of our compensation packages. Changes in the accounting for share-based compensation could adversely affect our earnings or force 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 shareholder 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, the loss of which could adversely affect our business or diminish our brands.

Competition in our industry for qualified employees, especially technical employees, is intense and from time to time our competitors directly target our employees. The loss of 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.

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. If we do not succeed in retaining and motivating our key employees and attracting new 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, and we are required to implement more complex organizational management structures, 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.

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 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 applications. 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.

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. 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.

An increased focus on developing and providing virtualization, storage and cloud computing 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, our business, financial condition, operating results and cash flows could be adversely affected.

If our customers do not renew their subscription agreements with us, 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 software or hardware 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 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 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.

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 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. In addition, our insurance policies may not adequately limit our exposure to this type of claim. 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 computing offerings are based on emerging technologies and business models, and the potential market for these offerings remains uncertain.

Our virtualization, storage and cloud computing 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. The virtualization, storage and cloud computing technologies are rapidly evolving. 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 computing 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 computing 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 revenues. Demand for our virtualization, storage and cloud computing offerings may unfavorably impact demand for our other products and services including software subscriptions and related professional services. If the market for our virtualization, storage and cloud computing 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 substantial 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 receive and process information about our employees, customers and partners, and we may store and process (or contract with third parties to store and process) our customers 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. 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 store and process (or the systems and data stored and processed by third parties on our behalf). These security measures may be breached or data lost as a result of actions by third parties or employee error or malfeasance. 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 and our customers

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information), cause the loss or disclosure of some or all of this information, cause interruptions in our or our customers operations 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. Actual or perceived vulnerabilities may lead to claims against us by customers, partners or other third parties, which could be material. 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. Any loss of data or compromise of our systems or the data we store or process (or the systems and data stored and processed by third parties on our behalf) could result in a loss of confidence in the security of our offerings, damage our reputation, 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 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 do 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 and partners would create a large volume of questions and complaints that would need to be addressed by our support personnel. If our support personnel cannot meet this demand, customer and partner satisfaction levels may fall, which in turn could cause additional claims, reduced revenue or loss of customers. 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, 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. government budget 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. government agencies. Government deficit reduction and austerity measures, along with continued economic challenges, continue to place pressure on U.S. 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.

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 could be required to redesign our offerings, replace components of our offerings, enter into license agreements with third parties and provide infringement indemnification.

We regularly commit to our subscription customers that if portions of our offerings are found to infringe any 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 it 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 often have limitations on these commitments, satisfying the commitments could be costly and time consuming and could 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.

We are vulnerable to claims that our technologies infringe third-party intellectual property rights because our technologies are comprised of software components, many of which are developed by numerous independent parties, and an adverse 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 patent, copyright and trade secrets because our technologies are comprised of software components, many of which are developed by numerous independent parties. Moreover, because the scope of software patent protection is often not well defined or readily determinable, patent applications in the United States are not publicly disclosed at the time of filing, and the number of software patents that are issued each year is significant and growing, among other concerns, we are 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. 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.

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 revenues 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.

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 unfavorable 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 adverse 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 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 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

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, which 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.

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 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 product and service offerings by us may cause new and different regulations to apply to our business. Increased regulation in the area of data privacy and protection is expected, and laws and regulations applying to the solicitation, collection, processing, protection or use 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 practices. If so, in addition to the possibility of fines and penalties, a governmental order could require that we change our data 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.

Any failure by us to comply with our posted privacy policies or other federal, state or international privacy-related or data protection laws and regulations or a requirement to change our data practices could have an adverse affect 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 procurements regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us to comply with the specific provisions in our customer contracts or any violation of government contracting regulations 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, 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.

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 technology 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.

Our stock price has been volatile historically and may continue to be volatile. Further, the sale of our common stock by significant stockholders may cause the price of our common stock to decrease.

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 products 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.

In addition, 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 lack the financial and operational resources needed to increase our market share and compete effectively.

We compete with a number of large and well-established companies that have significantly greater financial resources and name recognition, larger development staffs and more extensive marketing and distribution capabilities. Some of these competitors also bundle hardware and software offerings, making it more difficult for us to penetrate their customer bases. No assurance can be given that our efforts to compete effectively will be sufficient.

In the market for operating systems, we face significant competition from competitors which offer hardware-independent multi-user operating systems for Intel platforms and/or Linux and UNIX-based operating systems, including HP, IBM, Microsoft Corporation (Microsoft), Oracle and Unisys Corporation. With respect to Linux operating systems, our chief competitor has historically been Attachmate Corporation (Attachmate),

with its SUSE brand of Linux. Canonical Ltd. and Oracle also sell support for their versions of the Linux operating system. We also compete with freely available Linux distributions, such as Fedora, CentOS and Debian.

In the market for middleware offerings, our competitors include, but are not limited to, IBM, Microsoft, Oracle and VMware, Inc. (VMware) all of which offer portfolios of enterprise Java and non-Java middleware products. Our middleware offering is heavily dependent on the Java programming language, which is controlled by Oracle.

In the market for virtualization our competitors include, but are not limited to, Attachmate, Citrix Systems, Inc. (Citrix), Microsoft, Oracle and VMware.

With respect to our storage offerings we compete with companies that provide software-based storage products, such as EMC Corporation and NetApp, Inc. Public cloud providers such as Amazon and Rackspace Hosting, Inc. (Rackspace) also offer storage capabilities.

With our cloud technologies we compete with companies that provide tools for enterprises to create private clouds, such as Citrix, Microsoft and VMware, as well as with companies that provide public clouds, such as Amazon, Google Inc., Microsoft and Rackspace.

With respect to our management offerings our competitors include Attachmate, BMC Software, Inc., CA, Inc., HP, IBM, Microsoft and Oracle, all of which offer support for heterogeneous operating system environments, such as Linux, Solaris, AIX, HP-UX and Windows.

We face competition in the market for services related to the development, deployment and integration of enterprise technologies. Our competitors in the market include Accenture plc, HP, IBM and Tata Consultancy Services Limited, as well as other technology consulting companies. Some of these competitors may be able to leverage their existing service organizations and provide higher levels of support, consulting and training on a more cost-effective basis than we can.

We may lack the resources needed to compete successfully with our current competitors as well as potential new competitors. Moreover, we 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. Competitive pressures could affect prices or demand for our offerings, resulting in reduced profit margins and loss of market opportunity. We may have to lower the prices of our offerings to stay competitive, which could adversely affect our margins and financial condition. In addition, if our pricing and other factors are not sufficiently competitive, we may lose market share. Industry consolidation may also effect competition by creating larger and potentially stronger competitors in the markets in which we compete, which may adversely affect on our business.

We may not be able to meet the financial and operational challenges that we will encounter as our international operations, which represented approximately 43.3% of our total revenue for the fiscal year ended February 28, 2013, continue to expand.

Our international operations accounted for approximately 43.3% of total revenue for the fiscal year ended February 28, 2013. 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.

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Additional challenges associated with the conduct of our business overseas 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;
- Difficulty selecting and monitoring channel partners outside of the United States;
- Lower levels of availability or use of the Internet, through which our software is often delivered;
- Difficulty protecting our intellectual property rights overseas 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;
- Difficulty maintaining quality standards consistent with the our brands;
- Export and import laws and regulations 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 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 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 revenues is derived from our Red Hat Enterprise Linux platform.

During our fiscal year ended February 28, 2013, a substantial portion of our subscription revenues was derived from our Red Hat Enterprise Linux technologies. 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. Due to the concentration of our revenues 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.

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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. 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 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 position of our business could be adversely affected; current and potential future shareholders 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 illiquidity 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, 2013 consisted primarily of money market funds, U.S. government and agency securities, German sovereign securities, certificates of deposit, corporate securities and equity 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 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 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.

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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 will affect our net revenue, operating expenses and operating margins. We cannot predict the impact of future exchange rate fluctuations. As we expand international operations, our exposure to exchange rate fluctuations increases. We use financial instruments, primarily forward purchase contracts, to economically hedge U.S. dollar and other 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 Quantitative and Qualitative Disclosures About Market Risk .

Natural disasters and geo-political events could adversely affect our business, financial condition, operating results and cash flows.

The occurrence of one or more epidemics, natural disasters or geo-political events, such as civil unrest or terrorist attacks, 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 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 overseas, the disruption of utility services to our facilities or to suppliers, partners or customers, and disruption in our communications with our customers.

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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 first fiscal quarter ended May 31, 2013:

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) (3)	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (2) (3)
March 1, 2013 March 31, 2013	607,927	$ 49.37	607,927	$ 149.3 million
April 1, 2013 April 30, 2013	3,262,484	$ 49.14	3,040,648	$ 300.0 million
May 1, 2013 May 31, 2013		$		$ 300.0 million
Total	3,870,411	$ 49.17	3,648,575	$ 300.0 million

(1) During the three months ended May 31, 2013, the Company withheld an aggregate of 221,836 shares of its common stock from employees to satisfy minimum tax withholding obligations relating to the vesting of restricted share awards. These shares were not withheld pursuant to the program described in Note (2) below.

(2) On March 28, 2012, the Company announced that its Board of Directors authorized the repurchase of up to $300.0 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, 2012, and the Company completed the repurchases authorized under such program on April 15, 2013.

(3) On April 15, 2013, the Company announced that its Board of Directors has authorized the repurchase of up to $300.0 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program, which replaced the previously completed repurchase program, commenced on April 16, 2013, and will expire on the earlier of (i) March 31, 2015, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program. See NOTE 10 Share Repurchase Program to the Consolidated Financial Statements for information regarding the Company s $300.0 million stock repurchase program announced on April 15, 2013.

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ITEM 6. EXHIBITS

(a) List of Exhibits

Exhibit No.	Exhibit
10.1*+	Executive Base Salaries and Target Award Amounts under Red Hat, Inc. s Executive Variable Compensation Plan for the Fiscal Year Ending February 28, 2014 (incorporated by reference to Exhibit 99.1 to the registrant s Current Report on Form 8-K filed with the SEC on May 29, 2013 (File No. 001-33162))
10.2*+	Form of Operating PSU Award Agreement (incorporated by reference to Exhibit 99.2 to the registrant s Current Report on Form 8-K filed with the SEC on May 29, 2013 (File No. 001-33162))
10.3*+	Form of TSR PSU Award Agreement (incorporated by reference to Exhibit 99.3 to the registrant s Current Report on Form 8-K filed with the SEC on May 29, 2013 (File No. 001-33162))
10.4*+	Peer Group for PSUs Granted in FY2014 (incorporated by reference to Exhibit 99.4 to the registrant s Current Report on Form 8-K filed with the SEC on May 29, 2013 (File No. 001-33162))
10.5*+	Form of RSA Agreement (incorporated by reference to Exhibit 99.5 to the registrant s Current Report on Form 8-K filed with the SEC on May 29, 2013 (File No. 001-33162))
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

* Indicates a management contract or compensatory plan, contract or arrangement.

\+ Previously filed.

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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: July 5, 2013	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: July 5, 2013	By:	/s/ CHARLES E. PETERS, JR. **Charles E. Peters, Jr.** **Executive Vice President and** **Chief Financial Officer** **(Principal Financial Officer)**
	RED HAT, INC.	
Date: July 5, 2013	By:	/s/ MARK E. COOK **Mark E. Cook** **Vice President Finance and Controller** **(Principal Accounting Officer)**