RED HAT INC
Form 10-Q
October 09, 2018
Table of Contents

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

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended August 31, 2018
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .
Commission File Number: 001-33162

RED HAT, INC.
(Exact name of registrant as specified in its charter)

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

100 East Davie Street, Raleigh, North Carolina 27601
(Address of principal executive offices, including zip code)
(919) 754-3700
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of October 5, 2018, there were 175,973,678 shares of common stock outstanding.

Table of Contents

RED HAT, INC.

Table of Contents

CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS

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

Table of Contents

PART I

ITEM 1. FINANCIAL STATEMENTS

RED HAT, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands—except share and per share amounts)

	August 31, 2018 (Unaudited)	February 28, 2018 (1)
ASSETS		
Current assets:		
Cash, cash equivalents and restricted cash	$1,503,515	$1,724,132
Investments in debt and equity securities, short-term	264,945	318,358
Accounts receivable, net of allowances for doubtful accounts of $2,777 and $2,167, respectively	516,008	806,744
Prepaid expenses	247,197	267,197
Other current assets	46,088	25,666
Total current assets	2,577,753	3,142,097
Property and equipment, net of accumulated depreciation and amortization of $294,252 and $269,429, respectively	195,230	206,105
Goodwill	1,278,478	1,288,830
Identifiable intangibles, net	213,260	224,953
Investments in debt securities, long-term	389,402	430,442
Deferred tax assets, net	83,761	92,606
Other assets, net	68,984	89,460
Total assets	$4,806,868	$5,474,493
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$405,970	$427,139
Deferred revenue, short-term	1,683,503	1,853,719
Other current obligations	544	843
Convertible notes	4,435	23,806
Total current liabilities	2,094,452	2,305,507
Deferred revenue, long-term	709,746	741,453
Convertible notes	512,095	744,194
Other long-term obligations	200,771	205,215
Commitments and contingencies (NOTES 9 and 10)		
Stockholders' equity:		
Preferred stock, $0.0001 per share par value, 5,000,000 shares authorized, none outstanding	—	—
Common stock, $0.0001 per share par value, 300,000,000 shares authorized, 241,789,438 and 238,688,708 shares issued, and 175,859,770 and 177,073,904 shares outstanding, respectively	24	24
Additional paid-in capital	2,576,560	2,416,080
Retained earnings	1,820,124	1,619,688
Treasury stock, at cost, 65,929,668 and 61,614,804 shares, respectively	(3,055,268)	(2,525,072)
Accumulated other comprehensive loss	(51,636)	(32,596)
Total stockholders' equity	1,289,804	1,478,124
Total liabilities and stockholders' equity	$4,806,868	$5,474,493

(1) Derived from audited financial statements except for line items adjusted by the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

Table of Contents

RED HAT, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands—except per share amounts)
(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2018	August 31, 2017 (1)	August 31, 2018	August 31, 2017 (1)
Revenue:				
Subscriptions	$722,699	$637,562	$1,434,220	$1,234,070
Training and services	100,048	85,793	202,057	166,081
Total revenue	822,747	723,355	1,636,277	1,400,151
Cost of revenue:				
Subscriptions	51,931	46,324	104,104	89,957
Training and services	66,999	60,393	137,525	117,456
Total cost of revenue	118,930	106,717	241,629	207,413
Gross profit	703,817	616,638	1,394,648	1,192,738
Operating expense:				
Sales and marketing	334,380	278,317	683,195	572,640
Research and development	166,308	141,809	332,814	278,972
General and administrative	68,573	61,722	131,927	116,592
Total operating expense	569,261	481,848	1,147,936	968,204
Income from operations	134,556	134,790	246,712	224,534
Interest income	7,855	4,612	15,689	8,605
Interest expense	4,808	6,081	11,127	12,166
Other expense, net	(2,457)	(1,260)	(4,651)	(1,846)
Income before provision for income taxes	135,146	132,061	246,623	219,127
Provision for income taxes	48,292	34,973	46,579	46,725
Net income	$86,854	$97,088	$200,044	$172,402
Net income per share:				
Basic	$0.49	$0.55	$1.13	$0.97
Diluted	$0.46	$0.53	$1.06	$0.94
Weighted average shares outstanding:				
Basic	176,746	177,257	177,024	177,250
Diluted	186,936	183,021	188,061	182,460

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

Table of Contents

RED HAT, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2018	August 31, 2017 (1)	August 31, 2018	August 31, 2017 (1)
Net income	$86,854	$97,088	$200,044	$172,402
Other comprehensive income (loss):				
Change in foreign currency translation adjustment	(8,459)	31,861	(19,290)	54,531
Available-for-sale securities:				
Unrealized gain on available-for-sale securities during the period	416	990	454	1,154
Reclassification for loss (gain) realized on available-for-sale securities, reported in Other expense, net	3	—	(125)	—
Tax benefit (expense)	(95)	(287)	(79)	(509)
Net change in available-for-sale securities (net of tax)	324	703	250	645
Total other comprehensive (loss) income	(8,135)	32,564	(19,040)	55,176
Comprehensive income	$78,719	$129,652	$181,004	$227,578

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

6

Table of Contents

RED HAT, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Three Months Ended		Six Months Ended	
	August 31, 2018	August 31, 2017 (1)	August 31, 2018	August 31, 2017 (1)
Cash flows from operating activities:				
Net income	$86,854	$97,088	$200,044	$172,402
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	26,666	24,136	53,720	45,953
Amortization of debt discount and transaction costs	4,570	5,570	10,408	11,110
Repayments of convertible notes attributable to debt discount	(32,563)	—	(32,563)	—
Deferred income taxes	(293)	(359)	(3,688)	7,558
Share-based compensation expense	52,686	46,947	98,691	90,665
Net amortization of bond premium on debt securities available for sale	543	2,439	1,286	4,875
Other	2,553	571	3,650	1,532
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	(22,049)	17,036	277,390	225,797
Other receivables	14,915	(949)	(20,245)	(20,346)
Prepaid expenses	6,280	(11,793)	31,662	231
Accounts payable and accrued expenses	26,937	2,010	(1,705)	(53,316)
Deferred revenue	(33,786)	(40,575)	(138,378)	(86,292)
Other	(521)	775	(1,321)	599
Net cash provided by operating activities	132,792	142,896	478,951	400,768
Cash flows from investing activities:				
Purchase of investment in debt securities available for sale	(9,725)	(109,669)	(118,061)	(259,193)
Proceeds from maturities of investment in debt securities available for sale	106,050	105,303	193,054	217,344
Proceeds from sales of investment in debt securities available for sale	7,966	—	8,491	14,324
Proceeds from sales of strategic equity investments	—	—	1,300	—
Acquisition of businesses, net of cash acquired	—	(83,965)	—	(83,965)
Purchase of developed software and other intangible assets	(3,258)	(7,671)	(6,124)	(9,445)
Purchase of property and equipment	(13,653)	(25,781)	(26,616)	(51,681)
Other	—	(189)	(986)	(189)
Net cash provided by (used in) investing activities	87,380	(121,972)	51,058	(172,805)
Cash flows from financing activities:				
Proceeds from exercise of common stock options	189	862	1,064	3,830
Proceeds from employee stock purchase program	13,685	10,952	28,947	22,713
Payments related to net settlement of share-based compensation awards	(17,638)	(7,413)	(94,732)	(48,423)
Purchase of treasury stock	(250,035)	(75,015)	(400,054)	(137,002)
Payments on other borrowings	(250)	(418)	(549)	(861)
Repayments of convertible notes attributable to principal	(211,990)	—	(237,943)	—

Net cash used in financing activities	(466,039)	(71,032)	(703,267)	(159,743)
Effect of foreign currency exchange rates on cash, cash equivalents and restricted cash	(19,098)	29,959	(47,359)	51,280
Net (decrease) increase in cash, cash equivalents and restricted cash	(264,965)	(20,149)	(220,617)	119,500
Cash, cash equivalents and restricted cash at beginning of the period	1,768,480	1,230,457	1,724,132	1,090,808
Cash, cash equivalents and restricted cash at end of the period	$1,503,515	$1,210,308	$1,503,515	$1,210,308
Restricted cash included in cash, cash equivalents and restricted cash	$1,137	$3,104	$1,137	$3,104

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

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

7

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1—Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries ("Red Hat" or the "Company") is a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, management, middleware, cloud, mobile and storage technologies. Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code, generally, is freely shared, there are customarily no licensing fees for the use of open source software. Therefore, the Company does not recognize revenue from the licensing of the code itself. The Company provides value to its customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of its Red Hat technologies, and by providing a level of performance, scalability, flexibility, reliability and security for the technologies the Company packages and distributes. Moreover, because communities of developers not employed by the Company assist with the creation of the Company's open source offerings, opportunities for further innovation of the Company's offerings are supplemented by these communities.

The Company derives its revenue and generates cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat technologies. The arrangements with the Company's customers that produce this revenue and cash are explained in further detail in NOTE 2—Summary of Significant Accounting Policies.

NOTE 2—Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three and six months ended August 31, 2018 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair statement of the consolidated balance sheets, consolidated operating results, consolidated other comprehensive income and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the U.S. ("U.S. GAAP"). Operating results for the three and six months ended August 31, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2019. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. GAAP have been omitted in accordance with the SEC's rules and regulations for interim reporting. These unaudited financial statements should be read in conjunction with the Company's Consolidated Financial Statements, including notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2018. Other than the accounting pronouncement adopted during the three months ended May 31, 2018 related to accounting for revenue from contracts with customers as described below, there have been no changes to the Company's significant accounting policies from those described in NOTE 2—Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2018.

The Company adopted Accounting Standards Update 2014-09, Revenue from Contracts with Customers, now commonly referred to as Accounting Standards Codification Topic 606 ("ASC 606"), effective March 1, 2018, using the full retrospective transition method. All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standard and such information is designated "as adjusted."

Certain amounts for the three and six months ended August 31, 2017 have been reclassified to conform to the current period presentation.

The Company's fiscal year ends on the last day of February, and the Company identifies fiscal years by the calendar years in which they end. For example, the fiscal year ending February 28, 2019 is referred to as "fiscal 2019."

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 are eliminated in consolidation. There are no significant foreign exchange restrictions on the Company’s foreign subsidiaries.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Use of estimates
The preparation of financial statements in conformity with U.S. GAAP 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. Estimates are used for, but not limited to, revenue recognition, goodwill and other long-lived assets, share-based compensation, income taxes and loss contingencies.
Revenue recognition
The Company derives its revenues from subscription contracts and training and service contracts. Revenue is recognized when performance obligations, as stipulated in the contracts, are transferred to a customer for an amount that reflects the consideration the Company expects to receive in exchange for those subscription contracts and training and service contracts.
The Company applies the following five steps to recognize revenue:
1) Identify the contract with a customer. The Company determines that it has a contract with a customer when the contract is approved, the party's rights regarding the products and services to be transferred can be identified, the payment terms for the products and services are identified, the customer's ability and intent to pay can be determined, and the contract has commercial substance. Judgment is used to assess the customer's ability and intent to pay, which is based upon factors including the customer's historical payment experience or credit and financial information pertaining to the customer.
2) Identify the performance obligations in the contract. The Company's performance obligations are identified based on the products and services that will be transferred to the customer that are both capable of being distinct and are distinct in the context of the contract and consist of (i) subscription offerings, including non-proprietary open-source software code delivered to the customer, software support subscriptions delivered to the customer, software support subscriptions embedded in partner products and learning subscriptions and (ii) training and services, including professional services sold at a fixed fee, professional services sold on a time-and-material-basis, training courses or units, and consulting units. In limited cases, the option to purchase additional subscription offerings or training and services may be offered at a price representing a material right. In such cases, the option to purchase is considered a distinct performance obligation.
3) Determine the transaction price. The Company determines transaction price based on the consideration expected to be received in exchange for transferring certain performance obligations to the customer. In determining the transaction price, variable consideration, if any, would be considered if, in management's judgment, it is probable that a significant future reversal of cumulative revenue under the contract will not occur.
The Company's contracts do not contain significant financing components. Specifically, the Company does not typically extend customer payment terms beyond a standard 30- to 60-day term and as a result the Company has elected the one-year-or-less safe harbor expedient and does not impute any interest.
The Company has elected to exclude all taxes from the transaction price (e.g. sales, use, value-added, etc). Revenue is recognized net of such taxes.
4) Allocate the transaction price to performance obligations in the contract. When a contract contains a single performance obligation, the entire transaction price is allocated to that one performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price ("SSP"). The Company typically determines SSP based on the observable price when the Company sells the subscriptions or training and services separately, taking into consideration the geographical region of the customer, type of offering and sales channel. In instances where SSP is not directly observable, the Company determines SSP either from the renewal rate paid for the performance obligation to the extent it is the same rate as stipulated in the initial customer contract or by using the expected-cost-plus-margin approach.

5) Recognize revenue when or as the performance obligation is satisfied. Revenue is recognized at the time the related performance obligation is satisfied by transferring the promised subscription offerings and training and services to a customer. For each performance obligation, a determination is made as to whether the control is transferred over time or at a point in time. For performance obligations satisfied over time, a method to measure progress toward complete satisfaction is selected, based upon the most faithful depiction of performance. The selected method for each performance obligation type is applied consistently to similar contracts.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Subscription revenue

Subscription revenue is comprised of direct and indirect sales of subscriptions relating to Red Hat technologies. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding and non-cancellable subscription agreement for the purchase of a subscription, subscription services are made available to the customer and the customer is billed. The deferred revenue amount is recognized as revenue ratably over the subscription period. Red Hat technologies are generally offered with base subscription periods of either one year or three years; the majority of the Company's subscriptions have terms of one year. Under these subscription agreements, renewal rates are generally specified for renewal terms of one year or three years. Subscriptions generally entitle the end user to the technology itself and post-contract customer support, generally consisting of varying levels of support services as well as access to security updates, fixes, functionality enhancements, upgrades to the technologies, each on an if and when available basis, and compatibility with an ecosystem of certified hardware and software, during the term of the subscription. The Company sells its offerings through two principal channels: (1) direct, which includes sales by the Company's sales force as well as web store sales, and (2) indirect, which includes certified cloud and service providers ("CCSPs"), distributors, original equipment manufacturers ("OEMs"), systems integrators and value added resellers.

The Company recognizes revenue from the sale of Red Hat technologies ratably over the period of the subscription beginning on the commencement date of the subscription agreement. The Company has determined that the delivery of software code underlying the subscription is a distinct performance obligation as it is both capable of being distinct and is distinct within the context of a customer contract. The Company uses a non-proprietary open-source development and licensing model to provide its software technologies to customers and therefore the amount of transaction price allocated to the underlying software code is negligible. The Company derives a portion of its revenue from CCSPs that provide public clouds with, and allow users to consume, computing resources as a service. The Company earns revenue based on subscription units consumed by the CCSP or its end users. The Company uses its historical cloud-usage data to estimate the amount of revenue earned and recognized each month and adjusts to actual amounts earned upon receipt of usage reports from the CCSPs in the following month. The differences between actual amounts earned and estimates made have generally been insignificant.

Training and services revenue

Training and services revenue is comprised of revenue for consulting, engineering and customer training courses or units and education services. Consulting services consist of time-based units or fixed-fee arrangements. For time-based arrangements, revenue is recognized over time as these services are performed and for fixed-fee arrangements, revenue is recognized based on the proportion of services performed. Engineering services represent revenue earned under fixed-fee arrangements with the Company's OEM partners and other customers to provide for significant modification and customization of Red Hat technologies. The Company recognizes revenue for these fixed-fee engineering services based on a proportional performance basis using actual costs incurred to date over the estimated total projected costs, which includes a representative profit margin. A representative profit margin is determined based on analysis of a population of similar contracts by region. Revenue for customer training and education services is recognized on the dates the services are performed.

See NOTE 16—Segment Reporting for further information, including revenue by geographic area and significant product and service offerings.

Contract Balances

Timing of revenue recognition may differ from the timing of invoicing to customers. The Company records a receivable when revenue is recognized prior to invoicing, or deferred revenue when revenue is recognized subsequent to invoicing. For multi-year arrangements, the Company will generally invoice customers upfront or annually at the beginning of each annual coverage period. See below for the accounting policy related to receivables and see NOTE 12—Deferred Revenue and Performance Obligations for further information on deferred revenue balances.

Accounts receivable and allowance for doubtful accounts
Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company’s estimate of the amount of probable credit losses in the Company’s existing accounts receivable. The Company determines the allowance based on historical write-off experience and other qualitative factors. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectability. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company determines it is probable the receivable will not be recovered. The Company does not have off-balance sheet credit exposure related to its customers. Unbilled receivables related to subscription and training and services contracts are included in accounts receivable. See NOTE 3—Accounts Receivable for further information on accounts receivable balances.
Deferred selling costs
Deferred commissions are the incremental costs that are directly associated with non-cancellable subscription contracts with customers and consist of sales commissions and certain related fringe benefits earned by the Company’s sales force. The commissions are deferred and amortized on a straight-line basis over a period that approximates the subscription period. In determining the period that approximates the subscription period, the Company utilizes a portfolio approach that allows for the analysis of customer contracts with similar characteristics. The Company has determined that the effects on the financial statements of the portfolio approach would not differ materially from an individual customer contract analysis approach. The commission payments are paid in full subsequent to the month in which the customer’s service commences. The deferred commission amounts are recoverable through the future revenue streams under the non-cancellable customer contracts. In addition, the Company has the ability and intent under the commission plans with its sales force to recover commissions previously paid to its sales force in the event that customers breach the terms of their subscription agreements and do not fully pay for their subscription agreements. See NOTE 5—Deferred Selling Costs for further information on deferred commissions and the related amortization of deferred commissions.
Recent accounting pronouncements
Accounting pronouncements adopted
In February 2018, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update 2018-02, Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (“ASU 2018-02”). The FASB issued ASU 2018-02 to give entities the option to reclassify tax effects stranded in accumulated other comprehensive income as a result of the enactment of the Tax Cuts and Jobs Act (the “Tax Act”) to retained earnings. The Company adopted ASU 2018-02 as of June 1, 2018. The Company opted not to reclassify tax effects stranded in accumulated other comprehensive income as a result of the enactment of the Tax Act to retained earnings.
In January 2016, the FASB issued Accounting Standards Update 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”). The FASB issued ASU 2016-01 to require equity investments with readily determinable fair values to be measured at fair value with changes in fair value recognized in net income. Equity investments that do not have readily determinable fair values are allowed to be remeasured upon the occurrence of an observable price change or upon identification of an impairment. Along with ASU 2016-01, the Company evaluated the Accounting Standards Update 2018-03, Technical Corrections and Improvements to Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2018-03”), which was issued in February 2018, and Accounting Standards Update 2018-04, Investments—Debt Securities (Topic 320) and Regulated Operations (Topic 980): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273 (“ASU 2018-04”), which was issued in March 2018. The Company adopted ASU 2016-01, ASU 2018-03 and ASU 2018-04 as of March 1, 2018. The adoption of these standards did not significantly impact the Company’s Consolidated Financial Statements.
In May 2014, the FASB issued ASC 606 to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the most current revenue recognition guidance. ASC 606 requires the recognition of revenue when control of performance obligations as stipulated in the contracts, is transferred to a customer for an amount that reflects the consideration the entity expects to receive in

exchange promised goods and services. The standard also includes Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers, which requires the deferral of incremental costs of obtaining a contract with a customer. Collectively, ASC 606 and Subtopic 340-40 are referred to as “ASC 606.”

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The Company adopted ASC 606 as of March 1, 2018, utilizing the full retrospective method of transition, which requires a restatement of each prior reporting period presented. In adopting ASC 606, the Company used the practical expedient where the transaction price allocated to the remaining performance obligations before the date of the initial application is not disclosed. The Company implemented new policies, processes and systems to enable both the preparation of financial information and internal controls over financial reporting in connection with its adoption of ASC 606. The impact of adopting ASC 606 on the Company's fiscal 2018 and fiscal 2017 revenue was not material. The primary impact of adopting the standard related to the deferral of incremental commission and other costs of obtaining contracts with customers. Previously, the Company deferred direct and incremental commission costs to obtain a contract and amortized those costs on a straight-line basis over a period that approximated the subscription period, and under ASC 606, the Company now also defers related fringe benefit costs.

Select adjusted unaudited financial statement information, which reflects the Company's adoption of ASC 606, is set forth below.

Consolidated balance sheets (in thousands):

	February 28, 2018		
	As Reported	Adjustments	As Adjusted
Prepaid expenses	$260,092	$ 7,105	$267,197
Deferred tax assets, net	$93,300	$ (694)	$92,606
Other assets, net	$87,924	$ 1,536	$89,460
Accounts payable and accrued expenses	$427,086	$ 53	$427,139
Retained earnings	$1,611,794	$ 7,894	$1,619,688

Consolidated statements of operations (in thousands, except per share amounts):

	Three Months Ended August 31, 2017			Six Months Ended August 31, 2017		
	As Reported	Adjustments	As Adjusted	As Reported	Adjustments	As Adjusted
Operating expense:						
Sales and marketing	$278,548	$ (231)	$278,317	$575,007	$ (2,367)	$572,640
Net income	$96,859	$ 229	$97,088	$170,049	$ 2,353	$172,402
Net income per share:						
Basic	$0.55	$ —	$0.55	$0.96	$ 0.01	$0.97
Diluted	$0.53	$ —	$0.53	$0.93	$ 0.01	$0.94

The Company's adoption of ASC 606 had no impact on net cash provided by or used in operating, investing or financing activities for any of the periods reported.

Accounting pronouncements being evaluated

In August 2018, the FASB issued Accounting Standards Update 2018-15, Intangibles—Goodwill and Other—Internal-Use Software: Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (a consensus of the FASB Emerging Issues Task Force) ("ASU 2018-15"). The FASB issued ASU 2018-15 to align the requirements for capitalizing implementation costs in a cloud computing arrangement service contract with the requirements for capitalizing implementation costs incurred for an internal-use software license. The guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2020, with early adoption permitted. The Company is currently evaluating the impact that this updated standard will have on its consolidated financial statements.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

In February 2016, the FASB issued Accounting Standards Update 2016-02, Leases (Topic 842) ("ASU 2016-02"). The FASB issued ASU 2016-02 to increase transparency and comparability among organizations with respect to accounting for leases. Under ASU 2016-02, lessees will recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. This guidance is effective for the Company as of the first quarter of its fiscal year ending February 28, 2020. Along with ASU 2016-02, the Company is also evaluating Accounting Standards Update 2018-10, Codification Improvements to Topic 842 Leases ("ASU 2018-10") and Accounting Standards Update 2018-11, Targeted Improvements to Topic 842 Leases ("ASU 2018-11"). The Company expects to adopt the transition method, which will not require adjustments to comparative periods nor require modified disclosures in those comparative periods. Upon adoption, the Company expects to elect the transition package of practical expedients permitted within the new standard, which among other things, allows the carryforward of the historical lease classification. The Company continues to evaluate which other, if any, practical expedients will be elected.

The Company continues to assess the impact of ASU 2016-02, ASU 2018-10 and ASU 2018-11, now commonly referred to as Accounting Standards Codification Topic 842 ("ASC 842"), including for example, any potential changes to and investments in the Company's policies, processes, systems and internal controls over financial reporting that may be required to comply with the new guidance related to identifying and measuring right-of-use assets and lease liabilities. While the Company continues to evaluate the effect of adopting this guidance on its consolidated financial statements and related disclosures, it is expected that the operating leases, as disclosed in NOTE 13—Commitments and Contingencies contained in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2018, will be reported in the consolidated balance sheets upon adoption.

NOTE 3—Accounts Receivable

Accounts receivable are presented net of an allowance for doubtful accounts. Activity in the Company's allowance for doubtful accounts is presented in the following table (in thousands):

As of	Balance at beginning of period	Charged to (recovery of) expense	Adjustments [1]	Balance at end of period
February 28, 2018	$ 2,791	172	(796)	$ 2,167
August 31, 2018	$ 2,167	1,398	(788)	$ 2,777

[1] Represents foreign currency translation adjustments and amounts written-off as uncollectible accounts receivable.

Included in accounts receivable, net of allowance for doubtful accounts, are unbilled receivables of $32.2 million and $25.8 million as of August 31, 2018 and February 28, 2018, respectively.

As of August 31, 2018, the Company had one customer whose accounts receivable balance individually represented 12% of total accounts receivable. As of February 28, 2018, no individual customer accounted for 10% or more of the Company's total accounts receivable.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 4—Identifiable Intangible Assets

Identifiable intangible assets consist primarily of trademarks, copyrights and patents, purchased technologies, customer and reseller relationships and covenants not to compete, all of 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 over the estimated useful life or the related asset's pattern of economic benefit. Useful lives range from two years to 10 years. As of August 31, 2018 and February 28, 2018, trademarks with an indefinite estimated useful life totaled $11.6 million and $12.0 million, respectively. The following is a summary of identifiable intangible assets (in thousands):

	August 31, 2018			February 28, 2018		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$171,850	$ (76,812)	$95,038	$167,005	$ (70,749)	$96,256
Purchased technologies	210,710	(103,294)	107,416	208,096	(93,748)	114,348
Customer and reseller relationships	105,949	(98,202)	7,747	106,076	(95,558)	10,518
Covenants not to compete	15,939	(14,486)	1,453	15,861	(14,324)	1,537
Other intangible assets	8,833	(7,227)	1,606	8,833	(6,539)	2,294
Total identifiable intangible assets	$513,281	$ (300,021)	$213,260	$505,871	$ (280,918)	$224,953

Amortization expense associated with identifiable intangible assets recognized in the Company's Consolidated Financial Statements is summarized as follows (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2018	August 31, 2017	August 31, 2018	August 31, 2017
Cost of revenue	$6,219	$4,670	$12,704	$8,850
Sales and marketing	1,400	1,583	2,762	3,042
Research and development	35	35	69	69
General and administrative	2,380	2,227	4,753	4,053
Total amortization expense	$10,034	$8,515	$20,288	$16,014

NOTE 5—Deferred Selling Costs

Deferred selling costs include commissions paid to the Company's sales associates that are the incremental costs incurred to obtain contracts with customers. The commissions are deferred and amortized over a period to approximate the period of the subscription term. For further discussion on deferred commissions, see NOTE 2—Summary of Significant Accounting Policies. Current and non-current deferred commissions are included in Prepaid expenses and Other assets, respectively, in the Company's Consolidated Balance Sheets and are as follows (in thousands):

	August 31, 2018	February 28, 2018 (1)
Deferred commissions, current	$175,272	$ 188,944
Deferred commissions, non-current	32,457	48,653
Total deferred commissions	$207,729	$ 237,597

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

Amortization of deferred commissions is included in Sales and marketing expense in the Company's Consolidated Statements of Operations. Amortization expense related to deferred commissions totaled $56.9 million and $41.2 million for the three months ended August 31, 2018 and August 31, 2017, respectively. Amortization expense related to deferred commissions totaled $113.1 million and $85.3 million for the six months ended August 31, 2018 and August 31, 2017, respectively. There was no impairment loss in relation to the costs capitalized for the periods presented.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 6—Derivative Instruments

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. From time to time, the Company enters into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded in the Consolidated Balance Sheets at their respective fair 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. See NOTE 15—Assets and Liabilities Measured at Fair Value on a Recurring Basis for information regarding the fair value hierarchy of derivative instruments.

The effects of derivative instruments on the Company's Consolidated Financial Statements are as follows (in thousands):

	August 31, 2018					
	Balance Sheet Classification	Fair Value	Notional Value	Classification of Gain (Loss) Recognized in Income on Derivatives	Three Months Ended August 31, 2018	Six Months Ended August 31, 2018
Assets—foreign currency forward contracts not designated as hedges	Other current assets	$147	$37,815	Other expense, net	$ 282	$ 571
Liabilities—foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(83)	22,201	Other expense, net	(314)	(1,450)
Total		$64	$60,016		$ (32)	$ (879)

	August 31, 2017					
	Balance Sheet Classification	Fair Value	Notional Value	Classification of Gain (Loss) Recognized in Income on Derivatives	Three Months Ended August 31, 2017	Six Months Ended August 31, 2017
Assets—foreign currency forward contracts not designated as hedges	Other current assets	$203	$24,166	Other expense, net	$ 675	$ 1,280
Liabilities—foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(57)	12,748	Other expense, net	(263)	(583)
Total		$146	$36,914		$ 412	$697

NOTE 7—Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act ("Tax Act") was enacted into law. This new law includes significant changes to the U.S. corporate income tax system, including a permanent reduction in the corporate income tax rate from 35% to 21%, limitations on the deductibility of interest expense and executive compensation, elimination of the domestic production activities deduction and the transition of U.S. international taxation from a worldwide tax system to a territorial tax system.

On August 21, 2018, the Internal Revenue Service issued Notice 2018–68 providing guidance regarding amendments to Section 162(m) of the Internal Revenue Code contained in the Tax Act ("IRS Guidance"), which limit tax deductions for compensation granted to certain executives. As a result of this guidance, our provision for income taxes for the three and six months ended August 31, 2018 includes the impact of this tax deduction limitation. For the three and six months ended August 31, 2018, the Company recorded a tax charge of approximately $18.0 million resulting primarily from the write-off of deferred tax assets associated with the non-deductibility of certain share-based compensation and the reversal of certain share-based compensation benefits previously recognized during the three months ended May 31, 2018.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

In December 2017, the SEC staff issued Staff Accounting Bulletin 118 ("SAB 118"), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC Topic 740—Income Taxes ("ASC 740"). The Company has calculated as final its re-measurement of deferred taxes and uncertain tax positions. While the Company has substantially completed its provisional analysis of the income tax effects of the Tax Act and recorded a reasonable estimate of such effects, the Company regards as provisional the transition tax, withholding and other taxes on future repatriation of cash, and the accounting for compensation accruals. These provisional tax effects may differ during the measurement period, possibly materially, due to further refinement of the calculations, changes in interpretations and assumptions made, and additional guidance that may be issued by the Department of the U.S. Treasury, the Internal Revenue Service, and other regulatory and standard setting bodies. The Company will complete its analysis within fiscal 2019 consistent with the guidance provided in SAB 118, and any adjustments during this measurement period will be included in net earnings from continuing operations as an adjustment to income tax expense in the reporting period when such adjustments are determined. The $18.0 million additional tax expense resulting from the IRS Guidance discussed above is an adjustment during the SAB 118 measurement period.

The effective tax rate for the three and six months ended August 31, 2018 of 35.7% and 18.9%, respectively, differed from the U.S. federal statutory rate of 21% primarily due to impacts from share-based compensation, research tax credits and the impact from the Tax Act. Tax expense for the three and six months ended August 31, 2018 included net discrete tax expense of $15.7 million and net discrete excess tax benefits of $11.1 million, respectively, primarily related to the impact from share-based compensation, inclusive of the $18.0 million adjustment under SAB 118.

For the three and six months ended August 31, 2017, the Company's then-effective tax rate of 26.5%[(1)] and 21.3% [(1)], respectively, differed from the U.S. federal statutory rate of 35% primarily due to excess tax benefits from share-based compensation, foreign income taxed at lower rates, research tax credits and the domestic-production-activities deduction. Tax expense for the three and six months ended August 31, 2017 included net discrete tax benefits of $1.4 million and $13.1 million, respectively, primarily related to net excess tax benefits from share-based compensation.

The Company files a consolidated U.S. federal income tax return, as well as separate and combined income tax returns in numerous state and international jurisdictions. The Company is currently subject to examination by various taxing jurisdictions. The Company regularly assesses the potential outcomes of both ongoing and future examinations for the current and prior years, and believes that its provision for income taxes is adequate. The outcome of any one examination is not expected to have a material impact on the Company's consolidated financial statements. The Company believes that some of these audits and negotiations may conclude during the next 12 months.

As of August 31, 2018, it is reasonably possible that total unrecognized tax benefits may be reduced by up to $0.5 million within the next 12 months primarily as a result of statutes of limitations expirations in various tax jurisdictions, all of which would affect the Company's effective tax rate.

---

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

NOTE 8—Convertible Notes

Convertible note offering

On October 7, 2014, the Company completed its offering of $805.0 million aggregate principal amount of the convertible notes. The convertible notes were sold in a private placement under a purchase agreement, dated as of October 1, 2014, entered into by and among the Company and the initial purchasers, for resale to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended. For additional information, see NOTE 11—Convertible Notes to the Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2018.

Indenture

On October 7, 2014, the Company entered into an indenture (the “Indenture”) with respect to the convertible notes with U.S. Bank National Association, as trustee (the “Trustee”). Under the Indenture, the convertible notes are senior unsecured obligations of the Company and bear interest at a rate of 0.25% per year, payable semiannually in arrears on April 1 and October 1 of each year, beginning on April 1, 2015. The convertible notes will mature on October 1, 2019, unless previously purchased or converted.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

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

At their option, holders may convert their convertible notes prior to the close of business on the business day immediately preceding April 1, 2019, only upon the occurrence of certain circumstances. For example, during any fiscal quarter commencing after the fiscal quarter ended on November 30, 2014 (and only during such fiscal quarter), if the last reported sale price of the Company's common stock for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding fiscal quarter is greater than or equal to 130% of the conversion price, the convertible notes become convertible at the holders' option. The price of the Company's common stock was greater than or equal to 130% of the conversion price, which is $95.43, for at least 20 trading days during the 30 consecutive trading days ending on the last trading day of each of the fiscal quarters ended August 31, 2017 through August 31, 2018. Therefore, as of August 31, 2018, the convertible notes remain convertible at the holders' option until November 30, 2018.

On and after April 1, 2019, holders may convert their convertible notes at any time until the close of business on the second scheduled trading day immediately preceding the maturity date of the convertible notes.

During the second quarter of the fiscal year ending February 28, 2019, the Company settled notices of conversion with respect to $244.6 million aggregate principal amount of the convertible notes and elected to settle such conversions by paying cash for the principal amount and issuing 1,774,798 shares of common stock for the excess conversion value. During the three and six months ended August 31, 2018, the Company recognized a loss on settled conversions of $1.4 million and $1.7 million, respectively. Total settled conversions as of August 31, 2018 amounted to $270.5 million aggregate principal amount of the convertible notes. The Company expects to settle conversions of $4.6 million in principal amount of the convertible notes in the third quarter of the fiscal year ending February 28, 2019 by paying cash for the principal amount and issuing shares of common stock for the excess conversion value. The Company continues to receive conversion requests and as of October 5, 2018, such incremental requests totaled $11.4 million in principal amount of the convertible notes. The aggregate principal amount of the convertible notes remaining is expected to be $518.5 million after the expected conversion settlements as discussed above and the incremental conversion requests received as of October 5, 2018.

Based on the closing price of the Company's common stock of $147.73 on the last trading day of the second quarter of the fiscal year ending February 28, 2019, the if-converted value of the convertible notes as of August 31, 2018 exceeded their principal amount by approximately $541.1 million.

The Company continues to classify the net carrying amount of the convertible notes as a long-term liability, except for $4.4 million, classified as current and expected to be cash-settled within the next fiscal quarter. The equity component of the convertible notes will continue to be classified as additional paid-in capital because the Company has the option to settle the principal amount in shares and the convertible notes' maturity date is more than 12 months away. However, it is the Company's intent to settle the principal amount of the convertible notes in cash.

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

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

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

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

In accounting for the issuance of the convertible notes, the Company separated the convertible notes into liability and equity components. The Company allocated the total transaction costs incurred to the liability and equity components based on their relative fair values. Issuance costs attributable to the liability component are being amortized to interest expense over the term of the convertible notes. The excess of the face value of the convertible notes as a whole over the carrying amount of the liability component (the "debt discount") is being amortized to interest expense over the term of the convertible notes. In addition, the debt discount is impacted by the derecognition of the original debt discount on early settlements of convertible notes. The convertible notes consisted of the following (in thousands):

	August 31, 2018	February 28, 2018
Liability component:		
Principal	$534,454	$804,966
Less: debt issuance costs	(3,163)	(4,695)
Less: debt discount	(14,761)	(32,271)
Net carrying amount	$516,530	$768,000
Equity component [(1)]	$64,327	$96,890

[(1)] Recognized in the Consolidated Balance Sheets in Additional paid-in capital.

The following table includes total interest expense recognized related to the convertible notes (in thousands):

	Three Months Ended		Six Months Ended	
	August 31, 2018	August 31, 2017	August 31, 2018	August 31, 2017
Coupon rate 0.25% per year, payable semiannually	$215	$503	$686	$1,006
Amortization of convertible note issuance costs — liability component	701	680	1,532	1,353
Accretion of debt discount	3,869	4,890	8,876	9,757
Total interest expense related to convertible notes	$4,785	$6,073	$11,094	$12,116

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

	August 31, 2018	
	Fair Value	Carrying Value
Convertible notes	$516,641	$516,530

Convertible note hedge transactions and warrant transactions

On October 1, 2014, the Company entered into convertible note hedge transactions and warrant transactions with certain of the initial purchasers of the convertible notes or their respective affiliates. In connection with the conversions of the convertible notes that settled in the second quarter of the fiscal year ending February 28, 2019, the Company exercised a portion of the options that are part of the convertible note hedge transactions for 1,774,754 shares of the Company's common stock.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The convertible note hedge transactions are expected to offset, to the extent the Company's common stock per share price does not exceed $101.65, the potential dilution with respect to shares of the Company's common stock upon any conversion of the convertible notes and/or offset any cash payments the Company is required to make in excess of the principal amount of the converted notes, as the case may be. To partially offset the $148.0 million cost of the convertible note hedge transactions, the Company issued warrants and received proceeds of $79.8 million. The number of shares of the Company's common stock underlying the warrants total 10,965,630, the number of shares originally underlying the convertible notes and the convertible note hedge transactions. The combination of the convertible note hedge transactions and the warrant transactions effectively increases the initial conversion price of the convertible notes from $73.41 per share to $101.65 per share. As a result, the warrant transactions will have a dilutive effect with respect to the Company's common stock to the extent that the market price per share of the Company's common stock, as measured under the terms of the warrant transactions, exceeds the $101.65 strike price of the warrants. For the three and six months ended August 31, 2018, the warrants were included in the computation of diluted shares outstanding because the warrants' exercise price was less than the average market price of the Company's common stock during the related period. However, subject to certain conditions, the Company may elect to settle all of the warrants in cash.

NOTE 9—Commitments and Contingencies

Operating leases

As of August 31, 2018, the Company leased office space and certain equipment under various non-cancellable operating leases. Rent expense under operating leases for the three months ended August 31, 2018 and August 31, 2017 was $13.7 million and $12.8 million, respectively. Rent expense under operating leases for the six months ended August 31, 2018 and August 31, 2017 was $27.1 million and $25.3 million, respectively.

Product indemnification

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party from losses arising in connection with the Company's services or products, or from losses arising in connection with certain events defined within a particular contract, which may include litigation or claims relating to intellectual property infringement, certain losses arising from damage to property or injury to persons or other matters. In each of these circumstances, payment by the Company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party's claims. Further, the Company's obligations under these agreements may in certain cases be limited in terms of time and/or amount, and in some instances, the Company may have recourse against third parties for certain payments made by the Company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the facts and circumstances involved in each particular agreement. The Company does not record a liability for claims related to indemnification unless the Company concludes that the likelihood of a material claim is probable and estimable. Payments pursuant to these indemnification claims during the three and six months ended August 31, 2018 and August 31, 2017 were, in the aggregate, immaterial.

NOTE 10—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.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

NOTE 11—Stockholders' Equity

The following table summarizes the changes in the Company's stockholders' equity during the three months ended August 31, 2018 (in thousands):

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Shares	Amount					
Balance at May 31, 2018	239,779	$ 24	$2,399,925	$1,733,270	$(2,657,774)	$ (43,501)	$1,431,944
Net income	—	—	—	86,854	—	—	86,854
Other comprehensive loss, net of tax	—	—	—	—	—	(8,135)	(8,135)
Vest and exercise of share-based awards	235	—	189	—	—	—	189
Common stock repurchase	—	—	17,175	—	(267,210)	—	(250,035)
Share-based compensation expense	—	—	52,686	—	—	—	52,686
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(17,638)	—	—	—	(17,638)
Convertible note conversions	1,775	—	(6,075)	—	—	—	(6,075)
Exercises of convertible note hedges	—	—	130,298	—	(130,284)	—	14
Balance at August 31, 2018	241,789	$ 24	$2,576,560	$1,820,124	$(3,055,268)	$ (51,636)	$1,289,804

The following table summarizes the changes in the Company's stockholders' equity during the three months ended August 31, 2017 (in thousands):

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Shares	Amount					
Balance at May 31, 2017	237,789	$ 24	$2,295,123	$1,433,151	$(2,350,044)	$ (65,740)	$1,312,514
Net income	—	—	—	97,088	—	—	97,088
Other comprehensive income, net of tax	—	—	—	—	—	32,564	32,564
Vest and exercise of share-based awards	189	—	862	—	—	—	862
Common stock repurchase	—	—	—	—	(75,015)	—	(75,015)
Share-based compensation expense	—	—	46,947	—	—	—	46,947
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(7,413)	—	—	—	(7,413)

Other adjustments	—	—	(1)	—	—	—	(1)
Balance at August 31, 2017	237,978	$ 24	$2,335,518	$1,530,239	$(2,425,059)	$ (33,176)	$1,407,546

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The following table summarizes the changes in the Company's stockholders' equity during the six months ended August 31, 2018 (in thousands):

	Common Stock		Additional Paid-In Capital	Retained Earnings [1]	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Shares	Amount					
Balance at February 28, 2018	238,689	$ 24	$2,416,080	$1,619,688	$(2,525,072)	$ (32,596)	$1,478,124
Net income	—	—	—	200,044	—	—	200,044
Other comprehensive loss, net of tax	—	—	—	—	—	(19,040)	(19,040)
Vest and exercise of share-based awards	1,140	—	1,064	—	—	—	1,064
Common stock repurchase	—	—	—	—	(400,054)	—	(400,054)
Share-based compensation expense	—	—	98,691	—	—	—	98,691
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(94,732)	—	—	—	(94,732)
Re-issuance of treasury stock under employee stock purchase plan	—	—	18,471	—	13,740	—	32,211
Convertible note conversions	1,960	—	(6,910)	—	—	—	(6,910)
Exercises of convertible note hedges	—	—	143,896	—	(143,882)	—	14
Cumulative-effect adjustment from adoption of ASU 2016-01	—	—	—	392	—	—	392
Balance at August 31, 2018	241,789	$ 24	$2,576,560	$1,820,124	$(3,055,268)	$ (51,636)	$1,289,804

(1) As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

The following table summarizes the changes in the Company's stockholders' equity during the six months ended August 31, 2017 (in thousands):

	Common Stock		Additional Paid-In Capital	Retained Earnings [1]	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
	Shares	Amount					
Balance at February 28, 2017	236,805	$ 24	$2,294,462	$1,357,837	$(2,311,805)	$ (88,352)	$1,252,166
Net income	—	—	—	172,402	—	—	172,402
Other comprehensive income, net of tax	—	—	—	—	—	55,176	55,176
Vest and exercise of share-based awards	1,173	—	3,830	—	—	—	3,830
Common stock repurchase	—	—	—	—	(137,002)	—	(137,002)
Share-based compensation expense	—	—	90,665	—	—	—	90,665
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(48,423)	—	—	—	(48,423)
Re-issuance of treasury stock under employee stock purchase plan	—	—	—	—	23,748	—	23,748
Other adjustments	—	—	(5,016)	—	—	—	(5,016)
Balance at August 31, 2017	237,978	$ 24	$2,335,518	$1,530,239	$(2,425,059)	$ (33,176)	$1,407,546

[1] As adjusted to reflect the impact of the retrospective application of ASC 606. See NOTE 2—Summary of Significant Accounting Policies for detailed information on adoption of ASC 606.

Share repurchase programs

On June 22, 2016, the Company announced that its Board of Directors authorized the repurchase of up to $1.0 billion of Red Hat's common stock from time to time on the open market or in privately negotiated transactions. The program commenced on July 1, 2016 and expired on June 30, 2018.

From July 1, 2016 through its expiration on June 30, 2018, the Company repurchased 8,167,871 shares of its common stock for $751.3 million under this repurchase program.

On June 21, 2018, the Company announced that its Board authorized the repurchase of up to $1.0 billion of Red Hat's common stock from time to time on the open market or in privately negotiated transactions. The new program commenced on July 1, 2018, and will expire on the earlier of (i) June 30, 2020 or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program. The new program replaced the previous $1.0 billion repurchase program, which expired on June 30, 2018.

From its commencement on July 1, 2018 through August 31, 2018, the Company repurchased 1,744,034 shares of its common stock at an aggregate cost of $250.0 million under this repurchase program. These amounts are recognized in Treasury stock in the Company's Consolidated Balance Sheets in addition to $17.2 million, representing 103,744 shares, reclassified from Additional paid-in capital to Treasury stock during the quarter ended August 31, 2018 for transactions related to the prior repurchase program.

As of August 31, 2018, the amount available under this program for the repurchase of the Company's common stock was $750.0 million.

RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Accumulated other comprehensive loss

Accumulated other comprehensive loss was comprised of the following (in thousands):

	August 31, 2018	February 28, 2018
Accumulated loss from foreign currency translation adjustment	$(48,969)	$(29,679)
Accumulated unrealized loss, net of tax, on available-for-sale securities	(2,667)	(2,917)
Accumulated other comprehensive loss	$(51,636)	$(32,596)

NOTE 12—Deferred Revenue and Performance Obligations

Activity in the Company’s deferred revenue accounts is presented in the following table (in thousands):

	February 28, 2018	Revenue recognized from opening balance	Deferred revenue, net [(1)]	August 31, 2018
Deferred revenue, short-term	$1,853,719	$(619,067)	$448,851	$1,683,503
Deferred revenue, long-term	741,453	—	(31,707)	709,746
Total deferred revenue	$2,595,172	$(619,067)	$417,144	$2,393,249

(1) Includes revenue recognized from current period customer contracts and the impact from foreign currency exchange rate fluctuations.

As of August 31, 2018, the value of customer contracts allocated to performance obligations not yet satisfied, including $2.39 billion of total deferred revenue, was approximately $3.21 billion, of which approximately 60% is expected to be recognized as revenue within the next 12 months and the remainder thereafter.

In addition to the approximately $3.21 billion of customer contract value allocated to performance obligations not yet satisfied, as of August 31, 2018, the Company has offered customers options to purchase additional services at an agreed-upon price per hour that total approximately $129.6 million.

The summation of the customer contract value allocated to performance obligations not yet satisfied and the options to purchase additional services equals approximately $3.34 billion, which the Company considers as its total backlog.

NOTE 13—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 available to common stockholders 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, vesting of share-based awards, settlement of convertible notes, or exercise of warrants.

The following table reconciles the numerators and denominators of the earnings per share (“EPS”) calculation (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	August 31, 2018	August 31, 2017 (1)	August 31, 2018	August 31, 2017 (1)
Net income available to common stockholders	$86,854	$ 97,088	$200,044	$ 172,402
Weighted average common shares outstanding	176,746	177,257	177,024	177,250
	2,997	3,058	3,525	3,021

Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares				
Dilutive effect of convertible notes	3,699	2,706	3,801	2,189
Dilutive effect of warrants	3,494	—		