SOURCEFIRE INC
Form 10-Q
May 08, 2009

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

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2009

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number
1-33350

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

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

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. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

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

Yes o No þ

As of May 4, 2009, there were 26,136,368 outstanding shares of the registrant s Common Stock.

SOURCEFIRE, INC.
Form 10-Q
TABLE OF CONTENTS

Part I	
Item 1. Financial Statements	3
Consolidated Balance Sheets as of March 31, 2009 and December 31, 2008	3
Consolidated Statements of Operations for the three months ended March 31, 2009 and 2008	4
Consolidated Statement of Changes in Stockholders Equity for the three months ended March 31, 2009	5
Consolidated Statements of Cash Flows for the three months ended March 31, 2009 and 2008	6
Notes To Consolidated Financial Statements	7
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3. Quantitative and Qualitative Disclosures About Market Risk	28
Item 4. Controls and Procedures	28
Part II.	
Item 1. Legal Proceedings	30
Item 1a. Risk Factors	30
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	40
Item 3. Defaults Upon Senior Securities	40
Item 4. Submission of Matters to a Vote of Security Holders	40
Item 5. Other Information	40
Item 6. Exhibits	40
Signatures	42

Part I. FINANCIAL INFORMATION
Item 1. Financial Statements

SOURCEFIRE, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except par value and share amounts)

	March 31, 2009 (unaudited)	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 50,809	$ 39,768
Short-term investments	52,912	59,343
Accounts receivable, net of allowances of $606 as of March 31, 2009 and $538 as of December 31, 2008	21,944	27,864
Inventory	4,354	4,521
Prepaid expenses and other current assets	2,493	2,115
Total current assets	132,512	133,611
Property and equipment, net	8,178	8,341
Intangible assets, net of accumulated amortization	434	465
Investments	1,580	2,457
Other assets	1,581	1,431
Total assets	$ 144,285	$ 146,305
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,641	$ 4,505
Accrued compensation and related expenses	3,328	4,229
Other accrued expenses	2,991	3,558
Current portion of deferred revenue	22,335	21,513
Other current liabilities	623	789
Total current liabilities	30,918	34,594
Deferred revenue, less current portion	4,133	2,595
Other long-term liabilities	76	75
Total liabilities	35,127	37,264
Commitments and Contingencies		
Stockholders equity:		
Preferred stock, $0.001 par value; 19,700,000 shares authorized; no shares issued or outstanding at March 31, 2009 and December 31, 2008		

Series A junior participating preferred stock, $0.001 per value; 300,000 shares authorized; no shares issued or outstanding at March 31, 2009 and December 31, 2008				
Common stock, $0.001 par value; 240,000,000 shares authorized; 26,011,985 and 25,917,519 shares issued and outstanding as of March 31, 2009 and December 31, 2008, respectively		25		25
Additional paid-in capital		160,636		159,306
Accumulated deficit		(51,711)		(50,594)
Accumulated other comprehensive income		208		304
Total stockholders equity		109,158		109,041
Total liabilities and stockholders equity	$	144,285	$	146,305

See accompanying notes to consolidated financial statements.

SOURCEFIRE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(in thousands, except share and per share amounts)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Revenue:		
Products	$ 9,868	$ 6,851
Technical support and professional services	8,732	6,800
Total revenue	18,600	13,651
Cost of revenue:		
Products	2,767	1,997
Technical support and professional services	1,382	1,041
Total cost of revenue	4,149	3,038
Gross profit	14,451	10,613
Operating expenses:		
Research and development	3,320	3,111
Sales and marketing	7,870	7,234
General and administrative	3,843	4,414
Depreciation and amortization	821	492
Total operating expenses	15,854	15,251
Loss from operations	(1,403)	(4,638)
Other income, net:		
Interest and investment income	384	1,155
Interest expense	(10)	
Other income (expense)	(13)	49
Total other income, net	361	1,204
Loss before income taxes	(1,042)	(3,434)
Income tax expense	75	62
Net loss	$ (1,117)	$ (3,496)
Net loss:		
Basic and diluted	$ (0.04)	$ (0.14)
Weighted average shares outstanding used in computing per share amounts:		
Basic and diluted	25,934,259	24,766,375

See accompanying notes to consolidated financial statements

SOURCEFIRE, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)
(in thousands, except share amounts)

	Common Stock		Additional Paid In	Accumulated	Accumulated Other Comprehensive Income	
	Shares	Amount	Capital	Deficit	(Loss)	Total
Balance as of January 1, 2009	25,917,519	$ 25	$ 159,306	$ (50,594)	$ 304	$ 109,041
Exercise of common stock options	71,541		128			128
Issuance of restricted common stock	22,925					
Stock-based compensation expense			1,202			1,202
Comprehensive loss:						
Net loss for the three months ended March 31, 2009				(1,117)		(1,117)
Net unrealized loss on investments					(96)	(96)
Total comprehensive loss						(1,213)
Balance as of March 31, 2009	26,011,985	$ 25	$ 160,636	$ (51,711)	$ 208	$ 109,158

See accompanying notes to consolidated financial statements.

SOURCEFIRE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	Three Months Ended March 31,	
	2009	**2008**
Operating activities		
Net loss	$ (1,117)	$ (3,496)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	834	499
Provision for (benefit from) doubtful accounts	68	(49)
Non-cash stock-based compensation	1,202	922
Amortization of premium on investments	(105)	(345)
Realized gain from sales of investments		(23)
Changes in operating assets and liabilities:		
Accounts receivable	5,852	6,758
Inventory	167	(1,187)
Prepaid expenses and other assets	(528)	163
Accounts payable	(2,863)	(1,893)
Accrued expenses	(1,468)	779
Deferred revenue	2,360	(37)
Other liabilities	(133)	(247)
Net cash provided by operating activities	4,269	1,844
Investing activities		
Purchase of property and equipment	(639)	(1,692)
Purchase of investments	(15,335)	(19,162)
Proceeds from maturities of investments	22,650	27,500
Proceeds from sales of investments		3,230
Increase in restricted cash		(17)
Net cash provided by investing activities	6,676	9,859
Financing activities		
Repayments of capital lease obligations	(32)	
Proceeds from employee stock-based plans	128	177
Excess tax benefits related to share-based payments		10
Net cash provided by financing activities	96	187
Net increase in cash and cash equivalents	11,041	11,890
Cash and cash equivalents at beginning of period	39,768	33,071
Cash and cash equivalents at end of period	$ 50,809	$ 44,961

See accompanying notes to consolidated financial statements.

SOURCEFIRE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Description of Business

We are a leading provider of Enterprise Threat Management, or ETM, intelligent security infrastructure solutions for information technology, or IT, environments of commercial enterprises (such as healthcare, financial services, manufacturing, energy, education, retail and telecommunications) and federal and state government organizations. The Sourcefire 3D® System comprised of multiple Sourcefire hardware and software product offerings provides a comprehensive, intelligent approach to network protection that equips our customers with an efficient and effective layered security defense protecting computer network assets before, during and after an attack.

We are also the creator of Snort® and the owner of ClamAV®. Snort is an open source intrusion prevention technology that is incorporated into the IPS software component of the Sourcefire 3D® System (Discover, Determine, Defend). ClamAV is an open source anti-virus and anti-malware project.

In addition to our commercial and open source network security products, we offer a variety of services to aid our customers with installing and supporting Sourcefire ETM solutions. Available services include Customer Support, Education, Professional Services and Sourcefire Vulnerability Research Team, or VRT, Snort rule subscriptions.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to those rules or regulations. The interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, considered necessary for a fair presentation. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in our Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission on March 16, 2009. The results of operations for the interim periods are not necessarily indicative of results to be expected in future periods.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

On an ongoing basis, we evaluate our estimates, including those related to the accounts receivable allowance, sales return allowance, warranty, reserve for excess and obsolete inventory, useful lives of long-lived assets (including intangible assets), income taxes, and our assumptions used for the purpose of determining stock-based compensation, among other things. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the period presented.

Investments

We account for investments in accordance with Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standard, or SFAS, No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. We determine the appropriate classification of debt securities at the time of purchase and reevaluate such designation as of each balance sheet date. Our investments are comprised of money market funds, corporate debt investments, asset-backed securities, commercial paper, government-sponsored enterprises, government securities and certificates of deposit. These investments have been classified as available-for-sale. Available-for-sale investments are stated at fair value, with the unrealized gains and losses, net of tax, reported in accumulated other comprehensive income. The amortization of premiums and accretion of discounts to maturity are computed under the effective interest method. Such amortization is included in interest and investment income. Interest on securities classified as available-for-sale is also included in interest and investment income. Any other-than-temporary declines in fair value are recorded in earnings, and a new cost basis for the investment is established. (See Note 3 for further discussion of the classification of our investments.)

We evaluate our investments on a regular basis to determine whether an other-than-temporary decline in fair value has occurred. This evaluation consists of a review of several factors, including, but not limited to: the length of time and extent that an investment has been in an unrealized loss position; the existence of an event that would impair the issuer s future earnings potential; and our intent and ability to hold an investment for a period of time sufficient to allow for any anticipated recovery in fair value. Declines in value below cost for investments where it is considered probable that all contractual terms of the investment will be satisfied, where the decline is due primarily to changes in interest rates, and where we have the intent and ability to hold the investment for a period of time sufficient to allow a market recovery, are not assumed to be other-than-temporary.

Fair Value of Financial Instruments

Our financial instruments include cash and cash equivalents, accounts receivable, cash surrender value on our split-dollar life insurance policy, accounts payable and deferred revenue. The fair value of these financial instruments approximates their carrying amounts reported in the consolidated balance sheets. The fair value of available-for-sale investments is determined using quoted market prices for those investments.

Allowance for Doubtful Accounts and Sales Returns

We make estimates regarding the collectability of our accounts receivable. When we evaluate the adequacy of our allowance for doubtful accounts, we consider multiple factors, including historical write-off experience, the need for specific customer reserves, the aging of our receivables, customer creditworthiness and changes in customer payment cycles. Historically, our allowance for doubtful accounts has been adequate based on actual results. If any of the factors used to calculate the allowance for doubtful accounts change or does not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed, and our future results of operations could be materially affected.

We make estimates regarding potential future product returns related to reported product revenue. We analyze factors such as our historical return experience, current product sales volumes, and changes in product warranty claims when evaluating the adequacy of the sales returns allowance. Our judgment is used in connection with estimating the sales returns allowance in any accounting period. If any of the factors used to calculate the sales return allowance change, we may experience a material difference in the amount and timing of our product revenue for any period.

Inventories

Inventories consist of hardware and related component parts and are stated at the lower of cost on a first-in, first-out basis or market, except for evaluation units which are stated at the lower of cost, on a specific identification basis, or market. Evaluation units are used for customer testing and evaluation and are predominantly located at the customers premises. Inventory that is obsolete or in excess of our forecasted demand is written down to its estimated net realizable value based on historical usage, expected demand, and age. It is reasonably possible that our estimate of future demand for our products could change in the near term and result in additional inventory write-offs, which would negatively impact our gross margin.

Revenue Recognition

We derive revenue from arrangements that include products with embedded software, software licenses and royalties, technical support, and professional services. Revenue from products in the accompanying consolidated statements of operations consists primarily of sales of software-based appliances, but also includes fees and royalties for the license of our technology in a software-only format and subscriptions to receive rules released by the VRT that are used to update the appliances for current exploits and vulnerabilities. Technical support, which generally has a contractual term of 12 months, includes telephone and web-based support, software updates, and rights to software upgrades on a when-and-if-available basis. Professional services include training and consulting.

For each arrangement, we defer revenue recognition until: (a) persuasive evidence of an arrangement exists (e.g., a signed contract); (b) delivery of the product has occurred and there are no remaining obligations or substantive customer acceptance provisions; (c) the fee is fixed or determinable; and (d) collection of the fee is probable.

We allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on vendor-specific objective evidence. If vendor-specific objective evidence of fair value does not exist for each of the deliverables, all revenue from the arrangement is deferred until the earlier of the point at which sufficient vendor-specific objective evidence of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. However, if the only undelivered elements are elements for which we currently have vendor-specific objective evidence of fair value, we recognize revenue for the delivered elements based on the residual method as prescribed by the AICPA Statement of Position, or SOP, 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions*.

We have established vendor-specific objective evidence of fair value for our technical support based upon actual renewals of each type of technical support that is offered and for each customer class. Technical support and technical support renewals are currently priced based on a percentage of the list price of the respective product or software and historically have not varied from a narrow range of values in the substantial majority of our arrangements. Revenue related to technical support is deferred and recognized ratably over the contractual period of the technical support arrangement, which is generally 12 months. The vendor-specific objective evidence of fair value of our other services is based on the price for these same services when they are sold separately. Revenue for services that are sold either on a stand-alone basis or included in multiple element arrangements is deferred and recognized as the services are performed.

All amounts billed or received in excess of the revenue recognized are included in deferred revenue. In addition, we defer all direct costs associated with revenue that has been deferred. These amounts are included in either prepaid expenses and other current assets or inventory in the accompanying balance sheets, depending on the nature of the costs and the reason for the deferral.

For sales through resellers and distributors, we recognize revenue upon the shipment of the product only if those resellers and distributors provide us, at the time of placing their order, with the identity of the end-user customer to whom the product has been sold. We do not currently offer any rights to return products sold to resellers and distributors. To the extent that a reseller or distributor requests an inventory or stock of products, we defer revenue on that product until we receive notification that it has been sold through to an identified end-user.

We record taxes collected on revenue-producing activities on a net basis.

For the three months ended March 31, 2009 and 2008, we had no significant customers that accounted for 10% or more of revenue recognized during such periods.

As of March 31, 2009, one customer, a federal reseller, accounted for approximately 11% of our accounts receivable.

Warranty

We warrant that our software will perform in accordance with its documentation for a period of 90 days from the date of shipment. Similarly, we warrant that the hardware will perform in accordance with its documentation for a period of one year from date of shipment. We further agree to repair or replace software or products that do not conform to those warranties. The one year warranty on hardware coincides with the hardware warranty that we obtain from the manufacturer. We estimate the additional costs, if any, that may be incurred under our warranties outside of the warranties supplied by the manufacturer and record a liability at the time product revenue is recognized. Factors that affect our warranty liability include the number of sold units, historical and anticipated rates of warranty claims and the estimated cost per claim. We periodically assess the adequacy of our recorded warranty liability and adjust the amounts as necessary. While actual warranty costs have historically been within our cost estimations, it is possible that warranty rates could increase in the future due to new hardware introductions, general hardware component cost and availability, among other factors.

We also offer an additional warranty as part of our extended service arrangements. We provide for this warranty through an advance replacement pool, which includes replacement units and spare parts. This pool is used to provide replacement units under the extended warranty if a customer s unit is not functioning. This pool is included in other assets and is amortized using the straight-line method over their useful life, which is determined to be three years. Amortization expense is included in technical support and professional services cost of revenue on our consolidated statements of operations.

Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the basis of assets and liabilities recorded for financial reporting purposes and the amounts recognized for income tax purposes. We record a valuation allowance to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of March 31, 2009 and December 31, 2008, our deferred tax assets were fully reserved except for foreign deferred tax assets of $71,000, expected to be available to offset foreign tax liabilities in the future. For the three months ended March 31, 2009 and 2008, we recorded a provision for income taxes of $75,000 and $62,000, respectively, primarily related to foreign income taxes.

On January 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, Accounting for Income Taxes*, or FIN 48. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have an impact on our financial position or results of operations.

Stock-Based Compensation

On January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, which requires us to expense the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The expense must be recognized ratably over the requisite service period following the date of grant. We applied the prospective transition method, which requires us to apply its provisions only to awards granted, modified, repurchased or cancelled after the effective date. Under this prospective transition method, stock-based compensation expense recognized beginning January 1, 2006 is based on the grant date fair value of stock awards granted or modified after January 1, 2006. As we had used the minimum value method for valuing our stock options under the disclosure requirements of SFAS No. 123, *Accounting for Stock Based Compensation*, all options granted prior to January 1, 2006 continue to be accounted for under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Additionally, the pro forma disclosures that were required under the original provisions of SFAS No. 123 are no longer provided for outstanding awards accounted for under the intrinsic-value method of APB No. 25 beginning in periods after the adoption of SFAS No. 123(R).

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position, or FSP, No. 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2), which delayed the effective date of SFAS No. 157 by one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On January 1, 2008, we adopted SFAS No. 157 for financial assets and liabilities. The adoption did not have a material impact on our consolidated financial statements. On January 1, 2009, we adopted SFAS No. 157 for non-financial assets and liabilities. The adoption of SFAS No. 157 as it pertains to non-financial assets and non-financial liabilities did not have a material impact on our financial statements. See Note 6 for additional discussion of fair value measurements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The FSP amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments,* and APB Opinion No. 28, *Interim Financial Reporting*, to require disclosures about the fair value of financial instruments during interim reporting periods. The effective date for this FSP is interim and annual periods ending after June 15, 2009. We will comply with the required disclosures of this FSP when it is effective.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. The FSP amends the other-than-temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities. The FSP is effective for interim and annual periods ending after June 15, 2009. We do not expect this FSP to have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. The FSP provides additional guidance for estimating fair value when the market activity for an asset or liability has declined significantly and includes guidance on identifying circumstances that indicate a transaction is not orderly. The FSP is effective for interim and annual periods ending after June 15, 2009. We do not expect this FSP to have a material impact on our consolidated financial statements.

Reclassifications

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

3. Investments

The following is a summary of available-for-sale investments as of March 31, 2009 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Money market funds	$ 24,786	$	$	$ 24,786
Corporate debt investments	11,024	20	(22)	11,022
Asset-backed securities	3,312	28		3,340
Commercial paper	26,119	109		26,228
Government-sponsored enterprises	20,320	76	(4)	20,392
Government securities	998	1		999
Certificate of deposit	2,002			2,002
Total investments	88,561	$ 234	$ (26)	88,769
Amounts classified as cash equivalents	(34,275)	(2)		(34,277)
Total available-for-sale investments	$ 54,286	$ 232	$ (26)	$ 54,492

We concluded that there were no other-than-temporary declines in investments recorded as of March 31, 2009. For the three months ended March 31, 2009, the net unrealized holding loss on available-for-sale securities included in other comprehensive loss totaled $96,000. The investments in an unrealized loss position have a relatively short maturity and we have the intent and ability to hold these investments until they recover in value or mature. We expect to receive all of our principal and interest upon maturity. For the three months ended March 31, 2009, the deferred tax benefit recorded in other comprehensive loss was fully offset by the increase of the valuation allowance we recorded for related deferred tax assets.

The net carrying value and estimated fair value of available-for-sale investments by contractual maturity as of March 31, 2009 are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 52,704	$ 52,912
Due after one year through five years	1,582	1,580

Total	$ 54,286	$ 54,492

4. Stock-Based Compensation

During 2002, we adopted the Sourcefire, Inc. 2002 Stock Incentive Plan (the 2002 Plan). The 2002 Plan provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by our Board of Directors. As of March 31, 2009, we have reserved an aggregate of 5,100,841 shares of common stock for issuance under the 2002 Plan. Following the adoption of the 2007 Stock Incentive Plan (the 2007 Plan) described below, there are no additional shares available for grant under the 2002 Plan.

In March 2007, our Board of Directors approved the 2007 Plan, which provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Board of Directors. As of December 31, 2008, we had reserved an aggregate of 4,128,149 shares of common stock for issuance under the 2007 Plan. On January 1, 2009, under the terms of the 2007 Plan, the aggregate number of shares reserved for issuance under the 2007 Plan was increased by an amount equal to 4% of our outstanding common stock as of December 31, 2008, or 1,036,701 shares. Therefore, as of March 31, 2009, we have reserved an aggregate of 5,164,850 shares of common stock for issuance under the 2007 Plan.

The 2002 Plan and the 2007 Plan are administered by the Compensation Committee of our Board of Directors, which determines the vesting period for awards under the plans, generally from three to four years. Options granted have a maximum term of 10 years. The exercise price of stock option awards is generally equal to at least the fair value of the common stock on the date of grant. The fair value of our common stock is determined by reference to the closing trading price of the common stock on the NASDAQ Global Market on the date of grant.

Valuation of Stock-Based Compensation

SFAS No. 123(R), *Share-based Payment*, requires the use of a valuation model to calculate the fair value of stock-based awards. We use the Black-Scholes option pricing model for estimating the fair value of stock options granted and for employee stock purchases under the 2007 Employee Stock Purchase Plan (the ESPP). For certain option awards that contain market conditions relating to our stock price achieving certain levels, we use a Lattice option pricing model. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected price volatility. Additionally, the recognition of expense requires the estimation of the number of options that will ultimately vest and the number of options that will ultimately be forfeited. Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures. For the three months ended March 31, 2009, we have assumed a forfeiture rate of 17% per annum for options and 14% per annum for restricted stock grants. We rely on historical experience of employee turnover to estimate our expected forfeitures.

The following are the weighted-average assumptions and fair values used in the Black Scholes option valuation of stock options granted under the 2002 Plan and the 2007 Plan and employee stock purchases under the ESPP.

	Three Months Ended March 31,	
	2009	**2008**
Stock options:		
Average risk-free interest rate	2.22%	2.97%
Expected dividend yield	0.0%	0.0%
Expected useful life (years)	6.25	6.25
Expected volatility	64.7%	66.6%
Weighted-average fair value per grant	$ 4.00	$ 4.29
Employee stock purchase plan:		
Average risk-free interest rate	%	2.50%
Expected dividend yield		0.0%
Expected useful life (years)		0.37
Expected volatility	%	57.5%
Weighted-average fair value per purchase	$	$ 1.64

Average risk-free interest rate This is the average U.S. Treasury rate (with a term that most closely resembles the expected life of the option) for the period in which the option was granted.

Expected dividend yield We have never declared or paid dividends on our common stock and do not anticipate paying dividends in the foreseeable future.

Expected useful life This is the period of time that the stock options granted under the 2002 Plan and the 2007 Plan and employee purchases under the ESPP are expected to remain outstanding.

For stock options granted under the 2002 Plan and the 2007 Plan, this estimate is derived from the average midpoint between the weighted-average vesting period and the contractual term as described in the SEC s Staff Accounting Bulletin (SAB) No.107, *Share-Based Payment*, as amended by SAB No. 110.

For purchases under the ESPP, the expected useful life is the plan period.

Expected volatility Volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period.

For stock options granted under the 2002 Plan and the 2007 Plan, given our limited historical stock data from our IPO in March 2007, we have used a blended volatility to estimate expected volatility. The blended volatility includes the average of our historical volatility from our IPO to the respective grant date and an average of our peer group historical volatility consistent with the expected life of the option. Our peer group historical volatility includes the historical volatility of companies that are similar in revenue size, in the same industry or are competitors. We expect to continue to use a larger proportion of our historical volatility in future periods as we develop appropriate historical experience of our own stock price fluctuations considered in relation to the expected life of the option.

For purchases under the ESPP, we use our historical volatility since we have historical data available since our IPO consistent with the expected useful life.

If we had made different assumptions about the stock price volatility rates, expected useful life, expected forfeitures and other assumptions, the related stock-based compensation expense and net loss could have been significantly different.

The following table summarizes compensation expense included in the accompanying consolidated statements of operations (in thousands):

	Three Months Ended March 31,	
	2009	**2008**
Product cost of revenue	$ 11	$ 7
Services cost of revenue	33	21
Stock-based compensation expense included in cost of revenue	44	28
Research and development	205	174
Sales and marketing	383	343
General and administrative	570	377
Stock-based compensation expense included in operating expenses	1,158	894
Total stock-based compensation expense	$ 1,202	$ 922

Stock Options

The following table summarizes stock option activity under the plans for the three months ended March 31, 2009 (in thousands, except share and per share data):

	Number of Shares	**Range of Exercise Prices**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**
Outstanding at December 31, 2008	3,296,322	$ 0.24 to 15.49	$ 5.26	$ 5,878
Granted	78,000	5.58 to 7.23	6.55	
Exercised	(71,541)	0.24 to 5.26	1.79	
Forfeited	(20,415)	5.26 to 13.10	10.53	

Outstanding at March 31, 2009	3,282,366	$	0.24 to 15.49	$	5.33	$	8,704
Vested and exercisable at March 31, 2009	1,788,495	$	0.24 to 15.49	$	3.62	$	7,807
Vested and expected to vest at March 31, 2009	2,739,151			$	4.90	$	8,376

The following table summarizes information about stock options outstanding as of March 31, 2009:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted-Average Exercise Prices	Weighted-Average Contractual Life (Years)	Number of Shares	Weighted-Average Exercise Prices
$0.24 to 1.62	896,042	$ 0.73	4.61	896,042	$ 0.73
$2.03 to 6.47	830,209	4.34	7.55	493,757	3.36
$6.50 to 7.45	858,724	6.83	9.30	19,927	7.45
$7.93 to 15.49	697,391	10.56	7.72	378,769	10.62
	3,282,366	$ 5.33	7.24	1,788,495	$ 3.62

The aggregate intrinsic value of all options exercised during the three months ended March 31, 2009 and 2008 was $378,000 and $301,000, respectively.

Outstanding stock option awards are generally subject to service-based vesting; however, in some instances, awards contain provisions for acceleration of vesting upon performance measures, change in control and in certain other circumstances. On a quarterly basis, we evaluate the probability of achieving performance measures and adjust compensation expense accordingly. Based on the estimated grant date fair value of employee stock options granted, we recognized compensation expense of $641,000 and $535,000 for the three months ended March 31, 2009 and 2008, respectively. The grant date aggregate fair value of options, net of estimated forfeitures, not yet recognized as expense as of March 31, 2009 was $4.6 million, which will be recognized over a weighted average period of 2.89 years.

Restricted Stock Awards

The following table summarizes the unvested restricted stock award activity during the three months ended March 31, 2009:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested at December 31, 2008	656,361	$ 7.77
Granted	22,925	7.68
Restrictions Lapsed	(76,908)	7.31
Forfeited		
Unvested at March 31, 2009	602,378	$ 7.82

Restricted stock awards are generally subject to service-based vesting; however, in some instances, awards contain provisions for acceleration of vesting upon performance measures, change in control and in certain other circumstances. On a quarterly basis, we evaluate the probability of achieving performance measures and adjust compensation expense accordingly. The compensation expense is recognized ratably over the estimated vesting period. The vesting restrictions for outstanding restricted stock awards generally lapse over a period of 36 to 60 months.

The fair value of the unvested restricted stock awards is measured using the closing price of our stock on the date of grant, or the estimated fair value of the common stock if granted prior to our IPO. The total compensation expense related to restricted stock awards for the three months ended March 31, 2009 and 2008 was $506,000 and $349,000, respectively.

As of March 31, 2009, there was $2.3 million of unrecognized compensation expense, net of estimated forfeitures, related to unvested restricted stock awards. This amount is expected to be recognized over a weighted-average period of 2.53 years.

Restricted Stock Units

The following table summarizes the unvested restricted stock unit activity during the three months ended March 31, 2009:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested at December 31, 2008		$
Granted	280,000	7.22
Vested		
Forfeited		
Unvested at March 31, 2009	280,000	$ 7.22

Restricted stock units are generally subject to service-based vesting; however, in some instances, restricted stock units contain provisions for acceleration of vesting upon performance measures, change in control and in certain other circumstances. On a quarterly basis, we evaluate the probability of achieving performance measures and adjust compensation expense accordingly. The compensation expense is recognized ratably over the estimated vesting period. The vesting restrictions for outstanding restricted stock units generally lapse over a period of 36 to 60 months.

The fair value of the unvested restricted stock units is measured using the closing price of our stock on the date of grant. The total compensation expense related to restricted stock units for the three months ended March 31, 2009 was $18,000. No restricted stock units were granted in 2008.

As of March 31, 2009, there was $1.1 million of unrecognized compensation expense, net of estimated forfeitures, related to unvested restricted stock units. This amount is expected to be recognized over a weighted-average period of 4.56 years.

Employee Stock Purchase Plan

On October 3, 2007, our stockholders approved the ESPP that had previously been approved by our Board of Directors. We adopted the ESPP to provide a means by which our employees, and the employees of any parent or subsidiary as may be designated by the Board of Directors, will be given an opportunity to purchase shares of our common stock. The ESPP allows eligible employees to purchase our common stock at 85% of the lower of the stock price at the beginning or end of the offering period, which generally is a six-month period. The Compensation Committee of our Board of Directors administers the ESPP. An aggregate of 1,000,000 shares of our common stock have been reserved for issuance under the ESPP. During the three months ended March 31, 2009, no shares were purchased under the ESPP. For the three months ended March 31, 2009 and 2008, we recognized $37,000 and $38,000 of compensation expense related to the ESPP.

5. Net Loss per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per share includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The calculation of basic and diluted net loss per share for the three months ended March 31, 2009 and 2008 is summarized as follows (in thousands, except share and per share data):

	Three Months Ended March 31,	
	2009	2008
Numerator:		
Net loss	$ (1,117)	$ (3,496)

Denominator:				
Weighted-average shares of common stock outstanding		25,934,259		24,766,375
Net loss:				
Basic and diluted	$	(0.04)	$	(0.14)

Basic and diluted net loss per share are identical for all periods presented in the accompanying consolidated statements of operations. If our outstanding options, warrants and unvested restricted stock were exercised or converted into common stock, the result would be anti-dilutive.

The following summarizes the potential outstanding common stock as of the end of each period:

	March 31,	
	2009	**2008**
Options to purchase common stock	3,282,366	3,106,198
Unvested shares of restricted stock units	280,000	
Total	3,562,366	3,106,198

6. Comprehensive Loss

The components of comprehensive loss, net of tax, are as follows (in thousands):

	Three Months Ended March 31,	
	2009	**2008**
Net loss	$ (1,117)	$ (3,496)
Change in net unrealized loss on investments	(96)	
Total comprehensive loss	$ (1,213)	$ (3,496)

7. Fair Value Measurement

SFAS No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information.

SFAS No. 157 establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities.

Level 2 Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly.

Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

The fair value measurement of an asset or liability is based on the lowest level of any input that is significant to the fair value assessment. Our investments that are measured at fair value on a recurring basis are generally classified within Level 1 or Level 2 of the fair value hierarchy.

The following table presents our financial assets and liabilities that were accounted for at fair value as of March 31, 2009 by level within the fair value hierarchy (in thousands):

	Assets at Fair Value	Fair Value Measurement Using Level 1	Level 2	Level 3
Money market funds	$ 24,786	$ 24,786	$	$
Corporate debt investments	11,022		11,022	
Asset-backed securities	3,340		3,340	
Commercial paper	26,228		26,228	
Government-sponsored enterprises	20,392		20,392	
Government securities	999	999		
Certificate of deposit	2,002		2,002	
Total cash equivalents and investments	88,769	$ 25,785	$ 62,984	$
Cash	16,532			
Total cash, cash equivalents and investments	$ 105,301			

8. Business and Geographic Segment Information

We manage our operations on a consolidated basis for purposes of assessing performance and making operating decisions. Accordingly, we do not have reportable segments. Revenues by geographic area for the three months ended March 31, 2009 and 2008 were as follows (in thousands):

	Three Months Ended March 31, 2009	2008
United States	$ 12,195	$ 9,534
All foreign countries	6,405	4,117
Consolidated total	$ 18,600	$ 13,651

9. Legal Proceedings

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

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

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

On November 20, 2007, the defendants moved to dismiss the Amended Consolidated Class Action Complaint. On April 23, 2008, the motion to dismiss was granted in part and denied in part. On May 7, 2008, the defendants filed an answer denying all liability.

On May 12, 2008, the Court entered a scheduling order. On July 16, 2008, the Court granted the parties motion to amend the Court s prior scheduling order to provide the parties with an opportunity to conduct mediation.

On February 11, 2009, we filed a settlement stipulation and related papers with the Court, tentatively settling all claims in the litigation. If finally approved, the settlement will result in the dismissal of the claims against all defendants. The proposed settlement will include a cash payment of $3.2 million by the defendants, $3.1 million of which will be paid by our insurer and $0.1 million of which will be paid by us. Neither we nor any of the other defendants admitted any wrongdoing in connection with the proposed settlement. The settlement will require final approval from the Court before it becomes effective. A hearing at which the Court will consider whether to approve the settlement has been scheduled for June 12, 2009. No assurances can be given that the settlement ultimately will be approved.

From time to time, we are involved in other disputes and legal actions arising in the ordinary course of our business.

10. Commitments and Contingencies

We purchase components for our products from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon information we provide. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. Consequently, a portion of our reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments. As of March 31, 2009, we had total purchase commitments for inventory of approximately $6.3 million due within the next 12 months.

We maintain office space in the United Kingdom for which the lease agreement requires that we return the office space to its original condition upon vacating the premises. The present value of the costs associated with this retirement obligation is approximately $140,000, payable upon termination of the lease. This cost is being accreted based on estimated discounted cash flows over the lease term.

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

Certain statements contained in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words or phrases would be, will allow, intends to, will likely result, are expected to, will continue, is anticipated, estimate, project, or similar expressions, or the negative of such words or phrases, are intended to identify forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Quarterly Report on Form 10-Q, particularly in Risk Factors, and our other filings with the Securities and Exchange Commission. Statements made herein are as of the date of the filing of this Form 10-Q with the Securities and Exchange Commission and should not be relied upon as of any subsequent date. Unless otherwise required by applicable law, we do not undertake, and we specifically disclaim, any obligation to update any forward-looking statements to reflect occurrences, developments, unanticipated events or circumstances after the date of such statement.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes that appear elsewhere in this Quarterly Report on Form 10-Q and with our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Introduction

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

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

Results of Operations. This section provides an analysis of our results of operations for the three months ended March 31, 2009 as compared to the three months ended March 31, 2008.

Liquidity and Capital Resources. This section provides an analysis of our cash flows for the three months ended March 31, 2009 and a discussion of our capital requirements and the resources available to us to meet those requirements.

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

Overview

We are a leading provider of Enterprise Threat Management, or ETM, intelligent security infrastructure solutions for information technology, or IT, environments of commercial enterprises (such as healthcare, financial services, manufacturing, energy, education, retail, and telecommunications) and federal and state government organizations. The Sourcefire 3D® System comprised of multiple Sourcefire hardware and software product offerings provides a comprehensive, intelligent approach to network protection that equips our customers with an efficient and effective layered security defense protecting computer network assets before, during and after an attack.

We sell our network security solutions to a diverse customer base that includes Fortune 1000 companies, Global 500 companies, U.S. government agencies and small and mid-size businesses. We also manage two of the security industry s leading open source initiatives, Snort® and ClamAV®.

Key Financial Metrics and Trends

Our financial results are affected by a number of factors, including broad economic conditions, the amount and type of technology spending of our customers, and the financial condition of our customers and the industries and geographic areas that we serve. During the second half of 2008 and continuing in 2009, the industries and geographic areas that we serve experienced weakness as macroeconomic conditions, credit market conditions, and levels of business confidence and activity deteriorated. During the fourth quarter of 2008 and continuing in 2009, some of our commercial customers delayed purchases of our products and services in response to these factors and the operating and financial difficulties facing these customers. We expect to continue to experience some delays in customer purchases but cannot yet predict if this trend will worsen or the extent to which customers may decide not to purchase our products and services as a result of these or other factors. We are continuing to monitor economic conditions and their potential effect on our customers and on us. A severe or prolonged economic downturn could affect our customers financial condition and the levels of business activity. This could reduce demand and depress pricing for our products and services, which could have a material adverse effect on our results of operations or financial condition.

During the first quarter of 2009, a significant portion of our revenue growth resulted from sales of our products to U.S. government agencies. Contracts with the U.S. federal and state government agencies accounted for 14% and 8% of our total revenue for the three months ended March 31, 2009 and 2008, respectively. We expect sales to U.S. government agencies to continue to account for a significant portion of our total revenue in 2009. A reduction in the amount of U.S. government purchases of our products could have a material adverse effect on our results of operations or financial condition.

We evaluate our performance on the basis of several performance indicators, including pricing and discounts, credit and collections, revenue, cost of revenue, gross profit, and operating expenses. We compare these key performance indicators, on a quarterly basis, to both target amounts established by management and to our performance for prior periods.

Pricing and Discounts

We maintain a standard price list for all of our products. Additionally, we have a corporate policy that governs the level of discounts our sales organization may offer on our products, based on factors such as transaction size, volume of products, federal or state programs, reseller or distributor involvement and the level of technical support commitment. Our total product revenue and the resulting cost of revenue and gross profit percentage are directly affected by our ability to manage our product pricing policy. During the fourth quarter of 2008 and continuing in 2009, in some cases we increased discounts on the prices of our products and services as a result of the operating and financial difficulties facing our customers, and in response to discounts offered by our competitors. We expect the pressure to provide increased discounts to continue and, in the future, we may be forced to further discount or reduce our prices to remain competitive.

Credit and Collections

We evaluate the creditworthiness of our customers prior to accepting an order for our products and extending the customer terms of payment which typically range from 30 to 90 days from the date of our invoice. In the fourth quarter of 2008 and continuing in 2009, we experienced an increase in the aging of our outstanding receivables which we attributed to the decline in macroeconomic conditions and credit market conditions. Although our actual write-offs of uncollectible accounts were less than $10,000 for all of 2008, as a result of the increase in our aging, we increased our reserve for uncollectible accounts. We believe that the decline in macroeconomic conditions may lead to a further increase in the aging of our receivables and we may have to increase our reserve as a result.

Revenue

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

Product sales are typically recognized as revenue at shipment of the product to the customer. For sales through resellers and distributors, we recognize revenue upon the shipment of the product only if those resellers and distributors provide us, at the time of placing their order, with the identity of the end-user customer to whom the product has been sold. We recognize revenue from services when the services are performed. For technical support services, we recognize revenue ratably over the term of the support arrangement, which is generally 12 months. Our support agreements generally provide for payment in advance.

We sell our network security solutions globally. However, 66% and 70% of our revenue for the three months ended March 31, 2009 and 2008, respectively, was generated by sales to U.S.-based customers. We expect that our revenue from customers based outside of the United States will increase as we strengthen our international presence. We also expect that our revenue from sales through our indirect sales channel, comprised of resellers, distributors, managed security service providers, or MSSPs, government integrators and other partners, will increase in amount and as a percentage of total revenue as we expand our current relationships and establish new relationships with these third parties.

Historically, our product revenue has been seasonal, with a significant portion of our total product revenue in recent fiscal years generated in the third and fourth quarters. While we expect this historical trend to continue, potential weakness in general economic conditions in the third and fourth quarters and the effects of increased U.S. government spending in the first and second quarters may result in this trend being less pronounced in 2009. The timing of our year-end shipments could materially affect our fourth quarter product revenue in any fiscal year and quarterly comparisons. Revenue from our government customers has been influenced by the September 30th fiscal year-end of the U.S. federal government, which has historically resulted in our revenue from government customers being highest in the third quarter. Notwithstanding these general seasonal patterns, our revenue within a particular quarter is often affected significantly by the unpredictable procurement patterns of our customers. Our prospective customers usually spend a long time evaluating and making purchase decisions for network security solutions. Historically, many of our customers have not finalized their purchasing decisions until the final weeks or days of a quarter. We expect these purchasing patterns to continue in the future. Therefore, a delay in even one large order beyond the end of the quarter could materially reduce our anticipated revenue for a quarter. Because many of our expenses must be incurred before we expect to generate revenue, delayed orders could negatively impact our results of operations and cash flows for a particular period and could therefore cause us to fail to meet the financial performance expectations of securities industry research analysts or investors.

Cost of Revenue

Cost of product revenue includes the cost of the hardware platform bundled into our network security solution, royalties for third-party software included in our network security solution, materials and labor that are incorporated in the quality assurance of our products, logistics, warranty, shipping and handling costs, expense for inventory obsolescence and, in the limited instances where we lease our network security solutions to our customers, depreciation and amortization. Hardware costs, which are our most significant cost item, generally have not fluctuated materially as a percentage of revenue in recent years because competition among hardware platform suppliers has remained strong and, therefore, unit hardware costs have remained consistent. Because of the competition among hardware suppliers and our outsourcing of the manufacture of our products to three separate domestic contract manufacturers, we currently have no reason to expect that our cost of product revenue as a percentage of total product revenue will change significantly in the foreseeable future due to hardware pricing increases. However, hardware or other costs of manufacturing may increase in the future. We incur labor and allocated overhead costs as part of managing our outsourced manufacturing process. Allocated overhead costs include facilities, supplies, communication and information systems and employee benefits. Overhead costs are reflected in each cost of revenue and operating expense category.

Cost of services revenue includes the direct labor costs of our employees and outside consultants engaged to furnish those services, as well as their travel and associated direct material costs. Additionally, we include in cost of services revenue an allocation of overhead costs, as well as the cost of time and materials to service or repair the hardware component of our products covered under a renewed support arrangement beyond the manufacturer s warranty. As our customer base continues to grow, we anticipate incurring an increasing amount of these service and repair costs, as well as costs for additional personnel to support and service our customers.

Gross Profit

Our gross profit is affected by a variety of factors, including competition, the mix and average selling prices of our products, our pricing policy, technical support and professional services, new product introductions, the cost of hardware platforms, expense for inventory obsolescence, warranty expense, the cost of labor to generate such revenue and the mix of distribution channels through which our products are sold. Our gross profit would be adversely affected by price declines or pricing discounts if we are unable to reduce costs on existing products and fail to introduce new products with higher margins. Currently, product sales typically have a lower gross profit as a percentage of revenue than our services due to the cost of the hardware platform. Our gross profit for any particular quarter could be adversely affected if we do not complete a sufficient level of sales of higher-margin products by the end of the quarter. As discussed above, many of our customers do not finalize purchasing decisions until the final weeks or days of a quarter, so a delay in even one large order of a higher-margin product could reduce our total gross profit percentage for that quarter.

Operating Expenses

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

We have expanded our research and development capabilities and expect to continue to expand these capabilities in the future. We are committed to increasing the level of innovative design and development of new products as we strive to enhance our ability to serve our existing commercial and federal government markets as well as new markets for security solutions. To meet the changing requirements of our customers, we will need to fund investments in several development projects in parallel. Accordingly, we anticipate that our research and development expenses will continue to increase in absolute dollars for the foreseeable future; however, as a percentage of revenue we expect these expenses to remain relatively flat.

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

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

General and Administrative. General and administrative expenses consist primarily of salaries, incentive compensation and allocated overhead costs for executive, legal, finance, information technology, human resources and administrative personnel; corporate development expenses and professional fees related to legal, audit, tax and regulatory compliance; travel and related costs; and corporate insurance.

Stock-Based Compensation. Effective January 1, 2006, we adopted the fair value recognition provisions of the Financial Accounting Standards Board s, or FASB, Statement of Financial Accounting Standard, or SFAS, No. 123(R), *Share-Based Payment*, using the prospective transition method, which requires us to apply its provisions only to awards granted, modified, repurchased or cancelled after the effective date. Under this transition method, stock-based compensation expense recognized beginning January 1, 2006 is based on the grant date fair value of stock awards granted or modified after January 1, 2006.

We use the Black-Scholes option pricing model to estimate the fair value of stock options granted and employee stock purchases. For certain option awards that contain market conditions relating to our stock price achieving specified levels, we use a Lattice option pricing model. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility. Based on the estimated grant date fair value of stock-based awards, we recognized aggregate stock-based compensation expense of $1.2 million and $922,000 for the three months ended March 31, 2009 and 2008, respectively.

Results of Operations

Revenue. The following table shows products and technical support and professional services revenue (in thousands):

	Three Months Ended March 31,		Variance	
	2009	**2008**	**$**	**%**
Products	$ 9,868	$ 6,851	$ 3,017	44%
Percentage of total revenue	*53%*	*50%*		
Technical support and professional services	8,732	6,800	1,932	28%
Percentage of total revenue	*47%*	*50%*		
Total revenue	$ 18,600	$ 13,651	$ 4,949	36%

The increase in our product revenue for the three months ended March 31, 2009, as compared to the three months ended March 31, 2008, was mostly driven by higher demand for our sensor products, primarily our higher performance 3D products. For the three months ended March 31, 2009, sensor product revenue increased $3.6 million over the prior-year quarter, which included a $2.6 million increase in our higher performance 3D products, partially offset by a $667,000 decrease in royalty revenue.

The increase in our services revenue for the three months ended March 31, 2009, as compared to the three months ended March 31, 2008, resulted from an increase in our installed customer base due to new product sales in which associated support was purchased, as well as support renewals by our existing customers.

Cost of revenue. The following table shows products and technical support and professional services cost of revenue (in thousands):

	Three Months Ended March 31,		Variance	
	2009	**2008**	**$**	**%**
Products	$ 2,767	$ 1,997	$ 770	39%
Percentage of total revenue	*15%*	*15%*		
Technical support and professional services	1,382	1,041	341	33%
Percentage of total revenue	*7%*	*8%*		
Total cost of revenue	$ 4,149	$ 3,038	$ 1,111	37%
Percentage of total revenue	*22%*	*22%*		

For the three months ended March 31, 2009, the increase in product cost of revenue, as compared to the three months ended March 31, 2008, was driven primarily by higher volume demand for our sensor products, for which we must procure and provide the hardware platform to our customers. The increase in our services cost of revenue for the three months ended March 31, 2009 was attributable to increased hardware service expense related to support renewal contracts and our hiring of additional personnel to both service our larger installed customer base and to provide training and professional services to our customers.

Gross profit. The following table shows products and technical support and professional services gross profit (in thousands):

	Three Months Ended March 31,		Variance	
	2009	**2008**	**$**	**%**
Products	$ 7,101	$ 4,854	$ 2,247	46%

Product gross margin	*72%*	*71%*		
Technical support and professional services	7,350	5,759	1,591	28%
Technical support and professional services gross margin	*84%*	*85%*		
Total gross profit	$ 14,451	$ 10,613	$ 3,838	36%
Total gross margin	*78%*	*78%*		

Product gross margin for the three months ended March 31, 2009, as compared to the three months ended March 31, 2008, increased slightly, primarily due to the product mix sold being weighted more toward higher margin products, partially offset by additional product discounting due to competitive and global economic factors.

Services gross margin for the three months ended March 31, 2009, as compared to the three months ended March 31, 2008, decreased slightly, primarily due to the increased costs of servicing the hardware component of our products covered under renewed support arrangements.

Operating expenses. The following table highlights our operating expenses (in thousands):

	Three Months Ended March 31,		**Variance**	
	2009	**2008**	**$**	**%**
Research and development	$ 3,320	$ 3,111	$ 209	7%
Percentage of total revenue	*18%*	*23%*		
Sales and marketing	7,870	7,234	636	9%
Percentage of total revenue	*42%*	*53%*		
General and administrative	3,843	4,414	(571)	(13)%
Percentage of total revenue	*21%*			