

SOURCEFIRE INC  
Form 10-Q  
May 06, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2011

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number  
1-33350

**SOURCEFIRE, INC.**

(Exact name of Registrant as Specified in its Charter)

**Delaware**

(State or Other Jurisdiction of  
Incorporation or Organization)

**52-2289365**

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

**9770 Patuxent Woods Drive  
Columbia, Maryland**

(Address of Principal Executive Offices)

**21046**

(Zip Code)

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

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  No

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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated  
Filer

Accelerated  
Filer

Non-Accelerated Filer   
(Do not check if a smaller reporting

Smaller reporting  
Company

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company)

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

Yes  No

As of April 29, 2011, there were 28,434,221 outstanding shares of the registrant's Common Stock.

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**Part I. FINANCIAL INFORMATION****Item 1. Financial Statements**

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

|  | <b>March 31,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|--|---------------------------|----------------------------------|
|  | (unaudited)               |                                  |
| <b>Assets</b>  |                           |                                  |
| Current assets:  |                           |                                  |
| Cash and cash equivalents  | \$ 54,271                 | \$ 54,410                        |
| Short-term investments   | 84,838                    | 85,062                           |
| Accounts receivable, net of allowances of \$1,041 as of March 31, 2011 and \$1,091 as of December 31, 2010 | 27,392                    | 37,250                           |
| Inventory  | 4,346                     | 5,235                            |
| Deferred tax assets  | 6,508                     | 4,161                            |
| Prepaid expenses and other current assets  | 4,022                     | 3,793                            |
| <br>   |                           |                                  |
| Total current assets   | 181,377                   | 189,911                          |
| Property and equipment, net  | 9,485                     | 9,235                            |
| Goodwill   | 15,135                    | 15,135                           |
| Intangible assets, net   | 6,578                     | 6,830                            |
| Investments  | 13,687                    | 14,247                           |
| Deferred tax assets, non-current   | 3,561                     | 3,556                            |
| Other assets   | 3,596                     | 2,160                            |
| <br>   |                           |                                  |
| Total assets   | \$ 233,419                | \$ 241,074                       |
| <br>   |                           |                                  |
| <b>Liabilities and Stockholders Equity</b>   |                           |                                  |
| Current liabilities:   |                           |                                  |
| Accounts payable   | \$ 2,041                  | \$ 3,893                         |
| Accrued compensation and related expenses  | 5,985                     | 6,209                            |
| Other accrued expenses   | 4,229                     | 4,823                            |
| Current portion of deferred revenue  | 36,787                    | 38,708                           |
| Other current liabilities  | 6,566                     | 13,518                           |
| <br>   |                           |                                  |
| Total current liabilities  | 55,608                    | 67,151                           |
| Deferred revenue, less current portion   | 7,284                     | 7,714                            |
| Other long-term liabilities  | 128                       | 125                              |
| <br>   |                           |                                  |
| Total liabilities  | \$ 63,020                 | \$ 74,990                        |
| <br>   |                           |                                  |
| Commitments and contingencies  |                           |                                  |
| Stockholders equity:   |                           |                                  |

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|  |            |            |
|--|------------|------------|
| Preferred stock, \$0.001 par value; 19,700,000 shares authorized; no shares issued or outstanding  |            |            |
| Series A junior participating preferred stock, \$0.001 par value; 300,000 shares authorized; no shares issued or outstanding   |            |            |
| Common stock, \$0.001 par value; 240,000,000 shares authorized; 28,428,021 and 28,136,058 shares issued and outstanding as of March 31, 2011 and December 31, 2010, respectively | 28         | 27         |
| Additional paid-in capital   | 191,657    | 187,789    |
| Accumulated deficit  | (21,279)   | (21,739)   |
| Accumulated other comprehensive income (loss)  | (7)        | 7          |
| Total stockholders' equity   | 170,399    | 166,084    |
| Total liabilities and stockholders' equity   | \$ 233,419 | \$ 241,074 |

See accompanying notes to consolidated financial statements.

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

|  | <b>Three Months Ended</b> |               |
|--|---------------------------|---------------|
|  | <b>March 31,</b>          |               |
|  | <b>2011</b>               | <b>2010</b>   |
| Revenue:   |                           |               |
| Products   | \$ 15,798                 | \$ 14,338     |
| Technical support and professional services                              | 14,984                    | 11,493        |
| <b>Total revenue</b>   | <b>30,782</b>             | <b>25,831</b> |
| Cost of revenue:   |                           |               |
| Products   | 4,735                     | 3,796         |
| Technical support and professional services                              | 1,862                     | 1,405         |
| <b>Total cost of revenue</b>   | <b>6,597</b>              | <b>5,201</b>  |
| <b>Gross profit</b>  | <b>24,185</b>             | <b>20,630</b> |
| Operating expenses:  |                           |               |
| Research and development   | 6,962                     | 3,795         |
| Sales and marketing  | 14,078                    | 10,619        |
| General and administrative   | 4,673                     | 4,319         |
| Depreciation and amortization  | 965                       | 814           |
| <b>Total operating expenses</b>  | <b>26,678</b>             | <b>19,547</b> |
| <b>Income (loss) from operations</b>                                     | <b>(2,493)</b>            | <b>1,083</b>  |
| Other income (loss), net:  |                           |               |
| Interest and investment income   | 113                       | 118           |
| Interest expense   | (118)                     | (9)           |
| Other expense  | (1)                       | (109)         |
| <b>Total other income (loss), net</b>                                    | <b>(6)</b>                |               |
| <b>Income (loss) before income taxes</b>                                 | <b>(2,499)</b>            | <b>1,083</b>  |
| Provision for (benefit from) income taxes                                | (2,959)                   | 273           |
| <b>Net income</b>  | <b>\$ 460</b>             | <b>\$ 810</b> |
| Net income per share:  |                           |               |
| Basic  | \$ 0.02                   | \$ 0.03       |
| Diluted  | \$ 0.02                   | \$ 0.03       |
| Weighted average shares outstanding used in computing per share amounts: |                           |               |
| Basic  | 28,235,751                | 27,220,667    |

Diluted

29,179,309

29,060,559

See accompanying notes to consolidated financial statements.

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**SOURCEFIRE, INC.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME**  
**(UNAUDITED)**  
**(in thousands, except share amounts)**

|  | Common Stock |        | Additional<br>Paid In | Accumulated | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|--------------|--------|-----------------------|-------------|---|------------|
|  | Shares       | Amount | Capital               | Deficit     | (Loss)  |            |
| Balance as of January 1,<br>2011   | 28,136,058   | \$ 27  | \$ 187,789            | \$ (21,739) | \$ 7  | \$ 166,084 |
| Exercise of common<br>stock options  | 164,471      | 1      | 1,319                 |             |   | 1,320      |
| Issuance of restricted<br>common stock   | 129,179      |        |                       |             |   |            |
| Cancellation of restricted<br>common stock   | (1,687)      |        |                       |             |   |            |
| Stock-based<br>compensation expense  |              |        | 3,183                 |             |   | 3,183      |
| Excess tax benefits<br>relating to share-based<br>payments                           |              |        | (634)                 |             |   | (634)      |
| Comprehensive income:<br>Net income for the three<br>months ended March 31,<br>2011. |              |        |                       | 460         |   | 460        |
| Change in unrealized<br>loss on investments, net<br>of tax                           |              |        |                       |             | (14)  | (14)       |
| Total comprehensive<br>income  |              |        |                       |             |   | 446        |
| Balance as of March 31,<br>2011  | 28,428,021   | \$ 28  | \$ 191,657            | \$ (21,279) | \$ (7)  | \$ 170,399 |

See accompanying notes to consolidated financial statements.



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

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2011</b>               | <b>2010</b> |
| <b>Operating activities</b>   |                           |             |
| Net income  | \$ 460                    | \$ 810      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |             |
| Depreciation and amortization   | 1,266                     | 866         |
| Non-cash stock-based compensation   | 3,183                     | 1,926       |
| Excess tax benefits related to share-based payments                               | 634                       | (213)       |
| Amortization of premium on investments  | 471                       | 285         |
| Loss on disposal of assets  | 9                         | 22          |
| Deferred taxes  | (2,972)                   |             |
| Changes in operating assets and liabilities:                                      |                           |             |
| Accounts receivable, net  | 9,858                     | 7,217       |
| Inventory   | 889                       | (325)       |
| Prepaid expenses and other assets   | (1,665)                   | 657         |
| Accounts payable  | (1,852)                   | (1,345)     |
| Accrued expenses  | (819)                     | (1,327)     |
| Deferred revenue  | (2,351)                   | 2,074       |
| Other liabilities   | 147                       | 340         |
| Net cash provided by operating activities   | 7,258                     | 10,987      |
| <b>Investing activities</b>   |                           |             |
| Purchase of property and equipment  | (1,273)                   | (1,185)     |
| Acquisition-related payments  | (7,093)                   |             |
| Purchase of investments   | (47,077)                  | (30,499)    |
| Proceeds from maturities of investments   | 47,365                    | 24,200      |
| Net cash used in investing activities   | (8,078)                   | (7,484)     |
| <b>Financing activities</b>   |                           |             |
| Repayments of capital lease obligations   | (5)                       | (2)         |
| Proceeds from employee stock-based plans  | 1,320                     | 1,237       |
| Excess tax benefits related to share-based payments                               | (634)                     | 213         |
| Net cash provided by financing activities   | 681                       | 1,448       |
| Net increase (decrease) in cash and cash equivalents                              | (139)                     | 4,951       |
| Cash and cash equivalents at beginning of period                                  | 54,410                    | 53,071      |
| Cash and cash equivalents at end of period  | \$ 54,271                 | \$ 58,022   |

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 intelligent cybersecurity solutions for information technology, or IT, environments of commercial enterprises, including healthcare, financial services, manufacturing, energy, education, retail and telecommunications companies, and federal, state and local government organizations worldwide. Our solutions are comprised of multiple hardware, software and cloud-based product and service offerings, enabling comprehensive, intelligent protection before, during and after an attack.

We also manage the security industry's leading open source initiative, Snort®, as well as the ClamAV® and Razorback™ open source initiatives. Snort is an open source intrusion prevention technology that is incorporated into the IPS software component of our comprehensive Intrusion Detection and Prevention System. ClamAV is an open source anti-virus and anti-malware project. Razorback is an open-source project that addresses advanced detection problems associated with client-side attacks.

In addition to our commercial and open source network security products, we offer a variety of services to help our customers install and support our solutions. Available services include Technical Support, Professional Services, Education & Certification, Vulnerability Research Team, or VRT, and 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, 2010 filed with the Securities and Exchange Commission on March 11, 2011. 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, reserve for excess and obsolete inventory, useful lives of tangible and intangible long-lived assets, goodwill and intangible asset impairment, 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 periods presented.

***Investments***

We determine the appropriate classification of our investments at the time of purchase and reevaluate such classification as of each balance sheet date. Our investments are comprised of money market funds, corporate debt investments, commercial paper, government-sponsored enterprise securities, 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. Amortization is included in interest and investment income. Interest on securities classified as available-for-sale is also included in interest and investment income.

We evaluate our investments on a regular basis to determine whether an other-than-temporary impairment in fair value has occurred. If an investment is in an unrealized loss position and we have the intent to sell the investment, or it is more likely than not that we will have to sell the investment before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is charged against earnings for the period. For investments that we do not intend to sell or it is more likely than not that we will not have to sell the investment, but we expect that we will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is charged against earnings for the applicable period and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income on our consolidated statement of stockholders' equity and comprehensive income (loss). Unrealized losses entirely caused by non-credit related factors related to investments for which we expect to fully recover the amortized cost basis are recorded in accumulated other comprehensive income.

#### ***Fair Value of Financial Instruments***

Our financial instruments consist primarily of cash and cash equivalents, investments, 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 Return Allowance***

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 if the allowance does not reflect our actual ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed, and our future results of operations could be materially affected. As of March 31, 2011 and December 31, 2010, the allowance for doubtful accounts was \$404,000 and \$429,000, respectively.

We also use our judgment to make estimates regarding potential future product returns related to reported product revenue in each period. 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. If any of the factors used to calculate the sales return allowance were to change, we may experience a material difference in the amount and timing of our product revenue for any given period. As of March 31, 2011 and December 31, 2010, the sales return allowance was \$637,000 and \$662,000, respectively.

#### ***Inventory***

Inventory consists of hardware and related component parts and is stated at the lower of cost on a first-in, first-out basis, or market, except for evaluation and advance replacement 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. Advance replacement units, which include fully functioning appliances and spare parts, are used to provide replacement units under technical support arrangements if a customer's unit is not functioning properly. We make estimates of forecasted demand for our products, and inventory that is obsolete or in excess of our estimated demand is written down to its estimated net realizable value based on historical usage, expected demand, the timing of new product introductions 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-downs, which would negatively impact our gross margin.

Inventory consisted of the following (in thousands):

|                           | <b>March<br/>31,<br/>2011</b> | <b>As of<br/>December<br/>31,<br/>2010</b> |
|---------------------------|-------------------------------|--|
| Finished goods            | \$ 2,185                      | \$ 3,151                                   |
| Evaluation units          | 949                           | 828  |
| Advance replacement units | 1,212                         | 1,256                                      |
| Total                     | \$ 4,346                      | \$ 5,235                                   |

Inventory write-downs, primarily related to evaluation units and excess and obsolete inventory as a result of the introduction of new products, are recorded as a component of cost of revenues and amounted to approximately \$713,000 and \$43,000 for the three months ended March 31, 2011 and 2010, respectively.

#### ***Business Combinations***

We recognize all of the assets acquired, liabilities assumed and contingent consideration at their fair value on the acquisition date. The purchase price allocation process requires management to make significant estimates and assumptions, especially at the acquisition date with respect to intangible assets acquired, estimated contingent consideration payments and pre-acquisition contingencies assumed. Unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results. Additionally, any change in the fair value of the acquisition-related contingent consideration subsequent to the acquisition date, including changes from events after the acquisition date, will be recognized in earnings in the period of the estimated fair value change. All subsequent changes to a valuation allowance or uncertain tax position relating to the acquired company that occur within the measurement period and are based on facts and circumstances that existed at the acquisition date are recognized as an adjustment to goodwill. All other changes in a valuation allowance or uncertain tax positions are recognized as a reduction or increase to income tax expense.

Acquisition-related transaction costs, including legal and accounting fees and other external costs directly related to the acquisition are recognized separately from the acquisition and expensed as incurred in general and administrative expenses in the consolidated statements of operations.

#### ***Goodwill and Intangible Assets***

Goodwill represents the excess of the purchase price of an acquired business over the fair value of the underlying net tangible and intangible assets acquired. We test goodwill resulting from acquisitions for impairment annually on October 1, or whenever events or changes in circumstances indicate a potential impairment. If it is determined that an impairment has occurred, we will record a write-down of the carrying value and charge the impairment as an operating expense in the period the determination is made. Although we believe goodwill is appropriately stated in the consolidated financial statements, changes in strategy or market conditions could significantly impact these judgments and require an adjustment to the recorded balance.

Intangible assets that are not considered to have an indefinite life are amortized over their useful lives on a straight-line basis. On a periodic basis, we evaluate the estimated remaining useful life of acquired intangible assets and whether events or changes in circumstances warrant a revision to the remaining period of amortization. The carrying amounts of these assets are periodically reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of these assets may not be recoverable.

#### ***Revenue Recognition***

We derive revenue from arrangements that include hardware 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 hardware appliances containing software, 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 Vulnerability Research Team, or 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 recognize revenue when: (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 deemed probable.

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. 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.

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.

In October 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards for revenue recognition to remove from the scope of industry-specific software revenue recognition guidance any tangible products containing software components and non-software components that operate together to deliver the product's essential functionality. In addition, the FASB amended the accounting standards for certain multiple-element revenue arrangements to:

- (i) provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated and how the arrangement consideration should be allocated to the separate elements;
- (ii) require an entity to allocate arrangement consideration to each element based on a selling price hierarchy, where the selling price for an element is based on vendor-specific objective evidence, or VSOE, if available; third-party evidence, or TPE, if available and VSOE is not available; or the best estimate of selling price, or BEBP, if neither VSOE or TPE is available; and
- (iii) eliminate the use of the residual method and require an entity to allocate arrangement consideration based on the relative selling price of each element within the arrangement.

We adopted this accounting guidance on January 1, 2011 on a prospective basis for applicable transactions originating or materially modified after December 31, 2010.

The majority of our products are hardware appliances containing software components that operate together to provide the essential functionality of the product. Therefore, our hardware appliances are considered non-software deliverables and are no longer accounted for under the industry-specific software revenue recognition guidance.

Our product revenue also includes revenue from the sale of stand-alone software products. Stand-alone software may operate on our hardware appliance, but is not considered essential to the functionality of the hardware. Stand-alone software sales generally include a perpetual license to our software. Stand-alone software sales continue to be subject to the industry-specific software revenue recognition guidance.

For stand-alone software sales after December 31, 2010 and for all transactions entered into prior to the first quarter of 2011, we recognize revenue based on software revenue recognition guidance. Under the software revenue recognition guidance, we allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on VSOE. If VSOE 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 VSOE of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. If the only undelivered elements are elements for which we currently have VSOE of fair value, we recognize revenue for the delivered elements based on the residual method. When VSOE of fair value does not exist for undelivered elements such as maintenance and support, the entire arrangement fee is recognized ratably over the performance period.

For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with the amended accounting guidance. Certain arrangements with multiple deliverables may continue to have stand-alone software deliverables that are subject to the existing software revenue recognition guidance along with non-software deliverables that are subject to the amended revenue accounting guidance. The revenue for these multiple deliverable arrangements is allocated to the





stand-alone software deliverables as a group and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the fair value hierarchy in the amended revenue accounting guidance.

We have established VSOE of fair value for substantially all of 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 VSOE of fair value of our other services is based on the price for these same services when they are sold separately. Revenue for professional 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.

For our non-software deliverables we allocate the arrangement consideration based on the relative selling price of the deliverables. For our hardware appliances we use BESP as our selling price. For our support and services, we generally use VSOE as our selling price.

We are typically not able to determine TPE for our products or services. TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, our offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, we are unable to reliably determine what similar competitor products' selling prices are on a stand-alone basis.

When we are unable to establish the selling price of our non-software deliverables using VSOE or TPE, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, gross margin objectives, pricing practices, customer classes and geographies and distribution channels.

We anticipate that for certain arrangements we will be able to account for more transaction consideration upon delivery than allowed under the prior guidance, primarily due to more deliverables being accounted for as separate units of accounting and the elimination of the use of the residual method and a requirement to allocate arrangement consideration using a selling price hierarchy.

An estimate of the revenue that would have been reported if we had applied the new guidance for multiple deliverable arrangements for non-software deliverables for the quarter ended March 31, 2010 is \$26.3 million compared to the \$25.8 million of revenue recognized under the industry specific software revenue recognition rules.

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

For the three months ended March 31, 2011, two customers, one a reseller of our products and the other a distributor of our products to the U.S. government, accounted for 11% and 16%, respectively, of total revenue. For the three months ended March 31, 2010, two customers, one a reseller of our products and the other a distributor of our products to the U.S. government, accounted for 12% and 10%, respectively, of total revenue.

As of March 31, 2011, two customers, one a reseller of our products and the other a distributor of our products to the U.S. government, accounted for 15% and 14%, respectively, of our accounts receivable. As of December 31, 2010, two customers, a reseller of our products and a distributor of our products to the U.S. government, accounted for 14% and 10%, respectively, of our accounts receivable.

#### **Warranty**

Under our standard warranty arrangement, 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 units sold, 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.

#### ***Income Taxes***

Deferred tax assets and liabilities are determined based on temporary differences between financial reporting and tax bases of assets and liabilities and for tax carryforwards at enacted statutory tax rates in effect for the years in which the differences are expected to reverse.

We assess the realizability of our deferred tax assets, which primarily consists of net operating loss, or NOL, carryforwards, and temporary differences associated with stock-based compensation expense, deferred revenue and research and experimentation tax credit carryforwards. In assessing the realizability of these deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will be realized. In assessing the need for a valuation allowance, we consider all available evidence, both positive and negative, including historical levels of income, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible tax planning strategies.

With respect to foreign earnings, it is our policy to invest the earnings of foreign subsidiaries indefinitely outside the U.S. Any excess tax benefit, above amounts previously recorded on stock-based compensation expense, from the exercise of stock options is recorded in additional paid-in-capital in the consolidated balance sheets to the extent that cash taxes payable are reduced.

Because tax laws are complex and subject to different interpretations, significant judgment is required. As a result, we make certain estimates and assumptions, in (i) calculating our provision for income taxes, deferred tax assets and deferred tax liabilities, (ii) determining any valuation allowance recorded against deferred tax assets and (iii) evaluating the amount of unrecognized tax benefits, as well as the interest and penalties related to such uncertain tax positions. Our estimates and assumptions may differ significantly from tax benefits ultimately realized.

#### ***Stock-Based Compensation***

Stock-based awards granted include stock options, restricted stock awards and restricted stock units under our 2007 Stock Incentive Plan, or 2007 Plan, and stock purchased under our Amended and Restated 2007 Employee Stock Purchase Plan, or ESPP. Stock-based compensation expense is measured at the grant date, based on the fair value of the awards, and is recognized as expense ratably over the requisite service period, net of estimated forfeitures.

We use the Black-Scholes option pricing model for estimating the fair value of stock options granted under the 2007 Plan and for employee stock purchases under the ESPP. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock 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.

#### ***Net Income Per Share***

Basic net income per share is computed on the basis of the weighted-average number of shares of common stock outstanding during the period. Diluted net income per share is computed on the basis of the weighted-average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and restricted stock units.

### **3. Acquisition**

On December 30, 2010, we acquired all the outstanding securities of Immunet Corporation, or Immunet, a leading provider of advanced cloud-based anti-malware technologies. This acquisition expands our security solutions portfolio, adding an advanced cloud platform for end-point protection. The acquisition price of \$21 million consists of \$14.9 million in cash payable at closing, of which \$7.7 million was paid in 2010 and \$7.2 million was paid in the first quarter of 2011. An additional \$2.1 million will be paid on the twelve month anniversary of the acquisition date subject to working capital adjustments. The remaining \$4.0 million of the acquisition price is contingent consideration and is expected to be paid within 24 months of the

acquisition date to Immune common shareholders upon achievement of product delivery milestones related to the enterprise version of Immune's product.

Under the acquisition method of accounting, the total estimated purchase price was allocated to Immune's net tangible assets and liabilities and intangible assets based on their estimated fair values as of December 30, 2010. We recorded the excess of the purchase price over the net tangible assets and liabilities and intangible assets as goodwill. At the acquisition date, the fair value of consideration transferred and contingent consideration was \$20.4 million. This was preliminarily allocated to tangible assets of \$256,000, liabilities of \$233,000, net deferred tax liabilities of \$1.6 million, identifiable intangible assets of \$6.8 million and goodwill of \$15.1 million. The goodwill represents factors including expected synergies from combining operations and is not deductible for tax purposes. The items of the purchase price allocation that are not yet finalized relate primarily to income taxes.

Prior to the end of the measurement period for finalizing the purchase price allocation, if information becomes available that would indicate adjustments are required to the purchase price allocation, such adjustments will be included in the purchase price allocation and prior period financial statements will be retroactively adjusted, if material.

#### 4. Investments

The following is a summary of available-for-sale investments as of March 31, 2011 (in thousands):

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
| Money market funds                          | \$ 6,899          | \$                           | \$                            | \$ 6,899                   |
| Corporate debt investments                  | 51,199            | 31                           | (34)                          | 51,196                     |
| Asset-backed securities                     | 723               |                              |                               | 723                        |
| Commercial paper                            | 25,936            | 5                            |                               | 25,941                     |
| Government-sponsored enterprises            | 27,570            | 5                            | (19)                          | 27,556                     |
| Government securities                       | 5,795             | 2                            |                               | 5,797                      |
| CD  | 1,200             |                              |                               | 1,200                      |
| <b>Total investments</b>                    | <b>119,322</b>    | <b>\$ 43</b>                 | <b>\$ (53)</b>                | <b>119,312</b>             |
| Amounts classified as cash equivalents*     | (20,787)          |                              |                               | (20,787)                   |
| <b>Total available-for-sale investments</b> | <b>\$ 98,535</b>  |                              |                               | <b>\$ 98,525</b>           |
| Due in one year or less                     | \$ 84,822         | \$ 42                        | \$ (26)                       | \$ 84,838                  |
| Due after one year through five years       | 13,713            | 1                            | (27)                          | 13,687                     |
|   | <b>\$ 98,535</b>  | <b>\$ 43</b>                 | <b>\$ (53)</b>                | <b>\$ 98,525</b>           |

\* Does not include cash held in our bank accounts

The following is a summary of available-for-sale investments as of December 31, 2010 (in thousands):

|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-------------------------------------|
| Money market funds                          | \$ 12,385                 | \$                                    | \$                                     | \$ 12,385                           |
| Corporate debt investments                  | 47,178                    | 38                                    | (23)                                   | 47,193                              |
| Commercial paper                            | 18,241                    | 2                                     |  | 18,243                              |
| Government-sponsored enterprise securities  | 33,032                    | 4                                     | (11)                                   | 33,025                              |
| Government securities                       | 8,024                     | 5                                     | (3)                                    | 8,026                               |
| <b>Total investments</b>                    | <b>118,860</b>            | <b>\$ 49</b>                          | <b>\$ (37)</b>                         | <b>118,872</b>                      |
| Amounts classified as cash equivalents*     | (19,567)                  |                                       |  | (19,563)                            |
| <b>Total available-for-sale investments</b> | <b>\$ 99,293</b>          |                                       |  | <b>\$ 99,309</b>                    |
| Due in one year or less                     | \$ 85,048                 | \$ 44                                 | \$ (30)                                | \$ 85,062                           |
| Due after one year through five years       | 14,245                    | 5                                     | (3)                                    | 14,247                              |
|   | \$ 99,293                 | \$ 49                                 | \$ (33)                                | \$ 99,309                           |

\* Does not include cash held in our bank accounts

The following tables show the gross unrealized losses and fair value of our investments as of March 31, 2011 with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

|                                  | <b>Less Than 12 Months</b> |  | <b>12 Months or More</b> |  | <b>Total</b>          |  |
|----------------------------------|----------------------------|--|--------------------------|--|-----------------------|--|
|                                  | <b>Fair<br/>Value</b>      | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b>    | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> | <b>Gross<br/>Unrealized<br/>Losses</b> |
| Corporate debt investments       | \$ 29,387                  | \$ 34                                  | \$                       | \$                                     | \$ 29,387             | \$ 34                                  |
| Government-sponsored enterprises | 12,233                     | 19                                     |                          |  | 12,233                | 19                                     |
| <b>Total</b>                     | <b>\$ 41,620</b>           | <b>\$ 53</b>                           | <b>\$</b>                | <b>\$</b>                              | <b>\$ 41,620</b>      | <b>\$ 53</b>                           |

As of March 31, 2011, the unrealized holding loss, net of tax on available-for-sale securities included in accumulated other comprehensive loss totaled \$7,000. We have evaluated our investments and have determined there were no other-than-temporary impairments as of March 31, 2011. There are 23 corporate debt investments and 11 government-sponsored enterprise investments with unrealized losses that have existed for less than one year. The unrealized losses related to these investments are entirely caused by non-credit related factors. We do not have the intent to sell these securities and we expect to fully recover the amortized cost basis of these investments.

##### 5. Goodwill and Intangible Assets

Goodwill represents the excess of the consideration transferred over the fair values assigned to the assets acquired and liabilities assumed. On December 30, 2010, in connection with the acquisition of Immunet, we recorded goodwill

of \$15.1 million, which was allocated to our one reporting unit.

Also in connection with the acquisition of Immunet, we acquired certain intangible assets of \$6.8 million. We allocated \$1.8 million to in-process research and development with an indefinite life and \$5.0 million to acquired technology with an estimated useful life of 5 years. The in-process research and development will be considered indefinite lived until completion or abandonment of the associated research and development. While it is considered indefinite lived it will be tested for impairment on an annual basis. Once the associated research and development is complete, we will determine the useful life of the assets and amortize the in-process research and development over that time period on a straight-line basis.

Intangible assets consist of the following (in thousands):

|                                     |                | As of March 31, 2011 |                             |          |
|-------------------------------------|----------------|----------------------|-----------------------------|----------|
|                                     | Useful<br>Life | Gross                | Accumulated<br>Amortization | Net      |
| Acquired technology                 | 5 years        | \$ 5,039             | \$ (252)                    | \$ 4,787 |
| In-process research and development | Indefinite     | 1,791                |                             | 1,791    |
| Total intangible assets             |                | \$ 6,830             | \$                          | \$ 6,578 |

Amortization expense for the three months ended March 31, 2011 was \$252,000 and is recorded as a component of product cost of revenue. There was no amortization expense for the three months ended March 31, 2010.

#### 4. Income Taxes

Our effective tax rate for the three months ended March 31, 2011 is a benefit of 118.4%, compared to an expense of 25.2% in the prior-year period. Our benefit from income taxes is based on an estimated annual effective tax rate for 2011 of 38.4% and includes a discrete tax benefit of \$2.0 million from research and experimentation tax credits for the years 2003 through 2010 recorded in the three months ended March 31, 2011. Our estimated annual effective tax rate includes the U.S. federal statutory rate of 34%, state income taxes and foreign income taxed at different rates, partially offset by the impact of research and experimentation tax credits projected for 2011. Our provision for income taxes for the three months ended March 31, 2010 is based on an estimated annual effective tax rate for 2010 of 25.2%, which includes the U.S. federal statutory rate of 34%, state income taxes and foreign income taxed at different rates, offset by a release of the valuation allowance attributable to deferred tax assets associated with our net operating losses.

During the three months ended March 31, 2011, we established a liability for unrecognized income tax benefits of \$250,000 for tax positions recognized in the current year. The unrecognized tax benefits that, if recognized, would impact the effective tax rate were \$250,000 as of March 31, 2011.

#### 5. Stock-Based Compensation

In March 2007, our Board of Directors and stockholders approved the Sourcefire, Inc. 2007 Stock Incentive Plan, or 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, 2010, we had reserved an aggregate of 6,249,532 shares of common stock for issuance under the 2007 Plan. On January 1, 2011, 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, 2010, or 1,125,442 shares. Therefore, as of March 31, 2011, we have reserved an aggregate of 7,374,974 shares of common stock for issuance under the 2007 Plan. Prior to adoption of the 2007 Plan, we granted stock options and restricted stock awards under the Sourcefire, Inc. 2002 Stock Incentive Plan, or 2002 Plan.

The 2002 Plan and the 2007 Plan are administered by the Compensation Committee of our Board of Directors. The vesting period for awards under the plans is generally between three and five years. Options granted prior to March 2010 have a maximum term of ten years, and options granted beginning March 2010 have a maximum term of seven years. The exercise price of stock option awards is 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 Select Market on the date of grant.

##### *Valuation of Stock-Based Compensation*

We use the Black-Scholes option pricing model for estimating the fair value of stock options granted and for employee stock purchases under the ESPP. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock 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. The fair value of stock-based awards is recognized as expense ratably over the requisite service period, net of estimated forfeitures. 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 ESPP grants.

|   | <b>Three Months Ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2011</b>               | <b>2010</b> |
| <b>Stock options:</b>                     |                           |             |
| Average risk-free interest rate           | 2.1%                      | 2.7%        |
| Expected dividend yield                   | %                         | %           |
| Expected life (years)                     | 4.75                      | 6.06        |
| Expected volatility                       | 62.3%                     | 61.4%       |
| Weighted-average fair value at grant date | \$13.72                   | \$14.22     |

*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, as of the grant date.

*Expected dividend yield* We use an expected dividend yield of zero, as we have never declared or paid dividends on our common stock and do not anticipate paying dividends in the foreseeable future.

*Expected life* This is the period of time that the stock options granted under our equity incentive plans and ESPP grants are expected to remain outstanding.

We have elected to use the simplified method of determining the expected term of stock options. This estimate is derived from the average midpoint between the weighted-average vesting period and the contractual term. In future periods, we expect to begin to incorporate our own data in estimating the expected life as we develop appropriate historical experience of employee exercise and post-vesting termination behavior considered in relation to the contractual life of the option. For ESPP grants, the expected 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, since our historical stock data from our IPO in March 2007 is less than the expected life of the stock options, we have used a blended volatility to estimate expected volatility. The blended volatility includes a weighting of our historical volatility from the date of 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 additional historical experience of our own stock price fluctuations considered in relation to the expected life of the option.

For ESPP grants, we use our historical volatility since we have historical data available since our IPO, which is consistent with the expected life.

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

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

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2011</b>                             | <b>2010</b> |
| Product cost of revenue   | \$ 59                                   | \$ 31       |
| Services cost of revenue  | 110                                     | 71          |
| Stock-based compensation expense included in cost of revenue    | 169                                     | 102         |
| Research and development  | 697                                     | 318         |
| Sales and marketing   | 1,324                                   | 666         |
| General and administrative                                      | 993                                     | 840         |
| Stock-based compensation expense included in operating expenses | 3,014                                   | 1,824       |
| Total stock-based compensation expense                          | \$ 3,183                                | \$ 1,926    |

**Stock Options**

The following table summarizes stock option activity under the plans for the three months ended March 31, 2011 (in thousands, except share and per share data):

|   | <b>Number of<br/>Shares</b> | <b>Range of<br/>Exercise Prices</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Term</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|---|-----------------------------|-------------------------------------|---|--|--|
| Outstanding at December 31, 2010              | 2,225,449                   | \$ 0.24 to 28.90                    | \$ 12.11  |  | \$                                       |
| Granted                                       | 552,800                     | 25.58 to 26.82                      | 26.03   |  |  |
| Exercised                                     | (164,471)                   | 0.24 to 23.31                       | 7.40  |  |  |
| Forfeited                                     | (40,040)                    | 5.71 to 22.27                       | 18.71   |  |  |
| Outstanding at March 31, 2011                 | 2,573,738                   | \$ 0.24 to 28.90                    | \$ 15.30  | 6.72   | \$ 31,483                                |
| Vested and exercisable at March 31, 2011      | 1,063,791                   | \$ 0.24 to 27.09                    | \$ 8.33   | 6.09   | \$ 20,401                                |
| Vested and expected to vest at March 31, 2011 | 2,327,044                   |                                     | \$ 14.53  | 6.67   | \$ 30,252                                |

The following table summarizes information about stock options outstanding as of March 31, 2011:

| <b>Options Outstanding</b> | <b>Weighted-</b> | <b>Options Exercisable</b> |
|----------------------------|------------------|----------------------------|
|----------------------------|------------------|----------------------------|

| <b>Range of<br/>Exercise Prices</b> | <b>Number<br/>of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Prices</b> | <b>Average<br/>Contractual<br/>Life<br/>(Years)</b> | <b>Number<br/>of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Prices</b> |
|-------------------------------------|---------------------------------|--|---|---------------------------------|--|
| \$0.24 to 6.77                      | 966,528                         | \$ 5.40  | 6.33  | 685,171                         | \$ 4.93  |
| \$7.10 to 22.27                     | 727,053                         | 15.51  | 6.89  | 331,500                         | 12.97  |
| \$23.31 to 26.16                    | 655,332                         | 25.50  | 7.03  | 26,226                          | 23.67  |
| \$26.82 to 28.90                    | 224,825                         | 27.41  | 6.89  | 20,894                          | 27.01  |
|                                     | 2,573,738                       | \$ 15.30   | 6.72  | 1,063,791                       | \$ 8.33  |

The aggregate intrinsic value of all options exercised during the three months ended March 31, 2011 and 2010 was \$3.1 million and \$5.3 million, 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 \$1.2 million and \$892,000 for the three months ended March 31, 2011 and 2010, respectively. The grant date aggregate fair value of

options, net of estimated forfeitures, not yet recognized as expense as of March 31, 2011 was \$12.7 million, which is expected to be recognized over a weighted average period of 2.91 years.

**Restricted Stock Awards**

The following table summarizes the unvested restricted stock award activity during the three months ended March 31, 2011:

|                               | <b>Number<br/>of<br/>Shares</b> | <b>Weighted-Average<br/>Grant Date<br/>Fair Value</b> |
|-------------------------------|---------------------------------|---|
| Unvested at December 31, 2010 | 254,698                         | \$ 8.59   |
| Granted                       | 808                             | 25.33   |
| Vested                        | (70,300)                        | 6.82  |
| Forfeited                     | (2,057)                         | 7.84  |
| Unvested at March 31, 2011    | 183,149                         | \$ 9.31   |

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. Holders of restricted stock awards have the right to vote such shares and receive dividends. The restricted stock awards are considered issued and outstanding at the date the award is granted. 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. We recognized compensation expense related to restricted stock awards of \$415,000 and \$448,000 for the three months ended March 31, 2011 and 2010, respectively.

As of March 31, 2011, there was \$708,000 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 1.02 years.

**Restricted Stock Units**

The following table summarizes the unvested restricted stock unit activity during the three months ended March 31, 2011:

|                               | <b>Number of<br/>Shares</b> | <b>Weighted-Average<br/>Grant Date<br/>Fair Value</b> |
|-------------------------------|-----------------------------|---|
| Unvested at December 31, 2010 | 883,003                     | \$ 17.23  |
| Granted                       | 259,400                     | 25.87   |
| Vested                        | (128,371)                   | 14.13   |
| Forfeited                     | (21,600)                    | 20.96   |
| Unvested at March 31, 2011    | 992,432                     | \$ 19.81  |

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 48 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. We recognized compensation expense related to restricted stock units of \$1.4 million and \$485,000 for the three months ended March 31, 2011 and 2010, respectively.

As of March 31, 2011, there was \$12.4 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 3.28 years.

**Employee Stock Purchase Plan**

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. There were no shares purchased during the three months ended March 31, 2011 and 2010. The total compensation expense related to the ESPP for the three months ended March 31, 2011 and 2010 was \$154,000 and \$102,000, respectively.

**6. Net Income Per Share**

The calculation of basic and diluted net income per share for the three months ended March 31, 2011 and 2010 is summarized as follows (in thousands, except share and per share data):

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2011</b>                             | <b>2010</b> |
| Numerator:                                |   |             |
| Net income                                | \$ 460                                  | \$ 810      |
| Denominator:                              |   |             |
| Weighted-average shares outstanding basic | 28,235,751                              | 27,220,667  |
| Dilutive effect of employee stock plans   | 943,558                                 | 1,839,892   |
| Weighted-average shares diluted           | 29,179,309                              | 29,060,559  |
| Net income per share:                     |   |             |
| Basic                                     | \$ 0.02                                 | \$ 0.03     |
| Diluted                                   | \$ 0.02                                 | \$ 0.03     |

The following potential weighted-average common shares were excluded from the computation of diluted earnings per share, as their effect would have been anti-dilutive:

|                                  | <b>Three Months Ended<br/>March 31,</b> |             |
|----------------------------------|---|-------------|
|                                  | <b>2011</b>                             | <b>2010</b> |
| Options to purchase common stock | 913,938                                 | 381,979     |
| Restricted stock units           | 72,722                                  |             |
|                                  | 986,660                                 | 381,979     |

**7. Comprehensive Income**

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

|  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2011</b>                             | <b>2010</b> |
| Net income   | \$ 460                                  | \$ 810      |
| Comprehensive income:                                |   |             |
| Change in unrealized loss on investments, net of tax | (14)                                    | (26)        |

|                            |        |        |
|----------------------------|--------|--------|
| Total comprehensive income | \$ 446 | \$ 784 |
|----------------------------|--------|--------|

**8. Fair Value Measurement**

We measure the fair value of assets and liabilities using a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires us 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, 2011 by level within the fair value hierarchy (in thousands):

|  | Fair Value | Fair Value Measurement Using Level |            |          |
|--|------------|------------------------------------|------------|----------|
|  |            | 1                                  | Level 2    | Level 3  |
| <b>Assets:</b>                               |            |                                    |            |          |
| Money market funds                           | \$ 6,899   | \$ 6,899                           | \$         | \$       |
| Corporate debt investments                   | 51,196     |                                    | 51,196     |          |
| Asset-backed securities                      | 723        |                                    | 723        |          |
| Commercial paper                             | 25,941     |                                    | 25,941     |          |
| Government-sponsored enterprise securities   | 27,556     |                                    | 27,556     |          |
| Government securities                        | 5,797      | 3,008                              | 2,789      |          |
| CD   | 1,200      |                                    | 1,200      |          |
| Total  | \$ 119,312 | \$ 9,907                           | \$ 109,405 | \$       |
| <b>Liabilities:</b>                          |            |                                    |            |          |
| Acquisition-related contingent consideration | \$ 3,659   | \$                                 | \$         | \$ 3,659 |

We estimated the fair value of the acquisition-related contingent consideration using a probability-weighted discounted cash flow model. This fair value was classified as Level 3 because it was based on significant unobservable inputs that are supported by little or no market activity and reflect our own assumptions. During the period ended March 31, 2011, we recognized a \$114,000 increase in the fair value of the acquisition-related contingent consideration related primarily to the change in the discount period (accretion due to the passage of time).

Assets and liabilities that are measured at fair value on a non-recurring basis include intangible assets and goodwill. These items are recognized at fair value if and when they are considered to be impaired. For the three months ended March 31, 2011, there were no fair value adjustments for assets and liabilities measured on a non-recurring basis.

## 9. 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, 2011 and 2010 were as follows (in thousands):

| Three Months Ended |      |
|--------------------|------|
| March 31,          |      |
| 2011               | 2010 |



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|                       |           |           |
|-----------------------|-----------|-----------|
| United States         | \$ 22,397 | \$ 18,306 |
| All foreign countries | 8,385     | 7,525     |
| Total                 | \$ 30,782 | \$ 25,831 |

## **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. A portion of our reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments. As of March 31, 2011, we had total purchase commitments for inventory of approximately \$11.9 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 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, 2010.*

### **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 key financial metrics that we use in assessing our performance, 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, 2011 and 2010.

*Non-GAAP Financial Measures.* This section discusses non-GAAP financial results that we use in evaluating the operating performance of our business. These measures should be considered in addition to results prepared in accordance with United States generally accepted accounting principles, or GAAP, but should not be considered a substitute for, or superior to, GAAP results. The non-GAAP measures discussed have been reconciled to the nearest GAAP measure in a table included in this section.

*Liquidity and Capital Resources.* This section provides an analysis of our cash flows for the three months ended March 31, 2011 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 intelligent cybersecurity solutions for information technology, or IT, environments of commercial enterprises, including healthcare, financial services, manufacturing, energy, education, retail and telecommunications companies, and federal, state and local government organizations worldwide. Our solutions are comprised of multiple hardware, software and cloud-based product and service offerings, enabling comprehensive,

intelligent protection before, during and after an attack.

We sell our solutions to a diverse customer base that includes Global 2000 companies, global enterprises, U.S. and international government agencies, small and mid-size businesses, and through our acquisition of Immunet Corporation,

consumers. We also manage the security industry's leading open source initiative, Snort®, as well as the ClamAV® and Razorback™ open source initiatives.

***Key Financial Metrics and Trends***

During the first quarter of 2011, we continued to see strong sales to U.S. commercial and international customers. Our revenues from U.S. commercial customers increased by 33% for the three months ended March 31, 2011 as compared to the prior-year period. Similarly, our revenues from international customers increased by 11% for the three months ended March 31, 2011 as compared to the prior-year period. We expect to continue to see growth in our U.S. commercial and international business throughout 2011, although our ability to achieve this expected growth and the rate of any growth is subject to numerous factors as discussed in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2010.

Our revenues from U.S. federal and state government agencies increased by 1% for the three months ended March 31, 2011 as compared to the prior-year period. Our sales to U.S. federal government agencies were negatively affected by reduced federal spending levels in the first quarter of 2011. For 2011, we anticipate that federal spending, including spending on cybersecurity, will decline as compared to 2010 spending. As a result, we expect a material decrease in our revenue from U.S. federal and state government agencies for the year ended December 31, 2011 as compared to the prior year. We further expect that the decrease in federal revenue will result in a decline in our overall revenue growth rate, although we continue to expect positive overall revenue growth as a result of strength in our U.S. commercial and international business.

We evaluate our performance on the basis of several key financial metrics, including 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. We also evaluate performance on the basis of adjusted income from operations, adjusted income from operations as a percentage of revenue, adjusted net income, adjusted net income per share and free cash flow, which are non-GAAP financial measures. Information regarding our non-GAAP financial measures and a reconciliation of each to the nearest GAAP measure is provided under *Non-GAAP Financial Measures* below.

*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 and new rule releases on a when and if available basis 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 services typically occur on-site after delivery has occurred.

Product sales are typically recognized as revenue upon 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, 73% and 71% of our revenue for the three months ended March 31, 2011 and 2010, 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 in absolute dollars and as a percentage of revenue as we strengthen our international presence.

We continue to generate a majority of our product revenue through sales to existing customers, both for new locations and for additional technology to protect existing networks and locations. Product sales to existing customers accounted for 79% and 68% of total product revenue for the three months ended March 31, 2011 and 2010, respectively. We expect product sales to existing customers to continue to account for a significant portion of our product revenue in 2011.



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. 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 second half of the year. While we expect these historical trends to continue, they could be affected by a number of factors, including another decline in general economic conditions, changes in the timing or amounts of U.S. government spending and our planned international expansion. 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. In addition, because we typically recognize revenue upon shipment, the timing of our quarter-end and year-end shipments could materially affect our reported product revenue for a given quarter or year. 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 financial and industry research analysts or investors.

#### *Cost of Revenue*

Cost of product revenue includes the cost of the hardware platform, third-party manufacturing costs, royalties for third-party software, personnel costs associated with logistics and quality control, stock-based compensation expense, amortization of acquired intangible assets, supplies, warranty, shipping and handling costs, expense for inventory excess and obsolescence and depreciation in the instances where we lease our network security solutions to our customers. We allocate overhead costs, including facilities, supplies, communication and information systems and employee benefits, to the cost of product revenue. Overhead costs are reflected in each cost of revenue and operating expense category. As our product volume increases, we anticipate incurring an increased amount of both direct and overhead expenses to supply and manage the increased volume. In addition, hardware unit costs or other costs of manufacturing could increase in the future.

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 and stock-based compensation expense. 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 and the expense for advance replacement unit inventory excess and obsolescence. 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 provide support and service to 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, new product introductions, the cost of hardware platforms, expense for inventory excess and obsolescence, warranty expense, the cost of labor and materials 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 high-margin product could significantly reduce our total gross profit percentage for that quarter.

#### *Operating Expenses*

*Research and Development.* Research and development expenses consist primarily of salaries, incentive compensation and allocated overhead costs for our engineers; stock-based compensation expense; retention obligations related to our hiring of former Immunet employees; costs for professional services to design, test and certify 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 and increase significantly as a percentage of revenue for the year ending December 31, 2011.

*Sales and Marketing.* Sales and marketing expenses consist primarily of salaries, incentive compensation and allocated overhead costs for sales and marketing personnel; stock-based compensation expense; 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 continue to focus on increasing our market penetration, expanding internationally, increasing our indirect sales channel and building brand awareness, we anticipate that selling and marketing expenses will continue to increase in absolute dollars and increase modestly as a percentage of revenue for the year ending December 31, 2011.

*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; stock-based compensation expense; corporate development expenses and professional fees related to legal, audit, tax and regulatory compliance; travel and related costs; and corporate insurance. We anticipate that general and administrative expenses will increase in absolute dollars for the year ending December 31, 2011.

*Stock-Based Compensation.* Stock-based compensation expense is based on the grant date fair value of stock awards. We use the Black-Scholes option pricing model to estimate the fair value of stock options granted and employee stock purchases. 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 \$3.2 million and \$1.9 million for the three months ended March 31, 2011 and 2010, respectively.

## Results of Operations

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

|   | Three Months Ended |            | Variance |     |
|---|--------------------|------------|----------|-----|
|   | March 31,          |            | \$       | %   |
|   | 2011               | 2010       |          |     |
| Products                                    | \$ 15,798          | \$ 14,338  | \$ 1,460 | 10% |
| <i>Percentage of total revenue</i>          | <i>51%</i>         | <i>56%</i> |          |     |
| Technical support and professional services | 14,984             | 11,493     | 3,491    | 30% |
| <i>Percentage of total revenue</i>          | <i>49%</i>         | <i>44%</i> |          |     |
| Total revenue                               | \$ 30,782          | \$ 25,831  | \$ 4,951 | 19% |

The increase in our product revenue for the three months ended March 31, 2011, as compared to the prior-year period, was primarily due to the product mix favoring our higher priced sensor products. For the three months ended March 31, 2011, sensor product revenue increased \$2.5 million over the prior-year period, partially offset by a decrease of \$1.0 million in software license revenue.

The increase in our services revenue for the three months ended March 31, 2011, as compared to the prior-year period, resulted from an increase in our installed customer base due to new product sales in which associated support was purchased, as well as technical 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<br>March 31, |          | Variance |     |
|---|---------------------------------|----------|----------|-----|
|   | 2011                            | 2010     | \$       | %   |
| Products                                    | \$ 4,735                        | \$ 3,796 | \$ 939   | 25% |
| <i>Percentage of total revenue</i>          | 15%                             | 15%      |          |     |
| Technical support and professional services | 1,862                           | 1,405    | 457      | 33% |
| <i>Percentage of total revenue</i>          | 6%                              | 5%       |          |     |
| Total cost of revenue                       | \$ 6,597                        | \$ 5,201 | \$ 1,396 | 27% |
| <i>Percentage of total revenue</i>          | 21%                             | 20%      |          |     |

The increase in our product cost of revenue for the three months ended March 31, 2011, as compared to the prior-year period, was primarily due to an increase in inventory write-downs related to excess and obsolete inventory as a result of the introduction of new products and the amortization of acquired technology intangible assets.

The increase in our services cost of revenue for the three months ended March 31, 2011, as compared to the prior-year period, was primarily due to our hiring of additional personnel to service our larger installed customer base, provide training to our resellers and customers, provide professional services to our customers and increased hardware service expense we pay to our third-party integrators to help maintain our install base.

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

|   | Three Months Ended<br>March 31, |           | Variance |     |
|---|---------------------------------|-----------|----------|-----|
|   | 2011                            | 2010      | \$       | %   |
| Products  | \$ 11,063                       | \$ 10,542 | \$ 521   | 5%  |
| <i>Product gross margin</i>                                     | 70%                             | 74%       |          |     |
| Technical support and professional services                     | 13,122                          | 10,088    | 3,034    | 30% |
| <i>Technical support and professional services gross margin</i> | 88%                             | 88%       |          |     |
| Total gross profit  | \$ 24,185                       | \$ 20,630 | \$ 3,555 | 17% |
| <i>Total gross margin</i>                                       | 79%                             | 80%       |          |     |

Product gross margin decreased for the three months ended March 31, 2011, as compared to the prior-year period, primarily due to an increase in inventory write-downs related to excess and obsolete inventory as a result of the introduction of new products and the amortization of acquired technology intangible assets.

Technical support and professional services gross margin for the three months ended March 31, 2011, remained relatively flat over the prior-year period.

*Operating expenses.* The following table shows operating expenses (in thousands):

|                                    | Three Months Ended<br>March 31, |          | Variance |     |
|------------------------------------|---------------------------------|----------|----------|-----|
|                                    | 2011                            | 2010     | \$       | %   |
| Research and development           | \$ 6,962                        | \$ 3,795 | \$ 3,167 | 83% |
| <i>Percentage of total revenue</i> | 23%                             | 15%      |          |     |
| Sales and marketing                | 14,078                          | 10,619   | 3,459    | 33% |

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|                                    |           |           |          |     |
|------------------------------------|-----------|-----------|----------|-----|
| <i>Percentage of total revenue</i> | 46%       | 41%       |          |     |
| General and administrative         | 4,673     | 4,319     | 354      | 8%  |
| <i>Percentage of total revenue</i> | 15%       | 17%       |          |     |
| Depreciation and amortization      | 965       | 814       | 151      | 19% |
| <i>Percentage of total revenue</i> | 3%        | 3%        |          |     |
| Total operating expenses           | \$ 26,678 | \$ 19,547 | \$ 7,131 | 36% |
| <i>Percentage of total revenue</i> | 87%       | 76%       |          |     |

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Research and development expenses for the three months ended March 31, 2011 increased over the prior-year period, primarily due to an increase of \$1.2 million in salaries, incentive compensation and benefits as a result of additional personnel, including the hiring of former Immunet employees, \$667,000 for the accrual of retention obligations related to our hiring of former Immunet employees, an increase of \$566,000 in consulting fees, an increase of \$379,000 in stock-based compensation expense and an increase of \$215,000 in allocated overhead costs as a result of additional personnel and increased overhead costs.

Sales and marketing expenses for the three months ended March 31, 2011 increased over the prior-year period, primarily due to an increase of \$1.7 million in salaries, commissions and incentive compensation, and benefits as a result of additional personnel, an increase of \$658,000 in stock-based compensation expense, an increase of \$265,000 in advertising, promotion, partner-marketing programs and trade show expenses, an increase in consulting fees of \$211,000 and an increase of \$185,000 in travel and travel-related expenses.

General and administrative expenses for the three months ended March 31, 2011 increased from the prior-year period, primarily due to an increase of \$153,000 in stock-based compensation expense and an increase of \$88,000 in allocated overhead costs.

Depreciation and amortization expense for the three months ended March 31, 2011 increased from the prior-year period, primarily due to depreciation of additional lab and testing equipment purchased for our engineering department and computers purchased for personnel hired.

*Provision for (benefit from) income taxes.* The following table shows (benefit from) provision for income taxes (in thousands):

|   | <b>Three Months Ended</b> |             | <b>Variance</b> |          |
|---|---------------------------|-------------|-----------------|----------|
|   | <b>March 31,</b>          |             |                 |          |
|   | <b>2011</b>               | <b>2010</b> | <b>\$</b>       | <b>%</b> |
| Provision for (benefit from) income taxes | \$(2,959)                 | \$273       | \$(3,232)       | NM       |

NM not meaningful

Our effective tax rate for the three months ended March 31, 2011 is a benefit of 118.4%, compared to an expense of 25.2% in the prior-year period. Our benefit from income taxes is based on an estimated annual effective tax rate for 2011 of 38.4% and includes a discrete tax benefit of \$2.0 million from research and experimentation tax credits for the years 2003 through 2010 recorded in the three months ended March 31, 2011. Our estimated annual effective tax rate includes the U.S. federal statutory rate of 34%, state income taxes and foreign income taxed at different rates, partially offset by the impact of research and experimentation tax credits projected for 2011. Our provision for income taxes for the three months ended March 31, 2010 is based on an estimated annual effective tax rate for 2010 of 25.2%, which includes the U.S. federal statutory rate of 34%, state income taxes and foreign income taxed at different rates, offset by a release of the valuation allowance attributable to deferred tax assets associated with our net operating losses.

During the three months ended March 31, 2011, we established a liability for unrecognized income tax benefits of \$250,000 for tax positions recognized in the current year. The unrecognized tax benefits that, if recognized, would impact the effective tax rate were \$250,000 as of March 31, 2011.

Our future effective tax rate may be materially impacted by the amount of income taxes associated with our foreign earnings, which are taxed at rates different from the U.S. federal statutory rate, as well as the timing and extent of the realization of deferred tax assets and changes in the tax law. Further, our effective tax rate may fluctuate within a fiscal year, including from quarter-to-quarter, due to items arising from discrete events, including the resolution or identification of tax position uncertainties and acquisitions of other companies.

#### ***Seasonality***

Our product revenue has tended to be seasonal, with a significant portion generated in the third and fourth quarters. 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 second half of the year. In the fourth quarter, revenues have historically been strong due to purchases by North American enterprise customers, which operate on a calendar year budget and often wait until the fourth quarter to make their most significant capital equipment purchases. In addition, increased fourth quarter sales in Europe have historically resulted in higher fourth quarter revenues following a decline in sales in the summer months due to vacation practices in Europe and the resulting delay in capital purchase activities until the fall. While we expect these historical trends to continue, they could be affected by a number of factors, including another decline in general economic conditions, changes in the timing or amounts of U.S. government spending, and our planned international expansion. The timing of transactions could materially affect our quarterly or annual product revenue.

#### ***Quarterly Timing***

On a quarterly basis, we have usually generated the majority of our sales in the final month of the quarter. We believe this occurs for two reasons. First, many customers wait until the end of the quarter to extract favorable pricing terms from their vendors, including Sourcefire. Second, our sales personnel, who have a strong incentive to meet quarterly sales targets, have tended to increase their sales activity as the end of a quarter nears, while their participation in sales management review and planning activities is typically scheduled at the beginning of a quarter. The timing of our quarter-end and year-end shipments also affects our quarterly and annual product revenue, since we typically recognize revenue upon shipment of the product.

#### **Non-GAAP Financial Measures**

*Adjusted Net Income, Adjusted Net Income per Share, Adjusted Income from Operations and Adjusted Income from Operations as a Percentage of Revenue:* In evaluating the operating performance of our business, we exclude certain charges and credits that are required by GAAP. We believe these non-GAAP results provide useful information to both management and investors by excluding (i) stock-based compensation, which does not involve the expenditure of cash, (ii) amortization of acquisition-related intangible assets, which does not involve the expenditure of cash, and (iii) other acquisition-related expenses, which are unrelated to the ongoing operation of our business in the ordinary course. For all of 2011 we expect that non-GAAP results will continue to be adjusted to reflect the effect of an assumed tax rate of 35%. We believe this adjustment provides useful information to both management and investors.

*Free Cash Flow:* We define free cash flow as net cash provided by operating activities minus capital expenditures. We consider free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after the purchase of property and equipment, can be used for strategic opportunities, including investing in the business, making strategic acquisitions and strengthening the balance sheet.

These measures should be considered in addition to results prepared in accordance with GAAP, but should not be considered a substitute for, or superior to, GAAP results.

The following table shows a reconciliation of non-GAAP financial measures to the nearest GAAP measure (in thousands, except share and per share amounts):

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2011</b>                             | <b>2010</b> |
| Reconciliation to adjusted income from operations:    |   |             |
| GAAP income (loss) from operations                    | \$ (2,493)                              | \$ 1,083    |
| Stock-based compensation expense                      | 3,183                                   | 1,926       |
| Amortization of acquisition-related intangible assets | 252                                     |             |
| Other acquisition-related expenses*                   | 789                                     |             |
| Adjusted income from operations                       | \$ 1,731                                | \$ 3,009    |
| Adjusted income from operations as % of revenue       | 5.6%                                    | 11.6%       |
| Reconciliation to adjusted net income:                |   |             |
| GAAP net income                                       | \$ 460                                  | \$ 810      |
| Stock-based compensation expense                      | 3,183                                   | 1,926       |
| Amortization of acquisition-related intangible assets | 252                                     |             |
| Other acquisition-related expenses**                  | 903                                     |             |
| Tax credit for research and experimentation           | (2,001)                                 |             |
| Income tax adjustment ***                             | (1,602)                                 | (780)       |
| Adjusted net income                                   | \$ 1,195                                | \$ 1,956    |
| Adjusted net income per share basic                   | \$ 0.04                                 | \$ 0.07     |
| Adjusted net income per share diluted                 | \$ 0.04                                 | \$ 0.07     |
| Weighted-average shares outstanding basic             | 28,235,751                              | 27,220,667  |
| Weighted-average shares outstanding diluted           | 29,179,309                              | 29,060,559  |
| Reconciliation to free cash flow:                     |   |             |
| GAAP net cash provided by operating activities        | \$ 7,258                                | \$ 10,987   |
| Purchase of property and equipment                    | (1,273)                                 | (1,185)     |
| Free cash flow  | \$ 5,985                                | \$ 9,802    |

\* Consists of \$667,000 for the accrual of retention obligations related to our hiring of former Immunet employees and \$122,000 for other acquisition-related expenses.

\*\* Consists of \$667,000 for the accrual of retention obligations related to our hiring of former Immunet employees, \$114,000 related to the increase in the fair value of the acquisition-related contingent consideration and \$122,000 for other acquisition-related expenses.

\*\*\* Income tax adjustment is used to adjust the GAAP provision for income taxes to a non-GAAP provision for income taxes utilizing an assumed tax rate of 35%.

### Liquidity and Capital Resources

#### *Cash Flows*

The following table summarizes our cash flow activities for the periods indicated (in thousands):

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2011</b>               | <b>2010</b> |
| Cash and cash equivalents:                       |                           |             |
| Provided by operating activities                 | \$ 7,258                  | \$ 10,987   |
| Used in investing activities                     | (8,078)                   | (7,484)     |
| Provided by financing activities                 | 681                       | 1,448       |
| Increase (decrease) in cash and cash equivalents | (139)                     | 4,951       |
| Cash and cash equivalents at beginning of period | 54,410                    | 53,071      |
| Cash and cash equivalents at end of period       | 54,271                    | 58,022      |
| Investments                                      | 98,525                    | 76,136      |
| Total cash, cash equivalents and investments     | \$ 152,796                | \$ 134,158  |

*Operating Activities.* Cash provided by operating activities for the three months ended March 31, 2011 is the result of our net income of \$460,000, \$2.6 million of net non-cash revenues and expenses, which include a discrete benefit of \$2.0 million related our research and experimentation tax credit, and changes in our operating assets and liabilities of \$4.2 million. Cash provided by operating activities for the three months ended March 31, 2010 is the result of our net income of \$810,000, \$2.9 million of net non-cash revenues and expenses and changes in our operating assets and liabilities of \$7.3 million.

*Investing Activities.* Cash used in investing activities for the three months ended March 31, 2011 was primarily the result of purchases of investments of \$47.1 million, \$7.1 million for acquisition-related payments and capital expenditures of \$1.3 million, offset by maturities of investments of \$47.4 million. Cash used in investing activities for the three months ended March 31, 2010 was primarily the result of purchases of investments of \$30.5 million and capital expenditures of \$1.2 million, offset by maturities of investments of \$24.2 million.

*Financing Activities.* Cash provided by financing activities for the three months ended March 31, 2011 and 2010 was primarily the result of proceeds from the issuance of common stock under our employee stock-based plans.

### ***Liquidity Requirements***

We manufacture our products through contract manufacturers and other third parties. This approach provides us with the advantage of relatively low capital expenditure requirements and significant flexibility in scheduling production and managing inventory levels. The majority of our products are delivered to our customers directly from our contract manufacturers. Accordingly, our contract manufacturers are responsible for purchasing and stocking the components required to produce our products, and they invoice us when the finished goods are shipped. By leasing our office facilities, we also minimize the cash needed for expansion. Our capital spending is generally limited to leasehold improvements, computers, office furniture and lab and test equipment.

Our short-term liquidity requirements through March 31, 2012 consist primarily of the funding of working capital requirements, capital expenditures and the remaining payments related to our acquisition of Immunet. We expect to meet these short-term requirements primarily through cash flow from operations. To the extent that cash flow from operations is not sufficient to meet these requirements, we expect to fund these amounts through the use of existing cash and investment resources. As of March 31, 2011, we had cash, cash equivalents and investments of \$152.8 million and working capital of \$125.8 million.

As described above, our product sales are, and are expected to continue to be, highly seasonal. We believe that our current cash reserves are sufficient for any short-term needs arising from the seasonality of our business.

Our long-term liquidity requirements consist primarily of obligations under our operating leases. We expect to meet these long-term requirements primarily through cash flow from operations.

In addition, we may utilize cash resources, equity financing or debt financing to fund acquisitions or investments in complementary businesses, technologies or product lines.

### **Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We evaluate our estimates and assumptions on an ongoing basis. Our actual results may differ from these estimates.

We believe that, of our significant accounting policies, which are described in Note 2 to the consolidated financial statements contained in this report, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, we believe that the following accounting policies are the most critical to aid in fully understanding and evaluating our consolidated financial condition and results of operations.

*Revenue Recognition.* We derive revenue from arrangements that include hardware 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 hardware appliances containing software, 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 Vulnerability Research Team, or 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 recognize revenue when: (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 deemed probable.

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. 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.

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.

In October 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards for revenue recognition to remove from the scope of industry-specific software revenue recognition guidance any tangible products containing software components and non-software components that operate together to deliver the product's essential functionality. In addition, the FASB amended the accounting standards for certain multiple-element revenue arrangements to:

- (i) provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated and how the arrangement consideration should be allocated to the separate elements;
- (ii) require an entity to allocate arrangement consideration to each element based on a selling price hierarchy, where the selling price for an element is based on vendor-specific objective evidence, or VSOE, if available; third-party evidence, or TPE, if available and VSOE is not available; or the best estimate of selling price, or BEBP, if neither VSOE or TPE is available; and
- (iii) eliminate the use of the residual method and require an entity to allocate arrangement consideration based on the relative selling price of each element within the arrangement.

We adopted this accounting guidance on January 1, 2011 on a prospective basis for applicable transactions originating or materially modified after December 31, 2010.

The majority of our products are hardware appliances containing software components that operate together to provide the essential functionality of the product. Therefore, our hardware appliances are considered non-software deliverables and are no longer accounted for under the industry-specific software revenue recognition guidance.

Our product revenue also includes revenue from the sale of stand-alone software products. Stand-alone software may operate on our hardware appliance, but is not considered essential to the functionality of the hardware. Stand-alone software sales generally include a perpetual license to our software. Stand-alone software sales continue to be subject to the industry-specific software revenue recognition guidance.

For stand-alone software sales after December 31, 2010 and for all transactions entered into prior to the first quarter of 2011, we recognize revenue based on software revenue recognition guidance. Under the software revenue recognition guidance, we allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on VSOE. If VSOE 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 VSOE of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. If the only undelivered elements are elements for which we currently have VSOE of fair value, we recognize revenue for the delivered elements based on the residual method. When VSOE of fair value does not exist for undelivered elements such as maintenance and support, the entire arrangement fee is recognized ratably over the performance period.



For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with the amended accounting guidance. Certain arrangements with multiple deliverables may continue to have stand-alone software deliverables that are subject to the existing software revenue recognition guidance along with non-software deliverables that are subject to the amended revenue accounting guidance. The revenue for these multiple deliverable arrangements is allocated to the stand-alone software deliverables as a group and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the fair value hierarchy in the amended revenue accounting guidance.

We have established VSOE of fair value for substantially all of 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 VSOE of fair value of our other services is based on the price for these same services when they are sold separately. Revenue for professional 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.

For our non-software deliverables we allocate the arrangement consideration based on the relative selling price of the deliverables. For our hardware appliances we use BESP as our selling price. For our support and services, we generally use VSOE as our selling price.

We are typically not able to determine TPE for our products or services. TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, our offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, we are unable to reliably determine what similar competitor products' selling prices are on a stand-alone basis.

When we are unable to establish the selling price of our non-software deliverables using VSOE or TPE, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, gross margin objectives, pricing practices, customer classes and geographies and distribution channels.

We anticipate that for certain arrangements we will be able to account for more transaction consideration upon delivery than allowed under the prior guidance, primarily due to more deliverables being accounted for as separate units of accounting and the elimination of the use of the residual method and a requirement to allocate arrangement consideration using a selling price hierarchy.

An estimate of the revenue that would have been reported if we had applied the new guidance for multiple deliverable arrangements for non-software deliverables for the quarter ended March 31, 2010 is \$26.3 million compared to the \$25.8 million of revenue recognized under the industry specific software revenue recognition rules.

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

Changes in our judgments and estimates about these assumptions could materially impact the timing of our revenue recognition.

*Accounting for Stock-Based Compensation.* Stock-based awards granted include stock options, restricted stock awards, restricted stock units and stock purchased under our Amended and Restated 2007 Employee Stock Purchase Plan, or ESPP. Stock-based compensation expense is measured at the grant date, based on the fair value of the awards, and is recognized as expense over the requisite service period, net of estimated forfeitures.

We use the Black-Scholes option pricing model for estimating the fair value of stock options granted and for employee stock purchases under the ESPP. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock 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. The fair value of stock-based awards is recognized as expense ratably over the requisite service period, net of estimated forfeitures. We rely on historical experience of employee turnover to estimate our

expected forfeitures.

The key assumptions used in the Black-Scholes option valuation of stock options granted under the 2002 Plan and the 2007 Plan and ESPP grants include the following:

*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, as of the grant date.

*Expected dividend yield* We use an expected dividend yield of zero, as we have never declared or paid dividends on our common stock and do not anticipate paying dividends in the foreseeable future.

*Expected life* This is the period of time that the stock options granted under our equity incentive plans and ESPP grants are expected to remain outstanding.

We have elected to use the simplified method of determining the expected term of stock options. This estimate is derived from the average midpoint between the weighted-average vesting period and the contractual term. In future periods, we expect to begin to incorporate our own data in estimating the expected life as we develop appropriate historical experience of employee exercise and post-vesting termination behavior considered in relation to the contractual life of the option. For ESPP grants, the expected 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, since our historical stock data from our IPO in March 2007 is less than the expected life of the stock options, we have used a blended volatility to estimate expected volatility. The blended volatility includes a weighting of our historical volatility from the date of 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 additional historical experience of our own stock price fluctuations considered in relation to the expected life of the option.

For ESPP grants, we use our historical volatility since we have historical data available since our IPO, which is consistent with the expected life.

If we were to employ different assumptions for estimating stock-based compensation expense in future periods, or if we were to decide to use a different valuation model, the amount of expense recorded in future periods could differ significantly from what we have recorded in recent periods.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, which are characteristics that are not present in our option grants. Existing valuation models, including the Black-Scholes and Lattice models, may not provide reliable measures of the fair values of our stock-based compensation awards. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may be significantly different than the actual values upon the exercise, expiration, early termination or forfeiture of those stock-based payments in the future. Certain stock-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, values may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements.

The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency between past and future periods and materially affect the fair value estimate of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions.

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

compensation expense may fluctuate within a fiscal year, including from quarter-to-quarter, based on the probability of achieving those performance measures.

*Accounting for Income Taxes.* Deferred tax assets and liabilities are determined based on temporary differences between financial reporting and tax bases of assets and liabilities and for tax carryforwards at enacted statutory tax rates in effect for the years in which the differences are expected to reverse.

We assess the realizability of our deferred tax assets, which primarily consists of net operating loss, or NOL, carryforwards, and temporary differences associated with stock-based compensation expense, deferred revenue and research and experimentation tax credit carryforwards. In assessing the realizability of these deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will be realized. In assessing the need for a valuation allowance, we consider all available evidence, both positive and negative, including historical levels of income, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible tax planning strategies.

With respect to foreign earnings, it is our policy to invest the earnings of foreign subsidiaries indefinitely outside the U.S. Any excess tax benefit, above amounts previously recorded on stock-based compensation expense, from the exercise of stock options is recorded in additional paid-in-capital in the consolidated balance sheets to the extent that cash taxes payable are reduced.

Because tax laws are complex and subject to different interpretations, significant judgment is required. As a result, we make certain estimates and assumptions, in (i) calculating our provision for income taxes, deferred tax assets and deferred tax liabilities, (ii) determining any valuation allowance recorded against deferred tax assets and (iii) evaluating the amount of unrecognized tax benefits, as well as the interest and penalties related to such uncertain tax positions. Our estimates and assumptions may differ significantly from tax benefits ultimately realized.

*Allowance for Doubtful Accounts and Sales Return Allowance.* 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 if the allowance does not reflect our 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 also use our judgment to make estimates regarding potential future product returns related to reported product revenue in each period. 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. If any of the factors used to calculate the sales return allowance were to change, we may experience a material difference in the amount and timing of our product revenue for any given period.

*Inventory.* Inventory consists of hardware and related component parts and is stated at the lower of cost on a first-in, first-out basis, or market, except for evaluation and advance replacement 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. Advance replacement units, which include fully functioning appliances and spare parts, are used to provide replacement units under technical support arrangements if a customer's unit is not functioning properly. We make estimates of forecasted demand for our products, and inventory that is obsolete or in excess of our estimated demand is written down to its estimated net realizable value based on historical usage, expected demand, the timing of new product introductions 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-downs, which would negatively impact our gross margin.

*Investments.* We determine the appropriate classification of our investments at the time of purchase and reevaluate such classification as of each balance sheet date. Our investments are comprised of money market funds, corporate debt investments, commercial paper, government-sponsored enterprise securities, 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. Amortization is included in interest and investment income. Interest on securities classified as

available-for-sale is also included in interest and investment income.

We evaluate our investments on a regular basis to determine whether an other-than-temporary impairment in fair value has occurred. If an investment is in an unrealized loss position and we have the intent to sell the investment, or it is more likely than not that we will have to sell the investment before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is charged against earnings for the period. For investments that we do not intend to sell or it is more likely than not that we will not have to sell the investment, but we expect that we will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is charged against earnings for the applicable period and the non-credit component of the other-than-temporary impairment is recognized in other comprehensive income on our consolidated statement of stockholders' equity and comprehensive income (loss). Unrealized losses entirely caused by non-credit related factors related to investments for which we expect to fully recover the amortized cost basis are recorded in accumulated other comprehensive income.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

No material changes in our market risk occurred from December 31, 2010 through March 31, 2011. Information regarding our market risk at December 31, 2010, is contained in Item 7A, "Quantitative and Qualitative Disclosures About Market Risk," in our Annual Report on Form 10-K for the year ended December 31, 2010.

**Item 4. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures.* We maintain disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which are controls and other procedures that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. In addition, the design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level.

*Changes in Internal Control Over Financial Reporting.* No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



**PART II. OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS**

Information regarding reportable legal proceedings is contained in Item 3. Legal Proceedings, in our Annual Report on Form 10-K for the year ended December 31, 2010.

**Item 1A. RISK FACTORS**

See Item 1A. Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2010 for a detailed discussion of risk factors.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Use of Proceeds**

In March 2007, we completed the initial public offering of shares of our common stock. Our portion of the net proceeds from the initial public offering was approximately \$83.9 million after deducting underwriting discounts and commissions of \$6.5 million and \$2.4 million in offering expenses.

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

**Repurchase of Equity Securities During the Period Ended March 31, 2011**

The following table provides information about purchases by us during the three-month period ended March 31, 2011 of equity securities that are registered by us pursuant to Section 12 of the Securities Exchange Act.

Repurchases are made under the terms of our 2007 Equity Incentive Plan. Under this plan, we may award shares of restricted stock to our employees. These shares of restricted stock typically are subject to a lapsing right of repurchase by us. We may exercise this right of repurchase in the event that a restricted stock recipient's service to us is terminated. If we exercise this right, we are required to repay the purchase price paid by or on behalf of the recipient for the repurchased restricted shares, which typically is the par value per share of \$0.001. Repurchased shares are returned to the 2007 Equity Incentive Plan and are available for future awards under the terms of that plan.

These were the only repurchases of equity securities made by us during the three months ended March 31, 2011. We do not currently have a stock repurchase program.

| <b>Period</b>  | <b>Total Number of Shares Purchased</b> | <b>Average Price Paid per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b> | <b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b> |
|----------------|---|-------------------------------------|---|---|
| 1/1/11 1/31/11 | 500(1)                                  | \$ 0.001                            |   |   |
| 2/1/11 2/28/11 | 1,187(1)                                | \$ 0.001                            |   |   |

(1) Reflects the repurchase of restricted stock from employees that was unvested at the time of termination of employment. The purchase price represents the original price paid for the shares by the employee, which is equal to the par value of our common stock.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**Item 4. RESERVED**

**Item 5. OTHER INFORMATION**

None.

**Item 6. EXHIBITS**

The exhibits listed on the accompanying Exhibit Index are filed or incorporated by reference as part of this report and such Exhibit Index is incorporated herein by reference.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on May 6, 2011.

**SOURCEFIRE, INC.**

By: /s/ John C. Burris  
John C. Burris  
Chief Executive Officer  
(duly authorized officer)

By: /s/ Todd P. Headley  
Todd P. Headley  
Chief Financial Officer  
and Treasurer  
(principal financial and accounting  
officer)

**Exhibit Index**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>   | <b>Incorporation by Reference<br/>File</b> |               |                |                  | <b>Filed with<br/>this 10-Q</b> |
|---------------------------|--|--|---------------|----------------|------------------|---------------------------------|
|                           |  | <b>Form</b>                                | <b>Number</b> | <b>Exhibit</b> | <b>File Date</b> |                                 |
| 3.1                       | Sixth Amended and Restated Certificate of Incorporation  | 10-Q                                       | 1-33350       | 3.1            | 5/4/2007         |                                 |
| 3.2                       | Fifth Amended and Restated Bylaws  | 10-K                                       | 1-33350       | 3.2            | 3/16/2009        |                                 |
| 3.3                       | Certificate of Designation of the Series A Junior Participating Preferred Stock  | 8-A  | 1-33350       | 3.1            | 10/30/2008       |                                 |
| 4.1                       | Form of stock certificate of common stock  | S-1/A                                      | 333-138199    | 4.1            | 3/6/2007         |                                 |
| 4.2                       | Rights Agreement, dated as of October 30, 2008, by and between the Company and Continental Stock Transfer & Trust Co., as rights agent | 8-A  | 1-33350       | 4.1            | 10/30/2008       |                                 |
| 10.1                      | Amended and Restated Executive Retention Plan  |  |               |                |                  | X                               |
| 10.2                      | Amended and Restated Executive Change in Control Severance Plan  |  |               |                |                  | X                               |
| 10.3                      | Amendment No. 1 to Employment Agreement with John C. Burris  |  |               |                |                  | X                               |
| 10.4                      | Amendment No. 1 to Participation Agreement with Thomas M. McDonough under Executive Change in Control Severance Plan                   |  |               |                |                  | X                               |
| 10.5                      | Master Channel Agreement dated March 21, 2011 by and   |  |               |                |                  | X                               |

among EC America, Inc.,  
immixGroup, Inc., and  
Sourcefire, Inc.

|      |  |   |
|------|--|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                             | X |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                             | X |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X |