

SOURCEFIRE INC  
Form 10-Q  
May 05, 2008

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, 2008

**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 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. (Check one):

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

(Do not check if a smaller reporting company)

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

As of April 30, 2008, there were 24,989,055 outstanding shares of the registrant's Common Stock.

**SOURCEFIRE, INC.**  
**Form 10-Q**  
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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, 2008 (unaudited)</b>	<b>December 31, 2007</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 44,961	\$ 33,071
Short-term investments	58,995	69,816
Accounts receivable, net of allowance for doubtful accounts of \$110 in 2008 and \$160 in 2007	13,979	20,689
Inventory	6,105	4,863
Prepaid expenses and other current assets	2,317	2,651
Total current assets	126,357	131,090
Property and equipment, net	5,211	4,041
Intangible assets, net of accumulated amortization	560	592
Investments	4,065	4,140
Restricted cash	1,017	1,000
Other assets	986	815
Total assets	\$ 138,196	\$ 141,678
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 4,037	\$ 5,930
Accrued compensation and related expenses	3,423	3,151
Other accrued expenses	1,965	1,458
Current portion of deferred revenue	18,283	18,417
Other current liabilities	582	832
Total current liabilities	28,290	29,788
Deferred revenue, less current portion	2,707	2,610
Other long-term liabilities	89	86
Total liabilities	31,086	32,484
Commitments and contingencies		
Stockholders equity:		
Common stock, \$0.001 par value; 240,000,000 shares authorized; 24,984,928 and 24,642,433 shares issued and outstanding as of March 31, 2008 and December 31, 2007, respectively	24	24

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Additional paid-in capital	154,802	153,693
Accumulated deficit	(48,019)	(44,523)
Accumulated other comprehensive income	303	
Total stockholders' equity	107,110	109,194
Total liabilities and stockholders' equity	\$ 138,196	\$ 141,678

See accompanying notes to consolidated financial statements

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**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>2008</b>	<b>2007</b>
Revenue:		
Products	\$ 6,851	\$ 5,650
Technical support and professional services	6,800	4,805
<b>Total revenue</b>	<b>13,651</b>	<b>10,455</b>
Cost of revenue:		
Products	1,997	1,556
Technical support and professional services	1,041	728
<b>Total cost of revenue</b>	<b>3,038</b>	<b>2,284</b>
<b>Gross profit</b>	<b>10,613</b>	<b>8,171</b>
Operating expenses:		
Research and development	3,111	2,501
Sales and marketing	7,234	5,947
General and administrative	4,414	2,328
Depreciation and amortization	492	362
<b>Total operating expenses</b>	<b>15,251</b>	<b>11,138</b>
Loss from operations	(4,638)	(2,967)
Other income, net	1,204	491
Loss before income taxes	(3,434)	(2,476)
Income tax expense	(62)	(12)
Net loss	(3,496)	(2,488)
Accretion of preferred stock		(870)
<b>Net loss attributable to common stockholders</b>	<b>\$ (3,496)</b>	<b>\$ (3,358)</b>
Net loss attributable to common stockholders per share:		
Basic and diluted	\$ (0.14)	\$ (0.39)
Weighted average shares outstanding used in computing per share amounts:		
Basic and diluted	24,766,375	8,623,982



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

	<b>Common Stock Shares</b>	<b>Common Stock Amount</b>	<b>Additional Paid In Capital</b>	<b>Accumulated Deficit</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Total</b>
Balance as of January 1, 2008	24,642,433	\$ 24	\$ 153,693	\$ (44,523)	\$	\$ 109,194
Exercise of common stock options	65,386		88			88
Issuance of common stock under employee stock purchase plan	17,024		89			89
Issuance of restricted common stock	264,335					
Repurchase of restricted common stock	(4,250)					
Stock-based compensation expense			922			922
Excess tax benefit relating to share-based payments			10			10
Other comprehensive income:						
Net loss for the three months ended March 31, 2008				(3,496)		(3,496)
Net unrealized gain on investments, net of taxes					303	303
Comprehensive income						(3,193)
Balance as of March 31, 2008	24,984,928	\$ 24	\$ 154,802	\$ (48,019)	\$ 303	\$ 107,110

See accompanying notes to consolidated financial statements



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

	<b>Three Months Ended March</b>	
	<b>31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities</b>		
Net loss	\$ (3,496)	\$ (2,488)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	499	370
Provision for doubtful accounts	(1)	(16)
Non-cash stock-based compensation	922	524
Amortization of premium on investments	(345)	(123)
Realized gain from sales of investments	(23)	
Changes in operating assets and liabilities:		
Accounts receivable	6,710	5,547
Inventory	(1,187)	(1,284)
Prepaid expenses and other assets	163	(1,350)
Accounts payable	(1,893)	(537)
Accrued expenses	779	82
Deferred revenue	(37)	1,216
Other liabilities	(247)	235
Net cash provided by operating activities	1,844	2,176
<b>Investing activities</b>		
Purchase of property and equipment	(1,692)	(1,263)
Purchase of investments	(19,162)	(5,950)
Proceeds from maturities of investments	27,500	7,150
Proceeds from sales of investments	3,230	
Increase in restricted cash	(17)	
Net cash provided by (used in) investing activities	9,859	(63)
<b>Financing activities</b>		
Borrowings of long-term debt		113
Repayments of long-term debt		(1,424)
Proceeds from issuance of common stock, net of underwriters' discount of \$6,495		86,288
Proceeds from exercise of stock options	177	12
Excess tax benefits related to share-based payments	10	
Payment of equity offering costs		(878)
Net cash provided by financing activities	187	84,111
Net increase in cash and cash equivalents	11,890	86,224
Cash and cash equivalents at beginning of period	33,071	13,029

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Cash and cash equivalents at end of period	\$ 44,961	\$ 99,253
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See accompanying notes to consolidated financial statements.

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

**1. Description of Business**

Founded in January 2001, Sourcefire, Inc. (the Company) is a provider of Enterprise Threat Management (ETM) solutions for information technology (IT) infrastructures of commercial enterprises (e.g., healthcare, financial services, manufacturing, energy, education, retail, telecommunications) and federal and state government organizations. The Sourcefire 3D System comprised of multiple Sourcefire hardware and software product offerings provides a comprehensive, intelligent network defense that unifies intrusion prevention system (IPS), network behavior analysis (NBA), network access control (NAC) and vulnerability assessment (VA) solutions under a common management framework.

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

In addition to its commercial and open source network security products, Sourcefire also offers a variety of services to aid its customers with installing and supporting Sourcefire ETM solutions. Available services include Customer Support, Education, Product Services and Sourcefire Vulnerability Research Team (VRT) Snort rule subscriptions.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to those rules or regulations. The interim financial statements are unaudited, but reflect all adjustments (consisting of normal recurring accruals) 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 the Company's Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission on February 28, 2008. 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 management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

On an ongoing basis, the Company evaluates its estimates, including those related to the accounts receivable allowance, reserve for excess and obsolete inventory, useful lives of long-lived assets (including intangible assets), income taxes, and its assumptions used for the purpose of determining stock-based compensation, among other things. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

**Investments**

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

**Allowance for Doubtful Accounts**

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

**Inventories**

Inventories consist of hardware and related component parts and are stated at the lower of cost (on a first-in, first-out basis) or market. A significant portion of the Company's inventory includes products used for customer testing and evaluation. This inventory is predominantly located at the customer's premises. Inventory that is obsolete or in excess of the Company's forecasted demand is written down to its estimated net realizable value based on historical usage, expected demand, and evaluation unit age. Inherent in the Company's estimates of market value in determining inventory valuation are estimates related to economic trends, as well as technological obsolescence of the Company's products.

**Revenue Recognition**

The Company derives revenue from arrangements that include products with embedded software, software licenses and royalties, technical support, and professional services. Revenue from products in the accompanying consolidated statements of operations consists primarily of sales of software-based appliances, but also includes fees and royalties for the license of the Company's technology in a software-only format and subscriptions to receive rules released by the VRT that are used to update the appliances for current exploits and vulnerabilities. Technical support, which typically has a term of 12 to 48 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, the Company defers revenue recognition until: (a) persuasive evidence of an arrangement exists (e.g., a signed contract); (b) delivery of the product has occurred and there are no remaining obligations or substantive customer acceptance provisions; (c) the fee is fixed or determinable; and (d) collection of the fee is probable.

The Company allocates the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on vendor-specific objective evidence. If vendor-specific objective evidence of fair value does not exist for each of the deliverables, all revenue from the arrangement is deferred until the earlier of the point at which sufficient vendor-specific objective evidence of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. However, if the only undelivered elements are elements for which the Company currently has vendor-specific objective evidence of fair value, the Company recognizes revenue for the delivered elements based on the residual method as prescribed by the AICPA Statement of



The Company has established vendor-specific objective evidence of fair value for its 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 the Company's arrangements. Revenue related to technical support is deferred and recognized ratably over the contractual period of the technical support arrangement, which ranges from 12 to 48 months in most arrangements. The vendor-specific objective evidence of fair value of the Company's other services is based on the price for these same services when they are sold separately. Revenue for services that are sold either on a stand-alone basis or included in multiple element arrangements is deferred and recognized as the services are performed.

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

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

The Company records taxes collected on revenue-producing activities on a net basis.

For the three months ended March 31, 2008 and 2007, the Company had no significant customers that accounted for greater than 10% of revenue recognized during such periods.

#### ***Warranty***

The Company warrants that its software will perform in accordance with its documentation for a period of 90 days from the date of shipment. Similarly, the Company warrants that the hardware will perform in accordance with its documentation for a period of one year from date of shipment. The Company further agrees 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 the Company has obtained from the manufacturer. The Company estimates the costs that may be incurred under its warranties and records a liability at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of sold units, historical and anticipated rates of warranty claims and the estimated cost per claim. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the amounts as necessary. While warranty costs have historically been within the Company's expectations, it is possible that warranty rates will change in the future based on new product introductions and other factors.

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

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the tax basis of assets and liabilities for financial reporting purposes and amounts recognized for income tax purposes. The Company records a valuation allowance to reduce the Company's deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of March 31, 2008 and December 31, 2007, the Company's net deferred tax assets were fully reserved except for a foreign deferred tax benefit of \$39,000 and \$29,000, respectively, expected to be available to offset foreign tax liabilities in the future. The Company recorded a provision for income taxes of \$62,000 and \$12,000 for the three months ended March 31, 2008 and 2007, respectively, related to foreign income taxes.

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

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

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

#### ***Recent Accounting Pronouncements***

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which allows companies to measure financial assets or liabilities at fair value that are currently not required to be measured at fair value. Entities that elect the fair value option will report unrealized gains and losses in net income rather than as part of equity. The Company has not elected to adopt SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*. SFAS No. 141R will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, contingencies, acquisition costs, in-process research and development and restructuring costs. In addition, under SFAS No. 141R, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. SFAS 141R is effective for fiscal years beginning after December 15, 2008, and the Company will adopt this standard on January 1, 2009. The Company has not yet determined the impact, if any, of SFAS No. 141R on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Non-Controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. SFAS No. 160 will change the accounting and reporting for minority interests, which will be re-characterized as non-controlling interests and classified as a component of equity. This new consolidation method will significantly change the accounting for transactions with minority interest holders. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008, and the Company will adopt this standard on January 1, 2009. The Company has not yet determined the impact, if any, of SFAS No. 160 on its consolidated financial statements.

### 3. Investments

Prior to the first quarter of 2008, the Company's investment portfolio was designated as held-to-maturity, as the Company had the positive intent and ability to hold the securities to maturity, and had historically held all of its investments until their full maturity. During the first quarter of 2008, the Company determined that it no longer had the intent to hold its investments until maturity due to the desire to better manage its investment risks in the currently volatile credit markets. Accordingly, the amortized cost for all investment securities was reclassified from held-to-maturity to available-for-sale, and the unrealized holding gain at the date of the transfer was reported in other comprehensive income. At the date of the transfer, the amortized cost and unrealized holding gains for all investments were \$93.8 million and \$321,000, respectively. All investment securities are currently measured at fair value (see Note 6 for additional information).

During the first quarter of 2008, the Company sold securities for proceeds of \$3.2 million and recorded a realized gain of \$23,000.

The following is a summary of available-for-sale investments as of March 31, 2008 (in thousands):

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
Money market funds	\$ 28,251	\$	\$	\$ 28,251
Corporate debt investments	22,505	92	(9)	22,588
Asset-backed securities	8,271	58		8,329
Commercial paper	35,168	162		35,330
Total investments	94,195	\$ 312	\$ (9)	94,498
Amounts classified as cash equivalents	(31,438)			(31,438)
Total available-for-sale investments	\$ 62,757			\$ 63,060

There were no other-than-temporary declines in investments recorded in the first quarter of 2008. For the three months ended March 31, 2008, the unrealized holding gains on available-for-sale securities included in other comprehensive income totaled \$303,000, net of tax. The deferred tax expense recorded in other comprehensive income was fully offset by tax benefits resulting from the reduction in the valuation allowance the Company had recorded for deferred tax assets related to net operating loss carryforwards as of December 31, 2007. The reversal of the valuation allowance was solely due to the unrealized appreciation in the available-for-sale investments.

The net carrying value and estimated fair value of available-for-sale investments at March 31, 2008, by contractual maturity, are as follows (in thousands):

	<b>Amortized Cost</b>	<b>Estimated Fair Value</b>
Due in one year or less	\$ 58,721	\$ 58,995
Due after one year through five years	4,036	4,065



Total	\$	62,757	\$	63,060
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**4. Share-Based Compensation**

During 2002, the Company adopted the Sourcefire, Inc. 2002 Stock Incentive Plan (the 2002 Plan ). The plan provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Company's Board of Directors. As of March 31, 2008, the Company has reserved an aggregate of 5,100,841 shares of common stock for issuance under the 2002 Plan. Following the adoption of the 2007 Stock Incentive Plan (the 2007 Plan ) described below, there are no additional shares available for grant under the 2002 Plan.

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In March 2007, the Company's Board of Directors approved the 2007 Plan, which provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Board of Directors. As of December 31, 2007, the Company had reserved an aggregate of 3,142,452 shares of common stock for issuance under the 2007 Plan. On January 1, 2008, 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 the Company's outstanding common stock as of December 31, 2007, or 985,697 shares. Therefore, as of March 31, 2008, the Company has reserved an aggregate of 4,128,149 shares of common stock for issuance under the 2007 Plan.

The 2002 Plan and the 2007 Plan are administered by the Compensation Committee of the Company's Board of Directors, which determines the vesting period for awards under the plans, generally from three to four years. Options granted have a maximum term of 10 years. The exercise price of the awards is generally equal to at least the fair value of the common stock on the date of grant. Prior to the Company's initial public offering ( IPO ) in March 2007, the fair value of the common stock was determined by the Company's Board of Directors in good faith. Following the IPO, the fair value of the Company's common stock is determined by reference to the closing trading price of the common stock on the NASDAQ Global Market on the date of grant.

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

SFAS No. 123(R) requires the use of a valuation model to calculate the fair value of stock-based awards. The Company uses the Black-Scholes option pricing model for estimating the fair value of stock options granted and for employee stock purchases under the 2007 Employee Stock Purchase Plan (the 2007 ESPP ). The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected price volatility. Additionally, the recognition of expense requires the estimation of the number of options that will ultimately vest and the number of options that will ultimately be forfeited.

Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures. The Company has assumed a forfeiture rate of 15% per annum for options and 10% per annum for restricted stock grants. The Company will record additional expense if the actual forfeiture rate is lower than estimated, and it will record a recovery of prior expense if the actual forfeiture rate is higher than estimated. The Company relies on historical experience of employee turnover to estimate its expected forfeitures.

The following are the weighted-average assumptions and fair values used in valuing the stock options granted under the 2002 Plan and the 2007 Plan and employee stock purchases under the 2007 ESPP:

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Stock options:</b>		
Average risk-free interest rate	2.97%	4.69%
Expected dividend yield	0.0%	0.0%
Expected useful life (years)	6.25	6.25
Expected volatility	66.6%	78.1%
Weighted-average fair value per grant	\$4.29	\$9.86
<b>Employee stock purchase plan:</b>		
Average risk-free interest rate	2.50%	
Expected dividend yield	0.0%	
Expected useful life (years)	0.37	
Expected volatility	57.5%	
Weighted-average fair value per purchase	\$1.64	

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

*Expected dividend yield* The Company has never declared or paid dividends on its common stock and does not anticipate paying dividends in the foreseeable future.

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

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

For purchases under the 2007 ESPP, the expected useful life is the plan period.

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

For stock options granted under the 2002 Plan and the 2007 Plan, given the Company's limited historical stock data from its IPO in March 2007, the Company has used a blended volatility to estimate expected volatility. The blended volatility includes the average of the Company's preceding daily historical volatility from its initial public offering to the respective grant date and an average of the Company's peer group preceding daily historical volatility consistent with the expected life of the option. The Company's peer group historical volatility includes the historical volatility of companies that are similar in revenue size, in the same industry or are competitors.

For purchases under the 2007 ESPP, the Company uses its daily historical volatility, since the Company has historical data available since its IPO consistent with the expected useful life.

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

The following table summarizes compensation expense included in the accompanying consolidated statements of operations and the effect on net loss per share (in thousands, except per share data):

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Product cost of revenue	\$ 7	\$ 2
Services cost of revenue	21	6
Stock based compensation expense included in cost of revenue	28	8
Research and development	174	81
Sales and marketing	343	209
General and administrative	377	226
Stock-based compensation included in operating expenses	894	516
Total stock-based compensation	\$ 922	\$ 524
Effect on net loss per share:		
Basic and diluted	\$ 0.04	\$ 0.06

***Stock Options***

The following table summarizes the activity of the plans for the three months ended March 31, 2008 (in thousands, expect share and per share data):

	<b>Number of Shares</b>	<b>Range of Exercise Prices</b>	<b>Weighted- Average Exercise Price</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at December 31, 2007	3,063,588	\$ 0.24 to \$15.49	\$ 4.05	\$ 15,266
Granted	254,869	5.97 to 7.45	6.79	
Exercised	(65,386)	0.24 to 5.26	1.35	
Forfeited	(146,873)	1.14 to 13.10	7.38	
Outstanding at March 31, 2008	3,106,198	\$ 0.24 to \$15.49	\$ 4.17	\$ 9,470
Vested and exercisable at March 31, 2008	2,040,243	\$ 0.24 to \$15.49	\$ 2.16	\$ 8,669
Vested and expected to vest at March 31, 2008	2,762,070		\$ 3.71	\$ 9,176

The following table summarizes information about stock options outstanding as of March 31, 2008:

<b>Range of</b>	<b>Options Outstanding</b>		<b>Options Exercisable</b>
	<b>Weighted- Average</b>	<b>Weighted-Average Contractual</b>	<b>Weighted- Average</b>

<b>Exercise Prices</b>		<b>Number of Shares</b>	<b>Exercise Prices</b>	<b>Life (Years)</b>	<b>Number of Shares</b>	<b>Exercise Prices</b>
\$0.24	\$0.32	822,270	\$ 0.29	4.99	822,270	\$ 0.29
\$1.14	\$2.03	1,069,641	1.63	6.62	886,593	1.56
\$3.69	\$9.48	806,096	7.47	8.67	265,475	7.39
\$9.55	\$15.49	408,191	12.16	9.06	65,905	12.60
		3,106,198	\$ 4.17	7.04	2,040,243	\$ 2.16

The aggregate intrinsic value of all options exercised during the three months ended March 31, 2008 and 2007 was \$301,000 and \$239,000, respectively.

Outstanding stock option awards are generally subject to service-based vesting; however, in some instances, awards contain provisions for acceleration of vesting upon change in control and in certain other circumstances. Based on the estimated grant date fair value of employee stock options granted, the Company recognized compensation expense of \$535,000 and \$421,000 for the three months ended March 31, 2008 and 2007, respectively. The grant date aggregate fair value of options, net of estimated forfeitures, not yet recognized as expense as of March 31, 2008 was \$4.7 million, which will be recognized over a weighted average period of 2.63 years.

**Restricted Stock Awards**

The following table summarizes the unvested restricted stock award activity for the three months ended March 31, 2008:

	<b>Number of Shares</b>	<b>Weighted-Average Grant Date Fair Value</b>
Unvested at December 31, 2007	295,680	\$ 10.56
Granted	264,335	6.31
Restrictions Lapsed	(23,970)	14.61
Forfeited	(4,250)	9.59
Unvested at March 31, 2008	531,795	\$ 8.27

Restricted stock awards are subject to various restrictions including service-based vesting provisions, performance-based vesting provisions and provisions for acceleration of vesting upon change in control and in certain other circumstances. The compensation expense associated with these awards is evaluated on a quarterly basis based upon various restrictions. The compensation expense is recognized ratably over the estimated vesting period. The vesting restrictions for outstanding restricted stock awards lapse over a period of 6 to 60 months.

The fair value of the unvested restricted stock awards is measured using the closing price of the Company's stock on the date of grant, or the estimated fair value of the common stock if granted prior to the Company's initial public offering. The total compensation expense related to restricted stock awards for the three months ended March 31, 2008 and 2007 was \$349,000 and \$103,000, respectively.

As of March 31, 2008, there was \$3.0 million of unrecognized compensation expense, net of estimated forfeitures, related to unvested restricted stock awards. This amount is expected to be recognized over a weighted-average period of 2.88 years.

**Employee Stock Purchase Plan**

On October 3, 2007, the stockholders of the Company approved the 2007 ESPP that had previously been approved by the Company's Board of Directors. The Company adopted the 2007 ESPP to provide a means by which the Company's employees, and employees of any parent or subsidiary of the Company as may be designated by the Board of Directors, will be given an opportunity to purchase shares of the Company's common stock. The 2007 ESPP allows eligible employees to purchase the Company's common stock at 85% of the lower of the stock price at the beginning or ending of a six-month period. The Compensation Committee of the Company's Board of Directors administers the 2007 ESPP. An aggregate of 1,000,000 shares of the Company's common stock have been reserved for issuance under the 2007 ESPP. As of March 31, 2008, an aggregate of 17,024 shares were purchased under the 2007 ESPP for a total of \$89,000. The Company recognized \$38,000 of compensation expense related to the 2007 ESPP for the three months ended March 31, 2008.

## 5. Net Loss per Share

Basic net loss attributable to common stockholders per share is computed by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted net loss attributable to common stockholders per share includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The calculation of basic and diluted net loss per share for the three months ended March 31, 2008 and 2007 is summarized as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Numerator:		
Net loss attributable to common stockholders	\$ (3,496)	\$ (3,358)
Denominator:		
Weighted-average shares of common stock outstanding	24,766,375	8,623,982
Net loss attributable to common stockholders per share:		
Basic and diluted	\$ (0.14)	\$ (0.39)

Basic and diluted net loss attributable to common stockholders per share are identical for all periods presented in the accompanying consolidated statements of operations. If the Company's outstanding options, warrants and unvested restricted stock were exercised or converted into common stock, the result would be anti-dilutive. The following summarizes the potential outstanding common stock of the Company as of the end of each period:

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Options to purchase common stock	3,106,198	3,260,274
Shares of common stock into which outstanding warrants are convertible		36,944
Unvested shares of restricted common stock		87,835
Total	3,106,198	3,385,053

## 6. Fair Value Measurement

In the first quarter of 2008, the Company adopted SFAS No. 157, *Fair Value Measurements*, for financial assets and liabilities. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information.

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

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

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

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

The fair value measurement of an asset or liability is based on the lowest level of any input that is significant to the fair value assessment. The Company's 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 the Company's financial assets and liabilities that were accounted for at fair value as of March 31, 2008 by level within the fair value hierarchy (in thousands):

	Assets at Fair Value	Fair Value Measurement Using		
		Level 1	Level 2	Level 3
Money market funds	\$ 28,251	\$ 28,251	\$	\$
Corporate debt investments	22,588		22,588	
Asset-backed securities	8,329		8,329	
Commercial paper	35,330		35,330	
Total cash equivalents and investments	94,498	\$ 28,251	\$ 66,247	\$
Cash	13,523			
Total cash, cash equivalents and investments	\$ 108,021			

## 7. Business and Geographic Segment Information

The Company manages its operations on a consolidated basis for purposes of assessing performance and making operating decisions. Accordingly, the Company does not have reportable segments. Revenues by geographic area for the three months ended March 31, 2008 and 2007 were as follows (in thousands):

	Three Months Ended March 31,	
	2008	2007
United States	\$ 9,534	\$ 7,670
All foreign countries	4,117	2,785
Consolidated total	\$ 13,651	\$ 10,455

## 8. Legal Proceedings

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

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

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

On November 20, 2007, the defendants moved to dismiss the Amended Consolidated Class Action Complaint. On April 23, 2008, the motion to dismiss was granted in part and denied in part. A scheduling conference with the Court is expected to occur in May 2008.

The Court has not made a determination of whether a putative class can be certified. At this time, plaintiffs have not specified the amount of damages they are seeking in these actions. The Company intends to vigorously defend these actions.

From time to time, the Company is involved in other disputes and legal actions arising in the ordinary course of its business.

#### **9. Commitments and Contingencies**

On February 27, 2008, the Company and E. Wayne Jackson III, the Company's Chief Executive Officer, elected not to renew the term of the Employment Agreement, dated as of May 6, 2002, by and between Mr. Jackson and the Company. As a result, Mr. Jackson's employment as the Company's Chief Executive Officer is scheduled to expire at the close of business on May 5, 2008. Mr. Jackson has agreed to continue to serve in his role as Chief Executive Officer until a successor is named. In connection with the decision not to renew the term of Mr. Jackson's employment agreement, on February 27, 2008, the Company and Mr. Jackson entered into a transition agreement. The Company accrued \$316,000 in the first quarter of 2008 related to severance and benefits as outlined under the transition agreement and based on the Company's anticipation that Mr. Jackson will perform the necessary services set forth in the transition agreement. Upon completion of all requirements of the transition agreement, Mr. Jackson's unvested equity awards will accelerate and become fully vested. The Company will record the remaining unamortized stock compensation expense at that time.

The Company purchases components for its products from a variety of suppliers and uses several contract manufacturers to provide manufacturing services for its products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, the Company enters into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon information provided by the Company. In certain instances, these agreements allow the Company the option to cancel, reschedule, and adjust the Company's requirements based on its business needs prior to firm orders being placed. Consequently, a portion of the Company's reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments. As of March 31, 2008, the Company had total purchase commitments for inventory of approximately \$5.1 million.

The Company maintains office space in the United Kingdom for which the lease agreement requires that the Company 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.

#### **10. Subsequent Event**

On April 8, 2008, the Company entered into a second amendment to the lease agreement for its headquarters in Columbia, Maryland, which expands the leased space by approximately 12,000 square feet. The monthly rental fee for the additional space ranges from \$13,500 to \$14,400 per month for a term beginning April 1, 2008 and expiring May 31, 2010.

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

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes that appear elsewhere in this Quarterly Report on Form 10-Q and in *Risk Factors* in Part II, Item 1A in this Quarterly Report on Form 10-Q. Our actual results could differ materially from those discussed in or implied by the forward-looking statements.

### **Introduction**

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

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

*Results of Operations.* This section provides an analysis of our results of operations for the three months ended March 31, 2008 as compared to the three months ended March 31, 2007.

*Liquidity and Capital Resources.* This section provides an analysis of our cash flows for the three months ended March 31, 2008 and a discussion of our capital requirements and the resources available to us to meet those requirements.

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

### **Overview**

We are a leading provider of Enterprise Threat Management, or ETM, solutions for information technology infrastructures of commercial enterprises (e.g., healthcare, financial services, manufacturing, energy, education, retail, telecommunications) and federal and state government organizations. The Sourcefire 3D System comprised of multiple Sourcefire hardware and software product offerings provides a comprehensive, intelligent network defense that unifies intrusion prevention system, or IPS, network behavior analysis, or NBA, network access control, or NAC, and vulnerability assessment, or VA, solutions under a common management framework. This ETM approach equips our customers with an efficient and effective layered security defense protecting computer network assets before, during and after an attack.



We sell our network security solutions to a diverse customer base that includes 29 of the Fortune 100 and over half of the 30 largest U.S. government agencies. We also manage two of the security industry's leading open source initiatives, Snort and ClamAV.

***Key Financial Metrics and Trends***

*Pricing and Discounts*

We maintain a standard price list for all of our products. Additionally, we have a corporate policy that governs the level of discounts our sales organization may offer on our products, based on factors such as transaction size, volume of products, federal or state programs, reseller or distributor involvement and the level of technical support commitment. Our total product revenue and the resulting cost of revenue and gross profit percentage are directly affected by our ability to manage our product pricing policy. Although to date we have not experienced pressure to reduce our prices, competition is increasing and, in the future, we may be forced to reduce our prices to remain competitive.

*Revenue*

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

Product sales are typically recognized as revenue at shipment of the product to the customer, whether sold directly or through resellers. For sales made through distributors and original equipment manufacturers, or OEMs, we do not recognize revenue until we receive a monthly sales report indicating the product volume sold to end user customers. 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 and automatic renewals as evidenced by customer payment.

We sell our network security solutions globally. However, 70% and 73% of our revenue for the three months ended March 31, 2008 and 2007, 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 amount and as a percentage of total revenue as we strengthen our international presence. We also expect that our revenue from sales through OEMs and distributors will increase in amount and as a percentage of total revenue as we expand our relationships with these third parties.

Our product revenue has historically been highly seasonal, with more than one-third of our total product revenue in recent fiscal years generated in the fourth quarter and more than 60% in the second half of the year. The timing of our year-end shipments could materially affect our fourth quarter product revenue in any fiscal year and sequential quarterly comparisons. Revenue from our government customers has occasionally been influenced by the September 30th fiscal year-end of the U.S. federal government, which has historically resulted in our revenue from government customers being highest in the third quarter. Although we do not expect these general seasonal patterns to change substantially in the future, our revenue within a particular quarter is often affected significantly by the unpredictable procurement patterns of our customers. Our prospective customers usually spend a long time evaluating and making purchase decisions for network security solutions. Historically, many of our customers have not finalized their purchasing decisions until the final weeks or days of a quarter. We expect these purchasing patterns to continue in the future. Therefore, a delay in even one large order beyond the end of the quarter could materially reduce our anticipated revenue for a quarter. Because many of our expenses must be incurred before we expect to generate revenue, delayed orders could negatively impact our results of operations for a particular period and could therefore cause us to fail to meet the financial performance expectations of securities industry research analysts or investors.

*Cost of Revenue*

Cost of product revenue includes the cost of the hardware platform bundled into our network security solution, royalties for third-party software included in our network security solution, materials and labor that are incorporated in the quality assurance of our products, logistics, warranty, shipping and handling costs and, in the limited instance where we lease our network security solutions to our customers, depreciation and amortization. Hardware costs, which are our most significant cost item, generally have not fluctuated materially as a percentage of revenue in recent years because competition among hardware platform suppliers has remained strong and, therefore, unit hardware costs have remained consistent. Because of the competition among hardware suppliers and our outsourcing of the manufacture of our products to three separate domestic contract manufacturers, we currently have no reason to expect that our cost of product revenue as a percentage of total product revenue will change significantly in the foreseeable future due to hardware pricing increases. However, hardware or other costs of manufacturing may increase in the future. We incur labor and associated overhead expenses, such as occupancy costs and fringe benefits costs, as part of managing our outsourced manufacturing process. These costs are included as a component of our cost of product revenue, but they have not been material to date.

Cost of services revenue includes the direct labor costs of our employees and outside consultants engaged to furnish those services, as well as their travel and associated direct material costs. Additionally, we include in cost of services revenue an allocation of overhead expenses such as occupancy costs, fringe benefits and supplies, 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. We anticipate incurring an increasing amount of these services costs in the future for additional personnel to support and service our growing customer base.

*Gross Profit*

Our gross profit is affected by a variety of factors, including competition, the mix and average selling prices of our products, our pricing policy, technical support and professional services, new product introductions, the cost of hardware platforms, the cost of labor to generate such revenue and the mix of distribution channels through which our products are sold. Although we have not had to reduce the prices of our products or vary our pricing policy in recent years, our gross profit would be adversely affected by price declines if we are unable to reduce costs on existing products and fail to introduce new products with higher margins. Currently, product sales typically have a lower gross profit as a percentage of revenue than our services due to the cost of the hardware platform. Our gross profit for any particular quarter could be adversely affected if we do not complete a sufficient level of sales of higher-margin products by the end of the quarter. As discussed above, many of our customers do not finalize purchasing decisions until the final weeks or days of a quarter, so a delay in even one large order of a higher-margin product could reduce our total gross profit percentage for that quarter. For the three months ended March 31, 2008 and 2007, gross margin was 78% for both periods. Based on current market conditions, we do not expect these percentages to change significantly in the foreseeable future, although unexpected pricing pressures or an increase in hardware or other costs would cause our gross profit percentage to decline.

*Operating Expenses*

*Research and Development.* Research and development expenses consist primarily of payroll, benefits and related occupancy and other overhead for our engineers, costs for professional services to test our products, and costs associated with data used by us in our product development.

We have significantly expanded our research and development capabilities and expect to continue to expand these capabilities in the future. We are committed to increasing the level of innovative design and development of new products as we strive to enhance our ability to serve our existing commercial and federal government markets as well as new markets for security solutions. To meet the changing requirements of our customers, we will need to fund investments in several development projects in parallel. Accordingly, we anticipate that our research and development expenses will continue to increase in absolute dollars for the foreseeable future, but should decline moderately as a percentage of total revenue as we expect to grow our revenues more rapidly than our research and development expenditures.

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

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

*General and Administrative.* General and administrative expenses consist primarily of salaries, incentive compensation, benefits and related occupancy and other overhead costs for executive, finance, information system, human resources and administrative personnel; legal, accounting and tax preparation and advisory fees; travel and related costs; information systems and infrastructure costs; and corporate insurance.

General and administrative expenses increased during the period of time leading up to our IPO and, as we operate as a public company, we have incurred additional expenses for costs associated with compliance with Section 404 of the Sarbanes-Oxley Act of 2002, directors and officers liability insurance, our investor relations function, and an increase in personnel to perform SEC reporting functions.

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

As a result of adopting SFAS No. 123(R) on January 1, 2006, based on the estimated grant date fair value of stock-based awards, we recognized aggregate stock-based compensation expense of \$922,000 and \$524,000 for the three months ended March 31, 2008 and 2007, respectively. We use the Black-Scholes option pricing model to estimate the fair value of granted stock options. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility.

## Results of Operations

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

	Three Months Ended		Variance	
	2008	2007	\$	%
Products	\$ 6,851	\$ 5,650	\$1,201	21%
<i>Percentage of total revenue</i>	50%	54%		
Technical support and professional services	6,800	4,805	1,995	42%
<i>Percentage of total revenue</i>	50%	46%		
Total revenue	\$13,651	\$10,455	\$3,196	31%

The increase in our product revenue during the three months ended March 31, 2008 as compared to 2007 was driven primarily by higher demand for our enterprise class 3D products, sales of which increased by \$930,000. In addition, royalty income increased by \$610,000. These revenue increases were partially offset by a decrease in sales of our defense center products of \$390,000. The increase in our services revenue resulted from our support services being provided to a larger installed customer base comprised of new customers, as well as current customers who renewed their maintenance subscriptions.



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

	Three Months Ended		Variance	
	March 31,		\$	%
	2008	2007		
Products	\$1,997	\$1,556	\$441	28%
<i>Percentage of total revenue</i>	15%	15%		
Technical support and professional services	1,041	728	313	43%
<i>Percentage of total revenue</i>	8%	7%		
Total cost of revenue	\$3,038	\$2,284	\$754	33%
<i>Percentage of total revenue</i>	22%	22%		

The increase in product cost of revenue was driven primarily by higher volume demand for our sensor products, for which we must procure and provide the hardware platform to our customers. We did not experience a material increase in our cost per unit of hardware platforms, which is the largest component of our product cost of revenue. The increase in our services cost of revenue was attributable to increased hardware service expense and our hiring of additional personnel to both service our larger installed customer base and to provide training and professional services to our customers.

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

	Three Months Ended		Variance	
	March 31,		\$	%
	2008	2007		
Products	\$ 4,854	\$4,094	\$ 760	19%
<i>Percentage of total revenue</i>	36%	39%		
Technical support and professional services	5,759	4,077	1,682	41%
<i>Percentage of total revenue</i>	42%	39%		
Total	\$10,613	\$8,171	\$2,442	30%
<i>Percentage of total revenue</i>	78%	78%		

Gross profit as a percentage of total revenue between periods remained relatively flat for both products and services revenue.

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

	Three Months Ended		Variance	
	March 31,		\$	%
	2008	2007		
Research and development	\$ 3,111	\$ 2,501	\$ 610	24%
<i>Percentage of total revenue</i>	23%	24%		
Sales and marketing	7,234	5,947	1,287	22%
<i>Percentage of total revenue</i>	53%	57%		
General and administrative	4,414	2,328	2,086	90%
<i>Percentage of total revenue</i>	32%	22%		
Depreciation and amortization	492	362	130	36%
<i>Percentage of total revenue</i>	4%	3%		
Total operating expenses	\$15,251	\$11,138	\$4,113	37%
<i>Percentage of total revenue</i>	112%	107%		

Research and development expenses for the three months ended March 31, 2008 increased over the prior-year quarter, primarily due to an increase in payroll, benefits and overhead expenses of \$526,000. These increased

expenses resulted from the hiring of additional personnel in our research and development department to support the release of updates and enhancements to our 3D products. The increase in research and development expenses also included an increase in stock-based compensation expense of \$93,000.

Sales and marketing expenses for the three months ended March 31, 2008 increased over the prior-year quarter, primarily due to an increase of \$685,000 in payroll and benefit expenses for additional sales and marketing personnel, an increase of \$219,000 in sales travel and travel-related expenses and an increase of \$134,000 for stock-based compensation expense.

General and administrative expenses for the three months ended March 31, 2008 increased over the prior-year quarter, primarily due to an increase of payroll and benefit expenses of \$335,000 for personnel hired in our accounting, information technology, human resources and legal departments, severance and benefit expenses of \$316,000 associated with the transition agreement with E. Wayne Jackson, III, our Chief Executive Officer, an increase of \$151,000 in stock-based compensation expense, an increase of \$888,000 in corporate development expenses and professional fees related to audit, tax and regulatory compliance, and an increase of \$96,000 for D&O insurance premiums, which substantially increased beginning in March 2007 due to our IPO.

Depreciation and amortization expense for the three months ended March 31, 2008 increased over the prior-year quarter, primarily due to additional lab and testing equipment purchased for our engineering department and computers purchased for personnel hired since March 31, 2007.

*Other income.* The following table shows our other income, net (in thousands):

	Three Months Ended		Variance	
	March 31,		\$	%
	2008	2007		
Other income, net	\$1,204	\$491	\$713	145%
<i>Percentage of total revenue</i>	<i>9%</i>	<i>5%</i>		

Other income for the three months ended March 31, 2008 increased over the prior-year quarter, primarily due to an increase in interest and investment income as a result of higher cash and investment balances resulting from our March 2007 IPO.

*Income tax expense.* The following table shows our provision for income taxes (in thousands):

	Three Months Ended		Variance	
	March 31,		\$	%
	2008	2007		
Income tax expense	\$62	\$12	\$50	NM
NM not meaningful				

We record a valuation allowance to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of March 31, 2008, our net deferred tax assets were fully reserved, except for a \$39,000 benefit expected to be available to offset foreign tax liabilities in the future. As of March 31, 2007, our net deferred tax assets were fully reserved. The provision for income taxes for the three months ended March 31, 2008 and 2007 relate to foreign income taxes.

#### ***Seasonality***

Our product revenue has tended to be seasonal. In our third quarter, we have historically benefited from the Federal government's fiscal year end purchasing activity. This increase has been partially offset by European sales, which have tended to decline significantly in the summer months due to vacation practices in Europe and the resulting delay in capital purchase activities until the fall. We have historically generated a significant portion of our product revenue in the fourth quarter due to increased activity in Europe, coupled with North American enterprise customers who operate on a calendar year budget and often wait until the fourth quarter to make their most significant capital equipment purchases. The timing of these shipments could materially affect our year-end product revenue. Currently, we do not see any indication that these seasonal patterns will change significantly in the foreseeable future.

#### ***Quarterly Timing of Revenue***

On a quarterly basis, we have usually generated the majority of our product revenue in the final month of each 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 are typically scheduled at the beginning of a quarter.



## **Liquidity and Capital Resources**

### ***Cash Flows***

*Operating Activities.* The decrease of \$332,000 in net cash provided by operating activities during the three months ended March 31, 2008, as compared to the same period in 2007, was primarily due to an increase in our net loss, offset partially by changes in working capital and deferred revenue and an increase in our stock-based compensation expense.

*Investing Activities.* The increase of \$9.9 million in net cash provided by investing activities during the three months ended March 31, 2008, as compared to the same period in 2007, was primarily due to maturities and sales of investments.

*Financing Activities.* The decrease of \$83.9 million in net cash provided by financing activities during the three months ended March 31, 2008, as compared to the same period in 2007, was primarily due to the \$83.9 million in net cash proceeds of our IPO that closed in the first quarter of 2007.

As of March 31, 2008, we had unrestricted cash, cash equivalents and investments of \$108.0 million and working capital of \$98.1 million.

### ***Liquidity Requirements***

We manufacture and distribute our products through contract manufacturers and OEMs. This approach provides us with the advantage of relatively low capital investment 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 for the production of 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 product-specific test equipment.

Our short-term liquidity requirements through March 31, 2009 consist primarily of the funding of capital expenditures and working capital requirements. We believe that cash flow from operations will be sufficient to meet these short-term requirements. In the event that cash flow from operations is not sufficient, we expect to fund these amounts through the use of existing cash and investment resources.

As described above, our product sales are, and are expected to continue to be, highly seasonal. This seasonality typically results in a significant amount of cash provided by our operating activities during the first half of the year and lower or negative operating cash flows during the second half of the year. We also 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 and purchase commitments. We believe that cash flow from operations will also be sufficient to meet these long-term requirements.

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

**Contractual Obligations**

The following table describes our commitments to settle contractual obligations in cash as of March 31, 2008 (in thousands):

	<b>Total</b>	<b>Payments Due by Period</b>		
		<b>Less than One Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>
Operating Leases	\$4,372	\$1,530	\$2,260	\$582
Purchase Commitments <sup>(1)</sup>	5,134	5,134		

(1) We purchase components 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 provided by us. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our

requirements based on our business needs prior to firm orders being placed. Consequently, a portion of our reported purchase commitments arising from these agreements are firm, non-cancelable and unconditional commitments. As of March 31, 2008, we had total purchase commitments for inventory of approximately \$5.1 million.

### **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 fully described in Financial Statements and Supplementary Data in Part II, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2007, 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 recognize substantially all of our revenue in accordance with AICPA Statement of Position ( SOP ) No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-4 and SOP No. 98-9. For each arrangement, we defer revenue recognition until persuasive evidence of an arrangement exists, such as a signed contract; delivery of the product has occurred and there are no remaining obligations or substantive customer acceptance provisions; the fee is fixed or determinable; and collection of the fee is probable.

We allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on vendor-specific objective evidence. If vendor-specific objective evidence of fair value does not exist for each of the deliverables, we defer all revenue from the arrangement until the earlier of the point at which sufficient vendor-specific objective evidence of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. However, if the only undelivered elements are elements for which we currently have vendor-specific objective evidence of fair value, we recognize revenue for the delivered elements based on the residual method.

We have established vendor-specific objective evidence of fair value for our technical support based upon actual renewals of each type of technical support that is offered and for each customer class. Technical support and technical

support renewals are currently priced based on a percentage of the list price of the respective product or software and historically have not varied from a narrow range of values in the substantial majority of our arrangements. We defer and recognize revenue related to technical support ratably over the contractual period of the technical support arrangement, which generally ranges between 12 and 48 months. The vendor-specific objective evidence of fair value of our other services is based on the price for these same services when they are sold separately. We defer and recognize revenue for services that are sold either on a stand-alone basis or included in multiple element arrangements as the services are performed.



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

*Accounting for Stock-Based Compensation.* Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R) using the prospective transition method, which requires us to apply its provisions only to awards granted, modified, repurchased or cancelled after the effective date. Under this transition method, stock-based compensation expense recognized beginning January 1, 2006 is based on the grant date fair value of stock awards granted or modified after January 1, 2006. As we had used the minimum value method for valuing our stock options under the disclosure requirements of SFAS No. 123, *Accounting for Stock Based Compensation*, all options granted prior to January 1, 2006 continue to be accounted for under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB No. 25. Additionally, the pro forma disclosures that were required under the original provisions of SFAS No. 123 are no longer provided for outstanding awards accounted for under the intrinsic-value method of APB No. 25 beginning in periods after the adoption of SFAS No. 123(R).

Pursuant to SFAS No. 123(R), the fair value of each option grant is estimated on the date of grant using the Black-Scholes pricing model, which requires us to make assumptions as to volatility, risk-free interest rate, expected term of the awards, and expected forfeiture rate. 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.

Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures. We have assumed a forfeiture rate of 15% per annum for options and 10% per annum for restricted stock grants. We will record additional expense if the actual forfeiture rate is lower than estimated, and we will record a recovery of prior expense if the actual forfeiture rate is higher than estimated. We rely on historical experience of employee turnover to estimate our expected forfeitures.

*Accounting for Income Taxes.* We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the tax basis of assets and liabilities for financial reporting purposes and amounts recognized for income tax purposes. We record a valuation allowance to reduce deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of March 31, 2008 and December 31, 2007, net deferred tax assets were fully reserved except for a foreign deferred tax benefit of \$39,000 and \$29,000, respectively, expected to be available to offset foreign tax liabilities in the future. We recorded a provision for income taxes of \$62,000 and \$12,000 for the three months ended March 31, 2008 and 2007, respectively, related to foreign income taxes.

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

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

*Allowance for Doubtful Accounts.* 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 our customer payment cycle. Historically, our allowance for doubtful accounts has been adequate based on actual results. If any of the factors used to calculate the allowance for doubtful accounts change or does not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed and the future results of operations could be materially affected.

*Inventories.* Inventory consists of hardware and related component parts and are stated at the lower of cost (on a first-in, first-out basis) or market. A significant portion of our inventory includes products used for customer testing and evaluation. This inventory is predominantly located at the customer's premises. Inventory that is obsolete or in excess of our forecasted demand is written down to its estimated net realizable value based on historical usage, expected demand, and evaluation unit age. Inherent in our estimates of market value in determining inventory valuation are estimates related to economic trends, as well as technological obsolescence of our products.

#### ***Recent Accounting Pronouncements***

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which allows companies the option to measure financial assets or liabilities at fair value and include unrealized gains and losses in net income rather than equity. We have elected not to adopt SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*. SFAS No. 141R will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, contingencies, acquisition costs, in-process research and development and restructuring costs. In addition, under SFAS No. 141R, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. SFAS 141R is effective for fiscal years beginning after December 15, 2008, and we will adopt this standard on January 1, 2009. We have not yet determined the impact, if any, of SFAS No. 141R on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. SFAS No. 160 will change the accounting and reporting for minority interests, which will be re-characterized as non-controlling interests and classified as a component of equity. This new consolidation method will significantly change the accounting for transactions with minority interest holders. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008, and we will adopt this standard on January 1, 2009. We have not yet determined the impact, if any, of SFAS No. 160 on our consolidated financial statements.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Foreign Currency Risk**

Nearly all of our revenue is derived from transactions denominated in U.S. dollars, even though we maintain sales and business operations in foreign countries. As such, we have exposure to adverse changes in exchange rates, particularly the Euro, British pound and Yen, associated with operating expenses of, and cash held in, our foreign operations, but we believe this exposure to be immaterial at this time. As we grow our international operations, our exposure to foreign currency risk could become more significant. We do not currently engage in currency hedging activities to limit the risk of exchange rate fluctuations.

**Interest Rate Sensitivity**

We had unrestricted cash, cash equivalents and investments totaling approximately \$108.0 million at March 31, 2008. The unrestricted cash and cash equivalents are held for working capital purposes while investments, made in accordance with our low-risk investment policy, take advantage of higher interest income yields. In accordance with our investment policy, we do not enter into investments for trading or speculative purposes. Some of the securities in which we invest, however, may be subject to market risk. This means that a change in prevailing interest rates may cause the fair value amount of the investment to fluctuate. To minimize this risk in the future, we intend to maintain our portfolio of cash equivalents, short- and long-term investments in a variety of securities, including commercial paper, money market funds, debt securities and certificates of deposit. Due to the nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates.

**Item 4. CONTROLS AND PROCEDURES**

*Evaluation of Sourcefire's Disclosure Controls and Internal Controls.* Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended which we refer to as the Exchange Act, pursuant to Rule 13a-15(c) under the Exchange Act as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in applicable SEC rules and forms and is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Limitations.* A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part 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 deterioration in the degree of compliance with our policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. We continuously evaluate our internal controls and make changes to improve them.

*Changes in Internal Controls Over Financial Reporting.* There was no change in our internal controls over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, that occurred during the period covered by this Quarterly Report on Form 10-Q 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**

For a discussion of pending legal proceedings, see Note 8 Legal Proceedings in the Notes to the Consolidated Financial Statements included in Part I of this Form 10-Q.

### **Item 1A. RISK FACTORS**

Set forth below and elsewhere in this report and in other documents we file with the Securities and Exchange Commission, are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2007.

***Our expected transition to a new chief executive officer could be disruptive to our business, and our inability to hire or retain other key personnel would also slow our growth.***

On February 27, 2008, we announced that we and E. Wayne Jackson III, our Chief Executive Officer, had agreed not to renew the term of Mr. Jackson's employment contract with us, which is scheduled to expire at the close of business on May 5, 2008. Our board of directors has initiated an external search process for a new Chief Executive Officer to succeed Mr. Jackson, who will remain in his current role as Chief Executive Officer until we hire a successor.

While Mr. Jackson is fully cooperating with the search process, there can be no assurances that the transition to a new Chief Executive Officer will be smooth. Our success depends in part on having a successful Chief Executive Officer, yet we face significant competition for such an executive. We may not be able to find a suitable successor for the Chief Executive Officer position in a timely manner, and there are also no assurances that a new Chief Executive Officer would lead us in a successful manner. Any failure to implement a smooth transition to such a successor could have a material adverse effect on our business, results of operations or financial condition.

In addition to the transition of our Chief Executive Officer position, our business is also dependent on our ability to hire, retain and motivate highly qualified personnel, including other senior management, sales and technical professionals. In particular, as part of our growth strategy, we intend to expand the size of our direct sales force domestically and internationally and to hire additional customer support and professional services personnel. However, competition for qualified services personnel is intense, and if we are unable to attract, train or retain the number of highly qualified sales and services personnel that our business needs, our reputation, customer satisfaction and potential revenue growth could be seriously harmed. To the extent that we hire personnel from competitors, we may also be subject to allegations that they have been improperly solicited or divulged proprietary or other confidential information.

In light of the transition arrangement with Mr. Jackson as our Chief Executive Officer, our future success will depend to a significant extent on the continued services of Martin Roesch, our founder, and our other executive officers and senior personnel. Although we have recently adopted retention plans applicable to certain of these officers, including Mr. Roesch, there can be no assurance that we will be able to retain their services. The loss of the services of one or more of these individuals could adversely affect our business and could divert other senior management time in searching for their replacements.

***We are in the process of implementing a new enterprise resource planning system and any material disruption, malfunction or problem with the implementation or operation of this system may result in disruption to our business, operating processes and internal controls.***

The efficient operation of our business is dependent on the successful operation of our information systems. In particular, we rely on our information systems to process financial information, manage inventory and administer our sales transactions. In recent years, we have experienced a considerable growth in transaction volume, headcount and reliance upon international resources in our operations. Our information systems need to be sufficiently scalable to support the continued growth of our operations and the efficient management of our business. In an effort to improve the efficiency of our operations, achieve greater automation and support the growth of our business, we are in the process of implementing a new enterprise resource planning system. As we implement this system, we will be required to modify a number of operational processes and internal control procedures. We expect to finalize implementation of this system in the third quarter of 2008, and we cannot assure you that, upon implementation, the system will work as we currently intend. Any material disruption, malfunction or similar problems with the implementation or operation of this system could have a material negative effect on our business and results of operations. In addition, if our information system resources are inadequate, we may be required to undertake costly upgrades and the growth of our business could be harmed.

***As a result of becoming a public company, we are obligated to develop and maintain proper and effective internal controls over financial reporting and are subject to other requirements that will be burdensome and costly. We may not complete our analysis of our internal controls over financial reporting in a timely manner, or these internal controls may not be determined to be effective, which may adversely affect investor confidence in our company and, as a result, the value of our common stock.***

Beginning with our Annual Report on Form 10-K for the year ending December 31, 2008, we will be required, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404), to furnish a report by management on, among other things, the effectiveness of our internal control over financial reporting. This assessment will need to include disclosure of any material weaknesses identified by our management in our internal control over financial reporting. Our auditors may also be required to issue an attestation report on the effectiveness of our internal controls over financial reporting for the year ended December 31, 2008.

We are continuing the challenging process of compiling the system and processing documentation before we perform the evaluation needed to comply with Section 404. We are also implementing a new enterprise resource planning system in an effort to improve the efficiency of our operations, achieve greater automation and support the growth of our business. We currently expect to complete implementation of this system in the third quarter of 2008, which will require additional modifications of our internal controls in order to comply with Section 404. We may not be able to complete our evaluation, testing and any required remediation in a timely fashion. During the evaluation and testing process, if we identify one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that our internal control is effective. If we are unable to assert that our internal control over financial reporting is effective, or if our auditors are unable to attest that our internal control over financial reporting is effective, we could lose investor confidence in the accuracy and completeness of our financial reports, which could have a material adverse effect on the price of our common stock. Failure to comply with these rules might make it more difficult for us to obtain certain types of insurance, including director and officer liability insurance, and we might be forced to accept reduced policy limits and coverage and/or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, on committees of our board of directors, or as executive officers.

In addition, as a public company, we have and will continue to incur significant additional legal, accounting and other expenses that we did not incur as a private company, and our administrative staff has been and will continue to be required to perform additional tasks. For example, we have created and/or revised the roles and duties of our board committees, adopted disclosure controls and procedures, retained a transfer agent and adopted an insider trading policy and bear all of the internal and external costs of preparing and distributing periodic public reports in compliance with our obligations under the securities laws. In addition, changing laws, regulations and standards relating to corporate governance and public disclosure, and related regulations implemented by the Securities and Exchange Commission and the NASDAQ Global Market, are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time-consuming. These laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their

application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. We intend to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management's time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, regulatory authorities may initiate legal proceedings against us and our business may be harmed.

***We have had operating losses since our inception, we expect operating expenses to increase in the foreseeable future and we may never reach or maintain profitability.***

We have incurred operating losses each year since our inception in 2001. Our net loss was approximately \$3.5 million and \$2.5 million for the three months ended March 31, 2008 and 2007. Our accumulated deficit as of March 31, 2008 is approximately \$48.0 million. Becoming profitable will depend in large part on our ability to generate and sustain increased revenue levels in future periods. Although our revenue has generally been increasing, there can be no assurances that we will become profitable in the near future or at any other time. We may never achieve profitability and, even if we do, we may not be able to maintain or increase our level of profitability. We expect that our operating expenses will continue to increase in the foreseeable future as we seek to expand our customer base, increase our sales and marketing efforts, continue to invest in research and development of our technologies and product enhancements and incur significant costs associated with being a public company. These efforts may be more costly than we expect and we may not be able to increase our revenue enough to offset our higher operating expenses. In addition, if our new products and product enhancements fail to achieve adequate market acceptance, our revenue will suffer. If we cannot increase our revenue at a greater rate than our expenses, we will not become or remain profitable.

***We face intense competition in our market, especially from larger, better-known companies, and we may lack sufficient financial or other resources to maintain or improve our competitive position.***

The market for network security monitoring, detection, prevention and response solutions is intensely competitive, and we expect competition to increase in the future. We may not compete successfully against our current or potential competitors, especially those with significantly greater financial resources or brand name recognition. Our chief competitors include large software companies, software or hardware network infrastructure companies, smaller software companies offering relatively limited applications for network and Internet security monitoring, detection, prevention or response and small and large companies offering point solutions that compete with components of our product offerings.

Mergers or consolidations among these competitors, or acquisitions of our competitors by large companies, present heightened competitive challenges to our business. For example, Cisco Systems, Inc., McAfee, Inc., 3Com Corporation, Juniper Networks, Inc. and IBM have acquired, during the past several years, smaller companies that have intrusion detection or prevention technologies. These acquisitions may make these combined entities more formidable competitors to us if such products and offerings are effectively integrated. Large companies may have advantages over us because of their longer operating histories, greater brand name recognition, larger customer bases or greater financial, technical and marketing resources. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. They also have greater resources to devote to the promotion and sale of their products than we have. In addition, these companies have reduced and could continue to reduce, the price of their security monitoring, detection, prevention and response products and managed security services, which intensifies pricing pressures within our market.

Several companies currently sell software products (such as encryption, firewall, operating system security and virus detection software) that our customers and potential customers have broadly adopted. Some of these companies sell products that perform functions comparable to some of our products. In addition, the vendors of operating system software or networking hardware may enhance their products to include functions similar to those that our products currently provide. The widespread inclusion of comparable features comparable to our software in operating system software or networking hardware could render our products less competitive or obsolete, particularly if such features are of a high quality. Even if security functions integrated into operating system software or networking hardware are more limited than those of our products, a significant number of customers may accept more limited functionality to avoid purchasing additional products such as ours.

One of the characteristics of open source software is that anyone can offer new software products for free under an open source licensing model in order to gain rapid and widespread market acceptance. Such competition can develop without the degree of overhead and lead time required by traditional technology companies. It is possible for new competitors with greater resources than ours to develop their own open source security solutions, potentially reducing the demand for our solutions. We may not be able to compete successfully against current and future competitors.



Competitive pressure and/or the availability of open source software may result in price reductions, reduced revenue, reduced operating margins and loss of market share, any one of which could seriously harm our business.

***New competitors could emerge or our customers or distributors could internally develop alternatives to our products, and either such development could impair our sales.***

We may face competition from emerging companies as well as established companies who have not previously entered the market for network security products. Established companies may not only develop their own network intrusion detection and prevention products, but they may also acquire or establish product integration, distribution or other cooperative relationships with our current competitors. Moreover, our large corporate customers and potential customers could develop network security software internally, which would reduce our potential revenue. New competitors or alliances among competitors may emerge and rapidly acquire significant market share due to factors such as greater brand name recognition, a larger installed customer base and significantly greater financial, technical, marketing and other resources and experience.

***Our quarterly operating results are likely to vary significantly and be unpredictable, in part because of the purchasing and budget practices of our customers, which could cause the trading price of our stock to decline.***

Our operating results have historically varied significantly from period to period, and we expect that they will continue to do so as a result of a number of factors, most of which are outside of our control, including:

the budgeting cycles, internal approval requirements and funding available to our existing and prospective customers for the purchase of network security products;

the timing, size and contract terms of orders received, which have historically been highest in the fourth quarter (representing more than one-third of our total revenue in recent years), but may fluctuate seasonally in different ways;

the level of perceived threats to network security, which may fluctuate from period to period;

the level of demand for products sold by original equipment manufacturers, or OEMs, resellers and distributors that incorporate and resell our technologies;

the market acceptance of open-source software solutions;

the announcement or introduction of new product offerings by us or our competitors, and the levels of anticipation and market acceptance of those products;

price competition;

general economic conditions, both domestically and in our foreign markets;

the product mix of our sales; and

the timing of revenue recognition for our sales.

In particular, the network security technology procurement practices of many of our customers have had a measurable influence on the historical variability of our operating performance. Our prospective customers usually exercise great care and invest substantial time in their network security technology purchasing decisions. As a result, our sales cycles are long, generally between six and twelve months and often longer, which further impacts the variability of our results. Additionally, many of our customers have historically finalized purchase decisions in the last weeks or days of a quarter. A delay in even one large order beyond the end of a particular quarter can substantially diminish our anticipated revenue for that quarter. In addition, many of our expenses must be incurred before we generate revenue. As a result, the negative impact on our operating results would increase if our revenue fails to meet expectations in any period.

The cumulative effect of these factors will likely result in larger fluctuations and unpredictability in our quarterly operating results than in the operating results of many other software and technology companies. This variability and

unpredictability could result in our failing to meet the revenue or operating results expectations of securities industry analysts or investors for a particular period. If we fail to meet or exceed such expectations for these or any other reasons, the market price of our shares could fall substantially, and we could face costly securities class action suits as a result. Therefore, you should not rely on our operating results in any quarter as being indicative of our operating results for any future period, nor should you rely on other expectations, predictions or projections of our future revenue or other aspects of our results of operations.

***Economic, market and political conditions may adversely affect our revenue growth and our efforts to achieve profitability.***

Our business is influenced by a range of factors that are beyond our control. These include:

general economic and business conditions;

the overall demand for network security products and services; and

constraints on budgets and changes in spending priorities of corporations and government agencies.

A general weakening of the economy in the United States or of the global economy, or a curtailment in corporate spending due to factors that affect one or more of the industries to which we sell our products and services, could delay and decrease customer purchases, which could adversely affect our revenue growth and results of operations. For example, the decline in operating performance of financial institutions associated with the problems in the subprime mortgage industry could cause our current or potential financial institution customers to delay or forego purchases of our products and services. Our customers include, but are not limited to, financial institutions, defense contractors, health care providers, information technology companies, telecommunications companies and retailers. Similarly, a reduction in the budgets or spending priorities of government agencies could adversely affect our revenue growth and results of operations.

***The market for network security products is rapidly evolving, and the complex technology incorporated in our products makes them difficult to develop. If we do not accurately predict, prepare for and respond promptly to technological and market developments and changing customer needs, our competitive position and prospects will be harmed.***

The market for network security products is relatively new and is expected to continue to evolve rapidly. Moreover, many customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated new techniques to gain access to and attack systems and networks. Customers look to our products to continue to protect their networks against these threats in this increasingly complex environment without sacrificing network efficiency or causing significant network downtime. The software in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, without impeding the high network performance demanded by our customers. Although the market expects speedy introduction of software to respond to new threats, the development of these products is difficult and the timetable for commercial release of new products is uncertain. Therefore, we may in the future experience delays in the introduction of new products or new versions, modifications or enhancements of existing products. If we do not quickly respond to the rapidly changing and rigorous needs of our customers by developing and introducing on a timely basis new and effective products, upgrades and services that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

***If our new products and product enhancements do not achieve sufficient market acceptance, our results of operations and competitive position will suffer.***

We spend substantial amounts of time and money to research and develop new products and enhanced versions of Snort, the Defense Center and our 3D Sensor and RNA products to incorporate additional features, improved functionality or other enhancements in order to meet our customers' rapidly evolving demands for network security in our highly competitive industry. When we develop a new product or an advanced version of an existing product, we typically expend significant money and effort upfront to market, promote and sell the new offering. Therefore, when we develop and introduce new or enhanced products, they must achieve high levels of market acceptance in order to justify the amount of our investment in developing and bringing the products to market.

Our new products or enhancements could fail to attain sufficient market acceptance for many reasons, including:  
delays in introducing new, enhanced or modified products;

defects, errors or failures in any of our products;

inability to operate effectively with the networks of our prospective customers;

inability to protect against new types of attacks or techniques used by hackers;

negative publicity about the performance or effectiveness of our intrusion prevention or other network security products;

reluctance of customers to purchase products based on open source software; and

disruptions or delays in the availability and delivery of our products, which problems are more likely due to our just-in-time manufacturing and inventory practices.

If our new products or enhancements do not achieve adequate acceptance in the market, our competitive position will be impaired, our revenue will be diminished and the effect on our operating results may be particularly acute because of the significant research, development, marketing, sales and other expenses we incurred in connection with the new product.

***If existing customers do not make subsequent purchases from us or if our relationships with our largest customers are impaired, our revenue could decline.***

In the three months ended March 31, 2008, existing customers that purchased additional products and services from us, whether for new locations or additional technology to protect existing networks and locations, generated a majority of our total revenue for each respective period. Part of our growth strategy is to sell additional products to our existing customers and, in particular, to sell our RNA products to customers that previously bought our Intrusion Sensor products. We may not be effective in executing this or any other aspect of our growth strategy. Our revenue could decline if our current customers do not continue to purchase additional products from us. In addition, as we deploy new versions of our existing Snort, 3D Sensor and RNA products or introduce new products, our current customers may not require the functionality of these products and may not purchase them.

We also depend on our installed customer base for future service revenue from annual maintenance fees. Our maintenance and support agreements typically have durations of one year. No single customer contributed greater than 10% of our recurring maintenance and support revenues in the three months ended March 31, 2008. If customers choose not to continue their maintenance service, our revenue may decline.

***If we cannot attract sufficient government agency customers, our revenue and competitive position will suffer.***

Contracts with the U.S. federal and state and other national and state government agencies accounted for 8% and 7% of our total revenue for three months ended March 31, 2008 and 2007, respectively. We lost many government agency customers when a foreign company tried unsuccessfully to acquire us in late 2005 and early 2006. Since then, we have been attempting to regain government customers, which subjects us to a number of risks, including:

*Procurement.* Contracting with public sector customers is highly competitive and can be expensive and time-consuming, often requiring that we incur significant upfront time and expense without any assurance that we will win a contract;

*Budgetary Constraints and Cycles.* Demand and payment for our products and services are impacted by public sector budgetary cycles and funding availability, with funding reductions or delays adversely impacting public sector demand for our products, including delays caused by continuing resolutions or other temporary funding arrangements;

*Modification or Cancellation of Contracts.* Public sector customers often have contractual or other legal rights to terminate current contracts for convenience or due to a default. If a contract is cancelled for convenience, which can occur if the customer's product needs change, we may only be able to collect for products and services delivered prior to termination. If a contract is cancelled because of default, we may only be able to collect for products and alternative products and services delivered to the customer;

*Governmental Audits.* National governments and state and local agencies routinely investigate and audit government contractors' administrative processes. They may audit our performance and pricing and review our compliance with applicable rules and regulations. If they find that we improperly allocated costs, they may require us to refund those costs or may refuse to pay us for outstanding balances related to the improper allocation. An unfavorable audit could result in a reduction of revenue, and may result in civil or criminal liability if the audit uncovers improper or illegal activities; and

*Replacing Existing Products.* Many government agencies already have installed network security products of our competitors. It can be very difficult to convince government agencies or other prospective customers to replace their existing network security solutions with our products, even if we can demonstrate the superiority of our products.

***We are subject to risks of operating internationally that could impair our ability to grow our revenue abroad.***

We market and sell our software in North America, South America, Europe, Asia and Australia, and we plan to establish additional sales presence in these and other parts of the world. Therefore, we are subject to risks associated with having worldwide operations. Sales to customers located outside of the United States accounted for 30% of our total revenue for the three months ended March 31, 2008 and 27% for the three months ended March 31, 2007. The expansion of our existing operations and entry into additional worldwide markets will require significant management attention and financial resources. We are also subject to a number of risks customary for international operations, including:

economic or political instability in foreign markets;

greater difficulty in accounts receivable collection and longer collection periods;

unexpected changes in regulatory requirements;

difficulties and costs of staffing and managing foreign operations;

import and export controls;

the uncertainty of protection for intellectual property rights in some countries;

costs of compliance with foreign laws and laws applicable to companies doing business in foreign jurisdictions;

management communication and integration problems resulting from cultural differences and geographic dispersion;

multiple and possibly overlapping tax structures; and

foreign currency exchange rate fluctuations.

To date, a substantial portion of our sales have been denominated in U.S. dollars, and we have not used risk management techniques or hedged the risks associated with fluctuations in foreign currency exchange rates. In the future, if we do not engage in hedging transactions, our results of operations will be subject to losses from fluctuations

in foreign currency exchange rates.

***In the future, we may not be able to secure financing necessary to operate and grow our business as planned.***

In the future, we may need to raise additional funds to expand our sales and marketing and research and development efforts or to make acquisitions. Additional equity or debt financing may not be available on favorable terms, if at all. If adequate funds are not available on acceptable terms, we may be unable to fund the expansion of our sales and marketing and research and development efforts or take advantage of acquisition or other opportunities, which could seriously harm our business and operating results. If we issue debt, the debt holders would have rights senior to common stockholders to make claims on our assets and the terms of any debt could restrict our operations, including our ability to pay dividends on our common stock. Furthermore, if we issue additional equity securities, stockholders would experience dilution, and the new equity securities could have rights senior to those of our common stock.

***Our inability to acquire and integrate other businesses, products or technologies could seriously harm our competitive position.***

In order to remain competitive, we intend to acquire additional businesses, products or technologies. If we identify an appropriate acquisition candidate, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product or technology into our existing business and operations. Any acquisitions we are able to complete may not be accretive to earnings or result in the realization of any expected strategic benefits. Further, completing a potential acquisition and integrating an acquired business could significantly divert management's time and resources from the operation of our business.

***If other parties claim commercial ownership rights to Snort or ClamAV, our reputation, customer relations and results of operations could be harmed.***

While we created a majority of the current Snort code base and the current ClamAV code base, a portion of the current code for both Snort and ClamAV was created by the combined efforts of Sourcefire and the open source software community, and a portion was created solely by the open source community. We believe that the portions of the Snort code base and the ClamAV base code created by anyone other than by us are required to be licensed by us pursuant to the GNU General Public License, or GPL, which is how we currently license Snort and ClamAV. There is a risk, however, that a third party could claim some ownership rights in Snort or ClamAV, attempt to prevent us from commercially licensing Snort or ClamAV in the future (rather than pursuant to the GPL as currently licensed) or claim a right to licensing royalties. Any such claim, regardless of its merit or outcome, could be costly to defend, harm our reputation and customer relations or result in our having to pay substantial compensation to the party claiming ownership.

***Our products contain third party open source software, and failure to comply with the terms of the underlying open source software licenses could restrict our ability to sell our products.***

Our products are distributed with software programs licensed to us by third party authors under open source licenses, which may include the GPL, the GNU Lesser Public License, or LGPL, the BSD License and the Apache License. These open source software programs include, without limitation, Snort®, ClamAV™, Linux, Apache, Openssl, Etheral, IPTables, Tcpdump and Tripwire. These third party open source programs are typically licensed to us for a minimal fee or no fee at all, and the underlying license agreements generally require us to make available to the open source user community the source code for such programs, as well as the source code for any modifications or derivative works we create based on these third party open source software programs. With the exception of Snort and ClamAV, we have not created any modifications or derivative works to any other open source software programs referenced above. We regularly release updates and upgrades to the Snort and ClamAV software programs under the terms and conditions of the GNU GPL version 2.

Included with our software and/or appliances are copies of the relevant source code and licenses for the open source programs. Alternatively, we include instructions to users on how to obtain copies of the relevant open source code and licenses. Additionally, if we combine our proprietary software with third party open source software in a certain manner, we could, under the terms of certain of these open source license agreements, be required to release the source code of our proprietary software. This could also allow our competitors to create similar products, which would result in a loss of our product sales. We do not provide end users with a copy of the source code to our proprietary software because we believe that the manner in which our proprietary software is aligned with the relevant open source programs does not create a modification or derivative work of that open source program requiring the distribution of our proprietary source code. Our ability to commercialize our products by incorporating third party open source software may be restricted because, among other reasons:



the terms of open source license agreements may be unclear and subject to varying interpretations, which could result in unforeseen obligations regarding our proprietary products;

it may be difficult to determine the developers of open source software and whether such licensed software infringes another party's intellectual property rights;

competitors will have greater access to information by obtaining these open source products, which may help them develop competitive products; and

open source software potentially increases customer support costs because licensees can modify the software and potentially introduce errors.

***We could be prevented from selling or developing our products if the GNU General Public License and similar licenses under which our products are developed and licensed are not enforceable or are modified so as to become incompatible with other open source licenses.***

A number of our products and services have been developed and licensed under the GNU General Public License and similar open source licenses. These licenses state that any program licensed under them may be liberally copied, modified and distributed. It is possible that a court would hold these licenses to be unenforceable in that or other litigation or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Any ruling by a court that these licenses are not enforceable, or that open source components of our product offerings may not be liberally copied, modified or distributed, may have the effect of preventing us from distributing or developing all or a portion of our products. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of their license agreements in such a manner that those license terms may no longer be compatible with other open source licenses in our offerings or our end user license agreement, and thus could, among other consequences, prevent us from continuing to distribute the software code subject to the modified license.

The software program Linux is included in our products and is licensed under the GPL. The GPL is the subject of litigation in the case of The SCO Group, Inc. v. International Business Machines Corp., pending in the United States District Court for the District of Utah. It is possible that the court could rule that the GPL is not enforceable in such litigation. Any ruling by the court that the GPL is not enforceable could have the effect of limiting or preventing us from using Linux as currently implemented.

***Efforts to assert intellectual property ownership rights in our products could impact our standing in the open source community, which could limit our product innovation capabilities.***

If we were to undertake actions to protect and maintain ownership and control over our proprietary intellectual property, including patents, copyrights, trademark rights and trade secrets, our standing in the open source community could be diminished which could result in a limitation on our ability to continue to rely on this community as a resource to identify and defend against new viruses, threats and techniques to attack secure networks, explore new ideas and concepts and further our research and development efforts.

***Our proprietary rights may be difficult to enforce, which could enable others to copy or use aspects of our products without compensating us.***

We rely primarily on copyright, trademark, patent and trade secret laws, confidentiality procedures and contractual provisions to protect our proprietary rights. As of the date hereof, we have three patents issued and 33 applications pending for examination in the U.S. and foreign jurisdictions. We also hold numerous registered United States and foreign trademarks and have a number of trademark applications pending in the United States and in foreign jurisdictions. Valid patents may not be issued from pending applications, and the claims allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate protection or competitive advantages to us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our technologies or products is difficult. Our products incorporate open source Snort and ClamAV software, which is

readily available to the public. To the extent that our proprietary software is included by others in what are purported to be open source products, it may be difficult and expensive to enforce our rights in such software. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States, and many foreign countries do not enforce these laws as diligently as U.S. government agencies and private parties. It is possible that we may have to resort to litigation to enforce and protect our copyrights, trademarks, patents and trade secrets, which litigation could be costly and a diversion of management resources. If we are unable to protect our proprietary rights to the totality of the features in our software and products (including aspects of our software and products protected other than by patent rights), we may find ourselves at a competitive disadvantage to others who need not incur the additional expense, time and effort required to create products similar to ours.

In limited instances we have agreed to place, and in the future may place, source code for our software in escrow, other than the Snort and ClamAV source code, which are publicly available. In most cases, the source code may be made available to certain of our customers and OEM partners in the event that we file for bankruptcy or materially fail to support our products. Release of our source code may increase the likelihood of misappropriation or other misuse of our software. We have agreed to source code escrow arrangements in the past only rarely and usually only in connection with prospective customers considering a significant purchase of our products and services.

***Claims that our products infringe the proprietary rights of others could harm our business and cause us to incur significant costs.***

Technology products such as ours, which interact with multiple components of complex networks, are increasingly subject to infringement claims as the functionality of products in different industry segments overlaps. In particular, our RNA technology is a new technology for which we have yet to be issued a patent. It is possible that other companies have patents with respect to technology similar to our technology, including RNA. 10 of our 33 pending patent applications relate to our RNA technology and were filed in 2004 and 2005. If others filed patent applications before us, which contain allowable claims within the scope of our RNA technology, then we may be found to infringe on such patents, if and when they are issued. We are aware of at least one company that has filed an application for a patent that, on its face, contains claims that may be construed to be within the scope of the same broad technology area as our RNA technology. That company, NetClarity, previously filed a suit against us for misappropriation and incorporation in our products of its proprietary rights, as well as making claims that our RNA technology and 3D security solutions are covered by claims in its pending patent application. This pending patent application has not issued as a patent. On June 7, 2007, we reached a definitive agreement with NetClarity, Inc. to settle this lawsuit and on June 13, 2007, the Superior Court of Suffolk County, Massachusetts entered a Stipulation of Dismissal with prejudice.

Unless and until the U.S. Patent and Trademark Office, or PTO, issues a patent to an applicant, there can be no way to assess a potential patentee's right to exclude. Depending on the timing and substance of these patents and patent applications, our products, including our RNA technology, may be found to infringe the proprietary rights of others, and we may be subject to litigation with respect to any alleged infringement. The application of patent law to the software industry is particularly uncertain, as the PTO has only recently begun to issue software patents in large numbers, and there is a backlog of software-related patent applications pending claiming inventions whose priority dates may pre-date development of our own proprietary software. Additionally, in our customer contracts we typically agree to indemnify our customers if they incur losses resulting from a third party claim that their use of our products infringes upon the intellectual property rights of a third party. Any potential intellectual property claims against us, with or without merit, could:

be very expensive and time consuming to defend;

require us to indemnify our customers for losses resulting from such claims;

cause us to cease making, licensing or using software or products that incorporate the challenged intellectual property;

cause product shipment and installation delays;

require us to redesign our products, which may not be feasible;

divert management's attention and resources; or

require us to enter into royalty or licensing agreements in order to obtain the right to use a necessary product or component.

Royalty or licensing agreements, if required, may not be available on acceptable terms, or at all. A successful claim of infringement against us and our failure or inability to license the infringed or similar technology could prevent us from distributing our products and cause us to incur great expense and delay in developing non-infringing products. ***We rely on software licensed from other parties, the loss of which could increase our costs and delay software shipments.***

We utilize various types of software licensed from unaffiliated third parties. For example, we license database software from MySQL that we use in our 3D Sensors, our RNA Sensors and our Defense Centers. Our Agreement with MySQL permits us to distribute MySQL software on our products to our customers worldwide until December 31, 2010. We amended our MySQL agreement on December 29, 2006 to give us the unlimited right to distribute MySQL software in exchange for a one-time lump-sum payment. We believe that the MySQL agreement is material to our business because we have spent a significant amount of development resources to allow the MySQL software to function in our products. If we were forced to find replacement database software for our products, we would be required to expend resources to implement a replacement database in our products, and there would be no guarantee that we would be able to procure the replacement on the same or similar commercial terms.

In addition to MySQL, we rely on other open source software, such as the Linux operating system, the Apache web server and OpenSSL, a secure socket layer implementation. These open source programs are licensed to us under various open source licenses. For example, Linux is licensed under the GNU General Public License Version 2, while Apache and OpenSSL are licensed under other forms of open source license agreements. If we could no longer rely on these open source programs, the functionality of our products would be impaired, and we would be required to expend significant resources to find suitable alternatives.

Our business would be disrupted if any of the software we license from others or functional equivalents of this software were either no longer available to us, no longer offered to us on commercially reasonable terms or offered to us under different licensing terms and conditions. For example, our business could be disrupted if the widely-used Linux operating system were to be released under the new Version 3 of the GNU General Public License, as we could be required to expend significant resources to ensure that our use of Linux, as well as the manner in which our proprietary and other third party software work with Linux, complies with the new version of the GNU General Public License. Additionally, we would be required to either redesign our products to function with software available from other parties or develop these components ourselves, which would result in increased costs and could result in delays in our product shipments and the release of new product offerings. Furthermore, we might be forced to limit the features available in our current or future products. If we fail to maintain or renegotiate any of these software licenses, we could face significant delays and diversion of resources in attempting to license and integrate a functional equivalent of the software.

***Defects, errors or vulnerabilities in our software products would harm our reputation and divert resources.***

Because our products are complex, they may contain defects, errors or vulnerabilities that are not detected until after our commercial release and installation by our customers. We may not be able to correct any errors or defects or address vulnerabilities promptly, or at all. Any defects, errors or vulnerabilities in our products could result in:

expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;

loss of existing or potential customers;

delayed or lost revenue;

delay or failure to attain market acceptance;



increased service, warranty, product replacement and product liability insurance costs; and

negative publicity, which would harm our reputation.

In addition, because our products and services provide and monitor network security and may protect valuable information, we could face claims for product liability, tort or breach of warranty. Anyone who circumvents our security measures could misappropriate the confidential information or other valuable property of customers using our products, or interrupt their operations. If that happens, affected customers or others may sue us. In addition, we may face liability for breaches of our product warranties, product failures or damages caused by faulty installation of our products. Provisions in our contracts relating to warranty disclaimers and liability limitations may be deemed by a court to be unenforceable. Some courts, for example, have found contractual limitations of liability in standard computer and software contracts to be unenforceable in some circumstances. Defending a lawsuit, regardless of its merit, could be costly and divert management attention. Our business liability insurance coverage may be inadequate or future coverage may be unavailable on acceptable terms or at all.

***Our networks, products and services are vulnerable to, and may be targeted by, hackers.***

Like other companies, our websites, networks, information systems, products and services may be targets for sabotage, disruption or misappropriation by hackers. As a leading network security solutions company, we are a high profile target and our networks, products and services may have vulnerabilities that may be targeted by hackers. Although we believe we have sufficient controls in place to prevent disruption and misappropriation, and to respond to such situations, we expect these efforts by hackers to continue. If these efforts are successful, our operations, reputation and sales could be adversely affected.

***We utilize a just-in-time contract manufacturing and inventory process, which increases our vulnerability to supply disruption.***

Our ability to meet our customers' demand for certain of our products depends upon obtaining adequate hardware platforms on a timely basis, which must be integrated with our software. We purchase hardware platforms through our contract manufacturers from a limited number of suppliers on a just-in-time basis. In addition, these suppliers may extend lead times, limit the supply to our manufacturers or increase prices due to capacity constraints or other factors. Although we work closely with our manufacturers and suppliers to avoid shortages, we may encounter these problems in the future. Our results of operations would be adversely affected if we were unable to obtain adequate supplies of hardware platforms in a timely manner or if there were significant increases in the costs of hardware platforms or problems with the quality of those hardware platforms.

***We depend on a single source to manufacture our enterprise class intrusion sensor product; if that sole source were to fail to satisfy our requirements, our sales revenue would decline and our reputation would be harmed.***

We rely on one manufacturer, Bivio Networks, to build the hardware platform for three models of our intrusion sensor products that are used by our enterprise class customers. These enterprise class intrusion sensor products are purchased directly by customers for their internal use and are also utilized by third party managed security service providers to provide services to their customers. Revenue resulting from sales of these enterprise class intrusion sensor products accounted for approximately 20% of our product revenue in the three months ended March 31, 2008, and approximately 8% of our product revenue in the three months ended March 31, 2007. The unexpected termination of our relationship with Bivio Networks would be disruptive to our business and our reputation, which could result in a material decline in our revenue as well as shipment delays and possible increased costs as we seek and implement production with an alternative manufacturer.

***We depend on resellers and distributors for our sales; if they fail to perform as expected, our revenue will suffer.***

Part of our business strategy involves entering into additional agreements with resellers and distributors that permit them to resell our products and service offerings. Revenue resulting from our resellers and distributors accounted for approximately 59% of our total revenue in the three months ended March 31, 2008, and approximately 48% of our total revenue in the three months ended March 31, 2007. For the three months ended March 31, 2008 and 2007, no single reseller, distributor, customer or OEM accounted for more than 10% of our total revenue. There is a risk that our pace of entering into such agreements may slow, or that our existing agreements may not produce as much business as we anticipate. There is also a risk that some or all of our resellers or distributors may be acquired, may

change their business models or may go out of business, any of which could have an adverse effect on our business.

***If we do not continue to establish and effectively manage our OEM relationships, our revenue could decline.***

Our ability to sell our network security software products in new markets and to increase our share of existing markets will be impaired if we fail to expand our indirect distribution channels. Our sales strategy involves the establishment of multiple distribution channels domestically and internationally through strategic resellers, system integrators and OEMs. We have alliances with OEMs such as Nortel and Nokia and we cannot predict the extent to which these companies will be successful in marketing or selling our software. Our agreements with these companies could be terminated on short notice, and they do not prevent our OEMs, systems integrators, strategic resellers or other distributors from selling the network security software of other companies, including our competitors. Nortel and Nokia, or any other OEM, system integrator, strategic reseller or distributor, could give higher priority to other companies' software or to their own software than they give to ours, which could cause our revenue to decline.

***Our inability to effectively manage our expected headcount growth and expansion and our additional obligations as a public company could seriously harm our ability to effectively run our business.***

Our historical growth has placed, and our intended future growth is likely to continue to place, a significant strain on our management, financial, personnel and other resources. We will likely not continue to grow at our historical pace due to limits on our resources. We have grown from 190 employees at March 31, 2007 to 242 employees at March 31, 2008. Since January 1, 2005, we have opened additional sales offices and have significantly expanded our operations. This rapid growth has strained our facilities and required us to lease additional space at our headquarters. In several recent quarters, we have not been able to hire sufficient personnel to keep pace with our growth. In addition to managing our expected growth, we have substantial additional obligations and costs as a result of becoming a public company in March 2007. These obligations include investor relations, preparing and filing periodic SEC reports, developing and maintaining internal controls over financial reporting and disclosure controls, compliance with corporate governance rules, Regulation FD and other requirements imposed on public companies by the SEC and the NASDAQ Global Market that we did not experience as a private company. Fulfilling these additional obligations will make it more difficult to operate a growing company. Any failure to effectively manage growth or fulfill our obligations as a public company could seriously harm our ability to respond to customers, the quality of our software and services and our operating results. To effectively manage growth and operate a public company, we are in the process of implementing an enterprise-wide information management system that includes new accounting, finance, management information and human resource systems and controls. Any failure by us to implement this system as planned, including any failure to adequately train personnel to use the new system, complete the implementation on schedule, complete the implementation within our budget or successfully transition our existing systems to the new system, could require us to devote significant additional management attention and financial resources, which could negatively affect the operation of our business.

***The price of our common stock may be subject to wide fluctuations.***

Prior to our IPO in March 2007, there was not a public market for our common stock. The market price of our common stock is subject to significant fluctuations. Among the factors that could affect our common stock price are the risks described in this "Risk Factors" section and other factors, including:

quarterly variations in our operating results compared to market expectations;

changes in expectations as to our future financial performance, including financial estimates or reports by securities analysts;

changes in market valuations of similar companies;

liquidity and activity in the market for our common stock;

actual or expected sales of our common stock by our stockholders;



strategic moves by us or our competitors, such as acquisitions or restructurings;

general market conditions; and

domestic and international economic, legal and regulatory factors unrelated to our performance.

Stock markets in general have experienced extreme volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the trading price of our common stock, regardless of our operating performance.

***We and certain of our officers and directors have been named as co-defendants in, and are the subject of, certain legal proceedings which may result in substantial costs and divert management's attention and resources.***

As described in Legal Proceedings above, multiple federal securities class action lawsuits have been filed naming our company and certain of our officers and directors as co-defendants. We are not able to predict the ultimate outcome of this litigation. It is possible that these matters could be resolved adversely to us, could result in substantial costs and could divert management's attention and resources, which could harm our business.

Risks associated with legal liability often are difficult to assess or quantify, and their existence and magnitude can remain unknown for significant periods of time. While we maintain director and officer insurance, the amount of insurance coverage may not be sufficient to cover a claim, and the continued availability of this insurance cannot be assured. We may in the future be the target of additional proceedings, and these proceedings may result in substantial costs and divert management's attention and resources.

***Sales of substantial amounts of our common stock in the public markets, or the perception that they might occur, could reduce the price that our common stock might otherwise attain.***

As of April 30, 2008, we had 24,989,055 outstanding shares of common stock. This number includes 6,185,500 shares of our common stock that we sold in our IPO, which has been and may in the future be resold at any time in the public market. This number also includes an aggregate of approximately 12.0 million shares held by directors, officers and venture capital funds that invested in Sourcefire prior to our initial public offering, and who may sell such shares at their discretion subject to certain volume limitations. Sales of substantial amounts of our common stock in the public market, as a result of the exercise of registration rights or otherwise, or the perception that such sales could occur, could adversely affect the market price of our common stock and may make it more difficult for you to sell your common stock at a time and price that you deem appropriate.

***Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.***

Our amended and restated certificate of incorporation and our amended and restated bylaws, each of which became effective in March 2007 upon completion of our IPO, contain provisions that may delay or prevent an acquisition of us or a change in our management. These provisions include a classified board of directors, a prohibition on actions by written consent of our stockholders, and the ability of our board of directors to issue preferred stock without stockholder approval. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which prohibits stockholders owning in excess of 15% of our outstanding voting stock from merging or combining with us. Although we believe these provisions collectively provide for an opportunity to receive higher bids by requiring potential acquirers to negotiate with our board of directors, they would apply even if the offer may be considered beneficial by some stockholders. In addition, these provisions may frustrate or prevent attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND 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 and offering expenses. We intend to use the net proceeds from the offering for working capital and other general corporate purposes, including financing growth, developing new products and funding capital expenditures. Pending such usage, we have invested the net proceeds in interest-bearing, investment grade securities.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**Item 5. OTHER INFORMATION**

None.

**Item 6. EXHIBITS**

The following documents are filed as Exhibits with this report:

Exhibit Number	Exhibit Description	Incorporation by Reference				Filed with this 10-Q
		Form	File Number	Exhibit	File Date	
3.1	Sixth Amended and Restated Certificate of Incorporation	10-Q	1-33350	3.1	5/4/2007	
3.2	Fourth Amended and Restated Bylaws	10-Q	1-33350	3.2	5/4/2007	
4.1	Form of stock certificate of common stock	S-1/A	333-138199	4.1	3/6/2007	
10.1	Transition Agreement with E. Wayne Jackson, III					X
10.2	2008 Management Incentive Compensation Plan					X
10.3	Executive Retention Plan					X
10.4	Executive Change in Control Plan					X
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

**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 2, 2008.

**SOURCEFIRE, INC.**

By: /s/ E. Wayne Jackson, III  
E. Wayne Jackson, III  
Chief Executive Officer  
(duly authorized officer)

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

By: /s/ Nicholas G. Margarites  
Nicholas G. Margarites  
Chief Accounting Officer and Vice  
President of Finance  
(principal accounting officer)