SOURCEFIRE INC
Form 10-Q
August 07, 2009

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

**FORM 10-Q**

**(Mark One)**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended June 30, 2009**

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

**Commission File Number**
**1-33350**

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

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

| | | | |
|---|---|---|---|
| Large Accelerated Filer o | Accelerated Filer þ | Non-Accelerated Filer o<br>(Do not check if smaller reporting company) | Smaller reporting Company o |

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

As of August 4, 2009, there were 26,605,435 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)**

| | June 30, 2009 (unaudited) | December 31, 2008 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 46,703 | $ 39,768 |
| Short-term investments | 56,538 | 59,343 |
| Accounts receivable, net of allowances of $851 as of June 30, 2009 and $538 as of December 31, 2008 | 21,789 | 27,864 |
| Inventory | 3,316 | 4,521 |
| Prepaid expenses and other current assets | 3,130 | 2,115 |
| Total current assets | 131,476 | 133,611 |
| Property and equipment, net | 8,010 | 8,341 |
| Intangible assets, net of accumulated amortization | 402 | 465 |
| Investments | 5,047 | 2,457 |
| Other assets | 1,592 | 1,431 |
| Total assets | $ 146,527 | $ 146,305 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,413 | $ 4,505 |
| Accrued compensation and related expenses | 3,194 | 4,229 |
| Other accrued expenses | 2,599 | 3,558 |
| Current portion of deferred revenue | 23,395 | 21,513 |
| Other current liabilities | 592 | 789 |
| Total current liabilities | 31,193 | 34,594 |
| Deferred revenue, less current portion | 2,860 | 2,595 |
| Other long-term liabilities | 90 | 75 |
| Total liabilities | 34,143 | 37,264 |
| Commitments and Contingencies | | |
| Stockholders equity: | | |
| Preferred stock, $0.001 par value; 19,700,000 shares authorized; no shares issued or outstanding at June 30, 2009 and December 31, 2008 | | |
| Series A junior participating preferred stock, $0.001 par value; 300,000 shares authorized; no shares issued or outstanding at June 30, 2009 and December 31, 2008 | | |

| | | |
|---|---|---|
| Common stock, $0.001 par value; 240,000,000 shares authorized; 26,444,943 and 25,917,519 shares issued and outstanding as of June 30, 2009 and December 31, 2008, respectively | 26 | 25 |
| Additional paid-in capital | 163,272 | 159,306 |
| Accumulated deficit | (51,078) | (50,594) |
| Accumulated other comprehensive income | 164 | 304 |
| Total stockholders equity | 112,384 | 109,041 |
| Total liabilities and stockholders equity | $ 146,527 | $ 146,305 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended June 30, 2009 | Three Months Ended June 30, 2008 | Six Months Ended June 30, 2009 | Six Months Ended June 30, 2008 |
|---|---|---|---|---|
| Revenue: | | | | |
| Products | $ 12,280 | $ 8,677 | $ 22,148 | $ 15,528 |
| Technical support and professional services | 9,891 | 7,341 | 18,623 | 14,141 |
| Total revenue | 22,171 | 16,018 | 40,771 | 29,669 |
| Cost of revenue: | | | | |
| Products | 3,682 | 2,479 | 6,449 | 4,476 |
| Technical support and professional services | 1,393 | 1,197 | 2,775 | 2,238 |
| Total cost of revenue | 5,075 | 3,676 | 9,224 | 6,714 |
| Gross profit | 17,096 | 12,342 | 31,547 | 22,955 |
| Operating expenses: | | | | |
| Research and development | 3,396 | 3,147 | 6,716 | 6,258 |
| Sales and marketing | 8,428 | 7,945 | 16,298 | 15,179 |
| General and administrative | 3,992 | 4,531 | 7,835 | 8,945 |
| Depreciation and amortization | 830 | 585 | 1,651 | 1,077 |
| Total operating expenses | 16,646 | 16,208 | 32,500 | 31,459 |
| Income (loss) from operations | 450 | (3,866) | (953) | (8,504) |
| Other income, net: | | | | |
| Interest and investment income | 294 | 828 | 678 | 1,983 |
| Interest expense | (6) | (36) | (16) | (36) |
| Other income (expense) | (36) | (11) | (49) | 38 |
| Total other income, net | 252 | 781 | 613 | 1,985 |
| Income (loss) before income taxes | 702 | (3,085) | (340) | (6,519) |
| Income tax expense | 69 | 39 | 144 | 101 |
| Net income (loss) | $ 633 | $ (3,124) | $ (484) | $ (6,620) |
| Net income (loss): | | | | |
| Basic | $ 0.02 | $ (0.12) | $ (0.02) | $ (0.27) |
| Diluted | $ 0.02 | $ (0.12) | $ (0.02) | $ (0.27) |
| Weighted average shares outstanding used in computing per share amounts: | | | | |
| Basic | 26,249,424 | 25,154,568 | 26,092,712 | 24,960,471 |

| | | | | |
|---|---|---|---|---|
| Diluted | 27,551,669 | 25,154,568 | 26,092,712 | 24,960,471 |

See accompanying notes to consolidated financial statements.

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

| | Common Stock | | Additional Paid In | Accumulated | Accumulated Other Comprehensive Income | |
|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Deficit | (Loss) | Total |
| Balance as of January 1, 2009 | 25,917,519 | $ 25 | $ 159,306 | $ (50,594) | $ 304 | $ 109,041 |
| Exercise of common stock options | 430,060 | 1 | 1,202 | | | 1,203 |
| Issuance of common stock under employee stock purchase plan | 40,826 | | 176 | | | 176 |
| Issuance of restricted common stock | 56,538 | | | | | |
| Stock-based compensation expense | | | 2,557 | | | 2,557 |
| Excess tax benefits relating to share-based payments | | | 31 | | | 31 |
| Comprehensive loss: | | | | | | |
| Net loss for the six months ended June 30, 2009 | | | | (484) | | (484) |
| Change in net unrealized gains and losses on investments | | | | | (140) | (140) |
| Total comprehensive loss | | | | | | (624) |
| Balance as of June 30, 2009 | 26,444,943 | $ 26 | $ 163,272 | $ (51,078) | $ 164 | $ 112,384 |

See accompanying notes to consolidated financial statements.

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

| | Six Months Ended June 30, 2009 | Six Months Ended June 30, 2008 |
|---|---|---|
| **Operating activities** | | |
| Net loss | $ (484) | $ (6,620) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,692 | 1,092 |
| Provision for (benefit from) doubtful accounts | 93 | (49) |
| Non-cash stock-based compensation | 2,557 | 1,803 |
| Excess tax benefits related to share-based payments | (31) | (10) |
| Amortization of premium on investments | (58) | (656) |
| Realized gain from sales of investments | | (23) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 5,982 | 6,175 |
| Inventory | 1,205 | (252) |
| Prepaid expenses and other assets | (1,145) | (586) |
| Accounts payable | (3,091) | (3,178) |
| Accrued expenses | (1,994) | 2,745 |
| Deferred revenue | 2,147 | (46) |
| Other liabilities | (151) | 39 |
| Net cash provided by operating activities | 6,722 | 434 |
| **Investing activities** | | |
| Purchase of property and equipment | (1,298) | (4,552) |
| Purchase of investments | (44,417) | (49,580) |
| Proceeds from maturities of investments | 44,550 | 56,113 |
| Proceeds from sales of investments | | 3,230 |
| Net cash (used in) provided by investing activities | (1,165) | 5,211 |
| **Financing activities** | | |
| Repayments of capital lease obligations | (32) | |
| Proceeds from employee stock-based plans | 1,379 | 498 |
| Excess tax benefits related to share-based payments | 31 | 10 |
| Net cash provided by financing activities | 1,378 | 508 |
| Net increase in cash and cash equivalents | 6,935 | 6,153 |
| Cash and cash equivalents at beginning of period | 39,768 | 33,071 |
| Cash and cash equivalents at end of period | $ 46,703 | $ 39,224 |

See accompanying notes to consolidated financial statements.

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

**1. Description of Business**

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

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

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

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to those rules or regulations. The interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, considered necessary for a fair presentation. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in our Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission on March 16, 2009. The results of operations for the interim periods are not necessarily indicative of results to be expected in future periods. We have evaluated all subsequent events through August 7, 2009, the date the financial statements were issued.

***Use of Estimates***

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

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

***Investments***

We account for investments in accordance with Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standard, or SFAS, No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. We determine the appropriate classification of debt securities at the time of purchase and reevaluate such designation as of each balance sheet date. Our investments are comprised of money market funds, corporate debt investments, asset-backed securities, commercial paper, government-sponsored enterprises, government securities and certificates of deposit. These investments have been classified as

available-for-sale. Available-for-sale investments are stated at fair value, with the unrealized gains and losses, net of tax, reported in accumulated other comprehensive income. The amortization of premiums and accretion of discounts to maturity are computed under the effective interest method. Such amortization is included in interest and investment income. Interest on securities classified as available-for-sale is also included in interest and investment income. (See Note 3 for further discussion of the classification of our investments.)

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

***Fair Value of Financial Instruments***

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

***Allowance for Doubtful Accounts and Sales Returns***

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

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

***Inventories***

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

| | As of | |
|---|---|---|
| | **June 30, 2009** | **December 31, 2008** |
| Finished goods | $ 2,447 | $ 3,436 |
| Evaluation units | 869 | 1,085 |

| | | |
|---|---|---|
| Total inventory | $ 3,316 | $ 4,521 |

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Inventory write-downs, primarily related to evaluation units and excess and obsolete inventory, are reflected as cost of product revenues and amounted to $927,000 and $155,000 for the three months ended June 30, 2009 and 2008, respectively, and $1.1 million and $275,000 for the six months ended June 30, 2009 and 2008, respectively.

***Revenue Recognition***

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

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

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

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

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

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

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

For the three months and six months ended June 30, 2009, one customer, a distributor of our products to the U.S. government, accounted for greater than 10% of total revenue. For the three months and six months ended June 30, 2008, we had no significant customers that accounted for 10% of revenue recognized during such periods.

***Warranty***

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

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

***Income Taxes***

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the basis of assets and liabilities recorded for financial reporting purposes and the amounts recognized for income tax purposes. We record a valuation allowance to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of June 30, 2009 and December 31, 2008, our deferred tax assets were fully reserved except for foreign deferred tax assets of $71,000, expected to be available to offset foreign tax liabilities in the future. Our second quarter and year-to-date tax provision consists principally of foreign income tax expense.

On January 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, Accounting for Income Taxes*, or FIN 48. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

***Stock-Based Compensation***

On January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, which requires us to expense the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. The expense must be recognized ratably over the requisite service period following the date of grant. We applied the prospective transition method, which requires us to apply its provisions only to awards granted, modified, repurchased or cancelled after the effective date. Under this prospective transition method, stock-based compensation expense recognized beginning January 1, 2006 is based on the grant date fair value of stock awards granted or modified after January 1, 2006. As we had used the minimum value method for valuing our stock options under the disclosure requirements of SFAS No. 123, *Accounting for Stock Based Compensation*, all options granted prior to January 1, 2006 continue to be accounted for under Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*. Additionally, the pro forma disclosures that were required under the original provisions of SFAS No. 123 are no longer provided for outstanding awards accounted for under the intrinsic-value method of APB No. 25 beginning in periods after the adoption of SFAS No. 123(R). See Note 4 for additional discussion of stock-based compensation.

***Recent Accounting Pronouncements***

On January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements.* In February 2008, the FASB issued FASB Staff Position, or FSP, No. 157-2, *Effective Date of FASB Statement No. 157* ( FSP 157-2 ), which delayed the effective date of SFAS No. 157 by one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On January 1, 2009, we adopted SFAS No. 157

for non-financial assets and liabilities. The adoption of SFAS No. 157 as it pertains to non-financial assets and non-financial liabilities did not have a material impact on our financial statements. See Note 7 for additional discussion of fair value measurements.

In December 2007, the FASB issued Statement of Financial Accounting Standard, or 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 No. 141R is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 141R did not have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The FSP amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments,* and APB Opinion No. 28, *Interim Financial Reporting*, to require disclosures about the fair value of financial instruments during interim reporting periods. The effective date for this FSP is interim and annual periods ending after June 15, 2009. The adoption of this FSP did not have a material impact on our consolidated financial statements.

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

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

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events*. This standard is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS No. 165 is effective for fiscal years and interim periods ended after June 15, 2009. The adoption of SFAS No. 165 did not have a material impact on our consolidated financial statements.

***Reclassifications***

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

**3. Investments**

The following is a summary of available-for-sale investments as of June 30, 2009 (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Money market funds | $ 25,227 | $ | $ | $ 25,227 |
| Corporate debt investments | 11,896 | 22 | (6) | 11,912 |
| Commercial paper | 19,179 | 53 | | 19,232 |
| Government-sponsored enterprises | 30,346 | 94 | | 30,440 |
| Government securities | 999 | 1 | | 1,000 |
| Certificate of deposit | 1,201 | | | 1,201 |
| Total investments | 88,848 | $ 170 | $ (6) | 89,012 |
| Amounts classified as cash equivalents | (27,427) | | | (27,427) |
| Total available-for-sale investments | $ 61,421 | $ 170 | $ (6) | $ 61,585 |

Investments with unrealized losses at June 30, 2009 not recognized in income are as follows (in thousands):

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Corporate debt investments | $3,486 | $ 6 | $ | $ | $3,486 | $ 6 |

As of June 30, 2009, the net unrealized holding gain on available-for-sale securities included in accumulated other comprehensive income totaled $164,000. We have evaluated our investments and have determined there were no other-than-temporary impairments as of June 30, 2009. There are three investments in an unrealized loss position. The unrealized losses related to these investments are entirely caused by non-credit related factors and we expect to fully recover the amortized cost basis of these investments. For the six months ended June 30, 2009, the deferred tax benefit recorded in other comprehensive loss was fully offset by the increase of the valuation allowance we recorded for related deferred tax assets.

The net carrying value and estimated fair value of available-for-sale investments by contractual maturity as of June 30, 2009 are as follows (in thousands):

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Due in one year or less | $ 56,388 | $ 56,538 |
| Due after one year through five years | 5,033 | 5,047 |
| Total | $ 61,421 | $ 61,585 |

**4. Stock-Based Compensation**

During 2002, we adopted the Sourcefire, Inc. 2002 Stock Incentive Plan (the 2002 Plan ). The 2002 Plan provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by our Board of Directors. As of June 30, 2009, we have reserved an aggregate of 5,100,841 shares of common stock for issuance under the 2002 Plan. Following the adoption of the 2007 Stock Incentive Plan (the 2007 Plan ) described below, there are no additional shares available for grant under the 2002 Plan.

In March 2007, our Board of Directors approved the 2007 Plan, which provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Board of Directors. As of December 31, 2008, we had reserved an aggregate of 4,128,149 shares of common stock for issuance under the 2007 Plan. On January 1, 2009, under the terms of the 2007 Plan, the aggregate number of shares reserved for issuance under the 2007 Plan was increased by an amount equal to 4% of our outstanding common stock as of December 31, 2008, or 1,036,701 shares. Therefore, as of June 30, 2009, we have reserved an aggregate of 5,164,850 shares of common stock for issuance under the 2007 Plan.

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

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

SFAS No. 123(R), *Share-Based Payment*, requires the use of a valuation model to calculate the fair value of stock-based awards. We use the Black-Scholes option pricing model for estimating the fair value of stock options granted and for employee stock purchases under the 2007 Employee Stock Purchase Plan (the ESPP ). For certain option awards that contain market conditions relating to our stock price achieving certain levels, we use a Lattice option pricing model. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected price volatility. Additionally, the recognition of expense requires the estimation of the number of options that will ultimately vest and the number of options that will ultimately be forfeited. Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| **Stock options:** | | | | |
| Average risk-free interest rate | 2.53% | 2.96% | 2.37% | 2.97% |
| Expected dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |
| Expected useful life (years) | 6.25 | 6.25 | 6.25 | 6.25 |
| Expected volatility | 64.7% | 64.5% | 64.7% | 65.6% |
| Weighted-average fair value per grant | $6.84 | $4.17 | $5.39 | $4.24 |
| | | | | |
| **Employee stock purchase plan:** | | | | |
| Average risk-free interest rate | 0.30% | | 0.30% | 2.50% |
| Expected dividend yield | 0.0 | | 0.0 | 0.0 |
| Expected useful life (years) | 0.50 | | 0.50 | 0.37 |
| Expected volatility | 77.5% | | 77.5% | 57.5% |
| Weighted-average fair value per purchase | $3.52 | | $3.52 | $1.64 |

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

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

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

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

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

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

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

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

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

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

| | Three Months Ended June 30, | | Six Months Ended, June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Product cost of revenue | $ 14 | $ 9 | $ 25 | $ 16 |
| Services cost of revenue | 21 | 11 | 54 | 32 |
| Stock-based compensation expense included in cost of revenue | 35 | 20 | 79 | 48 |
| Research and development | 211 | 167 | 416 | 341 |
| Sales and marketing | 397 | 299 | 780 | 642 |
| General and administrative | 712 | 395 | 1,282 | 772 |
| Stock-based compensation expense included in operating expenses | 1,320 | 861 | 2,478 | 1,755 |
| Total stock-based compensation expense | $ 1,355 | $ 881 | $ 2,557 | $ 1,803 |

***Stock Options***

The following table summarizes stock option activity under the plans for the six months ended June 30, 2009 (in thousands, except share and per share data):

| | Number of Shares | Range of Exercise Prices | Weighted-Average Exercise Price | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at December 31, 2008 | 3,296,322 | $0.24 to 15.49 | $ 5.26 | $ 5,878 |
| Granted | 153,000 | 5.58 to 12.51 | 8.81 | |
| Exercised | (430,060) | 0.24 to 12.26 | 2.80 | |
| Forfeited | (72,656) | 5.26 to 13.10 | 9.74 | |
| Outstanding at June 30, 2009 | 2,946,606 | $ 0.24 to 15.49 | $ 5.69 | $ 19,863 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Vested and exercisable at June 30, 2009 | 1,572,735 | $ 0.24 to 15.49 | $ | 4.04 | $ | 13,203 |
| Vested and expected to vest at June 30, 2009 | 2,495,269 | | $ | 5.33 | $ | 17,721 |

The following table summarizes information about stock options outstanding as of June 30, 2009:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number of Shares | Weighted-Average Exercise Prices | Weighted-Average Contractual Life (Years) | Number of Shares | Weighted-Average Exercise Prices |
| $0.24 to 2.03 | 973,244 | $ 1.10 | 4.82 | 973,244 | $ 1.10 |
| $3.69 to 6.77 | 1,166,494 | 6.42 | 8.77 | 214,626 | 5.82 |
| $7.10 to 12.51 | 739,994 | 9.81 | 7.94 | 346,927 | 10.07 |
| $13.10 to 15.49 | 66,874 | 14.10 | 7.34 | 37,938 | 14.09 |
| | 2,946,606 | $ 5.69 | 7.22 | 1,572,735 | $ 4.04 |

The aggregate intrinsic value of all options exercised during the six months ended June 30, 2009 and 2008 was $3.3 million and $2.7 million, respectively.

Outstanding stock option awards are generally subject to service-based vesting; however, in some instances, awards contain provisions for acceleration of vesting upon performance measures, change in control and in certain other circumstances. On a quarterly basis, we evaluate the probability of achieving performance measures and adjust compensation expense accordingly. Based on the estimated grant date fair value of employee stock options granted, we recognized compensation expense of $732,000 and $439,000 for the three months ended June 30, 2009 and 2008, respectively, and $1.4 million and $974,000 for the six months ended June 30, 2009 and 2008, respectively. The grant date aggregate fair value of options, net of estimated forfeitures, not yet recognized as expense as of June 30, 2009 was $4.5 million, which will be recognized over a weighted average period of 2.82 years.

***Restricted Stock Awards***

The following table summarizes the unvested restricted stock award activity during the six months ended June 30, 2009:

| | Number of Shares | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Unvested at December 31, 2008 | 656,361 | $ 7.77 |
| Granted | 56,538 | 9.21 |
| Vested | (148,747) | 7.38 |
| Forfeited | | |
| Unvested at June 30, 2009 | 564,152 | 8.00 |

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

The fair value of the unvested restricted stock awards is measured using the closing price of our stock on the date of grant, or the estimated fair value of the common stock if granted prior to our IPO. The total compensation expense related to restricted stock awards for the three months ended June 30, 2009 and 2008 was $451,000 and $410,000, respectively, and $957,000 and $759,000 for the six months ended June 30, 2009 and 2008, respectively.

As of June 30, 2009, there was $2.2 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 2.49 years.

***Restricted Stock Units***

The following table summarizes the unvested restricted stock unit activity during the six months ended June 30, 2009:

| | Number of Shares | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Unvested at December 31, 2008 | | $ |
| Granted | 544,500 | 9.58 |
| Vested | | |
| Forfeited | | |
| Unvested at June 30, 2009 | 544,500 | $ 9.58 |

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

The fair value of the unvested restricted stock units is measured using the closing price of our stock on the date of grant. The total compensation expense related to restricted stock units for the three months and six months ended June 30, 2009 was $124,000, and $142,000, respectively. No restricted stock units were granted in 2008.

As of June 30, 2009, there was $3.1 million of unrecognized compensation expense, net of estimated forfeitures, related to unvested restricted stock units. This amount is expected to be recognized over a weighted-average period of 4.19 years.

***Employee Stock Purchase Plan***

On October 3, 2007, our stockholders approved the ESPP that had previously been approved by our Board of Directors. We adopted the ESPP to provide a means by which our employees, and the employees of any parent or subsidiary as may be designated by the Board of Directors, will be given an opportunity to purchase shares of our common stock. The ESPP allows eligible employees to purchase our common stock at 85% of the lower of the stock price at the beginning or end of the offering period, which generally is a six-month period. The Compensation Committee of our Board of Directors administers the ESPP. An aggregate of 1,000,000 shares of our common stock have been reserved for issuance under the ESPP. During the six months ended June 30, 2009, an aggregate of 40,826 shares were purchased under the ESPP for a total of $176,633. The total compensation expense related to the ESPP for the three months ended June 30, 2009 and 2008 was $45,000 and $32,000, respectively, and $82,000 and $70,000 for the six months ended June 30, 2009 and 2008.

**5. Earnings per Share**

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

The calculation of basic and diluted net income (loss) per share for the three months and six months ended June 30, 2009 and 2008 is summarized as follows (in thousands, except share and per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Net income (loss) | $ 633 | $ (3,124) | $ (484) | $ (6,620) |
| Weighted-average shares of common stock outstanding basic | 26,249,424 | 25,154,568 | 26,092,712 | 24,960,471 |
| Dilutive effect of employee stock plans | 1,302,245 | | | |
| Weighted-average shares of common stock outstanding diluted | 27,551,669 | 25,154,568 | 26,092,712 | 24,960,471 |
| Net income (loss): | | | | |
| Basic | $ 0.02 | $ (0.12) | $ (0.02) | $ (0.27) |
| Diluted | $ 0.02 | $ (0.12) | $ (0.02) | $ (0.27) |

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

| | Three Months Ended June 30, | | Six Months Ended, June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Options to purchase common stock | 690,857 | 3,111,583 | 3,206,181 | 3,112,167 |
| Restricted stock units | 61,835 | | 226,779 | |
| | 752,692 | 3,111,583 | 3,432,960 | 3,112,167 |

**6. Comprehensive Income (Loss)**

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

| | Three Months Ended June 30, | | Six Months Ended, June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Net income (loss) | $ 633 | $ (3,124) | $ (484) | $ (6,620) |
| Change in net unrealized gains (losses) on investments | (44) | (263) | (140) | 40 |
| Total comprehensive income (loss) | $ 589 | $ (3,387) | $ (624) | $ (6,580) |

**7. Fair Value Measurement**

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

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

The three levels of inputs used to measure fair value are as follows:

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

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

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

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

The following table presents our financial assets and liabilities that were accounted for at fair value as of June 30, 2009 by level within the fair value hierarchy (in thousands):

| | Assets at | Fair Value Measurement Using | | |
|---|---|---|---|---|
| | **Fair Value** | **Level 1** | **Level 2** | **Level 3** |
| Money market funds | $ 25,227 | $ 25,227 | $ | $ |
| Corporate debt investments | 11,912 | | 11,912 | |
| Commercial paper | 19,232 | | 19,232 | |
| Government-sponsored enterprises | 30,440 | | 30,440 | |
| Government securities | 1,000 | 1,000 | | |
| Certificate of deposit | 1,201 | | 1,201 | |
| Total cash equivalents and investments | 89,012 | $ 26,227 | $ 62,785 | $ |
| Cash | 19,276 | | | |
| Total cash, cash equivalents and investments | $ 108,288 | | | |

Assets and liabilities that are measured at fair value on a non-recurring basis include intangible assets, which are recognized at fair value when they are considered to be impaired. In the first six months of 2009, there were no fair value measurements for assets or liabilities on a non-recurring basis.

**8. Business and Geographic Segment Information**

We manage our operations on a consolidated basis for purposes of assessing performance and making operating decisions. Accordingly, we do not have reportable segments. Revenues by geographic area for the three months and six months ended June 30, 2009 and 2008 were as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| United States | $ 17,964 | $ 11,489 | $ 30,159 | $ 21,023 |
| All foreign countries | 4,207 | 4,529 | 10,612 | 8,646 |
| Consolidated total | $ 22,171 | $ 16,018 | $ 40,771 | $ 29,669 |

**9. Legal Proceedings**

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

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

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

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

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

On February 11, 2009, we filed a settlement stipulation and related papers with the Court, tentatively settling all claims in the litigation. The Court approved the settlement on June 12, 2009 and the Court s order approving the settlement became effective on July 12, 2009. The settlement resulted in the dismissal of the claims against all defendants. The settlement included a cash payment of $3.2 million by the defendants, $3.1 million of which was paid by our insurer and $0.1 million of which was paid by us. Neither we nor any of the other defendants admitted any wrongdoing in connection with the settlement.

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

**10. Commitments and Contingencies**

We purchase components for our products from a variety of suppliers and use several contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon information we provide. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. Consequently, a portion of our reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments. As of June 30, 2009, we had total purchase commitments for inventory of approximately $4.2 million due within the next 12 months.

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

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

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

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

**Introduction**

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

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

*Results of Operations*. This section provides an analysis of our results of operations for the three months and six months ended June 30, 2009 as compared to the three months and six months ended June 30, 2008.

*Liquidity and Capital Resources*. This section provides an analysis of our cash flows for the six months ended June 30, 2009 and a discussion of our capital requirements and the resources available to us to meet those requirements.

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

**Overview**

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

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

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***Key Financial Metrics and Trends***

Our financial results are affected by a number of factors, including broad economic conditions, the amount and type of technology spending of our customers, and the financial condition of our customers and the industries and geographic areas that we serve. During the second half of 2008 and continuing in 2009, the industries and geographic areas that we serve experienced weakness as macroeconomic conditions, credit market conditions, and levels of business confidence and activity deteriorated. We are continuing to monitor economic conditions and their potential effect on our customers and on us. A severe or prolonged economic downturn could affect our customers financial condition and the levels of business activity. This could reduce demand and depress pricing for our products and services, which could have a material adverse effect on our results of operations or financial condition.

During the three months and six months ended June 30, 2009, a significant portion of our revenue growth resulted from sales of our products to U.S. government agencies. Contracts with the U.S. federal and state government agencies accounted for 31% and 13% of our total revenue for the three months ended June 30, 2009 and 2008, respectively, and 23% and 11% for the six months ended June 30, 2009 and 2008, respectively. We expect sales to U.S. government agencies to continue to account for a significant portion of our total revenue in 2009. A reduction in the amount of U.S. government purchases of our products could have a material adverse effect on our results of operations or financial condition.

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

*Pricing and Discounts*

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

*Credit and Collections*

We evaluate the creditworthiness of our customers prior to accepting an order for our products and extending the customer terms of payment which typically range from 30 to 90 days from the date of our invoice. In the fourth quarter of 2008 and continuing in 2009, we experienced an increase in the aging of our outstanding receivables which we attributed to the decline in macroeconomic conditions and credit market conditions. As a result of the increase in our aging, we increased our reserve for uncollectible accounts. Any further decline in macroeconomic conditions may lead to a further increase in the aging of our receivables and we may have to increase our reserve as a result.

*Revenue*

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

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

We sell our network security solutions globally. However, 81% and 72% of our revenue for the three months ended June 30, 2009 and 2008, respectively, and 74% and 71% for the six months ended June 30, 2009 and 2008, respectively, was generated by sales to U.S.-based customers. We expect that our revenue from customers based outside of the United States will increase as we strengthen our international presence. We also expect that our revenue from sales through our indirect sales channel, comprised of resellers, distributors, managed security service providers, or MSSPs, government integrators and other partners, will increase in amount and as a percentage of total revenue as we expand our current relationships and establish new relationships with these third parties.

We continue to generate a majority of our product revenue through sales to existing customers, both for new locations and for additional technology to protect existing networks and locations. Product sales to existing customers accounted for 73% and 71% of total product revenue for the three months ended June 30, 2009 and 2008, respectively, and 75% and 69% of total product revenue for the six months ended June 30, 2009 and 2008, respectively. We expect product sales to existing customers to continue to account for a significant portion of our product revenue in 2009.

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

*Cost of Revenue*

Cost of product revenue includes the cost of the hardware platform bundled into our network security solution, royalties for third-party software included in our network security solution, materials and labor that are incorporated in the quality assurance of our products, logistics, warranty, shipping and handling costs, expense for inventory obsolescence and, in the limited instances where we lease our network security solutions to our customers, depreciation and amortization. We incur labor and allocated overhead costs as part of managing our outsourced manufacturing process. Allocated overhead costs include facilities, supplies, communication and information systems and employee benefits. Overhead costs are reflected in each cost of revenue and operating expense category. As our product volume increases, we anticipate incurring an increasing amount of both direct and overhead expenses to supply and manage the increased volume. Hardware unit costs, our most significant cost item, have generally remained constant on a per unit basis; however, hardware unit costs or other costs of manufacturing may increase in the future.

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

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*Gross Profit*

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

*Operating Expenses*

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

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

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

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

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

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

We use the Black-Scholes option pricing model to estimate the fair value of stock options granted and employee stock purchases. For certain option awards that contain market conditions relating to our stock price achieving specified levels, we use a Lattice option pricing model. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility. Based on the estimated grant date fair value of stock-based awards, we recognized aggregate stock-based compensation expense of $1.4 million and $881,000 for the three months ended June 30, 2009 and 2008, respectively, and $2.6 million and $1.8 million for the six months ended June 30, 2009 and 2008, respectively.

**Results of Operations**

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

| | Three Months Ended June 30, | | Variance | | Six Months Ended June 30, | | Variance | |
|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | **$** | **%** | **2009** | **2008** | **$** | **%** |
| Products | $ 12,280 | $ 8,677 | $ 3,603 | 42% | $ 22,148 | $ 15,528 | $ 6,620 | 43% |
| *Percentage of total revenue* | *55%* | *54%* | | | *54%* | *52%* | | |
| Technical support and professional services | 9,891 | 7,341 | 2,550 | 35% | 18,623 | 14,141 | 4,482 | 32% |
| *Percentage of total revenue* | *45%* | *46%* | | | *46%* | *48%* | | |
| Total revenue | $ 22,171 | $ 16,018 | $ 6,153 | 38% | $ 40,771 | $ 29,669 | $ 11,102 | 37% |

The increase in our product revenue for the three months and six months ended June 30, 2009, as compared to the prior-year periods, was mostly driven by higher volume demand for our sensor products, primarily our higher performance 3D products. For the three months and six months ended June 30, 2009, sensor product revenue increased $3.6 million and $7.2 million, respectively, over the prior-year periods, which included a $2.2 million and $4.8 million increase, respectively, in our higher performance 3D products.

The increase in our services revenue for the three months and six months ended June 30, 2009, as compared to the prior-year period, resulted from an increase in our installed customer base due to new product sales in which associated support was purchased, as well as support renewals by our existing customers.

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

| | Three Months Ended June 30, | | Variance | | Six Months Ended June 30, | | Variance | |
|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | **$** | **%** | **2009** | **2008** | **$** | **%** |
| Products | $ 3,682 | $ 2,479 | $ 1,203 | 49% | $ 6,449 | $ 4,476 | $ 1,973 | 44% |
| *Percentage of total revenue* | *17%* | *15%* | | | *16%* | *15%* | | |
| Technical support and professional services | 1,393 | 1,197 | 196 | 16% | 2,775 | 2,238 | 537 | 24% |
| *Percentage of total revenue* | *6%* | *7%* | | | *7%* | *8%* | | |
| Total cost of revenue | $ 5,075 | $ 3,676 | $ 1,399 | 38% | $ 9,224 | $ 6,714 | $ 2,510 | 37% |
| *Percentage of total revenue* | *23%* | *23%* | | | *23%* | *23%* | | |

For the three months and six months ended June 30, 2009, the increase in product cost of revenue, as compared to the prior-year periods, was driven primarily by higher volume demand for our sensor products, for which we must procure and provide the hardware platform to our customers, and a write-down of $833,000 for excess and obsolete inventory as a result of the introduction of newer products. The increase in our services cost of revenue for the three months and six months ended June 30, 2009 was attributable to increased hardware service expense related to support renewal contracts and our hiring of additional personnel to both service our larger installed customer base and to provide training and professional services to our customers.

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

| | Three Months Ended June 30, | | Variance | | Six Months Ended June 30, | | Variance | |
|---|---|---|---|---|---|---|---|---|
| | **2009** | **2008** | **$** | **%** | **2009** | **2008** | **$** | **%** |
| Products | $ 8,598 | $ 6,198 | $ 2,400 | 39% | $ 15,699 | $ 11,052 | $ 4,647 | 42% |
| *Product gross margin* | *70%* | *71%* | | | *71%* | *71%* | | |
| Technical support and professional services | 8,498 | 6,144 | 2,354 | 38% | 15,848 | 11,903 | 3,945 | 33% |
| *Technical support and professional services gross margin* | *86%* | *84%* | | | *85%* | *84%* | | |
| Total gross profit | $ 17,096 | $ 12,342 | $ 4,754 | 39% | $ 31,547 | $ 22,955 | $ 8,592 | 37% |
| *Total gross margin* | *77%* | *77%* | | | *77%* | *77%* | | |

Product gross margin for the three months and six months ended June 30, 2009 remained relatively constant compared to the prior-year periods, as higher margins on product revenue, primarily due to the product mix sold favoring products with higher gross margins, were offset by a write-down of $833,000 for excess and obsolete inventory as a result of the introduction of newer products.

Services gross margin for the three months and six months ended June 30, 2009, as compared to the prior-year periods, increased slightly, primarily due to service revenue increasing at a higher rate than service expense.

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

| | Three Months Ended June 30, | | Variance | | Six Months Ended June 30, | | Variance | |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2008 | $ | % | 2009 | 2008 | $ | % |
| Research and development | $ 3,396 | $ 3,147 | $ 249 | 8% | $ 6,716 | $ 6,258 | $ 458 | 7% |
| *Percentage of total revenue* | *15%* | *20%* | | | *16%* | *21%* | | |
| Sales and marketing | 8,428 | 7,945 | 483 | 6% | 16,298 | 15,179 | 1,119 | 7% |
| *Percentage of total revenue* | *38%* | *50%* | | | *40%* | *51%* | | |
| General and administrative | 3,992 | 4,531 | (539) | (12)% | 7,835 | 8,945 | (1,110) | (12)% |
| *Percentage of total revenue* | *18%* | *28%* | | | *19%* | *30%* | | |
| Depreciation and amortization | 830 | 585 | 245 | 42% | 1,651 | 1,077 | 574 | 53% |
| *Percentage of total revenue* | *4%* | *4%* | | | *4%* | *4%* | | |
| Total operating expenses | $ 16,646 | $ 16,208 | $ 438 | 3% | $ 32,500 | $ 31,459 | $ 1,041 | 3% |
| *Percentage of total revenue* | *75%* | *101%* | | | *80%* | *106%* | | |

Research and development expenses for the three months ended June 30, 2009 increased over the prior-year quarter, primarily due to an increase of $320,000 in salaries, incentive compensation and allocated overhead costs as a result of additional personnel and increased overhead costs, partially offset by a decrease of $111,000 in consulting fees. For the six months ended June 30, 2009, research and development expenses increased over the prior year period, primarily due to an increase of $482,000 in salaries, incentive compensation and allocated overhead costs as a result of additional personnel and increased overhead costs.

Sales and marketing expenses for the three months ended June 30, 2009 increased over the prior-year quarter, primarily due to an increase of $517,000 in salary, commissions and incentive compensation and allocated overhead costs as a result of additional sales and marketing personnel, increased revenue and increased overhead costs, and an increase of $203,000 in consulting fees, partially offset by a decrease of $261,000 in advertising, promotion, partner-marketing programs and trade show expenses and a decrease of $150,000 in travel and travel-related expenses. For the six months ended June 30, 2009, sales and marketing expenses increased over the prior year period, primarily due to an increase of $1.2 million in salary, commissions and incentive compensation and allocated overhead costs as a result of additional sales and marketing personnel, increased revenue and increased overhead costs, and an increase of $313,000 in consulting fees and an increase of $138,000 in stock-based compensation expense, partially offset by a decrease of $454,000 in advertising, promotion, partner-marketing programs and trade show expenses and a decrease of $312,000 in travel and travel-related expenses.

General and administrative expenses for the three months ended June 30, 2009 decreased from the prior-year quarter, primarily due to a decrease of $793,000 in corporate development expenses and professional fees related to legal, accounting, information technology, audit, tax and regulatory compliance and a decrease of $386,000 for a one-time charge associated with our CEO transition in the prior year, partially offset by an increase of $262,000 in salaries, incentive compensation and allocated overhead costs for personnel hired in our accounting, information technology, human resources and legal departments and increased overhead costs, and an increase of $317,000 in stock-based compensation expense. For the six months ended June 30, 2009, general and administrative expenses decreased over the prior year, primarily due to a decrease of $1.5 million in corporate development expenses and professional fees related to legal, accounting, information technology, audit, tax and regulatory compliance, a decrease of $224,000 in director attendance, retainer and other board-related fees and a decrease of $742,000 for a one-time charge associated with our CEO transition in the prior year, partially offset by an increase of $700,000 in salaries, incentive compensation and allocated overhead costs for personnel hired in our accounting, information technology, human resources and legal departments and increased overhead costs, and an increase of $510,000 in stock-based compensation expense.

Depreciation and amortization expense for the three months and six months ended June 30, 2009 increased over the prior-year periods, primarily due to the depreciation associated with our new enterprise resource planning, or ERP, system, as well as the depreciation of additional lab and testing equipment purchased for our engineering department and computers purchased for personnel hired.

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

| | Three Months Ended June 30, 2009 | Three Months Ended June 30, 2008 | Variance $ | Variance % | Six Months Ended June 30, 2009 | Six Months Ended June 30, 2008 | Variance $ | Variance % |
|---|---|---|---|---|---|---|---|---|
| Other income, net | $252 | $781 | $(529) | (68)% | $613 | $1,985 | $(1,372) | (69)% |
| *Percentage of total revenue* | *1%* | *5%* | | | *2%* | *7%* | | |
| Income tax expense | $ 69 | $ 39 | $ 30 | 77% | $144 | $ 101 | $ 43 | 43% |
| *Percentage of total revenue* | *0%* | *0%* | | | *0%* | *0%* | | |

Other income, net for the three months and six months ended June 30, 2009 decreased from the prior-year periods, primarily due to a decrease in interest and investment income as a result of lower average interest rates on invested cash balances.

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 June 30, 2009 and December 31, 2008, our deferred tax assets were fully reserved, except for a $71,000 benefit which is expected to be available to offset foreign tax liabilities in the future. The provision for income taxes for the three months and six months ended June 30, 2009 and 2008 primarily related to foreign income taxes.

***Seasonality***

Our product revenue has tended to be seasonal, with a significant portion generated in the third and fourth quarters. In our third quarter, sales have historically benefited from the U.S. 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. In the fourth quarter, sales have historically been strong due to purchases by 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, and increased activity in Europe. While we expect this historical trend of a lower portion of our annual revenue in the first half of the year and a more significant portion of our annual revenue in the third and fourth quarters to continue, any further decline in general economic conditions in the third and fourth quarters and the effects of increased U.S. government spending in the first and second quarters may result in this trend being less pronounced in 2009. The timing of these transactions could materially affect our quarterly or annual product revenue.

***Quarterly Timing of Revenue***

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

**Liquidity and Capital Resources**

***Cash Flows***

| | Six Months Ended June 30, | |
|---|---|---|
| | **2009** | **2008** |
| | (in thousands) | |
| Cash and cash equivalents: | | |
| Provided by operating activities | $ 6,722 | $ 434 |
| (Used in) provided by investing activities | (1,165) | 5,211 |
| Provided by financing activities | 1,378 | 508 |
| Increase in cash and cash equivalents | 6,935 | 6,153 |
| Net cash and cash equivalents at beginning of period | 39,768 | 33,071 |
| Net cash and cash equivalents at end of period | 46,703 | 39,224 |
| Investments | 61,585 | 64,911 |
| Total cash, cash equivalents and investments | $ 108,288 | $ 104,135 |

*Operating Activities*. Cash provided by operating activities for the six months ended June 30, 2009 is the result of our net loss of $484,000 adjusted for $4.3 million of net non-cash revenues and expenses and changes in our operating assets and liabilities of $2.9 million. Receivables decreased $6.0 million primarily as a result of collections from our large year-end receivable balance. Cash provided by operating activities for the six months ended June 30, 2008 is the result of our net loss of $6.6 million adjusted for $2.2 million of net non-cash revenues and expenses and changes in working capital of $4.8 million.

*Investing Activities*. Cash used in investing activities for the six months ended June 30, 2009 was primarily the result of purchases of investments of $44.4 million and capital expenditures of $1.3 million, offset by maturities of investments of $44.6 million. Cash provided by investing activities for the six months ended June 30, 2008 was primarily the result of maturities of investments of $56.1 million, offset by purchases of investments of $49.6 million and capital expenditures of $4.6 million. Capital expenditures for the six months ended June 30, 2008 includes $2.0 million of capitalized costs associated with the implementation of our new ERP system.

*Financing Activities*. Cash provided by financing activities for the six months ended June 30, 2009 was primarily the result of proceeds from the issuance of common stock under our employee stock-based plans. Cash provided by financing activities for the six months ended June 30, 2008 was primarily the result of proceeds from the issuance of common stock under our employee stock-based plans.

***Liquidity Requirements***

We manufacture our products through contract manufacturers and other third parties. This approach provides us with the advantage of relatively low capital 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 June 30, 2010 consist primarily of the funding of working capital requirements and capital expenditures. We expect to meet these short-term requirements primarily through cash flow from operations. To the extent that cash flow from operations is not sufficient to meet these requirements, we expect to fund these amounts through the use of existing cash and investment resources. As of June 30, 2009, we had cash, cash equivalents and investments of $108.3 million and working capital of $100.3 million.

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

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

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

**Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires the use of estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. An accounting estimate is considered critical if: the estimate requires management to make assumptions about matters that were highly uncertain at the time the estimate was made; different estimates reasonably could have been used; or the impact of the estimates and assumptions on financial condition or operating performance is material. We evaluate our estimates and assumptions on an ongoing basis. Our actual results may differ from these estimates.

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

*Revenue Recognition.* We recognize substantially all of our revenue in accordance with AICPA Statement of Position, or 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. 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 is generally 12 months. The vendor-specific objective evidence of fair value of our other services is based on the price for these same services when they are sold separately. 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.* SFAS No. 123(R) requires the use of a valuation model to calculate the fair value of stock-based awards. We use the Black-Scholes option pricing model for estimating the fair value of stock options granted and for employee stock purchases under the 2007 Employee Stock Purchase Plan (the ESPP ). For certain option awards that contain market conditions relating to our stock price achieving certain levels, we use a Lattice option pricing model. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected price volatility. Additionally, the recognition of expense requires the estimation of the number of options that will ultimately vest and the number of options that will ultimately be forfeited. Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures.

The following are the assumptions used in the Black-Scholes option valuation of stock options granted under our plans and employee stock purchases under the ESPP.

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

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

*Expected useful life* This is the period of time that stock options granted under our option plans and employee purchases under the ESPP are expected to remain outstanding.

For stock options granted under the 2002 Plan and the 2007 Plan, this estimate is derived from the average midpoint between the weighted-average vesting period and the contractual term as described in the SEC s Staff Accounting Bulletin, or SAB, No. 107, Share-Based Payment, as amended by SAB No. 110. In future periods, we expect to begin to incorporate our own data in estimating the expected life as we develop appropriate historical experience of employee exercise and post-vesting termination behavior considered in relation to the contractual life of the option.

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

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

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

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

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

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

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

*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 basis of assets and liabilities recorded for financial reporting purposes and the amounts recognized for income tax purposes. We record a

valuation allowance to reduce deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of June 30, 2009 and December 31, 2008, our deferred tax assets were fully reserved except for foreign deferred tax assets of $71,000, expected to be available to offset foreign tax liabilities in the future. Our provision for income taxes primarily relates to foreign income taxes.

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

*Allowance for Doubtful Accounts and Sales Returns.* We make estimates regarding the collectability of our accounts receivable. When we evaluate the adequacy of our allowance for doubtful accounts, we consider multiple factors including historical write-off experience, the need for specific customer reserves, the aging of our receivables, customer creditworthiness and changes in 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 if it 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.

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

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

*Investments.* We account for investments in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. We determine the appropriate classification of debt securities at the time of purchase and reevaluate such designation as of each balance sheet date. Our investments are comprised of money market funds, corporate debt investments, asset-backed securities, commercial paper, government-sponsored enterprises, government securities and certificates of deposit. These investments have been classified as available-for-sale. Available-for-sale investments are stated at fair value, with the unrealized gains and losses, net of tax, reported in accumulated other comprehensive income. The amortization of premiums and accretion of discounts to maturity are computed under the effective interest method. Such amortization is included in interest and investment income. Interest on securities classified as available-for-sale is also included in interest and investment income.

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

***Recent Accounting Pronouncements***

On January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements.* In February 2008, the FASB issued FASB Staff Position, or FSP, No. 157-2, *Effective Date of FASB Statement No. 157* ( FSP 157-2 ), which delayed the effective date of SFAS No. 157 by one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On January 1, 2009, we adopted SFAS No. 157 for non-financial assets and liabilities. The adoption of SFAS No. 157 as it pertains to non-financial assets and non-financial liabilities did not have a material impact on our financial statements. See Note 7 to our consolidated financial statements for additional discussion of fair value measurements.

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 No. 141R is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 141R did not have a material impact on our consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The FSP amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments,* and APB Opinion No. 28, *Interim Financial Reporting*, to require disclosures about the fair value of financial instruments during interim reporting periods. The effective date for this FSP is interim and annual periods ending after June 15, 2009. The adoption of this FSP did not have a material impact on our consolidated financial statements.

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

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

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events*. This standard is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS No. 165 is effective for fiscal years and interim periods ended after June 15, 2009. The adoption of SFAS No. 165 did not have a material impact on our consolidated financial statements.

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

No material changes in our market risk occurred from December 31, 2008 through June 30, 2009. Information regarding our market risk at December 31, 2008, is contained in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the year ended December 31, 2008.

**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 Control Over Financial Reporting.* There were no changes in our internal control 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 have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS**

On May 29, 2009 and August 3, 2009, Enhanced Security Research, LLC, or ESR, filed two nearly identical complaints in the United States District Court for the District of Delaware against 10 defendants, including Cisco Systems, Inc., International Business Machines Corporation, Check Point Software Technologies, Ltd., Check Point Software Technologies, Inc., Sonicwall, Inc., 3Com Corporation, Nokia Corporation, Nokia, Inc., Fortinet, Inc., and us. The only significant difference between the first and second complaints is the addition of Security Research Holdings LLC as a plaintiff. The complaints allege, among other things, that our network security appliances and software infringe two U.S. patents. Plaintiffs seek unspecified damages, enhancement of those damages, an attorney s fee award and an injunction against further infringement. We believe that the allegations of infringement against us are without merit, and we intend to defend this case vigorously on that basis. Given the inherent unpredictability of litigation and jury trials, we cannot at this early stage of the matter estimate the possible outcome of this litigation. Because patent litigation is time consuming and costly to defend, we may incur significant costs related to this matter in future periods. In addition, an unfavorable outcome in this matter could have a material adverse effect on our future results of operations or cash flows.

For a discussion of other pending legal proceedings, see Note 9, 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, 2008 and in Part II, Item 1A. Risk Factors of our Quarterly Report on Form 10-Q for the three months ended March 31, 2009.

***Economic, market and political conditions, including the current global recession, may adversely affect our revenue and results of operations.***

Our business depends significantly on 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.

The ongoing global financial recession has resulted in the significant weakening of the economy in the United States and of the global economy, the lack of availability of credit, the reduction in business confidence and activity, and other factors that may affect one or more of the industries to which we sell 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. These customers may suffer from reduced operating budgets, which could cause them to defer or forego purchases of our products or services. In addition, negative effects on the financial condition of our resellers and distributors could affect their ability or willingness to market our product and service offerings; negative effects on the financial condition of our product manufacturers could affect their ability to manufacture our products; and declines in economic and market conditions could impair our short-term investment portfolio. Any of these developments would adversely affect our revenue and results of operations.

***We have had operating losses each year since our inception, our operating expenses may continue to increase and we may never reach or maintain profitability.***

We have incurred operating losses each year since our inception in 2001. 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. Our operating

expenses may continue to increase in the future as we seek to expand our customer base, increase our sales and marketing efforts and continue to invest in research and development of our technologies and products. These efforts may be more costly than we expect and we may not be able to increase our revenue to offset our operating expenses. 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.

For example, Cisco Systems, Inc., McAfee, Inc., 3Com Corporation, Juniper Networks, Inc. and IBM have intrusion detection or prevention technologies that compete with our product offerings. 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 aggressively reduced, and could continue to reduce, the price of their security monitoring, detection, prevention and response products, managed security services, and maintenance and support 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 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 and 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. 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, 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 resellers, distributors, MSSPs, government integrators and other partners;
- 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 may 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.

***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 enhance versions of Snort, the Defense Center and our 3D Sensor and RNA products to incorporate additional features, improve functionality or add 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 renew their support arrangements with us, or if our relationships with our largest customers are impaired, our revenue could decline.***

In the six months ended June 30, 2009 and 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. 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. If customers choose not to continue their maintenance service or seek to renegotiate the terms of maintenance and support agreements prior to renewing such agreements, our revenue may decline.

***The U.S. government has contributed to our revenue growth and has become an important customer for us. If we cannot attract sufficient government agency customers, our revenue and competitive position will suffer.***

The U.S. government has become an important customer for the network security market and for us. There can be no assurance that we will maintain or grow our revenue from the U.S. government. Contracts with the U.S. federal and state government agencies accounted for 23% and 11% of our total revenue for the six months ended June 30, 2009 and 2008, respectively. Our reliance on government customers 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 the United States and internationally, and we plan to increase our international sales presence. Therefore, we are subject to risks associated with having worldwide operations. Sales to customers located outside of the United States accounted for 26% and 29% of our total revenue for the six months ended June 30, 2009 and 2008, respectively. 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, or to make acquisitions.***

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, or 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.

***If we are not able to acquire additional businesses, products or technologies, our long-term growth strategy could be harmed; acquisitions could also negatively affect our results of operations and financial condition.***

We may seek to buy or make investments in complementary or competitive businesses, products or technologies as part of our long-term growth strategy. We may not be successful in making these acquisitions. We may face competition for acquisition opportunities from other companies, including larger companies with greater financial resources. We may incur substantial expenses in identifying and negotiating acquisition opportunities, whether or not completed. Acquisitions may not result in the expected strategic benefits, and completed acquisitions may negatively affect our operating results and financial position because of the following and other factors:

- we may not effectively integrate an acquired business, product or technology into our existing business and operations;

- completing a potential acquisition and integrating an acquired business could significantly divert management s time and resources from the operation of our business;

- a completed acquisition may not be accretive to earnings;

- acquisitions may result in substantial accounting charges for restructuring and other expenses, write-offs of in-process research and development, amortization of intangible assets and stock-based compensation expense;

- acquired companies, particularly privately held and non-US companies, may have internal controls, policies and procedures that do not meet the requirements of the Sarbanes-Oxley Act and public accounting standards;

- we may use a significant portion of our cash resources to fund acquisitions; and

- we may issue stock to fund acquisitions, which could dilute the interests of our existing stockholders.

***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 provided 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 (including patent rights);

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

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

- the open source software licenses generally do not include a license to any patents.

***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 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.

***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 four patents issued and 32 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.

***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.

***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. Third parties may assert claims or initiate litigation related to exclusive copyright, trademark, patent, trade secret or other intellectual property rights with respect to technologies that are relevant to our business. For example, as described under Legal Proceedings above, we have been named as a defendant in a patent infringement lawsuit brought by Enhanced Security Research, or ESR. Third party asserted claims and/or initiated litigation can include claims against us or our customers, end-users, manufacturers, suppliers, partners or distributors, alleging infringement of intellectual property rights with respect to our existing or future products (or components of those products). Any such intellectual property claims, with or without merit, could:

- be very expensive and time consuming to defend;
- require us to indemnify our customers or others 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;

require us to enter into royalty or licensing agreements, which may not be available on acceptable terms, or at all, in order to obtain the right to use a necessary product or component;

divert the attention of management and technical personnel and other resources; or

result in our paying significant amounts to settle such claims.

ESR s complaint alleges, among other things, that our network security appliances and software infringe two U.S. patents. Plaintiffs seek unspecified damages, enhancement of those damages, an attorney s fee award and an injunction against further infringement. We believe that the allegations of infringement against us are without merit, and we intend to defend this case vigorously on that basis. Given the inherent unpredictability of litigation and jury trials, we cannot at this early stage of the matter estimate the possible outcome of this litigation. Because patent litigation is time consuming and costly to defend, we may incur significant costs related to this matter in future periods. In addition, an unfavorable outcome in this matter could have a material adverse effect on our future results of operations or cash flows.

The application of patent law to the software industry is particularly uncertain, as the U.S. Patent and Trademark Office, or PTO, has only recently begun to issue software patents in large numbers, and there is a backlog of software-related patent applications pending that claim inventions whose priority dates may pre-date development of our own proprietary technology. As a general matter, until the PTO issues a patent to an applicant, there can be no way to determine whether a product (or any of its components) will infringe a pending patent. In addition, the large number of patents in the Internet, networking, security and software fields may make it impractical to determine in advance whether a product (or any of its components) infringe the patent rights of others. Notwithstanding any such determination by us, we may be subject to claims, with or without merit, that our products infringe on the patent rights of others. It is conceivable that other companies have patents with respect to technology similar to our technology, including RNA and ClamAV. Our RNA technology, which is a new technology for which we have not yet been issued a patent, is the subject of 10 of our 32 pending patent applications which we began filing in 2004. Other companies have been issued patents, and have filed patent applications, that, on their face, contain claims that may be construed to be within the scope of the same broad technology area as our RNA technology. Although we do not believe that any of our products infringe upon the patent claims of others, there can be no assurance that such companies will not bring action against us based upon issued patents, or later on the basis of future patents when, and if, they issue. Similarly, while we have not sought to patent the ClamAV technology, which we acquired in August 2007, it competes with the product offerings of third parties who have extensive portfolios of patents in the same broad technology area as our ClamAV technology.

***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 June 30, 2014. Our agreement with MySQL gives 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 products would harm our reputation and business 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.

***Future litigation could have a material adverse impact on our results of operation, financial condition and liquidity.***

In addition to intellectual property litigation, from time to time we have been, and may be in the future, subject to litigation, including stockholder derivative actions. 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, with or without merit, and these proceedings may result in substantial costs and divert management s attention and resources.

***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 primarily utilize a just-in-time contract manufacturing and inventory process and depend on a limited number of manufacturers of our hardware products, 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 a limited number of contract manufacturers. For the intrusion sensor products that are used by our enterprise class customers, we rely on a limited number of manufacturers, each of which is the sole manufacturer of the hardware platforms for certain models of our intrusion sensor products. The unexpected termination of our relationship with any of these manufacturers would be disruptive to our business and our reputation, and 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.

In addition, our contract manufacturers obtain materials from a limited number of suppliers. 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.

***In some cases, we purchase products from contract manufacturers and hold them in inventory pending sale to our customers. If demand for these products does not meet our expectations, or if these products become obsolete, we could be required to write down the value of our inventory, which would adversely affect our results of operations.***

Although we primarily utilize a just-in-time contract manufacturing and inventory process, in some cases we purchase products from contract manufacturers based on our expectations of future demand. We then hold these products in inventory pending sale to our customers. Demand for these products may not meet our expectations as a result of a number of factors, including: weakness in general economic conditions; reductions in our customers purchasing budgets, discounting of prices on competitive products; defects or perceived defects in the products; or the introduction by us or our competitors of new or enhanced products. If we reduce our estimate of future demand for our products held in inventory, or if such products become obsolete, we may recognize expenses relating to inventory write-offs, which would negatively impact our gross margin and results of operations.

***We depend on resellers, distributors and other partners 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, distributors, MSSPs, government integrators and other partners that permit them to resell our products and service offerings. 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, distributors and other partners 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 indirect distribution channels, 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, distributors, MSSPs, government integrators and other partners. We have agreements with third parties for the distribution of our products and we cannot predict the extent to which these companies will be successful in marketing or selling our products. Our agreements with these companies could be terminated on short notice, and they do not prevent these companies from selling the network security software of other companies, including our competitors. Any distributor of our products could give higher priority to other companies products or to their own products than they give to ours, which could cause our revenue to decline.

***Our inability to hire or retain key personnel would slow our growth.***

Our business is dependent on our ability to hire, retain and motivate highly qualified personnel, including 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 addition, our future success will depend to a significant extent on the continued services of our executive officers and senior personnel. Although we have adopted retention plans applicable to certain of these officers, 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.

***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. We have grown from 261 employees at June 30, 2008 to 285 employees at June 30, 2009. 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 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, and 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.

***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.

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***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 August 4, 2009, we had 26,605,435 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 shares held by directors, officers and venture capital funds that invested in Sourcefire prior to our IPO, and who may sell such shares at their discretion subject, in some cases, 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.

***Our business is subject to complex corporate governance, public disclosure, accounting and tax requirements that have increased both our costs and the risk of noncompliance.***

Because our common stock is publicly traded, we are subject to certain rules and regulations of federal, state and financial market exchange entities charged with the protection of investors and the oversight of companies whose securities are publicly traded. These entities, including the Public Company Accounting Oversight Board, the SEC, and NASDAQ, have implemented requirements and regulations and continue developing additional regulations and requirements in response to corporate scandals and laws enacted by Congress, most notably the Sarbanes-Oxley Act of 2002. Our efforts to comply with these regulations have resulted in, and are likely to continue resulting in, increased general and administrative expenses and diversion of management time and attention from revenue-generating activities to compliance activities.

We completed our evaluation of our internal controls over financial reporting for the fiscal year ended December 31, 2008 as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing and evaluation resulted in our conclusion that as of December 31, 2008, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. If our internal controls are ineffective in future periods, our business and reputation could be harmed. We may incur additional expenses and commitment of management s time in connection with further evaluations, either of which could materially increase our operating expenses and accordingly increase our net loss.

Because new and modified laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

***Any material disruption or problem with the operation of our enterprise resource planning 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 have implemented a new enterprise resource planning, or ERP, system. As part of the implementation of this ERP system, we were required to modify a number of operational processes and internal control procedures.

We cannot assure you that the system will work as we currently intend. Any material disruption or similar problems with the operation of this ERP 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 modifications and the growth of our business could be harmed.

***Potential uncertainty resulting from unsolicited acquisition proposals and related matters may adversely affect our business.***

During the second quarter of 2008, we received two unsolicited proposals from a privately held company to acquire all of the outstanding shares of our common stock. In each case, our Board of Directors, after carefully reviewing the proposal, unanimously concluded that the proposal was not in the best interests of Sourcefire and its stockholders. The review and consideration of the acquisition proposals and related matters required the expenditure of significant time and resources by us. There can be no assurance we will not, in the future, receive unsolicited proposals to acquire us. Such proposals may create uncertainty for our employees, customers and business partners. Any such uncertainty could make it more difficult for us to retain key employees and hire new talent, and could cause our customers and business partners to not enter into new arrangements with us or to terminate existing arrangements. Additionally, we and members of our Board of Directors could be subject to future lawsuits related to unsolicited proposals to acquire us. Any such future lawsuits could become time consuming and expensive. These matters, alone or in combination, may harm our business.

***Anti-takeover provisions in our charter documents and under Delaware law and our adoption of a stockholder rights plan 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 certificate of incorporation and our bylaws 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 of our certificate of incorporation and bylaws and Delaware law and our stockholder rights plan, which is described below, 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.

In October 2008, our Board of Directors adopted a stockholder rights plan, which we refer to as the Rights Plan, and declared a dividend distribution of one preferred share purchase right, or Right, to be paid for each outstanding share of our common stock to stockholders of record as of November 14, 2008. Each Right, when exercisable, will entitle the registered holder to purchase from us one one-hundredth of a share of a newly designated Series A Junior Participating Preferred Stock at a purchase price of $30.00, subject to adjustment. The Rights expire on October 30, 2018, unless they are earlier redeemed, exchanged or terminated as provided in the Rights Plan. Each such fractional share of the new preferred stock has terms designed to make it substantially the economic equivalent of one share of common stock. Initially the Rights will not be exercisable and will trade with our common stock. Generally, the Rights may become exercisable if a person or group acquires beneficial ownership of 15% or more of our common stock or commences a tender or exchange offer upon consummation of which such person or group would beneficially own 15% or more of our common stock. Such person or group is referred to as an acquiring person. At such time as the Rights become exercisable, each holder of a Right (except Rights held by an acquiring person) shall thereafter have the right to receive, upon exercise, preferred stock or, at our option, shares of common stock having a value equal to two times the exercise price of the Right. Because the Rights may substantially dilute the stock ownership of a person or group attempting to take us over without the approval of our Board of Directors, our Rights Plan could make it more difficult for a third party to acquire us (or a significant percentage of our outstanding capital stock) without first negotiating with our Board of Directors regarding such acquisition.

## 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. The offer and sale of these shares were registered under the Securities Act of 1933, as amended, pursuant to our Registration Statement on Form S-1, as amended (File No. 333-138199), which was declared effective by the SEC on March 8, 2007. 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**

We held an annual meeting of our stockholders on May 14, 2009. The results of the voting on the matters submitted to the stockholders are as follows:

1. To elect the following two nominees for election as directors to hold office until the 2012 Annual Meeting of Stockholders:

| | Votes For | Withheld |
|---|---|---|
| Michael Cristinziano | 18,115,313 | 2,771,661 |
| Steven R. Polk | 17,316,374 | 3,570,600 |

2. To ratify the appointment of Ernst & Young LLP to serve as our independent registered public accounting firm the year ending December 31, 2009. The voting tabulation on the matter was 20,568,990 votes for, 275,614 votes against, and 42,370 abstentions.

**Item 5. OTHER INFORMATION**

None.

**Item 6. EXHIBITS**

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

**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 August 7, 2009.

**SOURCEFIRE, INC.**

By: /s/ John C. Burris

John C. Burris
Chief Executive Officer
(duly authorized officer)

By: /s/ Todd P. Headley

Todd P. Headley
Chief Financial Officer and Treasurer
(principal financial and accounting officer)

## Exhibit Index

| Exhibit Number | Exhibit Description | Incorporation by Reference Form | File Number | Exhibit | File Date | Filed with this 10-Q |
|---|---|---|---|---|---|---|
| 3.1 | Sixth Amended and Restated Certificate of Incorporation | 10-Q | 1-33350 | 3.1 | 5/4/2007 | |
| 3.2 | Fifth Amended and Restated Bylaws | 10-K | 1-33350 | 3.2 | 3/16/2009 | |
| 3.3 | Certificate of Designation of the Series A Junior Participating Preferred Stock | 8-A | 1-33350 | 3.1 | 10/30/2008 | |
| 4.1 | Form of stock certificate of common stock | S-1/A | 333-138199 | 4.1 | 3/6/2007 | |
| 4.2 | Rights Agreement, dated as of October 30, 2008, by and between the Company and Continental Stock Transfer & Trust Co., as rights agent | 8-A | 1-33350 | 4.1 | 10/30/2008 | |
| 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 |