SOURCEFIRE INC
Form 10-Q
August 02, 2012

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

FORM 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2012

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

For the transition period from to
Commission File Number
1-33350
SOURCEFIRE, INC.
(Exact name of Registrant as Specified in its Charter)

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

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

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

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

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

Large Accelerated Filer	ý	Accelerated Filer	¨
Non-Accelerated Filer	¨ (Do not check if smaller reporting company)	Smaller reporting Company	¨

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

As of July 31, 2012, there were 29,942,647 outstanding shares of the registrant's Common Stock.

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Part I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS

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

	June 30, 2012 (unaudited)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$77,537	$59,407
Short-term investments	93,519	68,858
Accounts receivable, net of allowances of $830 as of June 30, 2012 and $1,062 as of December 31, 2011	47,065	54,914
Inventory	5,868	4,285
Deferred tax assets	1,699	1,719
Prepaid expenses and other current assets	8,249	7,718
Total current assets	233,937	196,901
Property and equipment, net	13,874	12,233
Goodwill	15,000	15,000
Intangible assets, net	5,139	5,822
Investments	10,869	29,549
Deferred tax assets	9,621	9,620
Other assets	19,042	14,802
Total assets	$307,482	$283,927
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$5,558	$5,407
Accrued compensation and related expenses	10,822	10,618
Other accrued expenses	5,539	7,212
Current portion of deferred revenue	52,465	50,606
Other current liabilities	604	572
Total current liabilities	74,988	74,415
Deferred revenue, less current portion	14,761	10,964
Other long-term liabilities	757	691
Total liabilities	90,506	86,070
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value; 19,700,000 shares authorized; no shares issued or outstanding	—	—
Series A junior participating preferred stock, $0.001 par value; 300,000 shares authorized; no shares issued or outstanding	—	—
Common stock, $0.001 par value; 240,000,000 shares authorized; 29,911,841 and 29,041,530 shares issued and outstanding as of June 30, 2012 and December 31, 2011, respectively	29	28
Additional paid-in capital	231,315	213,402
Accumulated deficit	(14,369)	(15,549)
Accumulated other comprehensive income (loss)	1	(24)

Total stockholders' equity	216,976	197,857
Total liabilities and stockholders' equity	$307,482	$283,927

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,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenue:				
Products	$29,794	$20,857	$55,487	$36,655
Technical support and professional services	20,804	15,597	41,413	30,581
Total revenue	50,598	36,454	96,900	67,236
Cost of revenue:				
Products	8,682	6,036	17,171	10,771
Technical support and professional services	2,837	2,158	5,270	4,020
Total cost of revenue	11,519	8,194	22,441	14,791
Gross profit	39,079	28,260	74,459	52,445
Operating expenses:				
Research and development	10,661	8,074	20,089	15,036
Sales and marketing	19,764	15,198	38,968	29,276
General and administrative	5,911	4,692	11,355	9,365
Depreciation and amortization	1,133	923	2,317	1,888
Total operating expenses	37,469	28,887	72,729	55,565
Income (loss) from operations	1,610	(627)	1,730	(3,120)
Other income (expense), net:				
Interest and investment income	128	95	234	208
Interest expense	(1)	(116)	(5)	(234)
Other expense	(116)	(31)	(221)	(32)
Total other income (expense), net	11	(52)	8	(58)
Income (loss) before income taxes	1,621	(679)	1,738	(3,178)
Provision for (benefit from) income taxes	508	(280)	558	(3,239)
Net income (loss)	$1,113	$(399)	$1,180	$61
Net income (loss) per share:				
Basic	$0.04	$(0.01)	$0.04	$—
Diluted	$0.04	$(0.01)	$0.04	$—
Weighted average shares outstanding used in computing per share amounts:				
Basic	29,714,500	28,537,437	29,470,671	28,387,427
Diluted	30,961,421	28,537,437	30,669,716	29,286,095

See accompanying notes to consolidated financial statements.

SOURCEFIRE, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income (loss)	$1,113	$(399)	$1,180	$61
Unrealized gain (loss) on investments, net of tax	(21)	18	25	4
Total comprehensive income (loss)	$1,092	$(381)	$1,205	$65

See accompanying notes to consolidated financial statements.

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

	Common Stock		Additional Paid In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount				
Balance as of January 1, 2012	29,041,530	$28	$213,402	$(15,549)	$ (24)	$197,857
Exercise of common stock options	511,230	1	7,400	—	—	7,401
Issuance of common stock under employee stock purchase plan	38,644	—	1,114	—	—	1,114
Issuance of restricted common stock	321,562	—	—	—	—	—
Cancellation of restricted common stock	(1,125)	—	—	—	—	—
Stock-based compensation expense	—	—	8,976	—	—	8,976
Excess tax benefits relating to share-based payments	—	—	423	—	—	423
Net income for the six months ended June 30, 2012	—	—	—	1,180	—	1,180
Change in unrealized loss on investments, net of tax	—	—	—	—	25	25
Balance as June 30, 2012	29,911,841	$29	$231,315	$(14,369)	$ 1	$216,976

See accompanying notes to consolidated financial statements.

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

	Six Months Ended June 30, 2012	2011
Operating activities		
Net income	$1,180	$61
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,399	2,553
Non-cash stock-based compensation	8,976	6,493
Excess tax benefits related to share-based payments	(423)	634
Amortization of premium on investments	830	1,058
Loss on disposal of assets	—	9
Deferred taxes	(8)	(3,485)
Changes in operating assets and liabilities:		
Accounts receivable, net	7,849	4,189
Inventory	(1,864)	990
Prepaid expenses and other assets	(2,671)	(12,883)
Accounts payable	151	(500)
Accrued expenses	(1,046)	696
Deferred revenue	5,656	(236)
Other liabilities	282	334
Net cash provided by (used in) operating activities	22,311	(87)
Investing activities		
Purchase of property and equipment	(4,076)	(2,714)
Acquisition-related payments	(174)	(7,093)
Payment for cost method investment	(2,100)	—
Purchase of investments	(78,704)	(79,994)
Proceeds from maturities of investments	71,945	71,908
Net cash used in investing activities	(13,109)	(17,893)
Financing activities		
Repayments of capital lease obligations	(10)	(9)
Proceeds from employee stock-based plans	8,515	3,203
Excess tax benefits related to share-based payments	423	(634)
Net cash provided by financing activities	8,928	2,560
Net increase (decrease) in cash and cash equivalents	18,130	(15,420)
Cash and cash equivalents at beginning of period	59,407	54,410
Cash and cash equivalents at end of period	$77,537	$38,990

See accompanying notes to consolidated financial statements.

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

1. Description of Business

Founded in January 2001, Sourcefire delivers intelligent cybersecurity technologies. Our comprehensive portfolio of solutions enables commercial enterprises and government agencies worldwide to manage and minimize cybersecurity risks. From our industry-leading next-generation network security platform to our advanced malware protection, Sourcefire provides customers with Agile Security™ that addresses the need for more informed, adaptive, and automated security solutions to protect today’s dynamic information technology environments from constantly changing threats.

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

In addition to our commercial and open source network security products, we offer a variety of services to help our customers install and support our solutions. Available services include Technical Support, Professional Services, Education & Certification, Vulnerability Research Team, or VRT, and Snort rule subscriptions.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to those rules or regulations. The interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, considered necessary for a fair presentation. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission on February 29, 2012. The results of operations for the interim periods are not necessarily indicative of results to be expected in future periods.

Use of Estimates

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

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

Investments

We determine the appropriate classification of our investments at the time of purchase and reevaluate such classification as of each balance sheet date. Our available-for-sale investments are comprised of money market funds, corporate debt investments, commercial paper, government-sponsored enterprise securities, government securities and certificates of deposit. These investments are stated at fair value, with the unrealized gains and losses, net of tax, reported in the consolidated statements of comprehensive income. Amortization is included in interest and investment

income. Interest on securities classified as available-for-sale is also included in interest and investment income.
We evaluate our available-for-sale investments on a regular basis to determine whether an other-than-temporary impairment in fair value has occurred. If an investment is in an unrealized loss position and we have the intent to sell the

investment, or it is more likely than not that we will have to sell the investment before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is charged against earnings for the period. For investments that we do not intend to sell or it is more likely than not that we will not have to sell the investment, but we expect that we will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is charged against earnings for the applicable period and the non-credit component of the other-than-temporary impairment is recognized in the consolidated statements of comprehensive income and in accumulated other comprehensive income on our consolidated statement of stockholders' equity. 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.

We account for our investment in a minority interest in a company over which we do not exercise significant influence using the cost method. Under the cost method, an investment is carried at cost until it is sold or there is evidence that changes in the business environment or other facts and circumstances suggest it may be other-than-temporarily impaired. If a decline in the fair value of a cost method investment is determined to be other-than-temporary, an impairment charge will be recorded and the fair value will become the new cost basis of the investment. Our cost method investment is included in other assets on the consolidated balance sheets.

Fair Value of Financial Instruments

Our financial instruments consist primarily of cash and cash equivalents, investments, accounts receivable, cash surrender value on our split-dollar life insurance policy, accounts payable and deferred revenue. The fair value of these financial instruments approximates their carrying amounts reported in the consolidated balance sheets. The fair value of available-for-sale investments is determined using quoted market prices for those investments.The fair value of this cost method investment is not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment.

Allowance for Doubtful Accounts and Sales Return Allowance

We make estimates regarding the collectability of our accounts receivable. When we evaluate the adequacy of our allowance for doubtful accounts, we consider multiple factors, including historical write-off experience, the need for specific customer reserves, the aging of our receivables, customer creditworthiness and changes in customer payment cycles. Historically, our allowance for doubtful accounts has been adequate based on actual results. If any of the factors used to calculate the allowance for doubtful accounts change or if the allowance does not reflect our actual ability to collect outstanding receivables, changes to our provision for doubtful accounts may be needed, and our future results of operations could be materially affected. As of June 30, 2012 and December 31, 2011, the allowance for doubtful accounts was $0.1 million and $0.3 million, respectively.

We also use our judgment to make estimates regarding potential future product returns related to reported product revenue in each period. We analyze factors such as our historical return experience, current product sales volumes, and changes in product warranty claims when evaluating the adequacy of the sales returns allowance. If any of the factors used to calculate the sales return allowance were to change, we may experience a material difference in the amount and timing of our product revenue for any given period. As of June 30, 2012 and December 31, 2011, the sales return allowance was $0.7 million and $0.8 million, respectively.

Inventory

Inventory consists of hardware and related component parts and is stated at the lower of cost on a first-in, first-out basis, or market value, except for evaluation and advance replacement units which are stated at the lower of cost, on a specific identification basis, or market value. Evaluation units are used for customer testing and evaluation and are predominantly located at the customers' premises. Advance replacement units, which include fully functioning appliances and spare parts, are used to provide replacement units under technical support arrangements if a customer's unit is not functioning properly. We make estimates of forecasted demand for our products, and inventory that is obsolete or in excess of our estimated demand is written down to its estimated net realizable value based on historical usage, expected demand, the timing of new product introductions and age. It is reasonably possible that our estimate of future demand for our products could change in the near term and result in additional inventory write-downs, which would negatively impact our future results of operations.

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Inventory consisted of the following (in thousands):

	As of June 30, 2012	December 31, 2011
Finished goods	$1,848	$2,062
Evaluation units	2,364	790
Advance replacement units	1,656	1,433
Total	$5,868	$4,285

Inventory write-downs, primarily related to excess and obsolete inventory of our advance replacement and evaluation units, are reflected as cost of revenues and amounted to approximately $0.3 million and $0.4 million for the three months and six months ended ended June 30, 2012, respectively.

Inventory write-downs, primarily related to evaluation units and excess and obsolete inventory as a result of the introduction of new products, are reflected as cost of revenues and amounted to approximately $0.7 million and $1.4 million for the three months and six months ended ended June 30, 2011, respectively.

Goodwill and Intangible Assets

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

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

Revenue Recognition

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

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

For sales through resellers and distributors, we recognize revenue upon the shipment of the product only if those resellers and distributors provide us, at the time of placing their order, with the identity of the end-user customer to whom the product has been sold. To the extent that a reseller or distributor requests an inventory or stock of products, we defer revenue on that product until we receive notification that it has been sold through to an identified end-user. All amounts billed or received in excess of the revenue recognized are included in deferred revenue. In addition, we defer all direct costs associated with revenue that has been deferred. These amounts are included in either prepaid expenses and other current assets or inventory in the accompanying balance sheets, depending on the nature of the costs and the reason for the deferral.

In October 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards for revenue recognition to remove from the scope of industry-specific software revenue recognition guidance any tangible products

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containing software components and non-software components that operate together to deliver the product's essential functionality. In addition, the FASB amended the accounting standards for certain multiple-element revenue arrangements to:

i. provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated and how the arrangement consideration should be allocated to the separate elements;

ii. require an entity to allocate arrangement consideration to each element based on a selling price hierarchy, where the selling price for an element is based on vendor-specific objective evidence, or VSOE, if available; third-party evidence, or TPE, if available and VSOE is not available; or the best estimate of selling price, or BESP, if neither VSOE or TPE is available; and

iii. eliminate the use of the residual method and require an entity to allocate arrangement consideration based on the relative selling price of each element within the arrangement.

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

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

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

For stand-alone software sales, we recognize revenue based on software revenue recognition guidance. Under the software revenue recognition guidance, we allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on VSOE. If VSOE of fair value does not exist for each of the deliverables, all revenue from the arrangement is deferred until the earlier of the point at which sufficient VSOE of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. If the only undelivered elements are elements for which we currently have VSOE of fair value, we recognize revenue for the delivered elements based on the residual method. When VSOE of fair value does not exist for undelivered elements such as maintenance and support, the entire arrangement fee is recognized ratably over the performance period.

For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with the amended accounting guidance. Certain arrangements with multiple deliverables may continue to have stand-alone software deliverables that are subject to the industry-specific software revenue recognition guidance. The revenue for all of our other multiple deliverable arrangements is allocated to each element based on the relative selling prices of all of the elements in the arrangement using the fair value hierarchy in the amended revenue recognition guidance.

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

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

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

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

VSOE to determine our selling price.

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

For the three months and six months ended June 30, 2012, one customer, a distributor of our products to the U.S. government, accounted for 12% and 16%, respectively, of total revenue.

For the three months ended June 30, 2011, two customers, one a reseller of our products and the other a distributor of our products to the U.S. government, accounted for 12% and 10%, respectively, of total revenue. For the six months ended June 30, 2011, two customers, one a distributor of our products to the U.S. government and the other a reseller of our products, accounted for 13% and 12%, respectively, of total revenue.

As of June 30, 2012, three customers, one a distributor of our products to the U.S. government and the other two resellers of our products, accounted for 16%, 11% and 10%, respectively, of our accounts receivable. As of December 31, 2011, one customer, a reseller of our products, accounted for 14% of our accounts receivable.

Warranty

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

Income Taxes

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

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

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

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

Stock-Based Compensation

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

We use the Black-Scholes option pricing model for estimating the fair value of stock options granted under the 2007 Plan

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and for employee stock purchases under the ESPP. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility. Additionally, the recognition of expense requires the estimation of the number of stock-based awards that will ultimately vest and the number that will ultimately be forfeited.

Net Income Per Share

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

3. Investments

The following is a summary of available-for-sale investments as of June 30, 2012 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Money market funds	$13,283	$—	$—	$13,283
Corporate debt investments	50,235	8	(26)	50,217
Asset-backed securities	2,740	1	—	2,741
Commercial paper	32,196	29	—	32,225
Government-sponsored enterprises	14,752	2	(4)	14,750
Government securities	1,950	—	—	1,950
Certificates of deposit	4,450	5	—	4,455
Total investments	119,606	45	(30)	119,621
Amounts classified as cash equivalents*	(15,233)	—	—	(15,233)
Total available-for-sale investments	$104,373	$45	$(30)	$104,388
Due in one year or less	$93,497	$45	$(23)	$93,519
Due after one year through five years	10,876	—	(7)	10,869
Total available-for-sale investments	$104,373	$45	$(30)	$104,388

* Does not include cash held in our bank accounts

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Money market funds	$18,827	$—	$—	$18,827
Corporate debt investments	38,695	11	(61)	38,645
Asset-backed securities	500	—	—	500
Commercial paper	11,185	3	—	11,188
Government-sponsored enterprises	48,506	13	(5)	48,514
Certificates of deposit	1,700	—	—	1,700
Total investments	119,413	$27	$(66)	119,374
Amounts classified as cash equivalents*	(20,967)	—	—	(20,967)
Total available-for-sale investments	$98,446	$27	$(66)	$98,407
Due in one year or less	$68,901	$15	$(58)	$68,858
Due after one year through five years	29,545	12	(8)	29,549
Total available-for-sale investments	$98,446	$27	$(66)	$98,407

* Does not include cash held in our bank accounts

The following table shows the gross unrealized losses and fair value of our available-for-sale investments as of June 30, 2012 with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

	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	$36,743	$26	$—	$—	$36,743	$26
Government-sponsored enterprises	8,246	4	—	—	8,246	4
Total	$44,989	$30	$—	$—	$44,989	$30

As of June 30, 2012, the unrealized holding gain, net of tax, on available-for-sale securities included in accumulated other comprehensive income was less than $0.1 million. We have evaluated our investments and have determined there were no other-than-temporary impairments as of June 30, 2012. There are 29 corporate debt investments and 5 government-sponsored enterprises with unrealized losses that have existed for less than one year. The unrealized losses related to these investments are entirely caused by non-credit related factors. We do not have the intent to sell these securities and we expect to fully recover the amortized cost basis of these investments.

In May 2012, we committed to invest $3.0 million in a company that supplies components and performs design work for our hardware platform. We funded $2.1 million of this investment in May 2012 and expect to fund the remaining amount in February 2013. We account for this investment using the cost method, as our investment represents less than a 20% equity interest and we do not have significant influence or control over the company. We believe the current carrying amount approximates fair value and we have not evaluated it for impairment as there have been no indicators that would indicate the value of the investment has declined below cost. This cost method investment is included in other assets on the consolidated balance sheets.

4. Income Taxes

The U.S. and foreign components of our income before income taxes consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
U.S.	$1,211	$(691)	$834	$(3,221)
Foreign	410	12	904	43
Income (loss) before income taxes	$1,621	$(679)	$1,738	$(3,178)

Our effective tax rate for the three months ended June 30, 2012 is an expense of 31%, compared to benefit of 41% in the prior-year period. Our effective tax rate for the six months ended June 30, 2012 is an expense of 32%, compared to benefit of 102% in the prior-year period. Our provision for income taxes for the six months ended June 30, 2012 is based on an estimated annual effective tax rate for 2012 of 32%, which includes the U.S. federal statutory rate of 35%, state income taxes and foreign income taxed at various rates which are lower than the U.S. federal statutory rate.

Our benefit from income taxes for the six months ended June 30, 2011 is based on an estimated annual effective tax rate for 2011 of 38.9% and includes a discrete tax benefit of $2.0 million from research and experimentation tax credits for the years 2003 through 2010 recorded in the six months ended June 30, 2011. Our effective tax rate for the six months ended June 30, 2011 includes the U.S. federal statutory rate of 35%, state income taxes and foreign income taxed at different rates, partially offset by the impact of research and experimentation tax credits that was projected for 2011.

As of June 30, 2012 and December 31, 2011, we had $0.3 million of unrecognized tax benefits, of which $0.3 million, if recognized, would affect our effective tax rate.

5. Stock-Based Compensation

In March 2007, our Board of Directors and stockholders approved the Sourcefire, Inc. 2007 Stock Incentive Plan, or 2007 Plan, which provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Board of Directors. As of December 31, 2011, we had reserved an aggregate of 7,374,974 shares of common stock for issuance under the 2007 Plan. On January 1, 2012, 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, 2011, or 1,161,661 shares. Therefore, as of June 30, 2012, we have reserved an aggregate of 8,536,635 shares of common stock for issuance under the 2007 Plan. Prior to adoption of the 2007 Plan, we granted stock options and restricted stock awards under the Sourcefire, Inc. 2002 Stock Incentive Plan, or 2002 Plan.

The 2002 Plan and the 2007 Plan are administered by the Compensation Committee of our Board of Directors. The vesting period for awards under the plans is generally between three and five years. Options granted prior to March 2010 have a maximum term of ten years, and options granted beginning March 2010 have a maximum term of seven years. The exercise price of stock option awards is equal to at least the fair value of the common stock on the date of grant. The fair value of our common stock is determined by reference to the closing trading price of the common stock on the NASDAQ Global Select Market on the date of grant. Effective February 1, 2012, we changed our practice for equity awards to new employees to primarily grant restricted stock units rather than stock options.

Valuation of Stock-Based Compensation

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Stock options:				
Average risk-free interest rate	— %	1.9 %	0.8 %	2.0 %
Expected dividend yield	—	—	—	—
Expected life (years)	—	4.75	4.75	4.75
Expected volatility	— %	61.5 %	61.6 %	62.0 %
Weighted-average fair value at grant date	$—	$13.62	$15.41	$13.69
Employee stock purchase plan:				
Average risk-free interest rate	0.2 %	0.1 %	0.2 %	0.1 %
Expected dividend yield	—	—	—	—
Expected life (years)	0.50	0.50	0.50	0.50
Expected volatility	54.9 %	42.6 %	54.9 %	42.6 %
Weighted-average fair value at grant date	$14.66	$6.04	$14.66	$6.04

Average risk-free interest rate — This is the average U.S. Treasury rate, with a term that most closely resembles the expected life of the option, as of the grant date.

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

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

For determining the expected term of the stock options granted, we have based our expected term on the simplified method. This estimate is derived from the average midpoint between the weighted-average vesting period and the contractual term. In future periods, we expect to begin to incorporate our own data in estimating the expected life as we develop appropriate historical experience of employee exercise and post-vesting termination behavior considered in relation to the contractual life of the option. For ESPP grants, the expected life is the plan period.

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

For stock options granted prior to February 2012, since our historical stock data from our IPO in March 2007 was less than the expected life of the stock options, we used a blended volatility to estimate expected volatility. The blended volatility includes a weighting of our historical volatility from the date of our IPO to the respective grant date and an average of our peer group historical volatility consistent with the expected life of the option. Our peer group historical volatility includes the historical volatility of companies that are similar in revenue size, are in the same industry or are competitors. Beginning in February 2012, the expected volatility of any stock options granted will be based on the daily historical volatility of our stock price over the expected life of the options.

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

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Product cost of revenue	$93	$62	$171	$121
Services cost of revenue	211	109	377	219
Stock-based compensation expense included in cost of revenue	304	171	548	340
Research and development	1,184	803	2,156	1,500
Sales and marketing	2,137	1,384	3,883	2,708
General and administrative	1,244	952	2,389	1,945
Stock-based compensation expense included in operating expenses	4,565	3,139	8,428	6,153
Total stock-based compensation expense	$4,869	$3,310	$8,976	$6,493

Stock Options

The following table summarizes stock option activity under the plans for the six months ended June 30, 2012 (in thousands, except share and per share data):

	Number of Shares	Range of Exercise Prices	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2011	2,602,802	$ 0.24 to 33.47	$18.02		
Granted	23,750	30.36	30.36		
Exercised	(511,230)	0.24 to 30.25	14.48		
Forfeited	(66,330)	18.25 to 33.47	26.12		
Outstanding at June 30, 2012	2,048,992	$ 0.24 to 33.47	$18.78	5.70	$66,839
Vested and exercisable at June 30, 2012	981,309	$ 0.24 to 30.25	$11.57	5.39	$39,084
Vested and expected to vest at June 30, 2012	1,901,184		$18.19	5.68	$63,147

The following table summarizes information about stock options outstanding as of June 30, 2012:

	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 6.77	597,201	$5.69	5.31	570,245	$5.66
$ 7.10 to 25.05	516,995	18.52	5.89	264,191	16.04
$ 25.52 to 26.82	548,289	26.05	5.63	111,483	26.05
$ 26.85 to 33.47	386,507	29.03	6.12	35,390	27.86
	2,048,992	$18.78	5.70	981,309	$11.57

The aggregate intrinsic value of all options exercised during the six months ended June 30, 2012 and 2011 was $17.2 million and $4.8 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 change in control and in certain other circumstances. Based on the estimated grant date fair value of employee stock options granted, we recognized compensation expense of $1.6 million and $1.5 million for the three months ended June 30, 2012 and 2011, respectively, and $3.2 million and $2.7 million for the six months ended June 30, 2012 and 2011, respectively. The grant date aggregate fair value of options, net of estimated forfeitures, not yet

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recognized as expense as of June 30, 2012 was $11.3 million, which is expected to be recognized over a weighted average period of 2.50 years.

Restricted Stock Awards

The following table summarizes the unvested restricted stock award activity during the six months ended June 30, 2012:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested at December 31, 2011	102,163	$ 11.92
Granted	12,113	54.81
Vested	(51,608)	14.38
Forfeited	(1,125)	7.23
Unvested at June 30, 2012	61,543	$ 18.39

Restricted stock awards are generally subject to service-based vesting; however, in some instances, awards contain provisions for acceleration of vesting upon performance measures, change in control and in certain other circumstances. Holders of restricted stock awards have the right to vote such shares and receive dividends. The restricted stock awards are considered issued and outstanding at the date the award is granted. On a quarterly basis, we evaluate the probability of achieving performance measures and adjust compensation expense accordingly. The compensation expense is recognized ratably over the estimated vesting period. The vesting restrictions for outstanding restricted stock awards generally lapse over a period of 12 to 60 months.

The fair value of the unvested restricted stock awards is measured using the closing price of our stock on the date of grant. We recognized compensation expense related to restricted stock awards of $0.3 million and $0.4 million for the three months ended June 30, 2012 and 2011, respectively, and $0.5 million and $0.8 million for the six months ended June 30, 2012 and 2011, respectively.

As of June 30, 2012, there was $0.6 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 0.44 years.

Restricted Stock Units

The following table summarizes the unvested restricted stock unit activity during the six months ended June 30, 2012:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested at December 31, 2011	1,105,717	$ 21.50
Granted	719,550	49.01
Vested	(309,449)	18.63
Forfeited	(23,627)	23.97
Unvested at June 30, 2012	1,492,191	$ 35.32

Restricted stock units are generally subject to service-based vesting; however, in some instances, restricted stock units contain provisions for acceleration of vesting upon performance measures, change in control and in certain other circumstances. On a quarterly basis, we evaluate the probability of achieving performance measures and adjust compensation expense accordingly. The compensation expense is recognized ratably over the estimated vesting period. The vesting restrictions for outstanding restricted stock units generally lapse over a period of 48 to 60 months.

The fair value of the unvested restricted stock units is measured using the closing price of our stock on the date of grant. We recognized compensation expense related to restricted stock units of $2.9 million and $1.3 million for the three months ended June 30, 2012 and 2011, respectively, and $4.8 million and $2.7 million for the six months ended June 30, 2012 and 2011, respectively.

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As of June 30, 2012, there was $34.0 million of unrecognized compensation expense, net of estimated forfeitures, related to unvested restricted stock units. This amount is expected to be recognized over a weighted-average period of 3.19 years.

Employee Stock Purchase Plan

The ESPP allows eligible employees to purchase our common stock at 85% of the lower of the stock price at the beginning or end of the offering period, which is a six-month period. During the six months ended June 30, 2012, 38,644 shares were purchased under the ESPP for $1.1 million. We recognized compensation expense related to the ESPP of $0.2 million and $0.1 million for the three months ended June 30, 2012 and 2011, respectively, and $0.4 million and $0.3 million for the six months ended June 30, 2012 and 2011, respectively.

6. Net Income (Loss) Per Share

The calculation of basic and diluted net income per share for the three months and six months ended June 30, 2012 and 2011 is summarized as follows (in thousands, except share and per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Numerator:				
Net income (loss)	$1,113	$(399)	$1,180	$61
Denominator:				
Weighted-average shares outstanding - basic	29,714,500	28,537,437	29,470,671	28,387,427
Dilutive effect of employee stock plans	1,246,921	—	1,199,045	898,668
Weighted-average shares - diluted	30,961,421	28,537,437	30,669,716	29,286,095
Net income (loss) per share:				
Basic	$0.04	$(0.01)	$0.04	$—
Diluted	$0.04	$(0.01)	$0.04	$—

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,	
	2012	2011	2012	2011
Options to purchase common stock	—	2,681,657	98,069	1,098,134
Restricted stock units	148,096	1,094,508	120,445	60,262
	148,096	3,776,165	218,514	1,158,396

7. Fair Value Measurement

We measure the fair value of assets and liabilities using a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires us to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 — Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities.
- Level 2 — Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly.
- Level 3 — Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

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

We did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the six months ended June 30, 2012.

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The following table presents our financial assets and liabilities that were accounted for at fair value as of June 30, 2012 by level within the fair value hierarchy (in thousands):

		Fair Value Measurement Using		
	Fair Value	Level 1	Level 2	Level 3
Assets:				
Money market funds	$13,283	$13,283	$—	$—
Corporate debt investments	50,217	—	50,217	—
Asset-backed securities	2,741	—	2,741	—
Commercial paper	32,225	—	32,225	—
Government-sponsored enterprise securities	14,750	—	14,750	—
Government securities	1,950	1,950	—	—
Certificates of deposit	4,455	—	4,455	—
Total	$119,621	$15,233	$104,388	$—

Assets and liabilities that are measured at fair value on a non-recurring basis include intangible assets, goodwill, asset retirement obligations and our cost method investment. These items are recognized at fair value when they are considered to be impaired. For the six months ended June 30, 2012, there were no fair value adjustments for assets and liabilities measured on a non-recurring basis.

8. Business and Geographic Segment Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our Chief Executive Officer, or CEO. The CEO reviews financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance. As such, we have concluded that our operations constitute one operating and reportable segment.

Revenues by geographic area for the three months and six months ended June 30, 2012 and 2011 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
United States	$35,903	$26,948	$66,527	$49,345
All foreign countries	14,695	9,506	30,373	17,891
Total	$50,598	$36,454	$96,900	$67,236

9. Commitments and Contingencies

Contract Manufacturer Commitments – We purchase components for our products from a variety of suppliers and use contract manufacturers to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon information we provide. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. A portion of our reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments. As of June 30, 2012, we had total purchase commitments for inventory of approximately $21.7 million due within the next 12 months. It is possible that our estimate of future demand for our products could change in the near term and result in additional inventory or commitment reserves which would negatively impact our future results of operations.

Asset Retirement Obligation – We maintain office space in certain locations 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 $0.2 million, payable upon termination of the lease. This liability is being accreted over the lease term.

Indemnification – Our agreements with customers, as well as our reseller agreements, include certain provisions for indemnifying customers and resellers and their affiliated parties against damages and liabilities arising from third-party claims if our products infringe another party's intellectual property rights. Our exposure under these indemnification provisions is generally limited to the total amount paid by the customer or reseller, as applicable, under the agreement. However, certain agreements include indemnification provisions that could potentially expose us to liabilities in excess of the amount received under the agreement. To date, there have been no liabilities incurred under such indemnification provisions.

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, 2011.

Introduction

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

- Overview. This section provides a general description of our business, the key financial metrics that we use in assessing our performance, and anticipated trends that we expect to affect our financial condition and results of operations.
- Results of Operations. This section provides an analysis of our results of operations for the three months and six months ended June 30, 2012 and 2011.
- Non-GAAP Financial Measures and Supplemental Operating Data. This section discusses non-GAAP financial results that we use in evaluating the operating performance of our business. These measures should be considered in addition to results prepared in accordance with United States generally accepted accounting principles, or GAAP, but should not be considered a substitute for, or superior to, GAAP results. The non-GAAP measures discussed have been reconciled to the nearest GAAP measure in a table included in this section. This section also includes supplemental operating data.
- Liquidity and Capital Resources. This section provides an analysis of our cash flows for the six months ended June 30, 2012 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

Sourcefire delivers intelligent cybersecurity technologies. Our comprehensive portfolio of solutions enables commercial enterprises and government agencies worldwide to manage and minimize cybersecurity risks. From our industry-leading next-generation network security platform to our advanced malware protection, Sourcefire provides customers with Agile Security™ that addresses the need for more informed, adaptive, and automated security solutions to protect today's dynamic information technology environments from constantly changing threats.

We sell our solutions to a diverse customer base that includes Global 2000 companies, global enterprises, U.S. and international government agencies and small and mid-size businesses. We also manage the security industry's leading open source initiative, Snort®, as well as the ClamAV® and Razorback™ open source initiatives.

Key Financial Metrics and Trends

Revenue from U.S. commercial customers accounted for 55% and 50% of our total revenue for the three months and six months ended June 30, 2012, respectively, and 58% and 56% of our total revenue for the three months and six months ended June 30, 2011, respectively. Our revenue from U.S. commercial customers increased by 31% and 30% for the three months and six months ended June 30, 2012, respectively, as compared to the prior-year period.

Revenue from international customers accounted for 29% and 31% of our total revenue for the three months and six months ended June 30, 2012, respectively, and 26% and 27% of our total revenue for the three months and six months ended June 30, 2011, respectively. Our revenue from international customers increased by 55% and 70% for the three months and six months ended June 30, 2012, respectively, as compared to the prior-year period.

Revenue from U.S. federal and state government agencies collectively accounted for 16% and 19% of our total revenue for the three months and six months ended June 30, 2012, respectively, and 16% and 18% of our total revenue for the three months and six months ended June 30, 2011, respectively. Our revenue from U.S. federal and state government agencies increased by 43% and 51% for the three months and six months ended June 30, 2012, respectively, as compared to the prior-year period.

We believe that our revenue from product sales for the three months and six months ended June 30, 2012 was positively affected by a number of factors, including (i) the introduction of new, enhanced versions of our products in 2011, (ii) the expansion of our indirect sales channel both in the U.S. and internationally, (iii) investments in our international operations and the resulting increase in headcount, and (iv) a stabilized environment for federal spending. In addition, our revenue from sales of services for the three months and six months ended June 30, 2012 was positively affected by an increase in our installed customer base. We expect these factors to continue to positively affect our product revenue and services revenue for the remainder of 2012. However, we expect growth rates compared to 2011 to moderate for the remainder of 2012.

We evaluate our performance on the basis of several key financial metrics, including revenue, cost of revenue, gross profit, and operating expenses. We compare these key performance indicators, on a quarterly basis, to both target amounts established by management and to our performance for prior periods. We also evaluate performance on the basis of adjusted income from operations, adjusted income from operations as a percentage of revenue, adjusted net income, adjusted net income per share and free cash flow, which are non-GAAP financial measures. Information regarding our non-GAAP financial measures and a reconciliation of each to the nearest GAAP measure is provided under “Non-GAAP Financial Measures” below.

Revenue

We currently derive revenue from product sales and services. Product revenue is principally derived from the sale of our network security solutions. These solutions include a perpetual software license bundled with a third-party hardware platform. Services revenue is principally derived from technical support and professional services and training. We typically sell technical support to complement our network security product solutions.

Technical support entitles a customer to product updates and new rule releases on a when and if available basis and both telephone and web-based assistance for using our products. Our professional services include optional installation, configuration and tuning, which we refer to collectively as network security deployment services. These services typically occur on-site after delivery has occurred. Our training includes instructor-led and custom classes delivered at various locations around the world, onsite at customer premises, and online.

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

We sell our network security solutions globally. However, 71% and 69% of our revenue for the three months and six months ended June 30, 2012, respectively, and 74% of our total revenue for each of the three months and six months ended June 30, 2011, was generated by sales to U.S.-based customers. We expect that our revenue from customers based outside of the United States will increase in absolute dollars and as a percentage of revenue as we strengthen our international presence.

We continue to generate a majority of our product revenue through sales to existing customers, both for new locations and for additional technology to protect existing networks and locations. Product sales to existing customers accounted for 69% and 66% of total product revenue for the three months and six months ended June 30, 2012, respectively, and 69% and 74% of

our total product revenue for the three months and six months ended June 30, 2011, respectively. We expect product sales to existing customers to continue to account for a significant portion of our product revenue in 2012.
Historically, our product revenue has been seasonal, with a significant portion of our total product revenue in recent fiscal years generated in the third and fourth quarters. Revenue from our government customers has been influenced by the September 30th fiscal year-end of the U.S. federal government, which has historically resulted in our revenue from government customers being highest in the second half of the year. While we expect these historical trends to continue, they could be affected by a number of factors, including another decline in general economic conditions, changes in the timing or amounts of U.S. government spending and our planned international expansion.
Notwithstanding these general seasonal patterns, our revenue within a particular quarter is often affected significantly by the unpredictable procurement patterns of our customers. Our prospective customers usually spend a long time evaluating and making purchase decisions for network security solutions. Historically, many of our customers have not finalized their purchasing decisions until the final weeks or days of a quarter. We expect these purchasing patterns to continue in the future. Therefore, a delay in even one large order beyond the end of the quarter could materially reduce our anticipated revenue for a quarter. In addition, because we typically recognize revenue upon shipment, the timing of our quarter-end and year-end shipments could materially affect our reported product revenue for a given quarter or year. Delayed orders could negatively impact our results of operations and cash flows for a particular period and could therefore cause us to fail to meet the financial performance expectations of financial and industry research analysts or investors.

Cost of Revenue

Cost of product revenue includes the cost of the hardware platform, third-party manufacturing costs, royalties for third-party software, personnel costs associated with logistics and quality control, stock-based compensation expense, amortization of acquired intangible assets, supplies, warranty, shipping and handling costs, expense for excess and obsolete inventory and depreciation in the instances where we lease our network security solutions to our customers. In addition, in the first quarter of 2012, we began to incur cost of revenue expenses to support and run the infrastructure of our new FireAMP™ anti-malware product. We allocate overhead costs, including facilities, supplies, communication and information systems and employee benefits, to the cost of product revenue. Overhead costs are reflected in each cost of revenue and operating expense category. As our product volume increases, we anticipate incurring an increased amount of both direct and overhead expenses to supply and manage the increased volume. In addition, hardware unit costs or other costs of manufacturing could increase in the future.

Cost of services revenue includes the direct labor costs of our employees and outside consultants engaged to furnish those services, as well as their travel and associated direct material costs and stock-based compensation expense. Additionally, we include in cost of services revenue an allocation of overhead costs, as well as the cost of time and materials to service or repair the hardware component of our products covered under a renewed support arrangement beyond the manufacturer's warranty, the amortization of a long-term contract for a third-party to provide maintenance and support services for certain product offerings and the expense for advance replacement unit inventory excess and obsolescence. As our customer base continues to grow, we anticipate incurring an increasing amount of these service and repair costs, as well as costs for additional personnel to provide support and service to our customers.

Gross Profit

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

We substantially completed the transition of our product line to our next generation platform in the first quarter of 2012. Generally, the gross margins of our new products are lower as compared to the previous generation of products they are replacing. In addition, in the first quarter of 2012, we began to incur cost of revenue expenses to support and run the infrastructure of our new FireAMP anti-malware product. These items had a negative impact on our gross margin for the first two quarters of 2012 and we expect this impact to continue throughout 2012.

Operating Expenses

Research and Development. Research and development expenses consist primarily of salaries, incentive compensation and allocated overhead costs for our engineers; stock-based compensation expense; retention obligations related to our hiring of former Immunet employees; costs for professional services to design, test and certify our products; and costs associated with data used by us in our product development.

We have expanded our research and development capabilities and expect to continue to expand these capabilities in the future. We are committed to increasing the level of innovative design and development of new products as we strive to enhance our ability to serve our existing commercial and federal government markets as well as new markets for security solutions. To meet the changing requirements of our customers, we will need to fund investments in several development projects in parallel. Accordingly, we anticipate that our research and development expenses will continue to increase in absolute dollars for the year ending December 31, 2012 and, as a percentage of revenue, will be consistent with 2011.

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

As we continue to focus on increasing our market penetration, expanding internationally, increasing our indirect sales channel and building brand awareness, we anticipate that selling and marketing expenses will continue to increase in absolute dollars for the year ending December 31, 2012 and, as a percentage of revenue, will be consistent with 2011.

General and Administrative. General and administrative expenses consist primarily of salaries, incentive compensation and allocated overhead costs for executive, legal, finance, information technology, human resources and administrative personnel; stock-based compensation expense; corporate development expenses and professional fees related to legal, audit, tax and regulatory compliance; travel and related costs; and corporate insurance. We anticipate that general and administrative expenses will increase in absolute dollars for the year ending December 31, 2012.

Stock-Based Compensation. Stock-based compensation expense is based on the grant date fair value of stock awards. We use the Black-Scholes option pricing model to estimate the fair value of stock options granted and employee stock purchases. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility. Based on the estimated grant date fair value of stock-based awards, we recognized aggregate stock-based compensation expense of $4.9 million and $3.3 million for the three months ended June 31, 2012 and 2011, respectively, and $9.0 million and $6.5 million for the six months ended June 31, 2012 and 2011, 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	
	2012	2011	$	%	2012	2011	$	%
Products	$29,794	$20,857	$8,937	43 %	$55,487	$36,655	$18,832	51 %
Percentage of total revenue	59 %	57 %			57 %	55 %		
Technical support and professional services	20,804	15,597	5,207	33 %	41,413	30,581	10,832	35 %
Percentage of total revenue	41 %	43 %			43 %	45 %		
Total revenue	$50,598	$36,454	$14,144	39 %	$96,900	$67,236	$29,664	44 %

The increase in our product revenue for the three months and six months ended June 30, 2012, as compared to the prior-year periods, was primarily due to higher product sales volume and the sales product mix favoring our higher priced appliances. The increase in our services revenue for the three months ended June 30, 2012, as compared to the prior-year period, resulted from an increase in our installed customer base due to new product sales in which associated support was purchased, as well as technical support renewals by our existing customers.

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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	
	2012	2011	$	%	2012	2011	$	%
Products	$8,682	$6,036	$2,646	44 %	$17,171	$10,771	$6,400	59 %
Percentage of total revenue	17 %	17 %			18 %	16 %		
Technical support and professional services	2,837	2,158	679	31 %	5,270	4,020	1,250	31 %
Percentage of total revenue	6 %	6 %			5 %	6 %		
Total revenue	$11,519	$8,194	$3,325	41 %	$22,441	$14,791	$7,650	52 %
Percentage of total revenue	23 %	23 %			23 %	22 %		

The increase in our product cost of revenue for the three months and six months ended June 30, 2012, as compared to the prior-year periods, was primarily due to an increase in unit volume associated with higher revenue, higher costs of our new product platform and the infrastructure costs to support and run our new FireAMP anti-malware product, partially offset by lower inventory write-downs related to excess and obsolete inventory.

The increase in our services cost of revenue for the three months and six months ended June 30, 2012, as compared to the prior-year periods, was primarily due to our hiring of additional personnel to service our larger installed customer base, provide training to our resellers and customers and provide professional services to our customers and increased hardware service expense we pay to our contract manufacturers to help maintain our install base.

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

	Three Months Ended June 30,		Variance		Six Months Ended June 30,		Variance	
	2012	2011	$	%	2012	2011	$	%
Products	$21,112	$14,821	$6,291	42 %	$38,316	$25,884	$12,432	48 %
Product gross margin	71 %	71 %			69 %	71 %		
Technical support and professional services	17,967	13,439	4,528	34 %	36,143	26,561	9,582	36 %
Technical support and professional services gross margin	86 %	86 %			87 %	87 %		
Total revenue	$39,079	$28,260	$10,819	38 %	$74,459	$52,445	$22,014	42 %
Percentage of total revenue	77 %	78 %			77 %	78 %		

Product gross margin for the three months ended June 30, 2012 remained flat as compared to the prior-year period, primarily due to higher costs of our new products and the infrastructure costs to support and run our new FireAMP anti-malware product, which were offset by lower inventory write-downs related to excess and obsolete inventory.

Product gross margin for the six months ended ended June 30, 2012 decreased as compared to the prior-year period, primarily due to the higher costs of our new products and the infrastructure costs to support and run our new FireAMP anti-malware product, partially offset by lower inventory write-downs related to excess and obsolete inventory.

Technical support and professional services gross margin for the three months and six months ended June 30, 2012, remained flat as compared to the prior-year period.

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

	Three Months Ended June 30,		Variance		Six Months Ended June 30,		Variance	
	2012	2011	$	%	2012	2011	$	%
Research and development	$10,661	$8,074	$2,587	32 %	$20,089	$15,036	$5,053	34 %
Percentage of total revenue	21 %	22 %			21 %	22 %		
Sales and marketing	19,764	15,198	4,566	30 %	38,968	29,276	9,692	33 %
Percentage of total revenue	39 %	42 %			40 %	44 %		
General and administrative	5,911	4,692	1,219	26 %	11,355	9,365	1,990	21 %
Percentage of total revenue	12 %	13 %			12 %	14 %		
Depreciation and amortization	1,133	923	210	23 %	2,317	1,888	429	23 %
Percentage of total revenue	2 %	3 %			2 %	3 %		
Total operating expenses	$37,469	$28,887	$8,582	30 %	$72,729	$55,565	$17,164	31 %
Percentage of total revenue	74 %	79 %			75 %	83 %		

Research and development expenses for the three months ended June 30, 2012 increased over the prior-year period, primarily due to an increase of $1.3 million in salaries, incentive compensation and benefits as a result of additional personnel, an increase of $0.7 million in consulting fees, an increase of $0.4 million in stock-based compensation expense and an increase of $0.2 million in allocated overhead costs as a result of increased overhead costs.

Research and development expenses for the six months ended June 30, 2012 increased over the prior-year period, primarily due to an increase of $2.6 million in salaries, incentive compensation and benefits as a result of additional personnel, an increase of $1.4 million in consulting fees, an increase of $0.7 million in stock-based compensation expense and an increase of $0.4 million in allocated overhead costs as a result of increased overhead costs.

Sales and marketing expenses for the three months ended June 30, 2012 increased over the prior-year period, primarily due to an increase of $2.8 million in salaries, commissions and incentive compensation, and benefits as a result of additional personnel, an increase of $0.9 million in advertising, promotion, partner-marketing programs and trade show expenses and an increase of $0.8 million in stock-based compensation expense.

Sales and marketing expenses for the six months ended June 30, 2012 increased over the prior-year period, primarily due to an increase of $6.0 million in salaries, commissions and incentive compensation, and benefits as a result of additional personnel, an increase of $1.7 million in advertising, promotion, partner-marketing programs and trade show expenses, an increase of $1.2 million in stock-based compensation expense, an increase of $0.4 million in travel and travel-related expenses, an increase of $0.3 million in allocated overhead costs as a result of increased overhead costs, partially offset by a decrease of $0.4 million in consulting fees.

General and administrative expenses for the three months ended June 30, 2012 increased over the prior-year period, primarily due to an increase of $0.5 million in salaries, incentive compensation and benefits as a result of additional personnel, an increase of $0.4 million in professional fees related to legal and accounting and an increase of $0.3 million in stock-based compensation expense.

General and administrative expenses for the six months ended June 30, 2012 increased over the prior-year period, primarily due to an increase of $1.0 million in salaries, incentive compensation and benefits as a result of additional personnel, $0.5 million in professional fees related to legal and accounting and an increase of $0.4 million in stock-based compensation expense.

Depreciation and amortization expense for the three months and six months ended June 30, 2012 increased from the prior-year period, primarily due to depreciation of additional lab and testing equipment purchased for our engineering department, computers purchased for personnel hired and leasehold improvements to new office spaces.

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

	Three Months Ended June 30,		Variance		Six Months Ended June 30,		Variance	
	2012	2011	$	%	2012	2011	$	%
Provision for (benefit from) income taxes	$508	$(280)	$788	(281)%	$558	$(3,239)	$3,797	(117)%
Percentage of total revenue	1%	(1)%			1%	(5)%		

Our effective tax rate for the three months ended June 30, 2012 is an expense of 31%, compared to benefit of 41% in the prior-year period. Our effective tax rate for the six months ended June 30, 2012 is an expense of 32%, compared to benefit of 102% in the prior-year period. Our provision for income taxes for the six months ended June 30, 2012 is based on an estimated annual effective tax rate for 2012 of 32%, which includes the U.S. federal statutory rate of 35%, state income taxes and foreign income taxed at various rates which are lower than the U.S. federal statutory rate.

Our benefit from income taxes for the six months ended June 30, 2011 is based on an estimated annual effective tax rate for 2011 of 38.4% and includes a discrete tax benefit of $2.0 million from research and experimentation tax credits for the years 2003 through 2010 recorded in the three months ended March 31, 2011. Our effective tax rate for the six months ended June 30, 2011 includes the U.S. federal statutory rate of 35%, state income taxes and foreign income taxed at different rates, partially offset by the impact of research and experimentation tax credits that was projected for 2011.

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

With respect to foreign earnings, it is our policy to invest the earnings of foreign subsidiaries indefinitely outside the U.S. Accordingly, we do not record deferred taxes on such earnings. Any excess tax benefit, above amounts previously recorded for stock-based compensation expense, from the exercise of stock options is recorded in additional paid-in-capital in the consolidated balance sheets to the extent that cash taxes payable are reduced.

Seasonality

Our product revenue has tended to be seasonal, with a significant portion generated in the third and fourth quarters. Revenue from our government customers has been influenced by the September 30th fiscal year-end of the U.S. federal government, which has historically resulted in our revenue from government customers being highest in the second half of the year. In the fourth quarter, revenues have historically been strong due to purchases by North American enterprise customers, which operate on a calendar year budget and often wait until the fourth quarter to make their most significant capital equipment purchases. In addition, increased fourth quarter sales in Europe have historically resulted in higher fourth quarter revenues following a decline in sales in the summer months due to vacation practices in Europe and the resulting delay in capital purchase activities until the fall. While we expect these historical trends to continue, they could be affected by a number of factors, including another decline in general economic conditions, changes in the timing or amounts of U.S. government spending, and our planned international expansion. The timing of transactions could materially affect our quarterly or annual product revenue.

Quarterly Timing

On a quarterly basis, we have usually generated the majority of our sales in the final month of the quarter. We believe this occurs for two reasons. First, many customers wait until the end of the quarter to extract favorable pricing terms from their vendors, including Sourcefire. Second, our sales personnel, who have a strong incentive to meet quarterly sales targets, have tended to increase their sales activity as the end of a quarter nears, while their participation in sales management review and planning activities is typically scheduled at the beginning of a quarter. The timing of our quarter-end and year-end shipments also affects our quarterly and annual product revenue, since we typically recognize revenue upon shipment of the product and orders received at the end of a quarter or year may not be shipped until the beginning of the following quarter or year.

Non-GAAP Financial Measures and Supplemental Operating Data

To supplement our consolidated financial statements presented in accordance with GAAP, we consider certain financial measures that are not prepared in accordance with GAAP, including non-GAAP adjusted net income, adjusted net income per share, adjusted income from operations, adjusted income from operations as a percentage of revenue and free cash flow. We use these non-GAAP financial measures, in addition to GAAP financial measures, to evaluate our operating and financial performance and to compare such performance to that of prior periods and to the performance of our competitors. We also use these non-GAAP financial measures in making operational and financial decisions and in establishing operational goals. We believe that providing these non-GAAP financial measures to investors, as a supplement to GAAP financial measures, helps investors to evaluate our operating and financial performance and trends in our business, consistent with how management evaluates such performance and trends. We also believe these non-GAAP financial measures may be useful to investors in comparing our performance to the performance of other companies, although our non-GAAP financial measures are specific to us and the non-GAAP financial measures of other companies may not be calculated in the same manner.

Adjusted Net Income, Adjusted Net Income per Share, Adjusted Income from Operations and Adjusted Income from Operations as a Percentage of Revenue: In evaluating the operating performance of our business, we exclude certain charges and credits that are required by GAAP. These non-GAAP measures exclude (i) stock-based compensation, which does not involve the expenditure of cash, (ii) amortization of acquisition-related intangible assets, which does not involve the expenditure of cash, and (iii) other acquisition-related expenses, which are unrelated to the ongoing operation of our business in the ordinary course. For 2012, we expect non-GAAP results to be adjusted to reflect the effect of an assumed tax rate of 35%. This adjustment is intended to normalize the tax rate and provide a tax rate that approximates our expected full year GAAP tax rate.

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

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

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

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Reconciliation to adjusted income from operations:				
GAAP income (loss) from operations	$1,610	$(627)	$1,730	$(3,120)
Stock-based compensation expense	4,869	3,310	8,976	6,493
Amortization of acquisition-related intangible assets	342	252	684	504
Other acquisition-related expenses*	769	667	1,436	1,456
Adjusted income from operations	$7,590	$3,602	$12,826	$5,333
Adjusted income from operations as % of revenue	15.0 %	9.9 %	13.2 %	7.9 %
Reconciliation to adjusted net income:				
GAAP net income	$1,113	$(399)	$1,180	$61
Stock-based compensation expense	4,869	3,310	8,976	6,493
Amortization of acquisition-related intangible assets	342	252	684	504
Other acquisition-related expenses**	769	781	1,436	1,684
Tax credit for research and experimentation	—	—	—	(2,001)
Income tax adjustment***	(2,152)	(1,562)	(3,934)	(3,164)
Adjusted net income	$4,941	$2,382	$8,342	$3,577
Adjusted net income per share – basic	$0.17	$0.08	$0.28	$0.13
Adjusted net income per share – diluted	$0.16	$0.08	$0.27	$0.12
Weighted-average shares outstanding – basic	29,714,500	28,537,437	29,470,671	28,387,427
Weighted-average shares outstanding – diluted	30,961,421	29,391,215	30,669,716	29,286,095
Reconciliation to free cash flow:				
GAAP net cash provided by operating activities	$2,634	$(7,345)	$22,311	$(87)
Purchase of property and equipment	(1,534)	(1,441)	(4,076)	(2,714)
Free cash flow	$1,100	$(8,786)	$18,235	$(2,801)

* Includes the accrual of retention obligations related to our hiring of former Immunet employees and other acquisition-related expenses.

** Includes the accrual of retention obligations related to our hiring of former Immunet employees, the increase in the fair value of the acquisition-related contingent consideration and other acquisition-related expenses.

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

The following table shows supplemental data regarding our operations:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Supplemental operating data:				
Number of deals in excess of $500,000	13	10	25	22
Number of deals in excess of $100,000	83	67	162	120
Number of new customers	98	96	182	160
Percentage of channel-influenced deals	43 %	51 %	47 %	50 %
Total channel partners	691	469		
Number of full-time employees at end of period	519	426		

Liquidity and Capital Resources

Cash Flows

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

	Six Months Ended June 30,	
	2012	2011
Cash and cash equivalents:		
Provided by (used in) operating activities	$22,311	$(87)
Used in investing activities	(13,109)	(17,893)
Provided by financing activities	8,928	2,560
Increase (decrease) in cash and cash equivalents	18,130	(15,420)
Cash and cash equivalents at beginning of period	59,407	54,410
Cash and cash equivalents at end of period	77,537	38,990
Investments	104,388	106,340
Total cash, cash equivalents and investments	$181,925	$145,330

Operating Activities. Cash provided by operating activities for the six months ended June 30, 2012 is the result of changes in our operating assets and liabilities of $8.4 million and $12.8 million of adjustments to exclude the impact of net non-cash revenues and expenses. Cash used in operating activities for the six months ended June 30, 2011 is the result of changes in our operating assets and liabilities of $7.4 million, which includes a payment of $11.0 million for a long-term contract for a third-party to provide maintenance and support services for certain product offerings, offset by $7.3 million of adjustments to exclude the impact of net non-cash revenues and expenses.

Investing Activities. Cash used in investing activities for the six months ended June 30, 2012 was primarily the result of purchases of investments of $78.7 million, capital expenditures of $4.1 million and the payment for a cost method investment of $2.1 million, offset by maturities of investments of $71.9 million. Cash used in investing activities for the six months ended June 30, 2011 was primarily the result of purchases of investments of $80.0 million, $7.1 million for acquisition-related payments and capital expenditures of $2.7 million, offset by maturities of investments of $71.9 million.

Financing Activities. Cash provided by financing activities for the six months ended June 31, 2012 and 2011 was primarily the result of proceeds from the issuance of common stock under our employee stock-based plans.

Liquidity Requirements

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

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and test equipment.

We expect our short-term liquidity requirements through June 30, 2013 will 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, 2012, we had cash, cash equivalents and investments of $181.9 million and working capital of $158.9 million.

As described above, our product sales are, and are expected to continue to be, 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 existing cash resources, equity financing or debt financing to fund acquisitions or investments in complementary businesses, technologies or product lines.

Critical Accounting Policies and Estimates

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

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

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

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

For sales through resellers and distributors, we recognize revenue upon the shipment of the product only if those resellers and distributors provide us, at the time of placing their order, with the identity of the end-user customer to whom the product has been sold. To the extent that a reseller or distributor requests an inventory or stock of products, we defer revenue on that product until we receive notification that it has been sold through to an identified end-user.

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

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

i. provide updated guidance on whether multiple elements exist, how the elements in an arrangement should be separated and how the arrangement consideration should be allocated to the separate elements;

ii. require an entity to allocate arrangement consideration to each element based on a selling price hierarchy, where the selling price for an element is based on vendor-specific objective evidence, or VSOE, if available; third-party evidence, or TPE, if available and VSOE is not available; or the best estimate of selling price, or BESP, if neither

VSOE or TPE is available; and

iii. eliminate the use of the residual method and require an entity to allocate arrangement consideration based on the relative selling price of each element within the arrangement.

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

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

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

For stand-alone software sales, we recognize revenue based on software revenue recognition guidance. Under the software revenue recognition guidance, we allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on VSOE. If VSOE of fair value does not exist for each of the deliverables, all revenue from the arrangement is deferred until the earlier of the point at which sufficient VSOE of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. If the only undelivered elements are elements for which we currently have VSOE of fair value, we recognize revenue for the delivered elements based on the residual method. When VSOE of fair value does not exist for undelivered elements such as maintenance and support, the entire arrangement fee is recognized ratably over the performance period.

For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with the amended accounting guidance. Certain arrangements with multiple deliverables may continue to have stand-alone software deliverables that are subject to the industry-specific software revenue recognition guidance. The revenue for all of our other multiple deliverable arrangements is allocated to each element based on the relative selling prices of all of the elements in the arrangement using the fair value hierarchy in the amended revenue recognition guidance.

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

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

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

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

We record taxes collected on revenue-producing activities on a net basis.
Changes in our judgments and estimates about these assumptions could materially impact the timing of our revenue recognition.
Accounting for Stock-Based Compensation. Stock-based awards granted include stock options, restricted stock awards, restricted stock units and stock purchased under our Amended and Restated 2007 Employee Stock Purchase Plan, or ESPP.

Stock-based compensation expense is measured at the grant date, based on the fair value of the awards, and is recognized as expense over the requisite service period, net of estimated forfeitures.

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

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

Average risk-free interest rate — This is the average U.S. Treasury rate, with a term that most closely resembles the expected life of the option, as of the grant date.

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

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

For determining the expected term of the stock options granted, we have based our expected term on the simplified method. This estimate is derived from the average midpoint between the weighted-average vesting period and the contractual term. In future periods, we expect to begin to incorporate our own data in estimating the expected life as we develop appropriate historical experience of employee exercise and post-vesting termination behavior considered in relation to the contractual life of the option. For ESPP grants, the expected life is the plan period.

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

For stock options granted prior to February 2012, since our historical stock data from our IPO in March 2007 was less than the expected life of the stock options, we used a blended volatility to estimate expected volatility. The blended volatility includes a weighting of our historical volatility from the date of our IPO to the respective grant date and an average of our peer group historical volatility consistent with the expected life of the option. Our peer group historical volatility includes the historical volatility of companies that are similar in revenue size, are in the same industry or are competitors. Beginning in February 2012, the expected volatility of any stock options granted will be based on the daily historical volatility of our stock price over the expected life of the options.

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

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

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

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

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

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

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

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

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

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

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

Inventory. Inventory consists of hardware and related component parts and is stated at the lower of cost on a first-in, first-out basis, or market value, except for evaluation and advance replacement units which are stated at the lower of cost, on a specific identification basis, or market value. Evaluation units are used for customer testing and evaluation and are predominantly located at the customers' premises. Advance replacement units, which include fully functioning appliances and spare parts, are used to provide replacement units under technical support arrangements if a customer's unit is not functioning properly. We make estimates of forecasted demand for our products, and inventory that is obsolete or in excess of our estimated demand is written down to its estimated net realizable value based on historical usage, expected demand, the timing of new product introductions and age. It is reasonably possible that our estimate of future demand for our products could change in the near term and result in additional inventory write-downs, which would negatively impact our future results of operations.

Investments. We determine the appropriate classification of our investments at the time of purchase and reevaluate such classification as of each balance sheet date. Our available-for-sale investments are comprised of money market funds, corporate debt investments, commercial paper, government-sponsored enterprise securities, government securities and certificates of deposit. These investments are stated at fair value, with the unrealized gains and losses, net of tax, reported in the consolidated statements of comprehensive income. Amortization is included in interest and investment income. Interest on securities classified as available-for-sale is also included in interest and investment income.

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

We account for our investment in a minority interest in a company over which we do not exercise significant influence using the cost method. Under the cost method, an investment is carried at cost until it is sold or there is evidence that changes in the business environment or other facts and circumstances suggest it may be other-than-temporarily impaired. If a decline in the fair value of a cost method investment is determined to be other-than-temporary, an impairment charge will be recorded and the fair value will become the new cost basis of the investment. Our cost method investment is included in other assets on the consolidated balance sheets.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

No material changes in our market risk occurred from December 31, 2011 through June 30, 2012. Information regarding our market risk at December 31, 2011, 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, 2011.

Item 4. CONTROLS AND PROCEDURES

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

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

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

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Information regarding reportable legal proceedings is contained in Item 3. “Legal Proceedings,” in our Annual Report on Form 10-K for the year ended December 31, 2011.

Item 1A. RISK FACTORS

There have been no material changes to the risk factors included in Item 1A. of our Annual Report on Form 10-K for the year ended December 31, 2011, filed on February 29, 2012, except for the risk factor entitled “Our inability to hire or retain key personnel, or to effectively manage headcount increases, could impair our intended growth,” which is supplemented by the following risk factor.

Our future success will depend to a significant extent on the continued services of our executive officers and senior personnel, and the loss of services of any of these employees or the inability to timely retain a qualified replacement could harm our business.

Our future success will depend to a significant extent on the continued services of our executive officers and senior personnel. The loss of services of any of these individuals could harm our business. As previously disclosed, John Burris, our Chief Executive Officer, took a medical leave of absence effective June 28, 2012 to undergo a series of treatments for colon cancer. Mr. Burris' leave of absence could disrupt our business and cause our stock price to drop. In the event that Mr. Burris is unable to return to his position as Chief Executive Officer, we may experience increased costs in order to identify and recruit a suitable replacement in a timely manner. Even if we were able to hire a qualified successor, the search process and transition period may be difficult to manage, may cause concerns from current and potential customers and other third parties with whom we do business, may result in operational disruptions during such time that could adversely affect our business and may result in a drop in our stock price.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Use of Proceeds

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

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

Repurchase of Equity Securities During the Period Ended June 30, 2012

The following table provides information about purchases by us during the three months ended June 30, 2012 of equity securities that are registered by us pursuant to Section 12 of the Securities Exchange Act.

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

These were the only repurchases of equity securities made by us during the three months ended June 30, 2012. We do not currently have a stock repurchase program.

Period	Total Number of Shares Purchased		Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
4/1/12 – 4/30/12	375	(1)	$0.001	—	—

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

Item 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. OTHER INFORMATION

Sixth Amended and Restated Bylaws

Effective July 27, 2012, our Board of Directors approved the Sixth Amended and Restated Bylaws of the Company. Section 1.3 of the Fifth Amended and Restated Bylaws was amended to clarify the scope of business to be conducted at any special meeting, and Section 1.11 of the Fifth Amended and Restated Bylaws was amended to clarify that the provisions set forth therein are the exclusive means by which stockholders may propose business at annual meetings. In addition, the amended and restated bylaws no longer include Section 6.7 of the Fifth Amended and Restated Bylaws relating to review and approval requirements for related party transactions, which is a topic addressed by our Audit Committee Charter. The Sixth Amended and Restated Bylaws are attached to this Quarterly Report on Form 10-Q as Exhibit 3.2. The foregoing description of the Bylaws is qualified in its entirety by reference to the full text thereof.

Changes in Compensatory Arrangements with Interim Chief Executive Officer

As previously reported, effective June 28, 2012, our Board of Directors appointed Martin F. Roesch as our interim Chief Executive Officer in connection with the medical leave of absence taken by John C. Burris, our Chief Executive Officer. On July 27, 2012, the Compensation Committee of our Board of Directors approved changes, on an interim basis, in Mr. Roesch's compensation arrangements. Mr. Roesch's base salary was increased from $300,200 to $360,700 and his annualized target cash bonus amount under our executive annual bonus incentive plan for 2012 was increased from $129,300 to $239,300. The changes in Mr. Roesch's base salary and annualized target cash bonus amount are effective July 1, 2012 and will remain in effect for the duration of his service as our interim Chief Executive Officer or until such time as otherwise determined by the Compensation Committee. Additional information regarding compensation of our executive officers, including our executive annual bonus incentive plan for 2012, can be found in our definitive proxy statement dated April 10, 2012 filed with the Securities and Exchange Commission.

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 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.

	SOURCEFIRE, INC.
Date: August 2, 2012	By: /s/ Martin F. Roesch Martin F. Roesch Interim Chief Executive Officer and Chief Technology Officer (duly authorized officer)
Date: August 2, 2012	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	Sixth Amended and Restated Bylaws					X
3.3	Certificate of Designation of the Series A Junior Participating Preferred Stock	8-A	1-33350	3.1	10/30/2008	
4.1	Form of stock certificate of common stock	S-1/A	333-138199	4.1	3/6/2007	
4.2	Rights Agreement, dated as of October 30, 2008, by and between the Company and Continental Stock Transfer & Trust Co., as rights agent	8-A	1-33350	4.1	10/30/2008	
10.1	Amendment No. 1 to Amended and Restated Manufacturing Services and Supply Agreement by and between Sourcefire, Inc. and Patriot Technologies, Inc.					X
10.2	Amendment No. 1 to Manufacturing and Supply Agreement by and between Sourcefire, Inc. and Premio, Inc.					X
10.3	Non-Employee Director Compensation Policy, as amended effective May 31, 2012					X
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X
101.INS	XBRL Instance Document					X
101.SCH	XBRL Taxonomy Extension Schema Document					X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document					X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document					X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document					X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document					X

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