SOURCEFIRE INC
Form 10-Q
November 10, 2008

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

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

For the transition period from __________ to __________

Commission File Number
1-33350

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

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

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

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

Yes þ No o

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

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

Yes o No þ

As of November 4, 2008, there were 25,866,705 outstanding shares of the registrant s Common Stock.

SOURCEFIRE, INC.
Form 10-Q
TABLE OF CONTENTS

Part I. FINANCIAL INFORMATION
Item 1. Financial Statements

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

	September 30, 2008 (unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 28,599	$ 33,071
Short-term investments	64,463	69,816
Accounts receivable, net of allowances of $186 as of September 30, 2008 and $160 as of December 31, 2007	24,411	20,689
Inventory	4,192	4,863
Prepaid expenses and other current assets	3,078	2,651
Total current assets	124,743	131,090
Property and equipment, net	7,888	4,041
Intangible assets, net of accumulated amortization	497	592
Investments	2,404	4,140
Restricted cash		1,000
Other assets	1,280	815
Total assets	$ 136,812	$ 141,678
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,868	$ 5,930
Accrued compensation and related expenses	3,269	3,151
Other accrued expenses	2,362	1,458
Current portion of deferred revenue	19,525	18,417
Current portion of capital lease obligations	47	
Other current liabilities	712	832
Total current liabilities	28,783	29,788
Deferred revenue, less current portion	2,944	2,610
Capital lease obligations, less current portion	4	
Other long-term liabilities	86	86
Total liabilities	31,817	32,484

Commitments and Contingencies

Stockholders equity:				
Preferred stock, $0.001 par value; 20,000,000 shares authorized; no shares issued and outstanding at September 30, 2008 and December 31, 2007				
Common stock, $0.001 par value; 240,000,000 shares authorized; 25,865,977 and 24,642,433 shares issued and outstanding as of September 30, 2008 and December 31, 2007, respectively		25		24
Additional paid-in capital		158,051		153,693
Accumulated deficit		(52,862)		(44,523)
Accumulated other comprehensive loss		(219)		
Total stockholders equity		104,995		109,194
Total liabilities and stockholders equity	$	136,812	$	141,678

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 September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Revenue:				
Products	$ 12,661	$ 9,403	$ 28,189	$ 21,103
Technical support and professional services	7,628	5,403	21,769	15,418
Total revenue	20,289	14,806	49,958	36,521
Cost of revenue:				
Products	3,585	2,665	8,061	5,809
Technical support and professional services	1,345	800	3,583	2,277
Total cost of revenue	4,930	3,465	11,644	8,086
Gross profit	15,359	11,341	38,314	28,435
Operating expenses:				
Research and development	3,267	2,895	9,525	8,076
Sales and marketing	8,655	6,746	23,834	18,563
General and administrative	4,984	2,540	13,929	7,288
Depreciation and amortization	775	427	1,852	1,177
In-process research and development		2,947		2,947
Total operating expenses	17,681	15,555	49,140	38,051
Loss from operations	(2,322)	(4,214)	(10,826)	(9,616)
Other income, net:				
Interest and investment income	683	1,417	2,666	3,351
Interest expense	(2)		(38)	(35)
Other income (expense)	(39)	3	(1)	(9)
Total other income, net	642	1,420	2,627	3,307
Loss before income taxes	(1,680)	(2,794)	(8,199)	(6,309)
Income tax expense	39	50	140	120
Net loss	(1,719)	(2,844)	(8,339)	(6,429)
Accretion of preferred stock				(870)
Net loss attributable to common stockholders	$ (1,719)	$ (2,844)	$ (8,339)	$ (7,299)
Net loss attributable to common stockholders per share:				
Basic and diluted	$ (0.07)	$ (0.12)	$ (0.33)	$ (0.38)

Weighted average shares outstanding used in computing per share amounts:				
Basic and diluted	25,698,879	24,218,634	25,208,404	19,027,750

See accompanying notes to consolidated financial statements

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

	Common Stock		Additional Paid In	Accumulated	Accumulated Other Comprehensive Income	
	Shares	Amount	Capital	Deficit	(Loss)	Total
Balance as of January 1, 2008	24,642,433	$ 24	$ 153,693	$ (44,523)	$	$ 109,194
Exercise of common stock options	674,063	1	840			841
Issuance of common stock under employee stock purchase plan	50,796		264			264
Issuance of restricted common stock	524,550					
Repurchase of common stock	(25,865)		(140)			(140)
Stock-based compensation expense			3,370			3,370
Excess tax benefit relating to share-based payments			24			24
Comprehensive income (loss):						
Net loss for the nine months ended September 30, 2008				(8,339)		(8,339)
Net unrealized loss on investments					(220)	(220)
Currency translation adjustment					1	1
Total comprehensive income (loss)						(8,558)
Balance as of September 30, 2008	25,865,977	$ 25	$ 158,051	$ (52,862)	$ (219)	$ 104,995

See accompanying notes to consolidated financial statements

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

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Operating activities		
Net loss	$ (8,339)	$ (6,429)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,874	1,202
Non-cash stock-based compensation	3,370	1,911
Amortization of premium on investments	(871)	(933)
Loss on disposal of assets	7	
Realized gain from sales of investments	(23)	
Write-off of acquired in-process research and development costs		2,947
Changes in operating assets and liabilities:		
Accounts receivable	(3,722)	2,587
Inventory	672	(1,065)
Prepaid expenses and other assets	(891)	(1,871)
Accounts payable	(3,062)	(1,145)
Accrued expenses	2,022	54
Deferred revenue	1,442	1,773
Other liabilities	(113)	303
Net cash used in operating activities	(7,634)	(666)
Investing activities		
Purchase of property and equipment	(5,566)	(2,494)
Purchase of investments	(73,137)	(95,895)
Proceeds from maturities of investments	77,663	34,000
Proceeds from sales of investments	3,230	
Cash paid for acquisition of ClamAV, including direct acquisition costs of $81		(3,581)
Cash held in escrow related to acquisition of ClamAV		(1,000)
Net cash provided by (used in) investing activities	2,190	(68,970)
Financing activities		
Borrowings of long-term debt		113
Repayments of long-term debt and capital lease obligations	(17)	(1,424)
Proceeds from issuance of common stock, net of underwriters discount of $6,495		86,288
Proceeds from employee stock-based plans	1,105	214
Repurchase of common stock	(140)	
Excess tax benefits related to share-based payments	24	
Payment of equity offering costs		(1,367)
Net cash provided by financing activities	972	83,824
Net (decrease) increase in cash and cash equivalents	(4,472)	14,188

Cash and cash equivalents at beginning of period	33,071	13,029
Cash and cash equivalents at end of period	$ 28,599	$ 27,217

See accompanying notes to consolidated financial statements.

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

1. Description of Business

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

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

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

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to those rules or regulations. The interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, considered necessary for a fair presentation. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission on February 28, 2008. The results of operations for the interim periods are not necessarily indicative of results to be expected in future periods.

Use of Estimates

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

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

Investments

The Company accounts for investments in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company s investments are comprised of money market funds, corporate debt investments, asset-backed securities and commercial paper.

These investments have been classified as available-for-sale. Available-for-sale investments are stated at fair value, with the unrealized gains and losses, net of tax, reported in other comprehensive income. The amortization of premiums and accretion of discounts to maturity is computed under the effective interest method. Such amortization is included in interest and investment income. Interest on securities classified as available-for-sale is also included in interest and investment income. (See Note 3 for further discussion of the classification of the Company s investments.) The Company reviews its investments on a regular basis to determine whether an other-than-temporary decline in fair value has occurred. Any other-than-temporary declines in fair value are recorded in earnings, and a new cost basis for the investment is established.

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the tax basis of assets and liabilities for financial reporting purposes and amounts recognized for income tax purposes. The Company records a valuation allowance to reduce the Company s deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of September 30, 2008 and December 31, 2007, the Company s deferred tax assets were fully reserved except for foreign deferred tax assets of $53,000 and $29,000, respectively, expected to be available to offset foreign tax liabilities in the future. For the three months ended September 30, 2008 and 2007, the Company recorded a provision for income taxes of $39,000 and $50,000, respectively, related to foreign income taxes. For the nine months ended September 30, 2008 and 2007, the Company recorded a provision for income taxes of $140,000 and $120,000, respectively, related to foreign income taxes.

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

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2), which delays the effective date of SFAS No. 157 by one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On January 1, 2008, the Company adopted SFAS No. 157 for financial assets and liabilities. The adoption did not have a material impact on the consolidated financial statements. See Note 7 for additional discussion of fair value measurements. The Company has not yet determined the impact on its consolidated financial statements, if any, from the adoption of SFAS No. 157, as it pertains to non-financial assets and non-financial liabilities.

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

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

3. Investments

Prior to the first quarter of 2008, the Company s investment portfolio was designated as held-to-maturity , and all investments had historically been held until their full maturity. During the first quarter of 2008, the Company sold two investments. Due to the desire to better manage its investment risks in the currently volatile credit markets, the Company now classifies its investments as available-for-sale. Accordingly, the amortized cost for all investment securities was transferred from held-to-maturity to available-for-sale, and the unrealized holding gain at the date of the transfer was reported in other comprehensive income. At the date of the transfer between categories, the amortized cost and unrealized holding gains for all investments were $93.8 million and $321,000, respectively. All investment securities are currently measured at fair value (see Note 7 for additional information).

During the first quarter of 2008, the Company sold securities prior to their maturity for proceeds of $3.2 million and recorded a realized gain of $23,000. No securities were sold prior to their maturity during the second or third quarters of 2008.

The following is a summary of available-for-sale investments as of September 30, 2008 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Money market funds	$ 20,179	$	$	$ 20,179
Corporate debt investments	15,279	8	(261)	15,026
Asset-backed securities	22,289	6	(21)	22,274
Commercial paper	31,193	58	(2)	31,249
Government securities	1,820		(8)	1,812
Certificate of deposit	1,000			1,000
Total investments	91,760	$ 72	$ (292)	91,540
Amounts classified as cash equivalents	(24,665)	(8)		(24,673)
Total available-for-sale investments	$ 67,095	$ 64	$ (292)	$ 66,867

The Company concluded that there were no other-than-temporary declines in investments recorded in the nine months ended September 30, 2008. For the nine months ended September 30, 2008, the net unrealized holding losses on available-for-sale securities included in other comprehensive loss totaled $220,000. The investments in an unrealized loss position have a relatively short maturity and the Company has the intent and ability to hold these investments until they recover in value or mature. The deferred tax benefit recorded in other comprehensive loss was fully offset by the valuation allowance the Company recorded for related deferred tax assets.

The net carrying value and estimated fair value of available-for-sale investments by contractual maturity as of September 30, 2008 are as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 64,670	$ 64,463
Due after one year through five years	2,425	2,404
Total	$ 67,095	$ 66,867

4. Stock-Based Compensation

During 2002, the Company adopted the Sourcefire, Inc. 2002 Stock Incentive Plan (the 2002 Plan). The plan provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Company s Board of Directors. As of September 30, 2008, the Company has reserved an aggregate of 5,100,841 shares of common stock for issuance under the 2002 Plan. Following the adoption of the 2007 Stock Incentive Plan (the 2007 Plan) described below, there are no additional shares available for grant under the 2002 Plan.

In March 2007, the Company s Board of Directors approved the 2007 Plan, which provides for the granting of equity-based awards, including stock options, restricted or unrestricted stock awards, and stock appreciation rights to employees, officers, directors, and other individuals as determined by the Board of Directors. As of December 31, 2007, the Company had reserved an aggregate of 3,142,452 shares of common stock for issuance under the 2007 Plan. On January 1, 2008, under the terms of the 2007 Plan, the aggregate number of shares reserved for issuance under the 2007 Plan was increased by an amount equal to 4% of the Company s outstanding common stock as of December 31, 2007, or 985,697 shares. Therefore, as of September 30, 2008, the Company has reserved an aggregate of 4,128,149 shares of common stock for issuance under the 2007 Plan.

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

Valuation of Stock-Based Compensation

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

Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures. Effective April 1, 2008, the Company adjusted its estimated forfeiture rate from 15% to 20% per annum for options and from 10% to 14% per annum for restricted stock grants. The Company relies on historical experience of employee turnover to estimate its expected forfeitures.

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

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