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.

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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)

	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, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 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.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
Stock options:				
Average risk-free interest rate	3.4%	4.3%	3.2%	4.6%
Expected dividend yield	%	%	%	%
Expected useful life (years)	6.25	6.25	6.25	6.25
Expected volatility	62.7%	71.1%	64.0%	74.9%
Weighted-average fair value per grant	$4.20	$6.80	$4.22	$8.68
Employee stock purchase plan:				
Average risk-free interest rate	1.9%		2.3%	
Expected dividend yield			%	
Expected useful life (years)	0.25		0.34	
Expected volatility	52.6%		56.1%	
Weighted-average fair value per purchase	$1.91		$1.71	

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

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

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

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

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

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

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

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

During the third quarter of 2008, the Company granted an option to purchase 99,924 shares of common stock to its new Chief Executive Officer. The options vest based on the price of the Company's common stock achieving certain levels. The Lattice option pricing model was used for the valuation of this option because the valuation of this award cannot be reasonably estimated using the Black-Scholes option pricing model. The weighted-average assumptions using the Lattice option pricing model included a volatility of 65%, an average risk-free interest rate of 3.5%, a dividend yield of 0% and a strike price of $6.77.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Product cost of revenue	$ 11	$ 11	$ 27	$ 16
Services cost of revenue	34	38	66	50
Stock-based compensation expense included in cost of revenue	45	49	93	66
Research and development	202	88	543	257
Sales and marketing	375	300	1,017	755
General and administrative	945	282	1,717	833
Stock-based compensation expense included in operating expenses	1,522	670	3,277	1,845
Total stock-based compensation expense	$ 1,567	$ 719	$ 3,370	$ 1,911

Stock Options

The following table summarizes stock option activity under the plans for the nine months ended September 30, 2008 (in thousands, except share and per share data):

	Number of Shares	Range of Exercise Prices	Weighted-Average Exercise Price	Aggregate Intrinsic Value
Outstanding at December 31, 2007	3,063,588	$ 0.24 to 15.49	$ 4.05	$ 15,266
Granted	1,156,593	5.97 to 8.00	6.83	
Exercised	(674,063)	0.24 to 6.47	1.25	
Forfeited	(228,203)	1.14 to 13.10	7.91	
Outstanding at September 30, 2008	3,317,915	$ 0.24 to 15.49	$ 5.32	$ 9,151
Vested and exercisable at September 30, 2008	1,727,067	$ 0.24 to 15.49	$ 3.34	$ 8,061
Vested and expected to vest at September 30, 2008	2,663,979		$ 4.79	$ 8,670

The following table summarizes information about stock options outstanding as of September 30, 2008:

	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 1.14	862,985	$ 0.62	4.96	862,985	$ 0.62
$1.62 to 6.47	900,963	3.92	7.29	529,917	2.95
$6.73 to 8.00	849,924	6.94	9.58		
$9.48 to 15.49	704,043	10.93	7.82	334,165	11.00
	3,317,915	$ 5.32	7.38	1,727,067	$ 3.34

The aggregate intrinsic value of all options exercised during the nine months ended September 30, 2008 and 2007 was $4.2 million and $1.5 million, respectively.

Outstanding stock option awards are generally subject to service-based vesting; however, in some instances, awards contain provisions for acceleration of vesting upon performance, change in control and in certain other circumstances. Based on the estimated grant date fair value of employee stock options granted, the Company recognized compensation expense of $736,000 and $626,000 for the three months ended September 30, 2008 and 2007, respectively, and $1.7 million and $1.5 million for the nine months ended September 30, 2008 and 2007, respectively. The grant date aggregate fair value of options, net of estimated forfeitures, not yet recognized as expense as of September 30, 2008 was $4.9 million, which will be recognized over a weighted average period of 3.09 years.

Restricted Stock Awards

The following table summarizes the unvested restricted stock award activity during the nine months ended September 30, 2008:

	Number of Shares		Weighted-Average Grant Date Fair Value
Unvested at December 31, 2007	295,680	$	10.56
Granted	524,550		6.72
Restrictions Lapsed	(140,221)		9.55
Forfeited	(7,750)		9.59
Unvested at September 30, 2008	672,259	$	7.78

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

The fair value of the unvested restricted stock awards is measured using the closing price of the Company s stock on the date of grant, or the estimated fair value of the common stock if granted prior to the Company s IPO. The total compensation expense related to restricted stock awards for the three months ended September 30, 2008 and 2007 was $794,000 and $93,000, respectively, and $1.6 million and $431,000 for the nine months ended September 30, 2008 and 2007, respectively.

As of September 30, 2008, there was $3.0 million of unrecognized compensation expense, net of estimated forfeitures, related to unvested restricted stock awards. This amount is expected to be recognized over a weighted-average period of 2.68 years.

Employee Stock Purchase Plan

On October 3, 2007, the stockholders of the Company approved the 2007 ESPP that had previously been approved by the Company s Board of Directors. The Company adopted the 2007 ESPP to provide a means by which the Company s employees, and employees of any parent or subsidiary of the Company as may be designated by the Board of Directors, will be given an opportunity to purchase shares of the Company s common stock. The 2007 ESPP allows eligible employees to purchase the Company s common stock at 85% of the lower of the stock price at the beginning or end of the offering period, which generally is a six-month period. The Compensation Committee of the Company s Board of Directors administers the 2007 ESPP. An aggregate of 1,000,000 shares of the Company s common stock have been reserved for issuance under the 2007 ESPP. During the nine months ended September 30, 2008, an aggregate of 50,796 shares were purchased under the 2007 ESPP for a total of $264,000. For the three months and nine months ended September 30, 2008, the Company recognized $37,000 and $107,000, respectively, of compensation expense related to the 2007 ESPP.

5. Net Loss per Share

Basic net loss attributable to common stockholders per share is computed by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted net loss attributable to common stockholders per share includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The calculation of basic and diluted net loss per share for the three months and nine months ended September 30, 2008 and 2007 is summarized as follows (in thousands, except share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Numerator:				
Net loss attributable to common stockholders	$ (1,719)	$ (2,844)	$ (8,339)	$ (7,299)
Denominator:				
Weighted-average shares of common stock outstanding	25,698,879	24,218,634	25,208,404	19,027,750
Net loss attributable to common stockholders per share:				
Basic and diluted	$ (0.07)	$ (0.12)	$ (0.33)	$ (0.38)

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

The following summarizes the potential outstanding common stock of the Company as of the end of each period:

	September 30, 2008	September 30, 2007
Options to purchase common stock	3,317,915	3,313,532
Shares of common stock into which outstanding warrants are convertible		36,944
Unvested shares of restricted common stock		12,315
Total	3,317,915	3,362,791

6. Comprehensive Income (Loss)

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

	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2008
Net loss	$ (1,719)	(8,339)
Comprehensive income (loss):		
Change in net unrealized loss on investments	(260)	(220)
Change in cumulative translation adjustment	1	1
Total comprehensive income (loss)	$ (1,978)	$ (8,558)

There was no comprehensive income or loss for the three months and nine months ended September 30, 2007.

7. Fair Value Measurement

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

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

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

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

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

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

The following table presents the Company s financial assets and liabilities that were accounted for at fair value as of September 30, 2008 by level within the fair value hierarchy (in thousands):

	Assets at Fair Value	Fair Value Measurement Using Level 1	Level 2	Level 3
Money market funds	$ 20,179	$ 20,179	$	$
Corporate debt investments	15,026		15,026	
Asset-backed securities	22,274		22,274	
Commercial paper	31,249		31,249	
Government securities	1,812		1,812	
Certificate of deposit	1,000		1,000	
Total cash equivalents and investments	91,540	$ 20,179	$ 71,361	$
Cash	3,926			
Total cash, cash equivalents and investments	$ 95,466			

8. Business and Geographic Segment Information

The Company manages its operations on a consolidated basis for purposes of assessing performance and making operating decisions. Accordingly, the Company does not have reportable segments. Revenues by geographic area for the three months and nine months ended September 30, 2008 and 2007 were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
United States	$ 16,433	$ 11,415	$ 37,456	$ 27,981
All foreign countries	3,856	3,391	12,502	8,540
Consolidated total	$ 20,289	$ 14,806	$ 49,958	$ 36,521

For the three months ended September 30, 2008, the Company had two significant customers that accounted for 34% of total revenue. For the three months ended September 30, 2007, the Company had one significant customer that accounted for 15% of total revenue. For the nine months ended September 30, 2008 and 2007, the Company had one significant customer that accounted for 13% and 10% of total revenue, respectively. Each of the significant customers is a reseller of the Company s products.

As of September 30, 2008, approximately 35% of the Company s accounts receivable was due from two customers, both of which are resellers.

9. Legal Proceedings

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

United States District Court of the Southern District of New York has transferred the *Pincus* case to the United States District Court for the District of Maryland (the Court).

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

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

On November 20, 2007, the defendants moved to dismiss the Amended Consolidated Class Action Complaint. On April 23, 2008, the motion to dismiss was granted in part and denied in part. On May 7, 2008, the defendants filed an answer denying all liability. On May 12, 2008, the Court entered a scheduling order.

On or about June 18, 2008, the lead plaintiff filed a motion for class certification, appointment of class representative and for the appointment of class counsel and liaison counsel for the class. The defendants opposition to that motion is due on or before November 19, 2008 and any replies are due on or before January 9, 2009.

On July 16, 2008, the Court granted the parties motion to amend the Court s prior scheduling order to provide the parties with an opportunity to conduct a mediation. The initial meeting with the mediator took place on October 17, 2008.

The Court has not made a determination of whether a class can be certified. At this time, plaintiffs have not specified the amount of damages they are seeking in these actions. If the mediation should prove unsuccessful in resolving this matter, the Company intends to vigorously defend this action.

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

10. Commitments and Contingencies

The Company purchases components for its products from a variety of suppliers and uses several contract manufacturers to provide manufacturing services for its products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, the Company enters into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon information provided by the Company. In certain instances, these agreements allow the Company the option to cancel, reschedule, and adjust the Company s requirements based on its business needs prior to firm orders being placed. Consequently, a portion of the Company s reported purchase commitments arising from these agreements are firm, non-cancelable, and unconditional commitments. As of September 30, 2008, the Company had total purchase commitments for inventory of approximately $4.4 million due within the next 12 months.

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

11. Change in Management

On February 27, 2008, the Company and E. Wayne Jackson III, the Company s Chief Executive Officer at that time, elected not to renew the term of the Employment Agreement, dated as of May 6, 2002, by and between Mr. Jackson and the Company, which was originally scheduled to expire at the close of business on May 5, 2008. Mr. Jackson continued to serve as Chief Executive Officer during a transition period until his successor was named. In June 2008, the Company announced that John C. Burris, a director of the Company since March 2008, would assume the role of Chief Executive Officer effective as of July 14, 2008. On July 14, 2008, Mr. Jackson resigned as an executive officer and director of the Company, and Mr. Burris commenced his employment with the Company as its Chief Executive Officer.

The Company accrued $316,000 in the first quarter of 2008 related to severance and benefits as outlined under a transition agreement with Mr. Jackson. In the third quarter of 2008, the Company recognized stock-based compensation expense of $449,000 related to the accelerated vesting of Mr. Jackson s unvested equity awards on July 14, 2008.

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

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

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

Introduction

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

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

Results of Operations. This section provides an analysis of our results of operations for the three months and nine months ended September 30, 2008 as compared to the three months and nine months ended September 30, 2007.

Liquidity and Capital Resources. This section provides an analysis of our cash flows for the nine months ended September 30, 2008 and a discussion of our capital requirements and the resources available to us to meet those requirements.

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

Overview

We are a leading provider of Enterprise Threat Management, or ETM, solutions for information technology infrastructures of commercial enterprises (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, or IPS, network behavior analysis, or NBA, network access control, or NAC, and vulnerability assessment, or VA, solutions under a common management framework. This ETM approach equips our customers with an efficient and effective layered security defense protecting computer network assets before, during and after an attack.

We sell our network security solutions to a diverse customer base that includes 28 of the Fortune 100 and over half of the 30 largest U.S. government agencies. We also manage two of the security industry s leading open source initiatives, Snort and ClamAV.

Key Financial Metrics and Trends

Our financial results are affected by a number of factors, including broad economic conditions, the amount and type of technology spending of our customers, and the financial condition of our customers and the industries and geographic areas that we serve. During the third quarter of 2008, certain of the industries and geographic areas that we serve experienced weakness as macroeconomic conditions, credit market conditions, and levels of business confidence and activity deteriorated. We are continuing to monitor these factors and their potential effect on our customers and on us. A severe or prolonged economic downturn could affect our customers financial condition and the levels of business activity. This could reduce demand and depress pricing for our products and services, which could have a material adverse effect on our results of operations or financial condition. We evaluate our performance on the basis of several performance indicators, including pricing and discounts, revenue, cost of revenue, gross profit, and operating expenses. We compare these key performance indicators, on a quarterly basis, to both target amounts established by management and to our performance for prior periods.

Pricing and Discounts

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

Revenue

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

Product sales are typically recognized as revenue at shipment of the product to the customer, whether sold directly or through resellers. For sales made through distributors, we do not recognize revenue until we receive a monthly sales report indicating the product volume sold to end user customers. We recognize revenue from services when the services are performed. For technical support services, we recognize revenue ratably over the term of the support arrangement, which is generally 12 months. Our support agreements generally provide for payment in advance and automatic renewals as evidenced by customer payment.

We sell our network security solutions globally. However, 75% and 77% of our revenue for the nine months ended September 30, 2008 and 2007, respectively, was generated by sales to U.S.-based customers. We expect that our revenue from customers based outside of the United States will increase in amount and as a percentage of total revenue as we strengthen our international presence. We also expect that our revenue from sales through our indirect sales channel will increase in amount and as a percentage of total revenue as we expand our relationships with third-party distributors.

Historically, our product revenue has been seasonal, with a significant portion of our total product revenue in recent fiscal years generated in the fourth quarter. For 2008, we continue to expect a significant portion of our total revenue in the fourth quarter but do not expect that fourth quarter revenue will represent as great a percentage of total revenue as in past years. The timing of our year-end shipments could materially affect our fourth quarter product revenue in any fiscal year and quarterly comparisons. Revenue from our government customers has occasionally been influenced by the September 30th fiscal year-end of the U.S. federal government, which has historically resulted in our revenue from government customers being highest in the third quarter. Notwithstanding these general seasonal patterns, our revenue within a particular quarter is often affected significantly by the unpredictable procurement patterns of our customers. Our prospective customers usually spend a long time evaluating and making purchase decisions for network security solutions. Historically, many of our customers have not finalized their purchasing decisions until the final weeks or days of a quarter. We expect these purchasing patterns to continue in the future.

Therefore, a delay in even one large order beyond the end of the quarter could materially reduce our anticipated revenue for a quarter. Because many of our expenses must be incurred before we expect to generate revenue, delayed orders could negatively impact our results of operations for a particular period and could therefore cause us to fail to meet the financial performance expectations of securities industry research analysts or investors.

Cost of Revenue

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

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

Gross Profit

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

Operating Expenses

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

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

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, incentive compensation, benefits and related costs for sales and marketing personnel; trade show, advertising, marketing and other brand-building costs;

marketing consultants and other professional services; training, seminars and conferences; travel and related costs; and occupancy and other overhead costs.

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

General and Administrative. General and administrative expenses consist primarily of salaries, incentive compensation, benefits and related occupancy and other overhead costs for executive, legal, finance, information technology, human resources and administrative personnel; corporate development expenses and professional fees related to legal, audit, tax and regulatory compliance; travel and related costs; information systems, enterprise resource planning (ERP) system and other infrastructure costs; and corporate insurance.

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

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

Based on the estimated grant date fair value of stock-based awards, we recognized aggregate stock-based compensation expense of $1.6 million and $719,000 for the three months ended September 30, 2008 and 2007, respectively, and $3.4 million and $1.9 million for the nine months ended September 30, 2008 and 2007, respectively. We use the Black-Scholes option pricing and Lattice option pricing models to estimate the fair value of granted stock options. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility.

Results of Operations

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

	Three Months Ended September 30,		Variance		Nine Months Ended September 30,		Variance	
	2008	2007	$	%	2008	2007	$	%
Products	$ 12,661	$ 9,403	$ 3,258	35%	$ 28,189	$ 21,103	$ 7,086	34%
Percentage of total revenue	*62%*	*64%*			*56%*	*58%*		
Technical support and professional services	7,628	5,403	2,225	41%	21,769	15,418	6,351	41%
Percentage of total revenue	*38%*	*36%*			*44%*	*42%*		
Total revenue	$ 20,289	$ 14,806	$ 5,483	37%	$ 49,958	$ 36,521	$ 13,437	37%

The increase in our product revenue during the three months and nine months ended September 30, 2008, as compared to the three months and nine months ended September 30, 2007, was mostly driven by higher demand for our sensor products, primarily our enterprise class 3D products. For the three months ended September 30, 2008, sensor product revenue increased $2.9 million over the prior-year quarter, which included a $1.1 million increase in our enterprise class 3D products. For the nine months ended September 30, 2008, sensor product revenue increased $6.3 million over the prior year, which included a $3.6 million increase in our enterprise class 3D products. The increase in our services revenue for the three months and nine months ended September 30, 2008 resulted from an increase in our installed customer base due to new product sales in which associated support was purchased, as well as support renewals by our existing customers.

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

	Three Months Ended September 30,		Variance		Nine Months Ended September 30,		Variance	
	2008	2007	$	%	2008	2007	$	%
Products	$ 3,585	$ 2,665	$ 920	35%	$ 8,061	$ 5,809	$ 2,252	39%
Percentage of total revenue	*18%*	*18%*			*16%*	*16%*		
Technical support and professional services	1,345	800	545	68%	3,583	2,277	1,306	57%
Percentage of total revenue	*7%*	*5%*			*7%*	*6%*		
Total cost of revenue	$ 4,930	$ 3,465	$ 1,465	42%	$ 11,644	$ 8,086	$ 3,558	44%
Percentage of total revenue	*24%*	*23%*			*23%*	*22%*		

For the three months and nine months ended September 30, 2008, the increase in product cost of revenue was driven primarily by higher volume demand for our sensor products, for which we must procure and provide the hardware platform to our customers. We did not experience a material increase in our cost per unit of hardware platforms, which is the largest component of our product cost of revenue. The increase in our services cost of revenue for the three months and nine months ended September 30, 2008 was attributable to increased hardware service expense related to support renewal contracts and our hiring of additional personnel to both service our larger installed customer base and to provide training and professional services to our customers.

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

	Three Months Ended September 30,		Variance		Nine Months Ended September 30,		Variance	
	2008	2007	$	%	2008	2007	$	%
Products	$ 9,076	$ 6,738	$ 2,338	35%	$ 20,128	$ 15,294	$ 4,834	32%
Percentage of total revenue	*45%*	*46%*			*40%*	*42%*		
Technical support and professional services	6,283	4,603	1,680	36%	18,186	13,141	5,045	38%
Percentage of total revenue	*31%*	*31%*			*36%*	*36%*		
Total gross profit	$ 15,359	$ 11,341	$ 4,018	35%	$ 38,314	$ 28,435	$ 9,879	35%
Percentage of total revenue	*76%*	*77%*			*77%*	*78%*		

Gross profit as a percentage of total revenue for the three months and nine months ended September 30, 2008, as compared to the prior-year periods, remained relatively flat for services revenue. Gross profit as a percentage of total revenue for products for the three months and nine months ended September 30, 2008 decreased slightly, primarily due to the product mix sold being weighted more toward lower margin products and increased write-offs of our evaluation units.

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

	Three Months Ended September 30,		**Variance**		**Nine Months Ended September 30,**		**Variance**	
	2008	**2007**	**$**	**%**	**2008**	**2007**	**$**	**%**
Research and development	$ 3,267	$ 2,895	$ 372	13%	$ 9,525	$ 8,076	$ 1,449	18%
Percentage of total revenue	*16%*	*20%*			*19%*	*22%*		
Sales and marketing	8,655	6,746	1,909	28%	23,834	18,563	5,271	28%
Percentage of total revenue	*43%*	*46%*			*48%*	*51%*		
General and administrative	4,984	2,540	2,444	96%	13,929	7,288	6,641	91%
Percentage of total revenue	*24%*	*16%*			*28%*	*20%*		
Depreciation and amortization	775	427	348	81%	1,852	1,177	675	57%
Percentage of total revenue	*4%*	*3%*			*4%*	*3%*		
In-process research and development		2,947	(2,947)	(100)%		2,947	(2,947)	(100)%
Percentage of total revenue	*%*	*20%*			*%*	*8%*		
Total operating expenses	$ 17,681	$ 15,555	$ 2,126	14%	$ 49,140	$ 38,051	$ 11,089	29%
Percentage of total revenue	*87%*	*105%*			*99%*	*104%*		

Research and development expenses for the three months ended September 30, 2008 increased over the prior-year quarter, primarily due to an increase in salaries, incentive compensation, benefits and occupancy overhead expenses of $298,000 and an increase in stock-based compensation expense of $114,000, partially offset by a decrease of $82,000 in consulting fees. For the nine months ended September 30, 2008, research and development expenses increased over the prior year, primarily due to an increase in salaries, incentive compensation, benefits and occupancy overhead expenses of $1.3 million and an increase in stock-based compensation expense of $286,000, partially offset by a decrease of $168,000 in consulting fees. These increased expenses resulted from the hiring of additional personnel in our research and development department to support the release of updates and enhancements to our 3D products.

Sales and marketing expenses for the three months ended September 30, 2008 increased over the prior-year quarter, primarily due to an increase of $1.8 million in salary, commissions and incentive compensation and benefit expenses as a result of additional sales and marketing personnel and increased revenue, an increase of $178,000 in travel and travel-related expenses and an increase of $75,000 in stock-based compensation expense. For the nine months ended September 30, 2008, sales and marketing expenses increased over the prior-year period, primarily due to an increase of $4.1 million in salary, commissions and incentive compensation and benefit expenses as a result of additional sales and marketing personnel and increased revenue, an increase of $537,000 in travel and travel-related expenses, an increase of $298,000 in advertising, promotion, partner-marketing programs and trade show expenses in support of our network security solutions and an increase of $262,000 in stock-based compensation expense.

General and administrative expenses for the three months ended September 30, 2008 increased over the prior-year quarter, primarily due to an increase of $867,000 in professional fees related to legal, audit, tax and regulatory compliance, an increase of $699,000 in salaries, incentive compensation and benefit expenses for personnel hired in our accounting, information technology, human resources and legal departments, stock-based compensation expense of $449,000 for the acceleration of vesting of equity awards for our former CEO and an additional increase of $214,000 in stock-based compensation expense. For the nine months ended September 30, 2008, general and administrative expenses increased over the prior-year period, primarily due to an increase of $2.5 million in corporate development expenses and professional fees related to legal, audit, tax and regulatory compliance, an increase of $1.6 million in salaries, incentive compensation and benefit expenses for personnel hired in our accounting, information technology, human resources and legal departments, costs associated with our CEO transition of $742,000, an increase of $267,000 in director attendance, retainer and other board-related fees, stock-based compensation expense of $449,000 for the acceleration of vesting of equity awards for our former CEO and an additional increase of $435,000 in stock-based compensation expense.

Depreciation and amortization expense for the three months and nine months ended September 30, 2008 increased over the comparable prior-year periods, primarily due to the depreciation of additional lab and testing equipment purchased for our engineering department and computers purchased for personnel hired since September 30, 2007, as well as the depreciation associated with our new ERP system.

In-process research and development for the three months and nine months ended September 30, 2007 was attributable to the August 2007 acquisition of certain assets of ClamAV for which technological feasibility had not yet been reached and no alternative future use existed.

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

	Three Months Ended September 30,		**Variance**		**Nine Months Ended September 30,**		**Variance**	
	2008	**2007**	**$**	**%**	**2008**	**2007**	**$**	**%**
Other income, net	$642	$1,420	$(778)	(55)%	$2,627	$3,307	$(680)	(21)%
Percentage of total revenue	*3%*	*10%*			*5%*	*9%*		
Income tax expense	$ 39	$ 50	$ (11)	(22)%	$ 140	$ 120	$ 20	17%
	0%	*0%*			*0%*	*0%*		

Percentage of total revenue

Other income, net for the three months and nine months ended September 30, 2008 decreased over the prior-year period, primarily due to a decrease in interest and investment income as a result of lower average interest rates on invested cash balances.

We record a valuation allowance to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of September 30, 2008, our deferred tax assets were fully reserved, except for a $53,000 benefit expected to be available to offset foreign tax liabilities in the future. As of September 30, 2007, our net deferred tax assets were fully reserved. The provision for income taxes for the three and nine months ended September 30, 2008 and 2007 relates to foreign income taxes.

Seasonality

Our product revenue has tended to be seasonal. In our third quarter, we have historically benefited from the Federal government s fiscal year end purchasing activity. This increase has been partially offset by European sales, which have tended to decline significantly in the summer months due to vacation practices in Europe and the resulting delay in capital purchase activities until the fall. We have historically generated a significant portion of our product revenue in the fourth quarter due to increased activity in Europe, coupled with North American enterprise customers who operate on a calendar year budget and often wait until the fourth quarter to make their most significant capital equipment purchases. For 2008, we continue to expect a significant portion of our revenue in the fourth quarter but do not expect that fourth quarter revenue will represent as great a percentage of total revenue as in past years. The timing of these transactions could materially affect our quarterly or annual product revenue.

Quarterly Timing of Revenue

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

Liquidity and Capital Resources

Cash Flows

	Nine Months Ended September 30,	
	2008	**2007**
	(in thousands)	
Cash and cash equivalents:		
Used in operating activities	$ (7,634)	$ (666)
Provided by (used in) investing activities	2,190	(68,970)
Provided by financing activities	972	83,824
(Decrease) increase	(4,472)	14,188
Net cash at beginning of period	33,071	13,029
Net cash at end of period	28,599	27,217
Investments	66,867	76,120
Total cash, cash equivalents and investments	$ 95,466	$ 103,337

Operating Activities. Cash used in operating activities for the nine months ended September 30, 2008 is the result of our net loss of $8.3 million adjusted for $4.4 million of net non-cash revenues and expenses and changes in our operating assets and liabilities of $3.7 million. The decrease of $7.0 million in net cash provided by operating activities for the nine months ended September 30, 2008, as compared to the same period in 2007, was primarily due to an increase in our net loss, the write-off of acquired in-process research and development costs in 2007 and changes in our operating assets and liabilities, offset partially by an increase in stock-based compensation expense. Receivables increased $6.3 million primarily as a result of increased revenue and delayed customer billings during the implementation of our ERP system.

Investing Activities. Cash provided by investing activities for the nine months ended September 30, 2008 was primarily the result of maturities and sales of investments of $80.9 million, offset by purchases of investments of $73.1 million and capital expenditures of $5.6 million. Capital expenditures includes $2.7 million of capitalized costs associated with the implementation of our new ERP system. The increase of $71.2 million in net cash provided by investing activities during the nine months ended September 30, 2008, as compared to the same period in 2007, was primarily due to maturities and sales of investments.

Financing Activities. Cash provided by financing activities for the nine months ended September 30, 2008 was primarily the result of proceeds from employee stock-based plans. The decrease of $82.9 million in net cash provided by financing activities during the nine months ended September 30, 2008, as compared to the same period in 2007, was primarily due to the $86.2 million in net cash proceeds of our IPO that closed in the first quarter of 2007.

Liquidity Requirements

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

Our short-term liquidity requirements through September 30, 2009 consist primarily of the funding of working capital requirements and capital expenditures and expenses for the ongoing implementation of our new ERP system. 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 September 30, 2008, we had cash, cash equivalents and investments of $95.5 million and working capital of $96.0 million.

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

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

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

Contractual Obligations

The following table describes our commitments to settle contractual obligations in cash as of September 30, 2008 (in thousands):

		Payments Due by Period		
	Total	Less than One Year	1-3 Years	3-5 Years
Capital Leases	$ 51	$ 47	$ 4	$
Operating Leases	3,578	1,678	1,737	163
Purchase Commitments(1)	4,396	4,396		

(1) We purchase components from a variety of suppliers and use several contract manufacturers

to provide manufacturing services for our products. During the normal course of business, in order to manage manufacturing lead times and help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that allow them to procure inventory based upon information provided by us. In certain instances, these agreements allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to firm orders being placed. Consequently, a portion of our reported purchase commitments arising from these agreements are firm, non-cancelable and unconditional commitments. As of

September 30, 2008, we had total purchase commitments for inventory of approximately $4.4 million.

Critical Accounting Policies and Estimates

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

We believe that, of our significant accounting policies, which are fully described in Financial Statements and Supplementary Data in Part II, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2007, as supplemented by Note 2 to the consolidated financial statements contained in this report, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, we believe that the following accounting policies are the most critical to aid in fully understanding and evaluating our consolidated financial condition and results of operations.

Revenue Recognition. We recognize substantially all of our revenue in accordance with AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition,* as amended by SOP No. 98-4 and SOP No. 98-9. For each arrangement, we defer revenue recognition until persuasive evidence of an arrangement exists, such as a signed contract; delivery of the product has occurred and there are no remaining obligations or substantive customer acceptance provisions; the fee is fixed or determinable; and collection of the fee is probable. We allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on vendor-specific objective evidence. If vendor-specific objective evidence of fair value does not exist for each of the deliverables, we defer all revenue from the arrangement until the earlier of the point at which sufficient vendor-specific objective evidence of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. However, if the only undelivered elements are elements for which we currently have vendor-specific objective evidence of fair value, we recognize revenue for the delivered elements based on the residual method.

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

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

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

Pursuant to SFAS No. 123(R), the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing and Lattice option pricing models, which requires us to make assumptions as to volatility, risk-free interest rate, expected term of the awards, and expected forfeiture rate. The use of option valuation models requires the input of highly subjective assumptions, including the expected term and the expected stock price volatility. Additionally, the recognition of expense requires the estimation of the number of options that will ultimately vest and the number of options that will ultimately be forfeited.

Under the provisions of SFAS No. 123(R), the fair value of share-based awards is recognized as expense over the requisite service period, net of estimated forfeitures. We have assumed a forfeiture rate of 20% per annum for options and 14% per annum for restricted stock grants. We will record additional expense if the actual forfeiture rate is lower than estimated, and we will record a recovery of prior expense if the actual forfeiture rate is higher than estimated. We rely on historical experience of employee turnover to estimate our expected forfeitures.

Accounting for Income Taxes. We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the tax basis of assets and liabilities for financial reporting purposes and amounts recognized for income tax purposes. We record a valuation allowance to reduce deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. As of September 30, 2008, and December 31, 2007, our 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. We recorded a provision for income taxes of $140,000 and $120,000 for the nine months ended September 30, 2008 and 2007, respectively, related to foreign income taxes.

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

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

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

Recent Accounting Pronouncements

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

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

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

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Risk

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

Interest Rate Sensitivity

We had cash, cash equivalents and investments totaling approximately $95.5 million at September 30, 2008. The cash equivalents are held for working capital purposes while investments, made in accordance with our low-risk investment policy, take advantage of higher interest income yields. In accordance with our investment policy, we do not enter into investments for trading or speculative purposes. Some of the securities in which we invest, however, may be subject to market risk. This means that a change in prevailing interest rates may cause the fair value amount of the investment to fluctuate. To minimize this risk in the future, we intend to maintain our portfolio of cash equivalents, short- and long-term investments in a variety of securities, including commercial paper, money market funds, debt securities and certificates of deposit. Due to the nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates.

Credit Market Risk

We invest our cash in accordance with an established internal policy and in investments, comprised of money market funds, corporate debt investments, asset-backed securities and commercial paper, that historically have been highly liquid and matured at their full par value. However, as a result of the recent adverse conditions in the global credit markets, there is a risk that we may incur other-than-temporary impairment charges.

Item 4. CONTROLS AND PROCEDURES

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

Limitations. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with our policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. We continuously evaluate our internal controls and make changes to improve them.

Changes in Internal Control Over Financial Reporting. During the three months ended September 30, 2008, we substantially completed the implementation of the first phase of a new enterprise resource planning, or ERP, system, based on a suite of application software developed by Oracle Corporation. As part of the implementation, we migrated our legacy financial, human resources and order fulfillment systems to the new platform. The implementation of the ERP system represents a material change in our internal control over financial reporting. There were no other changes in our internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

For a discussion of pending legal proceedings, see Note 9, Legal Proceedings, in the Notes to the Consolidated Financial Statements included in Part I of this Form 10-Q.

Item 1A. RISK FACTORS

Set forth below and elsewhere in this report and in other documents we file with the Securities and Exchange Commission are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this report. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2007 and Part II, Item 1A. Risk Factors of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2008.

Economic, market and political conditions may adversely affect our revenue and results of operations.

Our business depends significantly on a range of factors that are beyond our control. These include:

- general economic and business conditions;
- the overall demand for network security products and services; and
- constraints on budgets and changes in spending priorities of corporations and government agencies.

The recent, significant weakening of the economy in the United States and of the global economy, the lack of availability of credit as a result of the adverse conditions in the global credit markets, the resulting reduction in business confidence and activity, or other factors that affect one or more of the industries to which we sell our products and services, could delay and decrease customer purchases, which could adversely affect our revenue and results of operations. For example, the substantial decline in the operating performance of financial institutions that is associated with problems in the financial industry could cause our current or potential financial institution customers to delay or forego purchases of our products and services. Our customers include, but are not limited to, financial institutions, defense contractors, health care providers, information technology companies, telecommunications companies and retailers. Similarly, a reduction in the budgets or spending priorities of government agencies could adversely affect our revenue and results of operations.

These same factors also could adversely affect the financial condition of our resellers and distributors, which could affect their ability to market our product and service offerings, or the financial condition of our product manufacturers, which could affect their ability to manufacture our products. Any disruption in the marketing of our product and service offerings by our resellers and distributors, or in the manufacturing of our products by our product manufacturers, could adversely affect our revenue and results of operations.

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

The efficient operation of our business is dependent on the successful operation of our information systems. In particular, we rely on our information systems to process financial information, manage inventory and administer our sales transactions. In recent years, we have experienced a considerable growth in transaction volume, headcount and reliance upon international resources in our operations. Our information systems need to be sufficiently scalable to support the continued growth of our operations and the efficient management of our business. In an effort to improve the efficiency of our operations, achieve greater automation and support the growth of our business, we are in the process of implementing a new enterprise resource planning system. As we implement this ERP system, we will be required to modify a number of operational processes and internal control procedures.

We finalized the implementation of the financial, human resources and order fulfillment components of the ERP system in the third quarter of 2008 and expect to add additional functionality in subsequent periods. We cannot assure you that the system will work as we currently intend.

Any material disruption or similar problems with the implementation or operation of this ERP system could have a material negative effect on our business and results of operations. In addition, if our information system resources are inadequate, we may be required to undertake costly modifications and the growth of our business could be harmed.

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

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

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

As a public company, we have and will continue to incur significant additional legal, accounting and other expenses that we did not incur as a private company, and our administrative staff has been and will continue to be required to perform additional tasks. In addition, changing laws, regulations and standards relating to corporate governance and public disclosure, and related regulations implemented by the Securities and Exchange Commission and the NASDAQ Global Market, are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time-consuming. These laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. We intend to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management s time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, regulatory authorities may initiate legal proceedings against us and our business may be harmed.

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

We have incurred operating losses each year since our inception in 2001. Our net loss was approximately $8.3 million and $6.4 million for the nine months ended September 30, 2008 and 2007, respectively. Our accumulated deficit as of September 30, 2008 is approximately $52.9 million. Becoming profitable will depend in large part on our ability to generate and sustain increased revenue levels in future periods.

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Although our revenue has generally been increasing, there can be no assurances that we will become profitable in the near future or at any other time. We may never achieve profitability and, even if we do, we may not be able to maintain or increase our level of profitability. We expect that our operating expenses will continue to increase in the foreseeable future as we seek to expand our customer base, increase our sales and marketing efforts, continue to invest in research and development of our technologies and product enhancements and incur significant costs associated with being a public company. These efforts may be more costly than we expect and we may not be able to increase our revenue enough to offset our higher operating expenses. In addition, if our new products and product enhancements fail to achieve adequate market acceptance, our revenue will suffer. If we cannot increase our revenue at a greater rate than our expenses, we will not become or remain profitable.

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

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

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

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

One of the characteristics of open source software is that anyone can offer new software products for free under an open source licensing model in order to gain rapid and widespread market acceptance. Such competition can develop without the degree of overhead and lead time required by traditional technology companies. It is possible for new competitors with greater resources than ours to develop their own open source security solutions, potentially reducing the demand for our solutions. We may not be able to compete successfully against current and future competitors. Competitive pressure and/or the availability of open source software may result in price reductions, reduced revenue, reduced operating margins and loss of market share, any one of which could seriously harm our business.

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

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

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

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

- the budgeting cycles, internal approval requirements and funding available to our existing and prospective customers for the purchase of network security products;
- the timing, size and contract terms of orders received, which have historically been highest in the fourth quarter, but may fluctuate seasonally in different ways;
- the level of perceived threats to network security, which may fluctuate from period to period;
- the level of demand for products sold by original equipment manufacturers, or OEMs, resellers and distributors that incorporate and resell our technologies;
- the market acceptance of open-source software solutions;
- the announcement or introduction of new product offerings by us or our competitors, and the levels of anticipation and market acceptance of those products;
- price competition;
- general economic conditions, both domestically and in our foreign markets;
- the product mix of our sales; and
- the timing of revenue recognition for our sales.

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

The cumulative effect of these factors will likely result in larger fluctuations and unpredictability in our quarterly operating results than in the operating results of many other software and technology companies. This variability and unpredictability could result in our failing to meet the revenue or operating results expectations of securities industry analysts or investors for a particular period. If we fail to meet or exceed such expectations for these or any other reasons, the market price of our shares could fall substantially, and we could face costly securities class action suits as a result. Therefore, you should not rely on our operating results in any quarter as being indicative of our operating results for any future period, nor should you rely on other expectations, predictions or projections of our future revenue or other aspects of our results of operations.

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

The market for network security products is relatively new and is expected to continue to evolve rapidly. Moreover, many customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated new techniques to gain access to and attack systems and networks. Customers look to our products to continue to protect their networks against these threats in this increasingly complex environment without sacrificing network efficiency or causing significant network downtime.

The software in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, without impeding the high network performance demanded by our customers. Although the market expects speedy introduction of software to respond to new threats, the development of these products is difficult and the timetable for commercial release of new products is uncertain. Therefore, we may in the future experience delays in the introduction of new products or new versions, modifications or enhancements of existing products. If we do not quickly respond to the rapidly changing and rigorous needs of our customers by developing and introducing on a timely basis new and effective products, upgrades and services that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

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

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

Our new products or enhancements could fail to attain sufficient market acceptance for many reasons, including:

- delays in introducing new, enhanced or modified products;
- defects, errors or failures in any of our products;
- inability to operate effectively with the networks of our prospective customers;
- inability to protect against new types of attacks or techniques used by hackers;
- negative publicity about the performance or effectiveness of our intrusion prevention or other network security products;
- reluctance of customers to purchase products based on open source software; and
- disruptions or delays in the availability and delivery of our products, which problems are more likely due to our just-in-time manufacturing and inventory practices.

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

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

In the nine months ended September 30, 2008 and 2007, existing customers that purchased additional products and services from us, whether for new locations or additional technology to protect existing networks and locations, generated a majority of our total revenue for each respective period. Part of our growth strategy is to sell additional products to our existing customers and, in particular, to sell our RNA products to customers that previously bought our Intrusion Sensor products. We may not be effective in executing this or any other aspect of our growth strategy. Our revenue could decline if our current customers do not continue to purchase additional products from us. In addition, as we deploy new versions of our existing Snort, 3D Sensor and RNA products or introduce new products, our current customers may not require the functionality of these products and may not purchase them.

We also depend on our installed customer base for future service revenue from annual maintenance fees. Our maintenance and support agreements typically have durations of one year. No single customer contributed greater than

10% of our recurring maintenance and support revenues in the nine months ended September 30, 2008. If customers choose not to continue their maintenance service, our revenue may decline.

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

Contracts with the U.S. federal and state and other national and state government agencies accounted for 21% and 12% of our total revenue for the nine months ended September 30, 2008 and 2007, respectively. Our reliance on government customers subjects us to a number of risks, including:

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

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

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

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

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

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

We market and sell our software in North America, South America, Europe, Asia and Australia, and we plan to establish additional sales presence in these and other parts of the world. Therefore, we are subject to risks associated with having worldwide operations. Sales to customers located outside of the United States accounted for 25% and 23% of our total revenue for the nine months ended September 30, 2008 and 2007, respectively. The expansion of our existing operations and entry into additional worldwide markets will require significant management attention and financial resources. We are also subject to a number of risks customary for international operations, including:

- economic or political instability in foreign markets;

- greater difficulty in accounts receivable collection and longer collection periods;

- unexpected changes in regulatory requirements;

- difficulties and costs of staffing and managing foreign operations;

- import and export controls;

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

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

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

multiple and possibly overlapping tax structures; and

foreign currency exchange rate fluctuations.

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

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

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

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

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

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

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

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

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

Included with our software and/or appliances are copies of the relevant source code and licenses for the open source programs. Alternatively, we include instructions to users on how to obtain copies of the relevant open source code and licenses. Additionally, if we combine our proprietary software with third party open source software in a certain manner, we could, under the terms of certain of these open source license agreements, be required to release the source code of our proprietary software. This could also allow our competitors to create similar products, which would result in a loss of our product sales.

We do not provide end users with a copy of the source code to our proprietary software because we believe that the manner in which our proprietary software is aligned with the relevant open source programs does not create a modification or derivative work of that open source program requiring the distribution of our proprietary source code. Our ability to commercialize our products by incorporating third party open source software may be restricted because, among other reasons:

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

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

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

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

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

A number of our products and services have been developed and licensed under the GNU General Public License and similar open source licenses. These licenses state that any program licensed under them may be liberally copied, modified and distributed. It is possible that a court would hold these licenses to be unenforceable in that or other litigation or that someone could assert a claim for proprietary rights in a program developed and distributed under them.

Any ruling by a court that these licenses are not enforceable, or that open source components of our product offerings may not be liberally copied, modified or distributed, may have the effect of preventing us from distributing or developing all or a portion of our products. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of their license agreements in such a manner that those license terms may no longer be compatible with other open source licenses in our offerings or our end user license agreement, and thus could, among other consequences, prevent us from continuing to distribute the software code subject to the modified license.

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

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

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

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

We rely primarily on copyright, trademark, patent and trade secret laws, confidentiality procedures and contractual provisions to protect our proprietary rights. As of the date hereof, we have four patents issued and 32 applications pending for examination in the U.S. and foreign jurisdictions. We also hold numerous registered United States and foreign trademarks and have a number of trademark applications pending in the United States and in foreign jurisdictions. Valid patents may not be issued from pending applications, and the claims allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate protection or competitive advantages to us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Policing unauthorized use of our technologies or products is difficult. Our products incorporate open source Snort and ClamAV software, which is readily available to the public.

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

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

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

Technology products such as ours, which interact with multiple components of complex networks, are increasingly subject to infringement claims as the functionality of products in different industry segments overlaps. Third parties may assert claims or initiate litigation related to exclusive copyright, trademark, patent, trade secret or other intellectual property rights with respect to technologies that are relevant to our business. Third party asserted claims and/or initiated litigation can include claims against us or our customers, end-users, manufacturers, suppliers, partners or distributors, alleging infringement of intellectual property rights with respect to our existing or future products (or components of those products). Any such intellectual property claims, with or without merit, could:

- be very expensive and time consuming to defend;
- require us to indemnify our customers or others for losses resulting from such claims;
- cause us to cease making, licensing or using software or products that incorporate the challenged intellectual property;
- cause product shipment and installation delays;
- require us to redesign our products, which may not be feasible;
- require us to enter into royalty or licensing agreements, which may not be available on acceptable terms, or at all, in order to obtain the right to use a necessary product or component;
- divert the attention of management and technical personnel and other resources;
- result in our paying significant amounts to settle such claims.

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

We are aware of at least one company, NetClarity, which has been issued a patent, and has filed several patent applications, that, on their face, contain claims that may be construed to be within the scope of the same broad technology area as our RNA technology. Prior to the issuance of the patent, NetClarity filed a suit against us alleging that our RNA technology and 3D security solutions misappropriated NetClarity s trade secrets. This lawsuit was settled and dismissed with prejudice in June 2007. Although we do not believe that any of our products infringe upon NetClarity s patent, there can be no assurance that NetClarity will not bring further action against us based upon the now issued patent, or later on the basis of future patents when, and if, they issue.

We rely on software licensed from other parties, the loss of which could increase our costs and delay software shipments.

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

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

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

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

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

- expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;
- loss of existing or potential customers;
- delayed or lost revenue;
- delay or failure to attain market acceptance;

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

negative publicity, which would harm our reputation.

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

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

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

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

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

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

We rely on one manufacturer, Bivio Networks, to build the hardware platform for three models of our intrusion sensor products that are used by our enterprise class customers. These enterprise class intrusion sensor products are purchased directly by customers for their internal use and are also utilized by third party managed security service providers to provide services to their customers. Revenue resulting from sales of these enterprise class intrusion sensor products accounted for approximately 27% and 20% of our product revenue for the nine months ended September 30, 2008 and 2007, respectively. The unexpected termination of our relationship with Bivio Networks would be disruptive to our business and our reputation, which could result in a material decline in our revenue as well as shipment delays and possible increased costs as we seek and implement production with an alternative manufacturer.

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

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

In addition, our future success will depend to a significant extent on the continued services of our executive officers and senior personnel. Although we have recently adopted retention plans applicable to certain of these officers, there can be no assurance that we will be able to retain their services. The loss of the services of one or more of these individuals could adversely affect our business and could divert other senior management time in searching for their replacements.

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

Part of our business strategy involves entering into additional agreements with resellers and distributors that permit them to resell our products and service offerings. Revenue resulting from our resellers and distributors accounted for approximately 64% and 55% of our total revenue for the nine months ended September 30, 2008 and 2007, respectively. For the three months ended September 30, 2008, we had two resellers that accounted for 34% of total revenue. For the three months ended September 30, 2007, one reseller accounted for 15% of total revenue. For the nine months ended September 30, 2008 and 2007, we had one reseller that accounted for 13% and 10% of total revenue, respectively. There is a risk that our pace of entering into such agreements may slow, or that our existing agreements may not produce as much business as we anticipate. There is also a risk that some or all of our resellers or distributors may be acquired, may change their business models or may go out of business, any of which could have an adverse effect on our business.

If we do not continue to establish and effectively manage our indirect distribution channels, our revenue could decline.

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

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

Our historical growth has placed, and our intended future growth is likely to continue to place, a significant strain on our management, financial, personnel and other resources. We will likely not continue to grow at our historical pace due to limits on our resources. We have grown from 227 employees at September 30, 2007 to 270 employees at September 30, 2008. Since January 1, 2005, we have opened additional sales offices and have significantly expanded our operations. This rapid growth has strained our facilities and required us to lease additional space at our headquarters.

In several recent quarters, we have not been able to hire sufficient personnel to keep pace with our growth. In addition to managing our expected growth, we have substantial additional obligations and costs as a result of becoming a public company in March 2007. These obligations include investor relations, preparing and filing periodic SEC reports, developing and maintaining internal controls over financial reporting and disclosure controls, compliance with corporate governance rules, Regulation FD and other requirements imposed on public companies by the SEC and the NASDAQ Global Market that we did not experience as a private company. Fulfilling these additional obligations will make it more difficult to operate a growing company. Any failure to effectively manage growth or fulfill our obligations as a public company could seriously harm our ability to respond to customers, the quality of our software and services and our operating results. To effectively manage growth and operate a public company, we are in the process of implementing an enterprise-wide information management system that includes new accounting, finance, management information and human resource systems and controls. Any failure by us to implement this system as planned, including any failure to adequately train personnel to use the new system, complete the implementation on schedule, complete the implementation within our budget or successfully transition our existing systems to the new system, could require us to devote significant additional management attention and financial resources, which could negatively affect the operation of our business.

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

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

- quarterly variations in our operating results compared to market expectations;
- changes in expectations as to our future financial performance, including financial estimates or reports by securities analysts;
- changes in market valuations of similar companies;
- liquidity and activity in the market for our common stock;
- actual or expected sales of our common stock by our stockholders;
- strategic moves by us or our competitors, such as acquisitions or restructurings;
- general market conditions; and
- domestic and international economic, legal and regulatory factors unrelated to our performance.

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

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

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

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

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

As of November 4, 2008, we had 25,866,705 outstanding shares of common stock. This number includes 6,185,500 shares of our common stock that we sold in our IPO, which has been and may in the future be resold at any time in the public market.

This number also includes an aggregate of approximately 10.8 million shares held by directors, officers and venture capital funds that invested in Sourcefire prior to our initial public offering, and who may sell such shares at their discretion subject to certain volume limitations. Sales of substantial amounts of our common stock in the public market, as a result of the exercise of registration rights or otherwise, or the perception that such sales could occur, could adversely affect the market price of our common stock and may make it more difficult for you to sell your common stock at a time and price that you deem appropriate.

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

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

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

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

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

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

In March 2007, we completed the initial public offering of shares of our common stock. Our portion of the net proceeds from the initial public offering was approximately $83.9 million after deducting underwriting discounts and commissions and offering expenses. We intend to use the net proceeds from the offering for working capital and other general corporate purposes, including financing growth, developing new products and funding capital expenditures. Pending such usage, we have invested the net proceeds in interest-bearing, investment grade securities.

Item 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

None.

Item 5. OTHER INFORMATION

On September 24, 2008, we entered into a letter agreement with WSR, LLC. E. Wayne Jackson, III, who was our Chief Executive Officer until July 2008, is the sole owner and chief executive officer of WSR, LLC. Under the terms of the agreement, Mr. Jackson will provide consulting and advisory services to us as may be requested from time to time.

The agreement is effective beginning October 1, 2008 and continues through September 30, 2009, unless terminated earlier by either party upon 45 days written notice or otherwise in accordance with the terms of the agreement. Under the terms of the agreement, WSR, LLC will be paid a fee of $10,000 per month.

The above description of the agreement is not complete and is qualified by reference to the full text of the agreement, which is filed as exhibit 10.3 to this Quarterly Report on Form 10-Q.

Item 6. EXHIBITS

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

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 10, 2008.

SOURCEFIRE, INC.

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

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

By: /s/ Nicholas G. Margarites
Nicholas G. Margarites
Chief Accounting Officer and
VP of Finance
(principal 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	Fourth Amended and Restated Bylaws	10-Q	1-33350	3.2	5/4/2007	
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	Participation Agreement with Thomas M. McDonough under the Sourcefire, Inc. Executive Retention Plan					þ
10.2	Participation Agreement with Thomas M. McDonough under the Sourcefire, Inc. Executive Change in Control Severance Plan					þ
10.3	Consulting Agreement with E. Wayne Jackson III					þ
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					þ
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					þ
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					þ

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The following table summarizes the carrying values and estimated fair values of our short-term and long-term debt (in thousands):

	September 30, 2015		June 30, 2015	
	Carrying Value	Fair Value	Carrying Value	Fair Value
3.75% Convertible Notes	$ 95,134	$ 100,910	$ 93,739	$ 102,645
3.50% Convertible Notes	44,654	49,424	44,654	65,230
3.50% Series A Convertible Notes	64,985	77,861	64,460	102,760
Total	$ 204,773	$ 228,195	$ 202,853	$ 270,635

The short-term and long-term debt is measured on a non-recurring basis using Level 2 inputs based upon observable inputs of the Company s underlying stock price and the time value of the conversion option, since an observable quoted price of the Convertible Notes is not readily available.

5. Commitments and Contingencies

The Company s contractual obligations were presented in the Annual Report on Form 10-K for the previous annual reporting period ended June 30, 2015. There have been no material changes outside of the ordinary course of business in those obligations during the three months ended September 30, 2015.

Litigation

From time to time, the Company is involved in legal proceedings arising in the ordinary course of its business. The Company records a provision for a loss when it believes that it is both probable that a loss has been incurred and the amount can be reasonably estimated. Currently, management believes the Company does not have any probable and estimable losses related to any current legal proceedings and claims. Although occasional adverse decisions or settlements may occur, except as described in the matters below, management does not believe that an adverse determination with respect to any of these claims would individually or in the aggregate materially and adversely affect the Company s financial condition or operating results. For certain legal proceedings, management believes that there is a reasonable possibility that material losses may be incurred; however, the Company is unable to reasonably estimate a range of reasonably possible losses with respect to these matters. Litigation is inherently unpredictable and is subject to significant uncertainties, some of which are beyond the Company s control. Should any of these estimates and assumptions change or prove to have been incorrect, the Company could incur significant charges related to legal matters that could have a material impact on its results of operations, financial position and cash flows.

Rotary Systems

On April 28, 2011, a former supplier to TomoTherapy, Rotary Systems Incorporated (Rotary Systems), filed suit in Minnesota state court, Tenth Judicial District, Anoka County, against TomoTherapy alleging misappropriation of trade secrets, as well as several other counts alleging various theories of injury. Rotary Systems alleges TomoTherapy misappropriated Rotary Systems trade secrets pertaining to a component previously purchased from Rotary Systems, which component TomoTherapy now purchases from a different supplier. The suit alleges

TomoTherapy improperly supplied the alleged trade secrets to its present supplier, Dynamic Sealing Technologies Inc. (also a named defendant in the suit). Rotary Systems has made an unspecified claim for damages of greater than $50,000. TomoTherapy moved to dismiss the case and, on August 29, 2011, the court granted the motion to dismiss with respect to all counts other than the count alleging misappropriation of trade secrets. On May 21, 2012, the court gave Rotary Systems sixty days to identify the alleged trade secrets with specificity or face dismissal of its claim with prejudice. The court held a hearing on September 20, 2012 to review Rotary Systems amended complaint. TomoTherapy filed a motion for summary judgment on the trade secret claim, the court ruled in favor of TomoTherapy on December 5, 2013, and Rotary Systems appealed. On December 22, 2014, the Minnesota Court of Appeals reversed the district court s dismissal of Rotary Systems trade secrets claim and remanded it to the district court but affirmed the dismissal of Rotary Systems other claims. In late October 2015, a final scheduling order was confirmed for the remanded claims.

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Cowealth Medical

On February 27, 2014, Cowealth Medical Holding Co., Ltd. (Cowealth), Accuray s former distributor in China, submitted a request for binding arbitration with the International Chamber of Commerce International Court of Arbitration (ICC) alleging, among other matters, that Accuray breached its distributor agreement with Cowealth by wrongfully terminating Cowealth as its distributor and misappropriated certain of Cowealth s confidential information. Cowealth is seeking damages of approximately $170.0 million and injunctive relief. Accuray has filed counterclaims for damages of approximately $35.0 million. Accuray s answer and counterclaim were submitted to the ICC on May 12, 2014, and Cowealth served its reply on June 27, 2014. A hearing was held in Hong Kong between January 26, 2015 and February 6, 2015. The parties filed closing submissions and reply closing submissions in March 2015. On October 29, 2015, the ICC ruled that Accuray was liable for certain damages and awarded Cowealth approximately $3.4 million. Interest on this amount will accrue at a rate of 5% per annum starting 30 days after the date of the award until payment. Accordingly, management has recorded a charge of $3.4 million for the first fiscal quarter ending September 30, 2015. The ICC will subsequently issue a separate ruling as to legal costs and associated expenses; however, management does not believe the likelihood of an award of legal fees to Cowealth is probable or estimable as of September 30, 2015, so no additional amount has been recorded. Prior to the ruling of the ICC, no accrual was established in the Company s consolidated financial statements because management did not believe the likelihood of an award of damages to Cowealth was probable or estimable. In addition, the Company won several of its counterclaims including the right to be assigned the existing service contracts between Cowealth and Accuray customers, transfer to Accuray any regulatory clearances, licenses or permits obtained and held for the purposes of selling the CyberKnife System in China and deliver any consigned parts in their possession.

Software License Indemnity

Under the terms of the Company s software license agreements with its customers, the Company agrees that in the event the software sold infringes upon any patent, copyright, trademark, or any other proprietary right of a third-party, it will indemnify its customer licensees against any loss, expense, or liability from any damages that may be awarded against its customer. The Company includes this infringement indemnification in all of its software license agreements and selected managed services arrangements. In the event the customer cannot use the software or service due to infringement and the Company cannot obtain the right to use, replace or modify the license or service in a commercially feasible manner so that it no longer infringes, then the Company may terminate the license and provide the customer a refund of the fees paid by the customer for the infringing license or service. The Company has not recorded any liability associated with this indemnification, as it is not aware of any pending or threatened actions that represent probable losses as of September 30, 2015.

6. Share-Based Compensation

The following table summarizes the share-based compensation charges included in the Company s condensed consolidated statements of operations and comprehensive loss (in thousands):

	Three Months Ended September 30,	
	2015	2014
Cost of revenue	$ 389	$ 395
Research and development	549	894
Selling and marketing	644	651
General and administrative	932	1,333

	$	2,514	$	3,273

7. Debt

3.75% Convertible Senior Notes due August 2016

On August 1, 2011, the Company issued the 3.75% Convertible Notes to certain qualified institutional buyers, or QIBs. The 3.75% Convertible Notes were offered and sold to the QIBs pursuant to Rule 144A under the Securities Act of 1933, as amended (the Securities Act), or Rule 144A. The net proceeds from the $100 million offering, after deducting the initial purchaser s discount and commission and the related offering costs, were approximately $96.1 million. The offering costs and the initial purchaser s discount and commission (which are recorded in Other Assets) are both being amortized to interest expense using the effective interest method over five years. The 3.75% Convertible Notes bear interest at a rate of 3.75% per year, payable semi-annually in arrears in cash on February 1 and August 1 of each year, beginning on February 1, 2012. The 3.75% Convertible Notes will mature on August 1, 2016, unless earlier repurchased, redeemed or converted.

The 3.75% Convertible Notes were issued under an Indenture between the Company and The Bank of New York Mellon Trust Company, N.A., as trustee. Holders of the 3.75% Convertible Notes may convert their 3.75% Convertible Notes at any time on or after May 1, 2016 until the close of business on the business day immediately preceding the maturity date. Prior to May 1, 2016, holders of the 3.75% Convertible Notes may convert their 3.75% Convertible Notes only under the following circumstances: (1) during any calendar quarter after the calendar quarter ending September 30, 2011, and only during such calendar quarter, if the closing sale price of the Company s common stock for each of 20 or more trading days in the 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the conversion price in effect on the last trading day of the immediately preceding calendar quarter; (2) during the five consecutive business days immediately after any five consecutive trading-day period (such five consecutive trading-day period, the Note Measurement Period) in which the trading price per $1,000 principal amount of 3.75% Convertible Notes for each trading day of that Note Measurement Period was equal to or less than 98% of the product of the closing sale price of shares of the Company s common stock and the applicable conversion rate for such trading day; (3) if the Company calls any or all of the 3.75% Convertible Notes for redemption, at any time prior to the close of business on the business day immediately preceding the redemption date; or (4) upon the occurrence of specified corporate transactions as described in the Indenture. Upon conversion by holders of the 3.75% Convertible Notes, the Company will have the right to pay or deliver, as the case may be, cash, shares of common stock of the Company or a combination thereof, at the Company s election. At any time on or prior to the 33rd business day immediately preceding the maturity date, the Company may irrevocably elect to (a) deliver solely shares of common stock of the Company in respect of the Company s conversion obligation or (b) pay cash up to the aggregate principal amount of the 3.75% Convertible Notes to be converted and pay or deliver, as the case may be, cash, shares of common stock of the Company or a combination thereof in respect of the remainder, if any, of the Company s conversion obligation in excess of the aggregate principal amount of the 3.75% Convertible Notes being converted. The initial conversion rate is 105.5548 shares of the Company s common stock per $1,000 principal amount of 3.75% Convertible Notes (which represents an initial conversion price of approximately $9.47 per share of the Company s common stock). The conversion rate, and thus the conversion price, are subject to adjustment as further described below.

Holders of the 3.75% Convertible Notes who convert their 3.75% Convertible Notes in connection with a make-whole fundamental change, as defined in the Indenture, may be entitled to a make-whole premium in the form of an increase in the conversion rate. Additionally, in the event of a fundamental change, as defined in the Indenture, holders of the 3.75% Convertible Notes may require the Company to purchase all or a portion of their 3.75% Convertible Notes at a fundamental change repurchase price equal to 100% of the principal amount of 3.75% Convertible Notes, plus accrued and unpaid interest, if any, to, but not including, the fundamental change repurchase date.

Prior to the maturity date, the Company may redeem for cash all or a portion of the 3.75% Convertible Notes if the closing sale price of its common stock exceeds 130% of the applicable conversion price (the initial conversion price is approximately $9.47 per share of common stock) of such 3.75% Convertible Notes for at least 20 trading days during any consecutive 30 trading-day period (including the last trading day of such period).

In accordance with ASC 470-20, *Debt with Conversion and Other Options*, the Company separately accounts for the liability and equity conversion components of the 3.75% Convertible Notes. The principal amount of the liability component of the 3.75% Convertible Notes was $75.9 million as of the date of issuance based on the present value of its cash flows using a discount rate of 10%, our approximate borrowing rate at the date of the issuance for a similar debt instrument without the conversion feature. The carrying value of the equity conversion component was $24.1 million. A portion of the initial purchaser s discount and commission and the offering costs totaling $0.9 million was allocated to the equity conversion component. The liability component is being accreted to the principal amount of the 3.75% Convertible Notes using the effective interest method over five years.

3.50% Convertible Senior Notes due February 2018

In February 2013, the Company issued $115.0 million aggregate principal amount of its 3.50% Convertible Notes to certain QIBs. The 3.50% Convertible Notes were offered and sold to the QIBs pursuant to Rule 144A. The net proceeds from the offering, after deducting the initial purchaser s discount and commission and the related offering costs, were approximately $110.5 million. The offering costs and the initial purchaser s discount and commission (which are recorded in Other Assets) are both being amortized to interest expense using the effective interest method over five years. The 3.50% Convertible Notes bear interest at a rate of 3.50% per year, payable semi-annually in arrears in cash on February 1 and August 1 of each year, which began on August 1, 2013. The 3.50% Convertible Notes will mature on February 1, 2018, unless earlier repurchased, redeemed or converted.

In April 2014, through a series of transactions, the Company refinanced approximately $70.3 million aggregate principal amount of the 3.50% Convertible Notes with approximately $70.3 million aggregate principal amount of the Company s new 3.50% Series A Convertible Senior Notes due 2018 (the 3.50% Series A Convertible Notes).

The 3.50% Convertible Notes were issued under an Indenture between the Company and The Bank of New York Mellon Trust Company, N.A., as trustee. Holders of the 3.50% Convertible Notes may convert their 3.50% Convertible Notes at any time until the close of business on the business day immediately preceding the maturity date. The 3.50% Convertible Notes are convertible, as described below into common stock of the Company at an initial conversion rate equal to 187.6877 shares of common stock per $1,000 principal amount of the 3.50% Convertible Notes, which is equivalent to a conversion price of approximately $5.33 per share of common stock, subject to adjustment.

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Holders of the 3.50% Convertible Notes who convert their 3.50% Convertible Notes in connection with a make-whole fundamental change , as defined in the Indenture, may be entitled to a make-whole premium in the form of an increase in the conversion rate. Additionally, in the event of a fundamental change, as defined in the Indenture, holders of the 3.50% Convertible Notes may require the Company to purchase all or a portion of their 3.50% Convertible Notes at a fundamental change repurchase price equal to 100% of the principal amount of 3.50% Convertible Notes, plus accrued and unpaid interest, if any, to, but not including, the fundamental change repurchase date.

In accordance with guidance in ASC 470-20, *Debt with Conversion and Other Options* and ASC 815-15, *Embedded Derivatives*, the Company determined that the embedded conversion components of the 3.50% Convertible Note do not require bifurcation and separate accounting. The remaining $44.7 million principal amount of the 3.50% Convertible Note has been recorded in Long-term Debt on the consolidated balance sheet as of September 30, 2015.

3.50% Series A Convertible Senior Notes due February 2018

On April 17, 2014, the Company entered into note exchange agreements with certain holders (the Participating Holders) of the 3.50% Convertible Notes to refinance approximately $70.3 million aggregate principal amount of the 3.50% Convertible Notes with approximately $70.3 million aggregate principal amount of the 3.50% Series A Convertible Notes. Pursuant to the note exchange agreements, the Company also paid the Participating Holders an aggregate of approximately $0.4 million in cash in connection with such transactions. The principal amount of 3.50% Convertible Notes refinanced for each $1,000 principal amount of the 3.50% Series A Convertible Notes was $1,000 and the amount in cash paid per $1,000 principal amount of such 3.50% Convertible Notes delivered was determined in individual negotiations between the Company and each Participating Holder. The Series A Convertible Notes have the same interest rate, maturity and other terms as the 3.50% Convertible Notes, except that the 3.50% Series A Convertible Notes are convertible into cash, shares of the Company s common stock or a combination of cash and shares of common stock, at the Company s option.

The 3.50% Series A Convertible Notes were issued under an Indenture between the Company and The Bank of New York Mellon Trust Company, N.A., as trustee. Holders of the 3.50% Series A Convertible Notes may convert their Securities at any time on or after November 1, 2017 until the close of business on the business day immediately preceding the maturity date. Prior to November 1, 2017, holders of the 3.50% Series A Convertible Notes may convert their Securities only under the following circumstances: (1) during any calendar quarter after the calendar quarter ending September 30, 2014, and only during such calendar quarter, if the closing sale price of the Company s common stock for each of 20 or more trading days in the 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the conversion price in effect on the last trading day of the immediately preceding calendar quarter; (2) during the five consecutive business days immediately after any five consecutive trading-day period (such five consecutive trading-day period, the Note Measurement Period) in which the trading price per $1,000 principal amount of 3.50% Series A Convertible Notes for each trading day of that Securities Measurement Period was equal to or less than 98% of the product of the closing sale price of shares of the Company s common stock and the applicable conversion rate for such trading day; or (3) upon the occurrence of specified corporate transactions as described in the Indenture. Upon conversion by holders of the 3.50% Series A Convertible Notes, the Company will have the right to pay or deliver, as the case may be, cash, shares of common stock of the Company or a combination thereof, at the Company s election. At any time on or prior to the 17th business day immediately preceding the maturity date, the Company may irrevocably elect to (a) deliver solely shares of common stock of the Company in respect of the Company s conversion obligation or (b) pay cash up to the aggregate principal amount of the 3.50% Series A Convertible Notes to be converted and pay or deliver, as the case may be, cash, shares of common stock of the Company or a combination thereof in respect of the remainder, if any, of the Company s conversion obligation in excess of the aggregate principal amount of the 3.50% Series A Convertible Notes being converted. The initial conversion rate is 187.6877 shares of the Company s common stock per $1,000 principal amount of 3.50% Series A Convertible Notes (which represents an initial conversion price of approximately $5.33 per share of the Company s common stock). The conversion rate, and thus the conversion price, are subject to adjustment as further described below.

Holders of the 3.50% Series A Convertible Notes who convert their Notes in connection with a make-whole fundamental change , as defined in the Indenture, may be entitled to a make-whole premium in the form of an increase in the conversion rate. Additionally, in the event of a fundamental change, as defined in the Indenture, holders of the 3.50% Series A Convertible Notes may require the Company to purchase all or a portion of their 3.50% Convertible Notes at a fundamental change repurchase price equal to 100% of the principal amount of the 3.50% Series A Convertible Notes, plus accrued and unpaid interest, if any, to, but not including, the fundamental change repurchase date.

In accordance with Accounting Standards Codification, or ASC 470-20, *Debt with Conversion and Other Options*, the Company separately accounts for the liability and equity conversion components of the 3.50% Series A Convertible Notes. The principal amount of the liability component of the 3.50% Series A Convertible Notes was $62.5 million as of the date of issuance based on the present value of its cash flows using a discount rate of 7%, our approximate borrowing rate at the date of the issuance for a similar debt instrument without the conversion feature. The carrying value of the equity conversion component was $7.9 million. In addition, the portion of the cash amount paid to the Participating Holders totaling $0.4 million was allocated to the debt discount with the remaining $47,000 to the equity component. The liability component is being accreted to the principal amount of the 3.50% Series A Convertible Notes using the effective interest method through the maturity in February 2018.

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The following table presents the carrying values of all Convertible Notes as of September 30, 2015 (in thousands):

	3.75% Notes	3.50% Notes	3.50% Series A Notes	TOTAL
Carrying amount of the equity conversion component	$ 23,189	$	$ 7,844	$ 31,033
Principal amount of the Convertible Notes	$ 100,000	$ 44,654	$ 70,346	$ 215,000
Unamortized debt discount	(4,866)		(5,361)	(10,227)
Net carrying amount	$ 95,134	$ 44,654	$ 64,985	$ 204,773

A summary of interest expense on the Convertible Notes is as follows (in thousands):

	Three months ended September 30,	
	2015	2014
Interest expense related to contractual interest coupon	$ 1,945	$ 1,943
Interest expense related to amortization of debt discount	1,920	1,759
Interest expense related to amortization of debt issuance costs	403	363
	$ 4,268	$ 4,065

8. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss consist of net loss, unrealized gains and losses on available-for-sale investments, changes in foreign currency exchange rate translation and net changes related to defined benefit pension plan. These components are excluded from earnings and reported as a component of stockholders equity. The foreign currency translation adjustment results from those subsidiaries not using the United States dollar as their functional currency since the majority of their economic activities are primarily denominated in their applicable local currency. Accordingly, all assets and liabilities related to these operations are translated at the current exchange rates at the end of each period. The resulting cumulative translation adjustments are recorded directly to the accumulated other comprehensive loss account in stockholders equity. Revenues and expenses are translated at average exchange rates in effect during the period.

The components of accumulated other comprehensive loss in the equity section of the balance sheets are as follows (in thousands):

	September 30, 2015	June 30, 2014
Net unrealized loss on short-term investments	$ (38)	$ (77)
Cumulative foreign currency translation gain	909	1,168
Defined benefit pension obligation	(1,517)	(1,517)
Accumulated other comprehensive loss	$ (646)	$ (426)

9. Subsequent Event

In February of 2014, Cowealth submitted a request for binding arbitration with the ICC alleging, among other matters, that Accuray breached its distributor agreement with Cowealth by wrongfully terminating Cowealth as its distributor and misappropriated certain of Cowealth s confidential information. Cowealth was seeking damages of approximately $170.0 million and injunctive relief.

On October 29, 2015, the ICC ruled that Accuray was liable for certain damages and awarded Cowealth approximately $3.4 million, while denying Cowealth s claim for injunctive relief. As the legal matter arose before September 30, 2015, management recorded a charge of $3.4 million into accrued liabilities and general and administrative expenses. No accrual had been recorded previously in the Company s consolidated financial statements because management did not believe the likelihood of an award of damages to Cowealth was probable or estimable. Under the terms of the ICC Rules of Arbitration all awards are binding and cannot be appealed by either party. Further issues remain to be finalized in the arbitration, none of which will affect the binding outcome under the interim award. The ICC will subsequently issue a separate ruling as to legal costs and associated expenses; however, management does not believe the likelihood of an award of legal fees to Cowealth is probable or estimable as of the date of the financials, so no additional amount has been recorded.

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

The following discussion and analysis of our financial condition as of September 30, 2015 and results of operations for the three months ended September 30, 2015 and 2014 should be read together with our condensed consolidated financial statements and related notes included elsewhere in this report. Statements made in this Form 10-Q report that are not statements of historical fact are forward-looking statements and are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report relate, but are not limited, to: our future results of operations and financial position, including the sufficiency of cash resources and expected cash flows to fund future operations, including the next 12 months; our backlog and expectations regarding age-outs and cancellations of contracts, the effects of our process improvements on age-outs, backlog and revenue; expected uses of cash during fiscal 2016; the anticipated drivers of our future capital requirements; the anticipated successful introduction of the MLC for the CyberKnife Systems, the timing of its release and its impact on our business; our expectations regarding the factors that will impact sales, competitive positioning and long-term success for our CyberKnife and TomoTherapy Systems; our belief that TomoTherapy Systems offer clinicians and patients significant benefits over other radiation therapy systems in the market; the anticipated risks associated with our foreign operations and fluctuations in the U.S. dollar and foreign currencies as well as our ability to mitigate such risks; and our business strategy, plans and objectives. Forward-looking statements generally can be identified by words such as anticipates, believes, estimates, expects, intends, plans, predicts, projects, will continue, will likely result, and similar expressions. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from expectations, including those risks discussed in this quarterly report, in particular under the heading Risk Factors in Part II, Item 1A as well as the risks detailed in Part I, Item 1A of the Company s annual report on Form 10-K for fiscal year 2015 and other filings we make with the Securities and Exchange Commission. Forward-looking statements speak only as of the date the statements are made and are based on information available to the Company at the time those statements are made and/or management s good faith belief as of that time with respect to future events. The Company assumes no obligation to update forward-looking statements to reflect actual performance or results, changes in assumptions or changes in other factors affecting forward-looking information, except to the extent required by applicable securities laws. Accordingly, investors should not place undue reliance on any forward-looking statements.

In this report, Accuray, the Company, we, us, and our refer to Accuray Incorporated and its subsidiaries.

Overview

Products and Markets

We are a radiation oncology company that develops, manufactures, sells and supports precise, innovative treatment solutions which set the standard of care, with the aim of helping patients live longer, better lives. Our leading edge technologies, the CyberKnife® and TomoTherapy Systems®, are designed to deliver advanced radiation therapy including radiosurgery, stereotactic body radiation therapy, intensity modulated radiation therapy, image-guided radiation therapy and adaptive radiation therapy tailored to the specific needs of each patient. The CyberKnife and TomoTherapy Systems are complementary offerings serving separate patient populations treated by the same medical specialty, radiation oncology, with advanced capabilities that offer increased treatment flexibility to meet the needs of an expanding patient population.

The CyberKnife Systems are robotic systems designed to deliver radiosurgery treatments to cancer tumors anywhere in the body. The CyberKnife Systems are the only dedicated, full-body robotic radiosurgery systems on the market. Radiosurgery is an alternative to traditional surgery for tumors and is performed on an outpatient basis in one to five treatment sessions. It enables the treatment of patients who otherwise would not be treated with radiation, who may not be good candidates for surgery, or who desire non-surgical treatments. The use of radiosurgery with CyberKnife Systems to treat tumors throughout the body has grown significantly in recent years, but currently only a small portion of the patients who develop tumors treatable with CyberKnife Systems are treated with these systems. A determination of when it may or may not be appropriate to use a CyberKnife System for treatment is at the discretion of the treating physician and depends on the specific patient. However, the CyberKnife Systems are generally not used to treat (1) very large tumors, which are considerably wider than the radiation beam that can be delivered by CyberKnife Systems, (2) diffuse wide-spread disease, as is often the case for late stage cancers, because they are not localized (though CyberKnife Systems might be used to treat a focal area of the disease) and (3) systemic diseases, like leukemia and lymphoma, which are not localized to an organ, but rather involve cells throughout the body. The addition of the multi-leaf collimator, or InCise MLC, now makes it faster and more efficient to treat a wider range of tumor types with the CyberKnife M6, including larger tumors and those with multiple sites of disease.

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Our CyberKnife M6 Series Systems have the option of: fixed collimator, iris collimator, and/or InCise MLC. The InCise MLC is designed specifically for the M6 Series. With the addition of the InCise MLC, clinicians can deliver the same precise radiosurgery treatments they have come to expect with the CyberKnife System, faster and for a wider range of tumor types. The InCise MLC was commercially launched in the third fiscal quarter of 2015.

We believe the long term success of the CyberKnife Systems is dependent on a number of factors including the following:

- Continued adoption of our CyberKnife M6 Series Systems;
- Production and shipment of MLC that meets the standards that we, and our customers, expect in our products;
- Change in medical practice leading to utilization of stereotactic body radiosurgery more regularly as an alternative to surgery or other treatments;
- Greater awareness among doctors and patients of the benefits of radiosurgery with the CyberKnife Systems;
- Continued evolution in clinical studies demonstrating the safety, efficacy and other benefits of using the CyberKnife Systems to treat tumors in various parts of the body;
- Continued advances in technology that improve the quality of treatments and ease of use of the CyberKnife Systems;
- Improved access to radiosurgery with the CyberKnife Systems in various countries through regulatory approvals;
- Medical insurance reimbursement policies that cover CyberKnife System treatments; and
- Expansion of sales of CyberKnife Systems in countries throughout the world.

The TomoTherapy Systems are advanced, fully integrated and versatile radiation therapy systems for the treatment of a wide range of cancer types. The TomoTherapy Systems are the only radiation therapy systems designed for image-guided intensity-modulated radiation therapy (IG-IMRT). The TomoTherapy H Series Systems come in configurations of TomoHTM, TomoHDTM and TomoHDATM. Based on a CT scanner platform, the systems provide continuous delivery of radiation from 360 degrees around the patient, or delivery from clinician-specified beam angles. These unique features, combined with daily 3D image guidance, enable physicians to delivery highly accurate, individualized dose distributions which precisely conform to the shape of the patient s tumor while minimizing dose to normal, healthy tissue, resulting in fewer side effects for patients. The TomoTherapy Systems are capable of treating all standard radiation therapy indications including breast, prostate, lung and head and neck cancers, in addition to complex treatments such as total marrow irradiation. Radiation therapy has been widely available and used in developed countries for decades, though many developing countries do not currently have a sufficient number of radiation therapy systems to adequately treat their domestic cancer patient populations. The number of radiation therapy systems in use and sold each year is currently many times larger than the number of radiosurgery systems. We believe the TomoTherapy Systems offer clinicians and patients significant benefits over other radiation therapy systems in the market. We believe our ability to capture more sales will be influenced by a number of factors including the following:

- Continued adoption of our TomoTherapy H Series Systems;

- Greater awareness among doctors and patients of the benefits of radiation therapy using TomoTherapy Systems;

- Advances in technology which improve the quality of treatments and ease of use of TomoTherapy Systems;

- Greater awareness among doctors of the now-established reliability of TomoTherapy Systems; and

- Expansion of TomoTherapy System sales in countries throughout the world.

Sale of Our Products

Generating revenue from the sale of our systems is a lengthy process. Selling our systems, from first contact with a potential customer to a signed sales contract that meets our backlog criteria (as discussed below) varies significantly and generally spans six months to two years. The time from receipt of a signed contract to revenue recognition is governed generally by the time required by the customer to build, renovate or prepare the treatment room for installation of the system.

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In the United States, we primarily market directly to customers, including hospitals and stand-alone treatment facilities, through our sales organization and we also market to customers through sales agents and group purchasing organizations. Outside the United States, we market to customers directly and through distributors and some sales agents. We have sales and service offices in many countries in Europe, Japan and other countries in Asia, South America, and throughout the world.

Backlog

For orders that cover both products and services, only the portion of the order that is recognizable as product revenue is reported as backlog. The portion of the order that is recognized as service revenue (for example, Post Contract Customer Support (PCS), installation, training and professional services) is not included in reported backlog. Product backlog totaled $379.8 million as of September 30, 2015.

In order for the product portion of a CyberKnife or TomoTherapy System sales agreement to be counted as backlog, it must meet the following criteria:

- The contract is signed and properly executed by both the customer and us. A customer purchase order that is signed and incorporates the terms of our contract quote will be considered equivalent to a signed and executed contract;

- The contract is non-contingent - it either has cleared all its contingencies or contains no contingencies when signed;

- We have received a minimum deposit or a letter of credit; the sale is a direct channel sale to a government entity, or the product has shipped to a customer with credit sufficient to cover the minimum deposit;

- The specific end customer site has been identified by the customer in the written contract or written amendment;

- For orders in our Latin America region, unless the system has already shipped and collection is reasonably assured, we request supporting evidence that the end customer has commenced construction to place our products if a site does not already exist; and

- Less than 2.5 years have passed since the contract met all the criteria above.

Although our backlog includes only contractual agreements with our customers for the purchase of CyberKnife Systems, TomoTherapy Systems and related upgrades, due to factors outside of our control, we cannot provide assurance that we will convert backlog into recognized revenue. The amount of backlog recognized into revenue is primarily impacted by three items: cancellations, age-outs and foreign currency fluctuations. Orders could be cancelled for reasons including, without limitation, changes in customers needs or financial condition, changes in government or health insurance reimbursement policies, changes to regulatory requirements, or other reasons. In addition to cancellations, after 2.5 years, if we have not been able to recognize revenue on a contract, we remove the revenue associated with the contract from backlog and the order is considered aged out. Contracts may age out for many reasons, including inability of the customer to pay, inability of the customer to adapt their facilities to accommodate our products in a timely manner, inability to timely obtain licenses necessary for customer facilities or operation of our equipment among other reasons for delays. Our backlog also includes amounts not denominated in U.S. Dollars and therefore fluctuations in the U.S. Dollar as compared to other currencies will impact backlog. Generally, strengthening in the U.S. Dollar will negatively impact backlog.

Gross orders are defined as the sum of new orders recorded during the period adjusted for any revisions to existing orders during the period. Net product orders are defined as gross product orders less cancellations, age-outs and foreign exchange adjustments.

	Three months ended September 30,	
(Dollars in thousands)	**2015**	**2014**
Gross orders	$ 64,928	$ 58,763
Net orders	44,799	32,282
Order backlog at the end of the period	379,792	364,007

Gross orders increased by $6.2 million for the three months ended September 30, 2015, as compared to the three months ended September 30, 2014. This was a result of increased order volume; in the three months ended September 30, 2015, TomoTherapy System order volume increased 7% compared to the same prior year period and CyberKnife System order volume increased 40% compared to the same prior year period.

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Net orders increased by $12.5 million for the three months ended September 30, 2015, as compared to the three months ended September 30, 2014, resulting from the increase in gross orders of $6.2 million plus an increase of $7.4 million due to foreign currency impacts. Cancellations and age-outs were similar in the three months ended September 30, 2015 as the same period in prior year.

- Age-outs were $18.5 million and $17.8 million in the three months ended September 30, 2015 and 2014, respectively. The age-outs of $18.5 million for the three months ended September 30, 2015 includes $5.3 million of age-ins which represent orders that previously aged-out but have been taken to revenue in the current period. There were no age-ins included in the age-out number for the three months ended September 30, 2014.

- Cancellations were $3.0 million and $2.6 million in the three months ended September 30, 2015 and 2014, respectively. Cancellations are outside of our control and difficult to forecast; however, we continue to work closely with our customers to minimize this impact to our business.

- Currency impact was $7.4 million as order backlog was increased due to foreign currency impacts by $1.3 million in the three months ended September 30, 2015; whereas, foreign currency impacts resulted in decreased backlog of $6.1 million in the three months ended September 30, 2014.

Currently, we expect age-outs in the second quarter of this fiscal year to be consistent with prior year at a range of $15.0 to $19.0 million as compared to the $18.1 million in age-outs recorded during the three months ended December 31, 2014. Between fiscal 2013 and 2015, we made changes to our order taking process, including increased oversight responsibility for and management of distributors and changes in timing as to when we enter some of our distributor orders into backlog. We believe these changes will improve the quality of backlog over time and reduce the level of age-outs.

Results of Operations Three months ended September 30, 2015 and 2014

	Three Months Ended September 30,						
	2015			2014			2015-2014
(Dollars in thousands except percentages)		**Amount**	**% (a)**		**Amount**	**% (a)**	**% change**
Products	$	39,995	45%	$	33,015	40%	21%
Services		49,636	55		49,366	60	1
Net revenue	$	89,631	100%	$	82,381	100%	9%
Gross profit	$	33,898	38%	$	27,801	34%	22%
Products gross profit		16,978	42		12,350	37	37
Services gross profit		16,920	34		15,451	31	10
Research and development expenses		14,296	16		14,149	17	1
Selling and marketing expenses		13,417	15		17,974	22	(25)
General and administrative expenses		13,416	15		10,950	13	23
Other expense, net		5,091	6		5,461	7	(7)
Provision for income taxes		704	1		917	1	(23)
Net loss	$	(13,026)	15%	$	(21,650)	26%	(40)%

(a) Expressed as a percentage of total net revenue, except for product and services gross profits which are expressed as a percentage of related product and sevices revenue.

Net Revenue

Product Net Revenue. Product net revenue increased by $7.0 million for the three months ended September 30, 2015, as compared to the three months ended September 30, 2014, primarily due to an increase of $5.1 million in the number of CyberKnife and TomoTherapy systems taken to revenue in the current period as compared to prior year period. In addition, upgrade and other revenue increased $1.9 million from the prior year period driven heavily by the demand for CyberKnife MLC upgrades.

Services Net Revenue. Services net revenue increased by $0.3 million for the three months ended September 30, 2015, as compared to the three months ended September 30, 2014. The increase in services net revenue was primarily attributable to an increase in spare parts revenue.

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Net revenue by geographic region, based on the shipping location of our customers, is as follows (in thousands, except percentages):

	Three Months Ended September 30, 2015	2014
Net revenue	$ 89,631	$ 82,381
Americas	50%	47%
Europe, Middle East, India and Africa	26%	37%
Asia-Pacific (excluding Japan and India)	19%	6%
Japan	5%	10%

Revenue derived from sales outside of the Americas region was $44.3 million and $43.9 million for the three months ended September 30, 2015 and 2014, respectively, and represented 50% and 53% of our net revenue during these periods.

Gross Profit

Overall gross profit for the three months ended September 30, 2015, increased $6.1 million, or 22%, as compared to the three months ended September 30, 2014. Product gross profit increased 37%, or $4.6 million, primarily due to the increase in systems taken to revenue resulting in a higher profit margin due to increased leveraging of certain fixed costs. Service gross profit increased 10%, or $1.5 million, which was caused by a combination of higher service revenues of $0.3 million and decreased service costs of $1.2 million. The decrease in the service costs was driven by cost management of departmental spend due to lower headcount as compared to the same period in prior year.

Research and Development

Research and development expenses were $14.3 million in the three months ended September 30, 2015 as compared to $14.2 million in the three months ended September 30, 2014, which represents an increase of $0.1 million, or 1%. The increase was primarily due to consulting fees which increased $1.6 million as a result of a development project that started in the third fiscal quarter of 2015. This increase was partially offset by decreased headcount related expenses of $1.1 million due to lower headcount as compared with prior period and a decrease in IT and facilities allocated expenses of $0.3 million due to the overall decrease in operating expenses as compared with prior period.

Selling and Marketing

Selling and marketing expenses for the three months ended September 30, 2015 were $13.4 million as compared to $18.0 million for the three months ended September 30, 2014, which represents a decrease of $4.6 million, or 25%. The decrease is primarily due to a $2.3 million reduction in marketing and travel related expenses due to the timing of trade show costs associated with the American Society for Radiation Oncology (or ASTRO) which will take place in the second fiscal quarter of 2016; whereas, it took place in the first fiscal quarter of the prior year. Headcount related expenses also decreased with reductions of $0.5 million in commissions due to several revenue deals with greater commission expense in the prior year and decreased salaries and benefits of $0.7 million due to lower headcount. In addition, consulting fees decreased by $0.5 million due to fewer projects and other marketing expenses, such as grants, decreased by $0.3 million due to timing of projects. Lastly, there were reductions of $0.2 million in IT and facilities allocated expenses due to a delay in capital spend and lower headcount.

General and Administrative

General and administrative expenses for the three months ended September 30, 2015 were $13.4 million as compared to $11.0 million for the three months ended September 30, 2014, which represents an increase of $2.4 million, or 22%. The increase was attributable to higher legal fees of $2.4 million which was driven by the damages of $3.4 million awarded to Cowealth from the binding arbitration with the ICC which we received October 29th, described in Note 5 and Note 8 to the financial statements. This award of damages was partially offset by lower department expenses for other ongoing defense and other costs for, among other things, the matters described in Note 5 to the financial statements.

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Other Expense, Net

Other expense, net for the three months ended September 30, 2015 was $5.1 million as compared to $5.5 million for the three months ended September 30, 2014. Foreign currency losses decreased by $1.1 million despite the fact that the U.S. Dollar continued to strengthen in comparison to the EURO, Japanese Yen and the Swiss Franc, because more sales agreements and related receivables outside of the U.S. were denominated in U.S. Dollar than in the same period of the previous year. This increase was partially offset by losses on hedging activities of $0.7 million as compared to the same period in prior year due to increased hedging activities in the current year.

Provision for Incomes Taxes

On a quarterly basis, the Company provides for income taxes based upon an estimated annual effective income tax rate. Income tax expenses were $0.7 million for the three months ended September 30, 2015, compared to income tax expenses of $0.9 million for the three months ended September 30, 2014. The decrease in tax expense of $0.2 million for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 was primarily related to a decrease in earnings of our foreign subsidiaries.

Liquidity and Capital Resources

At September 30, 2015, we had $85.6 million in cash and cash equivalents and $67.5 million in short-term investments, for a total of $153.1 million. Also refer to Note 7, Debt to the condensed consolidated financial statements for discussion of the Convertible Notes. Based on our current business plan and revenue prospects, we believe that we will have sufficient cash resources and anticipated cash flows to fund our operations for at least the next 12 months.

As of September 30, 2015, we had approximately $58.3 million of cash and cash equivalents at our foreign subsidiaries. The earnings of our foreign subsidiaries are considered to be indefinitely reinvested outside the U.S. and unavailable for distribution in the form of dividends or otherwise. Accordingly, no provisions for U.S. income taxes have been provided thereon. We anticipate that we have adequate liquidity and capital resources for the next twelve months and do not anticipate the need to repatriate the undistributed earnings of our foreign subsidiaries at September 30, 2015.

Our cash flows for the three months ended September 30, 2015 and 2014 are summarized as follows (in thousands):

	Three months ended September 30,			
		2015		2014
Net cash provided by (used in) operating activities	$	12,256	$	(14,719)
Net cash (used in) provided by investing activities		(4,983)		31,040
Net cash (used in) provided by financing activities		(26)		1,886
Effect of exchange rate changes on cash and cash equivalents		(1,214)		(3,258)
Net increase in cash and cash equivalents	$	6,033	$	14,949

Cash Flows From Operating Activities

Net cash provided by operating activities in the three months ended September 30, 2015 was $12.3 million, as compared to $14.7 million used in operating activities in the three months ended September 30, 2014. Net cash provided by operating activities in the three months ended September 30, 2015 was primarily related to:

- Net loss of $13.0 million;

- Net loss was offset by non-cash items of $10.1 million related to depreciation of fixed assets, amortization of intangible assets, share-based compensation, amortization and accretion of discount and premium on investments, amortization of debt issuance costs, accretion of interest on long-term debt, recovery of doubtful accounts receivable and provision for excess and obsolete inventory;

- Decrease in accounts receivable of $20.9 million as a result of collections on customer accounts in excess of billings resulting from significant sales transaction in the fourth fiscal quarter of 2015 that were collected in the first fiscal quarter of 2016;

- Increase in inventories of $7.2 million due to increase in purchases to support expected future sales and service needs;

- Decrease in prepaid expenses and other assets of $0.1 million primarily due to the settlement of value-add taxes of $1.6 million in foreign locations, a reduction in prepaid benefit costs of $0.5 million due to the timing of payments, and a decrease in prepaid maintenance of $0.5 million due to continued amortization partially offset by current period additions. These decreases were partially offset by an increase of $1.2 million in prepaid commissions due payment for orders taken in the prior quarter, an increase of $1.0 million in prepaid insurance related to various insurance renewals in September 2015 of $1.5 million offset by continued amortization of $0.5 million and an increase of $0.3 million in short-term other receivables due to additional tax refunds and other pre-payments;

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- Decrease in deferred revenue of $2.1 million primarily due to the timing of post-contract service contracts in the Americas and EIMEA regions;

- Increase in deferred cost of revenue of $0.7 million primarily due to the timing of inventory transfers to customers;

- Increase in accounts payable of $0.7 million primarily due to an increase in inventory purchasing activities in the first fiscal quarter of 2016;

- Slight decrease in accrued liabilities of 13,000 primarily related to accrued compensation with the bonus accrual reduction of $2.7 million due to bonus payments related to fiscal year 2015 made in the first fiscal quarter of 2016 offset by additional accrual for bonuses for the three months ended September 30, 2015. Additionally, there was a decrease in accrued severance of $0.8 million due to severance payments made in the first fiscal quarter of 2016 for terminations from fiscal 2015. These decreases were partially offset by an increase in legal accrual of $3.4 million due to the award of damages related to the Cowealth litigation as described in Footnotes 5 and 8 to our consolidated financial statements; and

- Increase in customer advances of $3.6 million due mainly to payments received for future revenue deliverables;

Net cash used in operating activities in the three months ended September 30, 2014 was primarily related to:

- Net loss of $21.7 million;

- Net loss was offset by non-cash items of $10.8 million related to depreciation of fixed assets, amortization of intangible assets, share-based compensation, amortization and accretion of discount and premium on investments, amortization of debt issuance costs, accretion of interest on long-term debt, recovery of doubtful accounts receivable and provision for excess and obsolete inventory;

- Decrease in accounts receivable of $17.7 million as a result of decreased sales of $19.6 million when compared to the previous fiscal quarter as well as more collections from the customers;

- Increase in inventories of $13.1 million to support expected future sales;

- Decrease in prepaid expenses and other assets of $3.2 million primarily due to the reduction of prepaid taxes of $2.7 million mostly in foreign locations due to settlements, and the transfer of non-current receivable of $2.7 million to a current accounts receivable account. This decrease was offset by an increase in prepaid insurance balance of $1.0 million due to the timing of payments, as well as an increase in prepaid commissions of $0.8 million due to higher commission rates in certain geographical regions; and

- Decrease in accrued liabilities of $13.2 million primarily related to the bonus accrual reduction of $11.2 million due to the payment made in the first fiscal quarter of 2015 offset by additional accrual for the three months period ended September 30, 2014. Foreign taxes payable decreased by $0.7 million and interest payable decreased by $1.4 million due to the timing of payments.

Cash Flows From Investing Activities

Net cash used in investing activities was $5.0 million for the three months ended September 30, 2015, which primarily consisted of purchases of short-term investments of $15.4 million and purchases of property and equipment of $1.6 million partially offset by sales and maturities of investments of $12.0 million.

Net cash provided by investing activities was $31.0 million for the three months ended September 30, 2014, which primarily consisted of purchases of property and equipment of $2.7 million, purchases of investments of $45.7 million and sales and maturities of short-term investments of $79.5 million.

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Cash Flows From Financing Activities

Net cash used in financing activities during the three months ended September 30, 2015 was $26,000, attributable to $1.0 million from proceeds from employee stock plans, offset by $1.1 million of taxes paid related to net share settlement of equity awards.

Net cash provided by financing activities during the three months ended September 30, 2014 was $1.9 million from proceeds from employee stock plans.

Operating Capital and Capital Expenditure Requirements

Our future capital requirements depend on numerous factors. These factors include but are not limited to the following:

- Revenue generated by sales of our products and service plans;
- Costs associated with our sales and marketing initiatives and manufacturing activities;
- Facilities, equipment and IT systems required to support current and future operations;
- Rate of progress and cost of our research and development activities;
- Costs of obtaining and maintaining FDA and other regulatory clearances of our products;
- Effects of competing technological and market developments; and
- Number and timing of acquisitions and other strategic transactions.

We believe that our current cash, cash equivalents and investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least 12 months. If our cash and cash equivalents are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities or obtain additional credit facilities. The sale of additional equity or convertible debt securities could result in dilution to our stockholders. If additional funds are raised through the issuance of debt securities, these securities could have rights senior to those associated with our common stock and could contain covenants that would restrict our operations. Additional financing may not be available in amounts or on terms acceptable to us or at all. If we are unable to obtain this additional financing, we may be required to reduce the scope of our planned product development and marketing efforts.

Contractual Obligations and Commitments

We presented our contractual obligations in our Annual Report on Form 10-K for the fiscal year ended June 30, 2015. There have been no material changes outside of the ordinary course of business in those obligations during the current quarter.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these condensed consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, as well as revenue and expenses during the reporting periods. We evaluate our estimates and judgments on an ongoing basis. We base our estimates on historical experience and on various other factors we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities. Actual results could therefore differ materially from those estimates if actual conditions differ from our assumptions.

During the three months ended September 30, 2015 we considered our estimated corporate bonus accrual to be a critical accounting estimate. The Company s bonus accrual for each quarter is based on its performance against Company defined metrics: net revenue, adjusted EBITDA and gross orders to backlog. There have been no other changes to the critical accounting policies and estimates, as discussed in Part II, Item 7 of our Form 10-K for the year ended June 30, 2015, which we believe are those related to revenue recognition, assessment of recoverability of goodwill and intangible assets, valuation of inventories, share-based compensation expense, income taxes, allowance for doubtful accounts and loss contingencies.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Rate Risk

A portion of our net sales are denominated in foreign currencies, most notably the EURO and the Japanese Yen. Future fluctuations in the value of the U.S. dollar may affect the price competitiveness of our products outside the United States. For direct sales outside the United States, we sell in both U.S. dollars and local currencies, which could expose us to additional foreign currency risks. Our operating expenses in countries outside the United States are payable in foreign currencies and therefore expose us to currency risk, such as risks related to fluctuations in foreign currencies. To the extent that management can predict the timing of payments under sales contracts or for operating expenses that are denominated in foreign currencies, we may engage in hedging transactions to mitigate such risks in the future. We expect the changes in the fair value of the intercompany receivables arising from fluctuations in foreign currency exchange rates to be materially offset by the changes in the fair value of the forward contracts. As of September 30, 2015, we had no open forward contracts and all open positions had been settled.

The purpose of these forward contracts is to minimize the risk associated with foreign exchange rate fluctuations. We have developed a foreign exchange policy to govern our forward contracts. These foreign currency forward contracts do not qualify as cash flow hedges and all changes in fair value are reported in earnings as part of other income and expenses. We have not entered into any other types of derivative financial instruments for trading or speculative purpose. Our foreign currency forward contract valuation inputs are based on quoted prices and quoted pricing intervals from public data and do not involve management judgment.

Interest Rate Risk

We maintain an investment portfolio of various holdings, types, and maturities. These securities are generally classified as available for sale and consequently, are recorded on the balance sheet at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income. At any time, a sharp rise or decline in interest rates could have a material adverse impact on the fair value of our investment portfolio. Likewise, increases and decreases in interest rates could have a material impact on interest earnings for our portfolio. The following table presents the hypothetical change in fair values in the financial instruments we held at September 30, 2015 that are sensitive to changes in interest rates. The modeling technique used measures the change in fair values arising from selected potential changes in interest rates on our investment portfolio, which had a fair value of $67.5 million at September 30, 2015. Market changes reflect immediate hypothetical parallel shifts in the yield curve of plus or minus 100, 75, 50 and 25 basis points (in thousands).

	Decrease in interest rates				Increase in interest rates			
Change in interest rate	**-100 BPS**	**-75 BPS**	**-50 BPS**	**-25 BPS**	**25 BPS**	**50 BPS**	**75 BPS**	**100 BPS**
Unrealized gain (loss)	$ 312	$ 281	$ 205	$ 111	$ (112)	$ (224)	$ (336)	$ (448)

Equity Price Risk

On August 1, 2011, we issued $100 million aggregate principal amount of 3.75% Convertible Notes. Upon conversion, we can settle the obligation by issuing our common stock, cash or a combination thereof at an initial conversion rate equal to 105.5548 shares of common stock per $1,000 principal amount of the 3.75% Convertible Notes, which is equivalent to a conversion price of approximately $9.47 per share of common stock, subject to adjustment. There is no equity price risk if the share price of our common stock is below $9.47 upon conversion of the 3.75% Convertible Notes. For every $1 that the share price of our common stock exceeds $9.47, we expect to issue an additional $10.6 million in cash or shares of our common stock, or a combination thereof, if all of the 3.75% Convertible Notes are converted.

On April 24, 2014, we issued approximately $70.3 million aggregate principal amount of 3.50% Series A Convertible Notes. Upon conversion, we can settle the obligation by issuing our common stock, cash or a combination thereof at an initial conversion rate equal to 187.6877 shares of common stock per $1,000 principal amount of the 3.50% Series A Convertible Notes, which is equivalent to a conversion price of approximately $5.33 per share of common stock, subject to adjustment. There is no equity price risk if the share price of our common stock is below $5.33 upon conversion of the 3.50% Series A Convertible Notes. For every $1 that the share price of our common stock exceeds $5.33, we expect to issue an additional $13.2 million in cash or shares of our common stock, or a combination thereof, if all of the 3.50% Series A Convertible Notes are converted.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow for timely decisions regarding required disclosure.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2015. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2015 our disclosure controls and procedures were effective to provide reasonable assurance that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

During the three months ended September 30, 2015, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations of Internal Control Over Financial Reporting

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and in reaching a reasonable level of assurance, management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

Please refer to Note 5, Commitments and Contingencies, to the condensed consolidated financial statements above for a description of certain legal proceedings currently pending against the Company. From time to time we are involved in legal proceedings arising in the ordinary course of our business.

Item 1A. Risk Factors.

A description of the risk factors associated with our business is included under Risk Factors contained in Part I, Item 1A of our Form 10-K for the year ended June 30, 2015, and is incorporated herein by reference. The descriptions below include material changes to the risk factors affecting our business that were previously disclosed in such filings. Any risk factor included below supersedes the description of the relevant risk factor in such filings. Other than the items discussed below, there have been no material changes in our risk factors since such filings.

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If third-party payors do not provide sufficient coverage and reimbursement to healthcare providers for use of the CyberKnife and TomoTherapy Systems, demand for our products and our revenue could be adversely affected.

Our customers rely significantly on reimbursement from public and private third-party payors for CyberKnife and TomoTherapy systems procedures. Our ability to commercialize our products successfully will depend in significant part on the extent to which public and private third-party payors provide adequate coverage and reimbursement for procedures that are performed with our products. Third-party payors, and in particular managed care organizations, challenge the prices charged for medical products and services and institute cost containment measures to control or significantly influence the purchase of medical products and services. If reimbursement policies or other cost containment measures are instituted in a manner that significantly reduces the coverage or payment for the procedures that are performed with our products, our existing customers may not continue using our products or may decrease their use of our products, and we may have difficulty obtaining new customers. Such actions would likely have a material adverse effect on our operating results.

On October 30, 2015, the Centers for Medicare and Medicaid Services (CMS) issued the final rule for 2016 Medicare payment rates for hospital outpatient services, physicians, and services performed in the freestanding center setting. The final rule included certain proposals that impact reimbursement rates for radiation therapy services, such as changes to the equipment utilization assumptions, which have resulted in small changes in reimbursement in the freestanding center setting.

While these coding changes will be implemented in 2016 they do not appear to be significant for services delivered with our products. CMS reviews reimbursement rates annually and may implement significant changes in future years, which could discourage existing and potential customers from purchasing or using our products.

We have a large accumulated deficit, may incur future losses and may be unable to achieve profitability.

As of September 30, 2015, we had an accumulated deficit of $408.3 million. We may incur net losses in the future, particularly as we improve our selling and marketing activities. Our ability to achieve and sustain long-term profitability is largely dependent on our ability to successfully market and sell the CyberKnife and TomoTherapy Systems, control our costs, and effectively manage our growth. We cannot assure you that we will be able to achieve profitability. In the event we fail to achieve profitability, our stock price could decline.

As a strategy to assist our sales efforts, we may offer extended payment terms, which may potentially result in higher Days Sales Outstanding and greater payment defaults.

We offer longer or extended payment terms for qualified customers in some circumstances. As of September 30, 2015, customer contracts with extended payment terms of more than one year amounted to less than 4% of our accounts receivable balance. While we qualify customers to whom we offer longer or extended payment terms, their financial positions may change adversely over the longer time period given for payment. This may result in an increase in payment defaults, which would affect our revenue, as we recognize revenue on such transactions on a cash basis.

Our liquidity could be adversely impacted by adverse conditions in the financial markets.

At September 30, 2015, we had $85.6 million in cash and cash equivalents and $67.5 million in investments. The available cash and cash equivalents are held in accounts managed by third-party financial institutions and consist of cash in our operating accounts and cash invested in money market funds. The investments are managed by third-party financial institutions and primarily consist of U.S. agency and corporate debt securities. We can provide no assurances that access to our invested cash and cash equivalents will not be impacted by adverse conditions in the financial markets.

At any point in time, we also have funds in our operating accounts that are with third-party financial institutions that exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor daily the cash balances in our operating accounts and adjust the cash balances as appropriate, these cash balances could be impacted if the underlying financial institutions fail or become subject to other adverse conditions in the financial markets. To date, we have experienced no loss or lack of access to cash in our operating accounts.

Our major stockholders own approximately 36.2% and directors and executive officers own approximately 2.7% of our outstanding common stock as of September 30, 2015, which could limit other stockholders ability to influence the outcome of key transactions, including changes of control.

As of September 30, 2015, our current holders of 5% or more of our outstanding common stock held in the aggregate approximately 36.2% of our outstanding common stock, while our directors and executive officers held in the aggregate approximately 2.7% of our outstanding common stock. This concentration of ownership may delay, deter or prevent a change of control of our company and will make some transactions more difficult or impossible without the support of these stockholders.

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Our operating results, including our quarterly orders, revenues and margins fluctuate from quarter to quarter and may be unpredictable, which may result in a decline in our stock price if such fluctuations result in a failure to meet the expectations of securities analysts or investors.

We have experienced and expect in the future to experience fluctuations in our operating results, including gross orders, revenues and margins, from period to period. Drivers of orders include the introduction and timing of announcement of new products or product enhancements by us and our competitors, as well as changes or anticipated changes in third-party reimbursement amounts or policies applicable to treatments using our products. The availability of economic stimulus packages or other government funding, or reductions thereof, may also affect timing of customer purchases. Our products have a high unit price and require significant capital expenditures by our customers. Accordingly, we experience long sales and implementation cycles, which is of greater concern during the current volatile economic environment where we have had customers delaying or cancelling orders. When orders are placed, installation, delivery or shipping, as applicable, is accomplished and the revenues recognized affect our quarterly results. Further, because of the high unit price of the CyberKnife and TomoTherapy Systems and the relatively small number of units sold or installed each quarter, each sale or installation of a CyberKnife or TomoTherapy System can represent a significant percentage of our net orders, backlog or revenue for a particular quarter.

Once orders are received and booked into backlog, factors that may affect whether these orders become revenue (or are cancelled or deemed aged-out and reflected as a reduction in net orders) and the timing of revenue include:

- delays in the customer obtaining funding or financing,
- delays in construction at the customer site, or
- delays in the customer obtaining receipt of regulatory approvals such as certificates of need.

Our quarterly operating results may also be affected by a number of other factors which are outside of our control, including:

- timing of when we are able to recognize revenue associated with sales of the CyberKnife and TomoTherapy Systems, which varies depending upon the terms of the applicable sales and service contracts;
- the proportion of revenue attributable to our legacy service plans;
- timing and level of expenditures associated with new product development activities;

- regulatory requirements in some states for a certificate of need prior to the installation of a radiation device;

- delays in shipment due, for example, to unanticipated construction delays at customer locations where our products are to be installed, cancellations by customers, natural disasters or labor disturbances;

- delays in our manufacturing processes or unexpected manufacturing difficulties;

- timing of the announcement, introduction and delivery of new products or product upgrades by us and by our competitors;

- timing and level of expenditures associated with expansion of sales and marketing activities such as trade shows and our overall operations; and

- how fluctuations in our gross margins and the factors that contribute to such fluctuations, as described in the Management s Discussion and Analysis of Financial Condition and Results of Operations.

Because many of our operating expenses are based on anticipated sales and a high percentage of these expenses are fixed for the short term, a small variation in the timing of revenue recognition can cause significant variations in operating results from quarter to quarter. Our overall gross margins are impacted by a number of factors described in our risk factor entitled Our ability to achieve profitability depends in part on maintaining or increasing our gross margins on product sales and service, which we may not be able to achieve. If our gross margins fall below the expectation of securities analysts and investors, the trading price of our common stock would almost certainly decline.

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We report on a quarterly and annual basis our orders and backlog. Unlike revenues, orders and backlog are not defined by GAAP, and are not within the scope of the audit conducted by our independent registered public accounting firm; therefore, investors should not interpret our orders or backlog in such a manner. Also, for the reasons set forth above, our orders and backlog cannot necessarily be relied upon as accurate predictors of future revenues. Order cancellation or significant delays in installation date will reduce our backlog and future revenues, and we cannot predict if or when orders will mature into revenues. Particularly high levels of cancellations or age-outs in one or more periods will make it difficult to compare our operating results. Our orders, backlog, revenues and net earnings in one or more future periods may fall below the expectations of securities analysts and investors, which could cause the trading price of our common stock to decline.

Because the majority of our product revenue is derived from sales of the CyberKnife and TomoTherapy Systems, and because we experience a long and variable sales and installation cycle, our quarterly results may be inconsistent from period to period.

Our primary products are the CyberKnife and TomoTherapy Systems. We expect to generate substantially all of our revenue for the foreseeable future from sales of and service contracts for the CyberKnife and TomoTherapy Systems. The CyberKnife and TomoTherapy Systems have lengthy sales and purchase order cycles because they are major capital equipment items and require the approval of senior management at purchasing institutions. Selling our systems, from first contact with a potential customer to a complete order, generally spans six months to two years and involves personnel with multiple skills. The sales process in the United States typically begins with pre-selling activity followed by sales presentations and other sales related activities. After the customer has expressed an intention to purchase a CyberKnife or TomoTherapy System, we negotiate and enter into a definitive purchase contract with the customer. The negotiation of terms that are not standard for Accuray may require additional time and approvals. Typically, following the execution of the contract, the customer begins the building or renovation of a radiation-shielded facility to house the CyberKnife or TomoTherapy System, which together with the subsequent installation of the CyberKnife or TomoTherapy System, can take up to 24 months to complete. In order to construct this facility, the customer must typically obtain radiation device installation permits, which are granted by state and local government bodies, each of which may have different criteria for permit issuance. If a permit was denied for installation at a specific hospital or treatment center, our CyberKnife or TomoTherapy System could not be installed at that location. In addition, some of our customers are cancer centers or facilities that are new, and in these cases it may be necessary for the entire facility to be completed before the CyberKnife or TomoTherapy System can be installed, which can result in additional construction and installation delays. Our sales and installations of CyberKnife and TomoTherapy Systems tend to be heaviest during the third month of each fiscal quarter.

Under our revenue recognition policy, we generally do not recognize revenue attributable to a CyberKnife or TomoTherapy System purchase until after installation has occurred, if we are responsible for providing installation, or delivery. For international sales through distributors, we typically recognize revenue when the system is shipped and we have evidence of a purchase commitment from the end user. Under our current forms of purchase and service contracts, we record a majority of the purchase price as revenue for a CyberKnife or TomoTherapy System upon installation or delivery of the system. Events beyond our control may delay installation and the satisfaction of contingencies required to receive cash inflows and recognize revenue, including delays in the customer obtaining funding or financing, delays in construction at the customer site or delays in the customer obtaining receipt of regulatory approvals such as certificates of need.

The long sales cycle, together with delays in the shipment and installation of CyberKnife and TomoTherapy Systems or customer cancellations, could adversely affect our cash flows and revenue, which would harm our results of operations and may result in significant fluctuations in our reporting of quarterly revenues. Because of these fluctuations, it is likely that in some future quarters, our operating results will fall below the expectations of securities analysts or investors. If that happens, the market price of our stock would likely decrease. These fluctuations also mean that you will not be able to rely upon our operating results in any particular period as an indication of future performance.

Increased leverage as a result of the Convertible Notes offering may harm our financial condition and operating results.

As of September 30, 2015, we had total consolidated liabilities of approximately $397.7 million, including the short-term liability component of the 3.75% Convertible Notes in the amount of $95.1 million, and the long-term liability component of the 3.50% Convertible Notes in the amount of $44.7 million and the 3.50% Series A Convertible Notes of $64.9 million.

In April 2014, we refinanced approximately $70.3 million aggregate principal amount of the 3.50% Convertible Notes held by certain investors (the Participating Holders) with approximately $70.3 million aggregate principal amount of the 3.50% Series A Convertible Notes. In connection with such transactions, we also paid the Participating Holders approximately $0.4 million in cash.

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Our level of indebtedness could have important consequences to stockholders and note holders, because:

- It could affect our ability to satisfy our obligations under the Convertible Notes;
- A substantial portion of our cash flows from operations will have to be dedicated to interest and principal payments and may not be available for operations, working capital, capital expenditures, expansion, acquisitions or general corporate or other purposes;
- It may impair our ability to obtain additional financing in the future;
- It may limit our flexibility in planning for, or reacting to, changes in our business and industry; and
- It may make us more vulnerable to downturns in our business, our industry or the economy in general.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. **Other Information**

None.

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Item 6. **Exhibits**

Exhibit No.	Exhibit Description	Form	Incorporated by Reference File No.	Exhibit	Filing Date	Filed Herewith
10.1**	Executive Employment Agreement by and between Registrant and Kevin Waters, dated September 15, 2015	8-K	001-33301	10.1	September 15, 2015	
10.2**	General Release and Separation Agreement by and between the Registrant and Gregory Lichtwardt, dated September 15, 2015					X
10.3**	Agreement for Consulting Services by and between Registrant and Gregory Lichtwardt, dated September 15, 2015					X
10.4**	Amended and Restated Executive Employment Agreement by and between Registrant and Kelly Londy, Dated October 15, 2015	8-K	001-33301	10.1	October 15, 2015	
10.5**	Accuray Incorporated Performance Bonus Plan, as amended on September 29, 2015					X
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended					X
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended					X
32.1*	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. 1350					
99.1**	Form of Market Stock Unit Grant Notice and Award Agreement	8-K	001-33301	99.1	October 2, 2015	
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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*The certification attached as Exhibit 32.1 that accompanies this Quarterly Report on Form 10-Q is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Accuray Incorporated under the Securities Act or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

** Management contract or compensatory plan or agreement.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ACCURAY INCORPORATED

By: /s/ Joshua H. Levine
Joshua H. Levine
President and Chief Executive Officer
(Principal Executive Officer)

By: /s/ Kevin M. Waters
Kevin M. Waters
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: November 5, 2015