SOURCEFIRE INC
Form 10-Q
August 05, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011

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

For the transition period from __________ to __________

Commission File Number
1-33350

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

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

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

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

Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes 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 definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

Yes o No þ

As of July 29, 2011, there were 28,695,010 outstanding shares of the registrant s Common Stock.

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Part I. FINANCIAL INFORMATION
Item 1. Financial Statements

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

	June 30, 2011 (unaudited)	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 38,990	$ 54,410
Short-term investments	95,048	85,062
Accounts receivable, net of allowances of $978 as of June 30, 2011 and $1,091 as of December 31, 2010	33,061	37,250
Inventory	3,523	5,235
Deferred tax assets	7,005	4,161
Prepaid expenses and other current assets	5,252	3,793
Total current assets	182,879	189,911
Property and equipment, net	10,614	9,235
Goodwill	15,135	15,135
Intangible assets, net	6,326	6,830
Investments	11,292	14,247
Deferred tax assets, non-current	3,561	3,556
Other assets	13,585	2,160
Total assets	$ 243,392	$ 241,074
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 3,393	$ 3,893
Accrued compensation and related expenses	6,792	6,209
Other accrued expenses	4,936	4,823
Current portion of deferred revenue	37,546	38,708
Other current liabilities	6,747	13,518
Total current liabilities	59,414	67,151
Deferred revenue, less current portion	8,640	7,714
Other long-term liabilities	127	125
Total liabilities	$ 68,181	$ 74,990
Commitments and contingencies		
Stockholders equity:		

Preferred stock, $0.001 par value; 19,700,000 shares authorized; no shares issued or outstanding				
Series A junior participating preferred stock, $0.001 par value; 300,000 shares authorized; no shares issued or outstanding				
Common stock, $0.001 par value; 240,000,000 shares authorized; 28,675,857 and 28,136,058 shares issued and outstanding as of June 30, 2011 and December 31, 2010, respectively		28		27
Additional paid-in capital		196,850		187,789
Accumulated deficit		(21,678)		(21,739)
Accumulated other comprehensive income		11		7
Total stockholders equity		175,211		166,084
Total liabilities and stockholders equity	$	243,392	$	241,074

See accompanying notes to consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	**2010**	**2011**	**2010**
Revenue:				
Products	$ 20,857	$ 17,552	$ 36,655	$ 31,890
Technical support and professional services	15,597	13,056	30,581	24,549
Total revenue	36,454	30,608	67,236	56,439
Cost of revenue:				
Products	6,036	4,647	10,771	8,443
Technical support and professional services	2,158	1,657	4,020	3,062
Total cost of revenue	8,194	6,304	14,791	11,505
Gross profit	28,260	24,304	52,445	44,934
Operating expenses:				
Research and development	8,074	4,342	15,036	8,137
Sales and marketing	15,198	11,410	29,276	22,029
General and administrative	4,692	4,736	9,365	9,055
Depreciation and amortization	923	833	1,888	1,647
Total operating expenses	28,887	21,321	55,565	40,868
Income (loss) from operations	(627)	2,983	(3,120)	4,066
Other income (loss), net:				
Interest and investment income	95	81	208	199
Interest expense	(116)	(3)	(234)	(12)
Other expense	(31)	(59)	(32)	(168)
Total other income (loss), net	(52)	19	(58)	19
Income (loss) before income taxes	(679)	3,002	(3,178)	4,085
Benefit from income taxes	(280)	(7,546)	(3,239)	(7,273)
Net income (loss)	$ (399)	$ 10,548	$ 61	$ 11,358
Net income (loss) per share:				
Basic	$ (0.01)	$ 0.38	$ 0.00	$ 0.41
Diluted	$ (0.01)	$ 0.37	$ 0.00	$ 0.39
Weighted average shares outstanding used in computing per share amounts:				

Basic	28,537,437	27,565,334	28,387,427	27,393,953
Diluted	28,537,437	28,600,689	29,286,095	28,831,577

See accompanying notes to consolidated financial statements.

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

	Common Stock Shares	Common Stock Amount	Additional Paid In Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balance as of January 1, 2011	28,136,058	$ 27	$ 187,789	$ (21,739)	$ 7	$ 166,084
Exercise of common stock options	272,512	1	2,372			2,373
Issuance of common stock under employee stock purchase plan	41,558		830			830
Issuance of restricted common stock	230,216					
Cancellation of restricted common stock	(4,487)					
Stock-based compensation expense			6,493			6,493
Excess tax benefits relating to share-based payments			(634)			(634)
Comprehensive income:						
Net income for the six months ended June 30, 2011				61		61
Change in unrealized gain on investments, net of tax					4	4
Total comprehensive income						65
Balance as of June 30, 2011	28,675,857	$ 28	$ 196,850	$ (21,678)	$ 11	$ 175,211

See accompanying notes to consolidated financial statements.

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

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Operating activities		
Net income	$ 61	$ 11,358
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,553	1,754
Non-cash stock-based compensation	6,493	3,931
Excess tax benefits related to share-based payments	634	(16)
Amortization of premium on investments	1,058	530
Loss on disposal of assets	9	36
Deferred taxes	(3,485)	(7,386)
Changes in operating assets and liabilities:		
Accounts receivable, net	4,189	9,056
Inventory	990	(381)
Prepaid expenses and other assets	(12,883)	1,351
Accounts payable	(500)	90
Accrued expenses	696	(1,672)
Deferred revenue	(236)	301
Other liabilities	334	343
Net cash provided by (used in) operating activities	(87)	19,295
Investing activities		
Purchase of property and equipment	(2,714)	(2,053)
Acquisition-related payments	(7,093)	
Purchase of investments	(79,994)	(55,269)
Proceeds from maturities of investments	71,908	53,945
Net cash used in investing activities	(17,893)	(3,377)
Financing activities		
Repayments of capital lease obligations	(9)	(8)
Proceeds from employee stock-based plans	3,203	2,662
Excess tax benefits related to share-based payments	(634)	16
Net cash provided by financing activities	2,560	2,670
Net increase (decrease) in cash and cash equivalents	(15,420)	18,588
Cash and cash equivalents at beginning of period	54,410	53,071
Cash and cash equivalents at end of period	$ 38,990	$ 71,659

See accompanying notes to consolidated financial statements.

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

1. Description of Business

We are a leading provider of intelligent cybersecurity solutions for information technology, or IT, environments of commercial enterprises, including healthcare, financial services, manufacturing, energy, education, retail and telecommunications companies, and federal, state and local government organizations worldwide. Our solutions are comprised of multiple hardware, software and cloud-based product and service offerings, enabling comprehensive, intelligent protection before, during and after an attack.

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

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

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial reporting and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to those rules or regulations. The interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, considered necessary for a fair presentation. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes included in our Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission on March 11, 2011. The results of operations for the interim periods are not necessarily indicative of results to be expected in future periods.

Use of Estimates

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

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

Investments

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

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

Fair Value of Financial Instruments

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

Allowance for Doubtful Accounts and Sales Return Allowance

We make estimates regarding the collectability of our accounts receivable. When we evaluate the adequacy of our allowance for doubtful accounts, we consider multiple factors, including historical write-off experience, the need for specific customer reserves, the aging of our receivables, customer creditworthiness and changes in customer payment cycles. Historically, our allowance for doubtful accounts has been adequate based on actual results. If any of the factors used to calculate the allowance for doubtful accounts change or if the allowance does not reflect our actual ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed, and our future results of operations could be materially affected. As of June 30, 2011 and December 31, 2010, the allowance for doubtful accounts was $343,000 and $429,000, respectively.

We also use our judgment to make estimates regarding potential future product returns related to reported product revenue in each period. We analyze factors such as our historical return experience, current product sales volumes, and changes in product warranty claims when evaluating the adequacy of the sales returns allowance. If any of the factors used to calculate the sales return allowance were to change, we may experience a material difference in the amount and timing of our product revenue for any given period. As of June 30, 2011 and December 31, 2010, the sales return allowance was $635,000 and $662,000, respectively.

Inventory

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

Inventory consisted of the following (in thousands):

	As of June 30, 2011	As of December 31, 2010
Finished goods	$ 1,707	$ 3,151
Evaluation units	625	828
Advance replacement units	1,191	1,256
Total	$ 3,523	$ 5,235

Inventory write-downs, primarily related to evaluation units and excess and obsolete inventory as a result of the introduction of new products, are recorded as a component of cost of revenues and amounted to approximately $684,000 and $1.4 million for the three months and six months ended June 30, 2011, respectively. Inventory write-downs, primarily related to evaluation units and excess and obsolete inventory, amounted to approximately $284,000 and $327,000 for the three months and six months ended June 30, 2010, respectively.

Business Combinations

We recognize all of the assets acquired, liabilities assumed and contingent consideration at their fair value on the acquisition date. The purchase price allocation process requires management to make significant estimates and assumptions, especially at the acquisition date with respect to intangible assets acquired, estimated contingent consideration payments and pre-acquisition contingencies assumed. Unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results. Additionally, any change in the fair value of the acquisition-related contingent consideration subsequent to the acquisition date, including changes from events after the acquisition date, will be recognized in earnings in the period of the estimated fair value change. All subsequent changes to a valuation allowance or uncertain tax position relating to the acquired company that occur within the measurement period and are based on facts and circumstances that existed at the acquisition date are recognized as an adjustment to goodwill. All other changes in a valuation allowance or uncertain tax positions are recognized as a reduction or increase to income tax expense.

Acquisition-related transaction costs, including legal and accounting fees and other external costs directly related to the acquisition are recognized separately from the acquisition and expensed as incurred in general and administrative expenses in the consolidated statements of operations.

Goodwill and Intangible Assets

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

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

Other Assets

Other assets primarily consist of a prepaid long-term contract for a third-party to provide maintenance and support services for certain product offerings and will be amortized through 2015 based on its expected usage. The amortization will be recorded as a component of cost of revenues.

Revenue Recognition

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

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

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

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

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

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

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

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

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

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

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

For stand-alone software sales after December 31, 2010 and for all transactions entered into prior to the first quarter of 2011, we recognize revenue based on software revenue recognition guidance. Under the software revenue recognition guidance, we allocate the total arrangement fee among each deliverable based on the fair value of each of the deliverables, determined based on VSOE. If VSOE of fair value does not exist for each of the deliverables, all revenue from the arrangement is deferred until the earlier of the point at which sufficient VSOE of fair value can be determined for any undelivered elements or all elements of the arrangement have been delivered. If the only undelivered elements are elements for which we currently have VSOE of fair value, we recognize revenue for the delivered elements based on the residual method. When VSOE of fair value does not exist for undelivered elements such as maintenance and support, the entire arrangement fee is recognized ratably over the performance period.

For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with the amended accounting guidance. Certain arrangements with multiple deliverables may continue to have stand-alone software deliverables that are subject to the existing software revenue recognition guidance along with non-software deliverables that are

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subject to the amended revenue accounting guidance. The revenue for these multiple deliverable arrangements is allocated to the stand-alone software deliverables as a group and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the fair value hierarchy in the amended revenue accounting guidance.

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

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

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

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

We anticipate that for certain arrangements we will be able to account for more transaction consideration upon delivery than allowed under the prior guidance, primarily due to more deliverables being accounted for as separate units of accounting and the elimination of the use of the residual method and a requirement to allocate arrangement consideration using a selling price hierarchy.

An estimate of the revenue that would have been reported if we had applied the new guidance for multiple deliverable arrangements for non-software deliverables for the three months ended June 30, 2010 is $30.9 million compared to the $30.6&