SOURCEFIRE INC
Form S-1/A
January 19, 2007

As filed with the Securities and Exchange Commission on January 19, 2007

Registration No. 333-138199

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

AMENDMENT NO. 3 TO
FORM S-1
REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

SOURCEFIRE, INC.
(Exact name of registrant as specified in its charter)

Delaware	**7375**	**52-2289365**
(State or Other Jurisdiction of Incorporation or Organization)	*(Primary Standard Industrial Classification Code Number)*	*(IRS Employer Identification No.)*

9770 Patuxent Woods Drive
Columbia, Maryland 21046
(410) 290-1616
(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

E. Wayne Jackson, III
Chief Executive Officer
Sourcefire, Inc.
9770 Patuxent Woods Drive
Columbia, Maryland 21046
(410) 290-1616
(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: As soon as practicable after this Registration Statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933 check the following box. o

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same
offering. o ___

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ___

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ___

CALCULATION OF REGISTRATION FEE

Title of each Class of Securities to be Registered	Proposed Maximum Aggregate Offering Price[(a)(b)]	Amount of Registration Fee[(c)]
Common stock, $0.001 par value	$75,000,000	$8,025.00

(a) Estimated solely for the purpose of calculating the registration fee in accordance with Rule 457(o) promulgated under the Securities Act of 1933.
(b) Including shares of common stock which may be purchased by the underwriters to cover over-allotments, if any.
(c) Previously paid.

The Registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

The information contained in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting offers to buy these securities in any state where the offer or sale is not permitted.

PROSPECTUS (Subject to Completion)
Issued January 19, 2007

Shares

COMMON STOCK

Sourcefire, Inc. is offering shares of its common stock and the selling stockholders are offering shares. We will not receive any proceeds from the sale of shares by the selling stockholders. This is our initial public offering and no public market exists for our shares. We anticipate that the initial public offering price will be between $ and $ per share.

We have applied to list our common stock for quotation on the Nasdaq Global Market under the symbol FIRE.

Investing in our common stock involves risks. See Risk Factors beginning on page 9.

PRICE $ A SHARE

	Price to Public	***Underwriting Discounts and Commissions***	***Proceeds to Sourcefire***	***Proceeds to Selling Stockholders***
Per share	*$*	*$*	*$*	*$*
Total	*$*	*$*	*$*	*$*

We and the selling stockholders have granted the underwriters the right to purchase up to an additional shares of common stock to cover over-allotments.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Morgan Stanley & Co. Incorporated expects to deliver the shares of common stock to purchasers on , 2007.

MORGAN STANLEY *LEHMAN BROTHERS*

UBS INVESTMENT BANK ***JEFFERIES & COMPANY***

, 2007

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You should rely only on the information contained in this prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus. We are offering to sell, and seeking offers to buy, shares of common stock only in jurisdictions where offers and sales are permitted. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of shares of common stock.

Until and including , 2007, 25 days after the commencement of this offering, all dealers that buy, sell or trade shares of our common stock, whether or not participating in this offering, may be required to deliver a prospectus. This delivery requirement is in addition to the dealers obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

For investors outside the United States. Neither we nor any of the underwriters have done anything that would permit this offering or possession or distribution of this prospectus in any jurisdiction where action for that purpose is required, other than in the United States. You are required to inform yourselves about, and to observe any restrictions relating to, this offering and the distribution of this prospectus.

PROSPECTUS SUMMARY

This summary highlights selected information contained elsewhere in this prospectus and does not contain all of the information you should consider in making your investment decision. You should read the following summary together with all of the more detailed information regarding us and our common stock being sold in the offering, including our financial statements and the related notes, appearing elsewhere in this prospectus. Unless we state otherwise, Sourcefire, the Company, we, us, and our refer to Sourcefire, Inc., a Delaware corporation, and its subsidiaries as a whole.

SOURCEFIRE, INC.

Overview

We are a leading provider of intelligence driven, open source network security solutions that enable our customers to protect their computer networks in an effective, efficient and highly automated manner. We sell our security solutions to a diverse customer base that includes more than 25 of the Fortune 100 companies and over half of the 30 largest U.S. government agencies. We also manage one of the security industry s leading open source initiatives, Snort.

Our family of network security products forms a comprehensive Discover, Determine and Defend, or 3D, approach to network security. Using this approach, our technology can automatically:

- Discover potential threats and points of vulnerability;
- Determine the potential impact of those observations to the network; and
- Defend the network through proactive enforcement of security policy.

Our Sourcefire 3D approach is comprised of three key components:

RNA. At the heart of the Sourcefire 3D security solution is Real-time Network Awareness, or RNA, our network intelligence product that provides persistent visibility into the composition, behavior, topology (the relationship of network components) and risk profile of the network. This information provides a platform for the Defense Center s automated decision-making and network policy compliance enforcement. The ability to continuously discover characteristics and vulnerabilities of any computing device, or endpoint, communicating on a network (such as a computer, printer or server), or endpoint intelligence, along with the ability to observe how those endpoints communicate with each other, or network intelligence, enables our Intrusion Prevention products to more precisely identify and block threatening traffic and to more efficiently classify threatening and/or suspicious behavior than products lacking network intelligence.

Intrusion Sensors. The Intrusion Sensors utilize open source Snort® and our proprietary technology to monitor network traffic. These sensors compare observed traffic to a set of Rules , or a set of anomalous network traffic characteristics, which can be indicative of malicious activity. Once the Intrusion Sensors match a Rule to the observed traffic, they block malicious traffic and/or send an alert to the Defense Center for further analysis, prioritization and possible action.

Defense Center. The Defense Center aggregates, correlates and prioritizes network security events from RNA Sensors and Intrusion Sensors to synthesize multipoint event correlation and policy compliance analysis. The Defense

Center s policy and response subsystems are designed to leverage existing IT infrastructure such as firewalls, routers, trouble ticketing and patch management systems for virtually any task, including alerting, blocking and initiating corrective measures.

The traffic inspection engine used in our intrusion prevention products is the open source technology called Snort. Martin Roesch, our founder and Chief Technology Officer, created Snort in 1998. Our employees, including Mr. Roesch, have authored all major components of Snort, and we maintain control over the Snort project, including the principal Snort community forum, Snort.org. Snort, which has become a de facto industry standard, has been downloaded over 3 million times. We believe that a majority of the Fortune 100 companies and all of the 30 largest U.S. government agencies use Snort technology to monitor network traffic and that Snort is the most widely deployed intrusion prevention technology worldwide. The ubiquitous nature of the Snort user community represents a significant opportunity to sell our proprietary products to customers that require a complete enterprise solution.

For the year ended December 31, 2005, we generated approximately 82% of our revenue from customers in the U.S. and 18% from international customers. We increased our revenue from $16.7 million in 2004 to $32.9 million in 2005, representing a growth rate of 97%. For the nine months ended September 30, 2006, our revenue was $28.9 million, compared to $21.2 million for the nine months ended September 30, 2005, representing a growth rate of 36%.

Our Industry

According to reports by International Data Corporation, or IDC, from 2005 and 2006, the network security industry is estimated to be a $18.4 billion market in 2006 and is projected to grow to $26.9 billion in 2009, representing a compound annual growth rate of over 13%. Our addressable markets include intrusion prevention, vulnerability management and unified threat management, which are collectively projected to total $2.9 billion in 2006 and are expected to grow at a compound annual growth rate in excess of 21% to $5.2 billion in 2009, according to IDC. We expect that this growth should continue as organizations seek solutions to various growing and evolving security challenges, including:

Greater Sophistication, Severity and Frequency of Network Attacks. The growing use of the Internet as a business tool has required organizations to increase the number of access points to their networks, which has made vast amounts of critical information more vulnerable to attack. Theft of sensitive information for financial gain motivates network attackers, who derive profit through identity theft, credit card fraud, money laundering, extortion, intellectual property theft and other illegal means. These profit-motivated attackers, in contrast to the hobbyist hackers of the past, are employing much more sophisticated tools and techniques to generate profits for themselves and their well-organized and well-financed sponsors.

Increasing Risks from Unknown Vulnerabilities. Unknown vulnerabilities in computer software that are discovered by network attackers before they are discovered by security and software vendors represent a tremendous risk. These uncorrected flaws can leave networks largely defenseless and open to exploitation. According to Computer Emergency Response Team Coordination Center, or CERT-CC, data as of October 2006, the trends in the rate of vulnerability disclosure are particularly alarming, with approximately 3,780 disclosed in 2004 and more than 5,990 disclosed in 2005, representing a growth rate of approximately 58%.

Potential Degradation of Network Performance. Many security products degrade network performance and are, therefore, disfavored by network administrators who generally prioritize network performance over incremental gains in network security. For example, the use of active scanners that probe networks for vulnerabilities often meets heavy resistance from administrators concerned about excessive network noise, clogged firewall logs and disruption of network assets that are critical to business operations.

Diverse Demands on Security Administrators. The proliferation of targeted security solutions such as firewalls, intrusion prevention systems, URL filters, spam filters and anti-spyware solutions, while critical to enhancing network security, create significant administrative burdens on personnel who must manage numerous disparate technologies that are seldom integrated and often difficult to use. Most network security products require manual, labor intensive incident response and investigation by security administrators, especially when false positive results are generated.

Heightened Government Regulation. Rapidly growing government regulation is forcing compliance with increased requirements for network security, which has escalated demand for security solutions that meet both compliance requirements and reduce the burdens of compliance, reporting and enforcement. Examples of these laws include The

Health Insurance Portability and Accountability Act of 1996, or HIPAA, The Financial Services Modernization Act of 1999, commonly known as the Gramm-Leach-Bliley Act, The Sarbanes-Oxley Act of 2002 and The Federal Information Security Management Act.

Our Competitive Strengths

We believe that our leading market position results from several key competitive strengths, including:

Real-Time Approach to Network Security. Our solution is designed to support a continuum of network security functions that span pre-attack hardening of assets, high fidelity attack identification and disruption and real-time compromise detection and incident response. In addition, our ability to confidently classify and prioritize threats in network traffic and determine the composition, behavior and relationships of network devices, or endpoints, allows us to reliably automate what are otherwise manual, time-intensive processes.

Comprehensive Network Intelligence. Our innovative network security solution incorporates RNA, which provides persistent visibility into the composition, behavior, topology and risk profile of the network and serves as a platform for automated decision-making and network security policy enforcement. RNA performs passive, or non-disruptive, network discovery. This enables real-time compositional cataloging of network assets, including their configuration, thereby significantly increasing the network intelligence available to IT and security administrators. By integrating this contextual understanding of the network s components and situational awareness of network events, our solution is effective across a broad range of security domains, especially in the area of threat identification and impact assessment.

The Snort Community. The Snort user community, with over 100,000 registered users and over 3 million downloads to date, has enabled us to establish a market footprint unlike any other in the industry. We believe the Snort open source community provides us with significant benefits, including a broad threat awareness network, significant research and development leverage, and a large pool of security experts that are skilled in the use of our technology. We believe that Snort s broad acceptance makes us one of the most trusted sources of intrusion prevention and related security solutions.

Leading-Edge Performance. Our solutions have the ability to process multiple gigabits of traffic with latency as low as 100 microseconds. Our intrusion prevention technology incorporates advanced traffic processing functionality, including packet acquisition, protocol normalization and target-based traffic inspection, which yields increased inspection precision and efficiency and enables more granular inspection of network traffic. The Defense Center supports event loads as high as 1,300 events per second, which we believe meets or exceeds the requirements of the most demanding enterprise customers.

Significant Security Expertise. We have a highly knowledgeable management team with extensive network security industry experience gained from past service in leading enterprises and government organizations including Symantec, McAfee, the Department of Defense and the National Security Agency. Our founder and CTO, Martin Roesch, invented Snort and our core RNA technology and is widely regarded as a network security visionary. Our senior management team averages 16 years of experience in the networking and security industries. In addition, our Vulnerability Research Team, or VRT, is comprised of highly experienced security experts who research new vulnerabilities and create innovative methods for preventing attempts to exploit them.

Broad Industry Recognition. We have received numerous industry awards and certifications, including recognition by Gartner, Inc. as a leader in the network intrusion prevention systems market, supporting our position as one of a select few companies that best combines completeness of vision with ability to execute. RNA is one of only five network security products to receive the NSS Gold award, which is awarded by The NSS Group only to those products that are distinguished in terms of advanced or unique features, and which offer outstanding value. In addition, our technology has achieved Common Criteria Evaluation Assurance Level 2, or EAL2, which is an international evaluation standard for information technology security products sanctioned by, among others, the International Standards Organization, the National Security Agency and the National Institute for Standards and

Technology.

Our Growth Strategy

We intend to become the preeminent provider of network security solutions on a global basis. The key elements of our growth strategy include:

Continue to Develop Innovative Network Security Technology. We will continue to invest significantly in internal development and product enhancements and to hire additional network security experts to broaden our proprietary knowledge base. We believe our platform is capable of expanding into new markets such as unified threat management, security management and compliance and network management.

Grow our Customer Base. With over 3 million downloads of Snort and over 100,000 registered users, we believe Snort is the most ubiquitous network intrusion detection and prevention technology. We seek to monetize the Snort installed base by targeting enterprises that implement Snort but have not yet purchased any of the components of our Sourcefire 3D security solution. We will continue to target large enterprises and government agencies that require advanced security technology and high levels of network availability and performance in sectors including finance, technology, healthcare, manufacturing and defense.

Further Penetrate our Existing Customer Base. As of September 30, 2006, over 1,200 customers have purchased our Intrusion Sensors and Defense Center products. We intend to sell additional Intrusion Sensors to existing customers and expand our footprint in the networks of our customers to include branch offices, remote locations and data centers. In addition, we believe we have a significant opportunity to up-sell our higher margin RNA product to existing customers because of the significant incremental benefit that increased network intelligence can bring to their security systems.

Expand our OEM Alliances and Distribution Relationships. As part of our ongoing effort to expand our OEM alliances, we recently entered into a relationship with Nokia whereby Nokia Enterprise Solutions will market to its enterprise customers network security solutions that utilize our proprietary software and technology. In addition, we seek to expand our strategic reseller agreements and increasingly use this channel to generate additional inbound customer prospects. We also intend to utilize our relationships with managed security service providers such as Verizon, VeriSign and Symantec, to derive incremental revenue. In 2005, we generated approximately 16% of our revenue from governmental organizations and, in the future, we believe we will generate an increasing amount of revenue from government suppliers such as Lockheed Martin, Northrop Grumman and Immix Technology.

Strengthen Our International Presence. We believe the network security needs of many enterprises located outside of the United States are not being adequately served and represent a significant potential market opportunity. In 2005, we generated only approximately 17% of our revenue from international customers. We are expanding our sales in international markets by adding distribution relationships and expanding our direct sales force, with plans in the next year to double the number of personnel in Europe and to hire a country manager for Japan.

Selectively Pursue Acquisitions of Complementary Businesses and Technologies. To accelerate our expected growth, enhance the capabilities of our existing products and broaden our product and service offerings, we intend to selectively pursue acquisitions of businesses, technologies and products that could complement our existing operations.

Certain Risk Factors

Investing in our common stock involves substantial risk. You should carefully consider all the information in this prospectus prior to investing in our common stock. These risks and uncertainties include, but are not limited to, the following:

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

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.

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

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.

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 to technological and market developments and changing customer needs, our competitive position and prospects will be harmed.

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

Our Corporate Information

We were incorporated as a Delaware corporation in December 2001. Our principal executive office is located at 9770 Patuxent Woods Drive, Columbia, Maryland 21046. Our telephone number at that location is (410) 290-1616. Our website address is *www.sourcefire.com.* We also operate *www.snort.org.* These are textual references only. We do not incorporate the information on, or accessible through, any of our websites into this prospectus, and you should not consider any information on, or that can be accessed through, our websites as part of this prospectus.

THE OFFERING

Common stock offered by Sourcefire	shares
Common stock offered by the selling stockholders	shares
Total	shares
Over-allotment option to be offered by Sourcefire	shares
Over-allotment option to be offered by the selling stockholders	shares
Total over-allotment option	shares
Common stock to be outstanding after this offering	shares
Use of proceeds	We intend to use the net proceeds from this offering for working capital and other general corporate purposes. We may also use a portion of the net proceeds to repay our equipment facility or acquire other businesses, products or technologies. However, we do not have agreements or commitments for any specific repayments or acquisitions at this time. We will not receive any proceeds from the sale of common stock by the selling stockholders. See Use of Proceeds.
Proposed Nasdaq Global Market symbol	FIRE

The number of shares to be outstanding after this offering is based on 28,887,369 shares outstanding as of September 30, 2006, and excludes:

- 4,457,866 shares that may be issued upon the exercise of options outstanding as of September 30, 2006 under our stock option plan;
- 59,998 shares that may be issued upon the exercise of warrants outstanding as of September 30, 2006;
- 1,044,194 shares that are reserved for issuance pursuant to our stock option plan; and
- 45,000 shares that are subject to repurchase by us.

Unless we specifically state otherwise, all information in this prospectus assumes:

- an initial public offering price of $;
- the conversion of all outstanding shares of our preferred stock into shares of our common stock immediately prior to the completion of this offering; and

the underwriters over-allotment option to purchase up to an additional shares of common stock is not exercised.

SUMMARY CONSOLIDATED FINANCIAL DATA

The table below summarizes our consolidated financial information for the periods indicated. The unaudited financial statements include all adjustments, consisting of normal recurring accruals, which Sourcefire considers necessary for a fair presentation of its financial position and the results of operations for these periods. Operating results for the nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the entire year ending December 31, 2006 or for any other future period. You should read the following information together with the more detailed information contained in Selected Consolidated Financial Data, Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the accompanying notes appearing elsewhere in this prospectus.

	Year ended December 31,			Nine months ended September 30,	
	2003	**2004**	**2005**	**2005**	**2006**
				(unaudited)	
	(in thousands, except share, per share and other operating data)				
Consolidated statement of operations data:					
Revenue:					
Products	$ 8,153	$ 12,738	$ 23,589	$ 14,889	$ 18,390
Services	1,328	3,955	9,290	6,335	10,544
Total revenue	9,481	16,693	32,879	21,224	28,934
Cost of revenue:					
Products	2,570	4,533	6,610	4,229	4,931
Services	436	872	1,453	981	2,016
Total cost of revenue	3,006	5,405	8,063	5,210	6,947
Gross profit	6,475	11,288	24,816	16,014	21,987
Operating expenses:					
Research and development	3,751	5,706	6,831	4,934	6,334
Sales and marketing	9,002	12,585	17,135	12,131	14,512
General and administrative	2,141	2,905	5,120	3,123	3,587
Depreciation and amortization	441	752	1,103	846	912
Total operating expenses	15,335	21,948	30,189	21,034	25,345
Income (loss) from operations	(8,860)	(10,660)	(5,373)	(5,020)	(3,358)
Other income (expense), net	16	164	(85)	(50)	442
Net loss	(8,844)	(10,496)	(5,458)	(5,070)	(2,916)
Accretion of preferred stock	(1,262)	(2,451)	(2,668)	(2,001)	(2,687)
Net loss attributable to common stockholders	$ (10,106)	$ (12,947)	$ (8,126)	$ (7,071)	$ (5,603)

Net loss attributable to common stockholders per common share:					
Basic and diluted	$ (2.89)	$ (3.06)	$ (1.56)	$ (1.38)	$ (1.03)
Pro forma (unaudited)[1]			(0.22)		(0.11)
Shares used in per common share calculations:					
Basic and diluted	3,502,521	4,226,855	5,197,316	5,132,011	5,456,806
Pro forma (unaudited)[1]			25,159,550		26,944,685
Other operating data:					
Number of sales in excess of $500,000	2	5	9	4	6
Number of new customers	161	136	149	116	171
Cumulative number of Fortune 100 customers at end of period	10	17	24	22	27
Number of full-time employees at end of period	84	107	135	142	174

(footnotes on following page)

	As of September 30, 2006		
	Actual	Pro forma(2) (unaudited) (in thousands)	Pro forma As Adjusted(3)
Consolidated balance sheet data:			
Cash and cash equivalents	$ 25,137	$ 25,137	$
Held-to-maturity investments	1,401	1,401	
Total assets	43,854	43,854	
Long-term debt	434	434	
Total liabilities	18,515	18,515	
Total convertible preferred stock	65,615		
Total stockholders equity (deficit)	(40,276)	25,339	

(1) Pro forma to give effect to the conversion of all outstanding shares of our preferred stock into shares of our common stock immediately prior to the completion of this offering.

(2) The pro forma balance sheet data reflect the conversion of all outstanding shares of our preferred stock into shares of our common stock immediately prior to the completion of this offering.

(3) The pro forma as adjusted balance sheet data reflect the conversion of all outstanding shares of our preferred stock into shares of our common stock immediately prior to the completion of this offering and our receipt of estimated net proceeds of $ from our sale of shares of common stock that we are offering at an assumed public offering price of $ per share, after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us.

RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the following risks and all other information contained in this prospectus, including our consolidated financial statements and the related notes, before investing in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, also may become important factors that affect us. If any of the following risks materialize, our business, financial condition or results of operations could be materially harmed. In that case, the trading price of our common stock could decline, and you may lose some or all of your investment.

Risks Related to Our Business

We have had operating losses since our inception and 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 $10.5 million for the year ended December 31, 2004, $5.5 million for the year ended December 31, 2005 and $2.9 million for the nine months ended September 30, 2006. Our accumulated deficit as of September 30, 2006 is approximately $40.3 million. Becoming profitable will depend in large part on our ability to generate and sustain increased revenue levels in future periods. Although our revenue has generally been increasing and our losses have generally been decreasing when compared to prior periods, you should not assume 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 new costs associated with becoming 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 and 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, Symantec Corporation, Cisco Systems, Inc., McAfee, Inc., 3Com Corporation and Juniper Networks, Inc. have acquired during the past several years smaller companies, which have intrusion detection or prevention technologies and Internet Security Systems, Inc. has recently been acquired by IBM. These acquisitions will make these combined entities potentially 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 the same functions as 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 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 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. For example, one of our competitors, Internet Security Systems, Inc., has recently been acquired by IBM and the combined company, if successfully integrated, could become a formidable competitor to us. In addition, the acquisition could result in a loss of our current sales to IBM if IBM were to discontinue reselling our products and services. If these new competitors are successful, we would lose market share and our revenue would likely decline.

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 (representing more than one-third of our total revenue in recent years), 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. 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 any 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. 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, while not 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 enhanced versions of Snort, the Defense Center and our Intrusion Sensors and RNA products to incorporate additional features, improved 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 (including, but not limited to, version 4.0 of RNA, which we plan to introduce in the next several months) 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 2004, 2005 and the nine months ended September 30, 2006, 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 up-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, Intrusion Sensors 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. Approximately 83% of our customers renewed their maintenance and support agreements upon expiration in the nine months ended September 30, 2006. No single customer contributed greater than 10% of our recurring maintenance and support revenues in 2005 or in the nine months ended September 30, 2006. 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 17% of our total revenue for the year ended December 31, 2004, 16% for the year ended December 31, 2005 and 13% for the nine months ended September 30, 2006. We lost many government agency customers when a foreign company tried unsuccessfully to acquire us in late 2005 and early 2006. Since then, we have been attempting to regain government customers, which 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;

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 other 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.

Replacing Existing Products. After we announced in October 2005 that we had agreed to be acquired by a foreign company, many government agencies were unwilling to buy products from us and instead purchased and installed products sold by our competitors. The proposed acquisition was terminated in April 2006 following objections from the Committee on Foreign Investment in the United States. Since that time, we have been attempting to retain government agency customers. Many government agencies, however, 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 and Asia 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 North America accounted for approximately 16% of our total revenue in the year ended December 31, 2004, approximately 17% of our total revenue in the year ended December 31, 2005 and approximately 18% of our total revenue during the nine months ended September 30, 2006. 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.

We expect that the net proceeds from this offering together with current cash, cash equivalents, borrowings under our credit facility and short-term investments should be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 24 months. However, our business and operations may consume resources faster than we anticipate. 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 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 will 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. Further, completing a potential acquisition and integrating an acquired business will significantly divert management time and resources.

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

While we created a majority of the current Snort code base, a portion of the current Snort code was created by the combined efforts of the Company 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 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. There is a risk, however, that a third party could claim some ownership rights in Snort, and attempt to prevent us from commercially licensing Snort in the future (rather than pursuant to the GPL as it is currently licensed) and 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 and 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®, 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, 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 software program 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 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.

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.

When we undertake actions to protect and maintain ownership and control over our proprietary intellectual property, including patents, copyrights and trademark rights, 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 secrets laws, confidentiality procedures and contractual provisions to protect our proprietary rights. As of the date hereof, we had 19 patent 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 software, which is readily available to the public. 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 the innovative products that have enabled us to be successful to date.

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 source code which is 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. This 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. In particular, our RNA technology is a new technology for which we have yet be issued a patent. It is possible that other companies have patents with respect to technology similar to our technology, including RNA. Ten of our 19 pending patent applications relate to our RNA technology and were filed in 2003, 2004 and 2005. If others filed patent applications before us, which contain allowable claims within the scope of our RNA technology, then we may be found to infringe on such patents, if and when they are issued. We are aware of at least one company that has filed an application for a patent that, on its face, contains claims that may be construed to be within the scope of the same broad technology area as our RNA technology. That company, PredatorWatch, has filed suit against us for misappropriation and incorporation in our RNA technology of its proprietary rights (see discussion in next risk factor). PredatorWatch has separately notified us that it believes that our RNA technology is covered by claims in a pending patent application filed by PredatorWatch. Unless and until the U.S. Patent and Trademark Office, or PTO, issues a patent to an applicant, there can be no way to assess a potential patentee s right to exclude. Depending on the timing and substance of these patents and patent applications, our products, including our RNA technology, may infringe the proprietary rights of others, and we may be subject to litigation with respect to any alleged infringement. The application of patent law to the software industry is particularly uncertain as the PTO has only recently begun to issue software patents in large numbers and there is a backlog of software related patent applications pending claiming inventions whose priority dates may pre-date development of our own proprietary software. Additionally, in our customer contracts we typically agree to indemnify our customers if they incur losses resulting from a third party claim that their use of our products infringes upon the intellectual property rights of a third party. Any potential intellectual property claims against us, with or without merit, could:

- be very expensive and time consuming to defend;
- require us to indemnify our customers 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;
- divert management s attention and resources; or
- require us to enter into royalty or licensing agreements in order to obtain the right to use a necessary product or component.

Royalty or licensing agreements, if required, may not be available on acceptable terms, if at all. A successful claim of infringement against us and our failure or inability to license the infringed or similar technology could prevent us from distributing our products and cause us to incur great expense and delay in developing non-infringing products.

We have been sued by a company claiming that we misappropriated and incorporated its proprietary rights into our RNA Technology and our defense of these claims is costly, diverts the attention of our management and may be unsuccessful.

On April 20, 2006, a lawsuit was filed against us, Martin F. Roesch, our Chief Technology Officer, Inflection Point Ventures, L.P., one of our stockholders, and certain general partners of Inflection Point Ventures, L.P. by PredatorWatch Inc. (now named NetClarity) in the Superior Court for Suffolk County, Massachusetts. The complaint alleges that the defendants: (i) misappropriated and incorporated the plaintiff s trade secrets into our RNA Technology; (ii) breached an oral agreement of confidentiality; (iii) breached a covenant of good faith and fair dealing owed to the plaintiff; (iv) were unjustly enriched; (v) misrepresented certain material facts to the plaintiff, upon which the plaintiff relied to its detriment; and (vi) engaged in unfair and deceptive acts in violation of Massachusetts state law. The plaintiff has sought to recover amounts to be ascertained and established, as well as double and treble damages and attorney s fees.

Litigation is subject to inherent uncertainties, especially in cases like this where sophisticated factual issues must be assessed and complex technical issues must be resolved. In addition, these types of cases involve issues of law that are evolving, presenting further uncertainty. Our defense of this litigation, regardless of the merits of the complaint, has been, and will likely continue to be, time consuming, extremely costly and a diversion of time and attention for our technical and management personnel. Through September 30, 2006, we have spent approximately $174,000 in legal fees and expenses on this litigation and expect to incur substantial additional expenses even if we ultimately prevail. In addition, publicity related to this litigation has in the past, and could likely in the future, have a negative impact on sales of our RNA products. Sales of our RNA product amounted to $4.5 million and $2.6 million for 2005 and the nine months ended September 30, 2006, respectively.

A failure to prevail in the litigation could result in one or more of the following:

- our paying substantial monetary damages, which could be tripled if any misappropriation is found to have been willful, and which may include paying an ongoing significant royalty to PredatorWatch or compensation for lost profits to PredatorWatch;

- our paying substantial punitive damages;

- our having to provide an accounting of all revenue received from selling RNA in its current form;

- the issuance of a preliminary or permanent injunction requiring us to stop selling RNA in its current form;

- our having to redesign RNA, which could be costly and time-consuming and could substantially delay RNA shipments, assuming that a redesign is feasible;

- our having to reimburse PredatorWatch for some or all of its attorneys fees and costs, which would be substantial;

- our having to obtain from PredatorWatch a license to use its technology, which might not be available on reasonable terms, if at all; or

- our having to indemnify our customers against any losses they may incur due to the alleged infringement.

Additionally, PredatorWatch has separately notified us that they believe that our RNA technology is covered by claims contained in a pending patent application. This pending patent application has not issued as a patent, but in the event it does issue, PredatorWatch could file an additional complaint to include a patent infringement claim against us.

If we are enjoined from selling RNA in its current form, we may be required to redesign RNA to avoid infringing on the intellectual property rights of others. If we are unable to efficiently redesign commercially acceptable products, our sales will decline substantially. This litigation is at a very early stage, so we cannot predict its course or its costs to us. We do, however, expect to continue to incur significant costs in defending against this litigation and these costs could increase substantially if this litigation approaches or enters a trial phase. It is possible that these costs could substantially exceed our expectations in future periods. For a more detailed description of this litigation, please see Business Legal Proceedings.

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 Intrusion 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, 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 or no longer offered to us on commercially reasonable terms. In either case, 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 software 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 will 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 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 two 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 3.8% of our product revenue in the year ended December 31, 2005 and approximately 18% of our product revenue during the nine months ended September 30, 2006. The unexpected termination of our relationship with Bivio Networks would be disruptive to our business and our reputation which could result in a decline in our revenue as well as shipment delays and possible increased costs as we seek and implement production with an alternate manufacturer.

Our inability to hire and 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, 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 we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited or divulged proprietary or other confidential information.

Our future success will depend to a significant extent on the continued services of Martin Roesch, our founder and Chief Technology Officer, and E. Wayne Jackson, III, our Chief Executive Officer. The loss of the services of either of these or other 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 46% of our total revenue in the year ended December 31, 2004, approximately 48% of our total revenue in the year ended December 31, 2005 and approximately 48% of our total revenue during the nine months ended September 30, 2006. For the year ended December 31, 2005 and for the nine months ended September 30, 2006, no single reseller, distributor, customer or OEM accounted for more than ten percent of our total revenue. 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. For example, IBM, our current reseller, recently completed its acquisition of

Internet Security Systems, Inc., one of our competitors. Sales of our products to IBM or where IBM helped influence the sales process as a percentage of our total revenue were 3.3% and 1.2% for the nine months ended September 30, 2006 and the year ended December 31, 2005, respectively. While we have received oral assurances from IBM that it does not expect any material change to our reseller relationship solely on account of its acquisition of Internet Security Systems, Inc., we cannot currently anticipate how our relationship with IBM may change. IBM may decide to discontinue reselling our products and services.

If we do not continue to establish and effectively manage our OEM relationships, 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 and OEMs. We have alliances with OEMs such as IBM and Nokia and we cannot predict the extent to which these companies will be successful in marketing or selling our software. These agreements could be terminated on short notice and they do not prevent our OEMs, systems integrators, strategic resellers or other distributors from selling the network security software of other companies, including our competitors. IBM and Nokia or any other OEM, system integrator, strategic reseller or distributor could give higher priority to other companies software or to their own software than they give to ours, which could cause our revenue to decline. Additionally, IBM recently completed its acquisition of Internet Security Systems, Inc., one of our competitors. Our ability to sell our network security software products through IBM as a reseller or have our product sales influenced by them as a partner could be materially diminished.

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 84 employees at December 31, 2003 to 174 employees at September 30, 2006. 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 will have substantial additional obligations and costs as a result of being a public company. 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. 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 will need to implement additional management information systems, improve our operating, administrative, financial and accounting systems and controls, train new employees and maintain close coordination among our executive, engineering, accounting, finance, marketing, sales and operations organizations.

Risks Related to Your Investment

The price of our common stock may be subject to wide fluctuations and may trade below the initial public offering price.

Before this offering, there has not been a public market for our common stock. The initial public offering price of our common stock will be determined by negotiations between us and representatives of the underwriters, based on numerous factors, including those that we discuss under Underwriters. This price may not be indicative of the market price of our common stock after this offering. We cannot assure you that an active public market for our common stock will develop or be sustained after this offering. The market price of our common stock also could be subject to significant fluctuations. As a result, you may not be able to sell your shares of our common stock quickly or at prices equal to or greater than the price you paid in this offering.

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.

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 and may dilute your voting power and your ownership interest in us.

After the completion of this offering, we will have outstanding shares of common stock (shares of common stock if the underwriters exercise in full their option to purchase additional shares). This number is comprised of all the shares of our common stock that we are selling in this offering, which may be resold immediately in the public market. Subject to certain exceptions described under the caption Underwriters, we and all of our directors and executive officers and certain of our stockholders and option holders have agreed not to offer, sell or agree to sell, directly or indirectly, any shares of common stock without the permission of the underwriters for a period of 180 days from the date of this prospectus. When this period expires we and our locked-up stockholders will be able to sell our shares in the public market. Sales of a substantial number of such shares upon expiration, or early release, of the lock-up (or the perception that such sales may occur) could cause our share price to fall.

Sales of substantial amounts of our common stock in the public market following our initial public offering, 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.

We also may issue our shares of common stock from time to time as consideration for future acquisitions and investments. If any such acquisition or investment is significant, the number of shares that we may issue may in turn be significant. In addition, we may also grant registration rights covering those shares in connection with any such acquisitions and investments.

Investors purchasing common stock in this offering will experience immediate and substantial dilution.

The assumed initial public offering price of our common stock is substantially higher than the net tangible book value per outstanding share of our common stock immediately after this offering. As a result, you will pay a price per share that substantially exceeds the book value of our tangible assets after subtracting our liabilities. Purchasers of our common stock in this offering will incur immediate and substantial dilution of $ per share in the net tangible book value of our common stock from the assumed initial public offering price of $ per share, which is the mid-point of the estimated range set forth on the cover of this prospectus. If the underwriters exercise in full their option to purchase additional shares, there will be an additional dilution of $ per share in the net tangible book value of our common stock, assuming the same public offering price.

As a result of becoming a public company, we will be obligated to develop and maintain proper and effective internal controls over financial reporting and will be 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.

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 for the first fiscal year beginning after the effective date of this offering. This assessment will need to include disclosure of any material weaknesses identified by our management in our internal control over financial reporting, as well as a statement that our auditors have issued an attestation report on our management s assessment of our internal controls.

We are just beginning the costly and challenging process of compiling the system and processing documentation before we perform the evaluation needed 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 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 management s report is fairly stated or they are unable to express an opinion on the effectiveness of our internal control, we could lose investor confidence in the accuracy and completeness of our financial reports, which would have a material adverse effect on the price of our common stock. Failure to comply with the new 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.

In addition, as a public company, we will incur significant additional legal, accounting and other expenses that we did not incur as a private company, and our administrative staff will be required to perform additional tasks. For example, in anticipation of becoming a public company, we will need to create or revise the roles and duties of our board committees, adopt disclosure controls and procedures, retain a transfer agent, adopt an insider trading policy and bear all of the internal and external costs of preparing and distributing periodic public reports in compliance with our obligations under the securities laws. 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.

Anti-takeover provisions in our charter documents and under Delaware law 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.

We intend to amend and restate our certificate of incorporation and bylaws, both of which will become effective upon the completion of this offering, to add 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 collectively provide for an opportunity to receive higher bids by requiring potential acquirors 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.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus contains both historical and forward-looking statements. All statements other than statements of historical fact are, or may be deemed to be, forward-looking statements. For example, statements concerning projections, predictions, expectations, estimates or forecasts and statements that describe our objectives, plans or goals are or may be forward-looking statements. These forward-looking statements reflect management s current expectations concerning future results and events and generally can be identified by use of expressions such as may, will, should, could, would, predict, potential, continue, expect, anticipate, future, intend, plan estimate, and similar expressions, as well as statements in future tense. These forward-looking statements include, but are not limited to, the following:

- expected growth in the markets for network security products;
- our plans to continue to invest in and develop innovative technology and products for our existing markets and other network security markets;
- the timing of expected introductions of new or enhanced products;
- our expectation of growth in our customer base and increasing sales to existing customers;
- our plans to increase revenue through more relationships with original equipment manufacturers, resellers, distributors, government suppliers and co-marketers;
- our plans to grow international sales;
- our plans to acquire and integrate new businesses and technologies;
- our plans to hire more network security experts and broaden our knowledge base; and
- our plans to hire additional sales personnel and the additional revenue we expect them to generate.

The forward-looking statements included in this prospectus are made only as of the date of this prospectus. We expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be different from any future results, performance and achievements expressed or implied by these statements. These risks and uncertainties include, but are not limited to, the following:

- the market for network security products is rapidly evolving and the complex technology incorporated in our products makes them difficult to develop, and 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;
- defects, errors or vulnerabilities in our software products would harm our reputation and divert resources;
- in the future, we may not be able to secure financing necessary to operate and grow our business as planned;

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

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;

new competitors could emerge or our customers or distributors could internally develop alternatives to our products and either development could impair our sales;

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

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

if we cannot attract sufficient government agency customers, our revenue and competitive position will suffer;

if we do not continue to establish and effectively manage our OEM relationships, our revenue could decline;

we are subject to risks of operating internationally that could impair our ability to grow our revenue abroad;

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

our inability to hire and retain key personnel would slow our growth; and

our inability to effectively manage our headcount growth and expansion could seriously harm our ability to effectively run our business.

We operate in an industry in which it is difficult to obtain precise industry and market information. Although we have obtained some industry data from outside sources that we believe to be reliable, in certain cases we have based certain statements contained in this prospectus regarding our industry and our position in the industry on our estimates concerning, among other things, our customers and competitors. These estimates are based on our experience in the industry, conversations with our principal suppliers and customers and our own investigations of market conditions. Unless otherwise noted, the statistical data contained in this prospectus regarding the network security software industry are based on data we obtained from IDC, a provider of market intelligence for the information technology, telecommunications and consumer technology markets.

SOURCEFIRE®, SNORT®, the Sourcefire logo, the Snort and Pig logo, SECURITY FOR THE REAL WORLD™, SOURCEFIRE DEFENSE CENTER™, SOURCEFIRE 3D™, RNA™ and certain other trademarks and logos are trademarks or registered trademarks of Sourcefire, Inc. in the United States and other countries. This prospectus also refers to the products or services of other companies by the trademarks and trade names used and owned by those companies.

USE OF PROCEEDS

Assuming an initial public offering price of $ per share, we estimate that we will receive net proceeds from this offering of approximately $ million, after deducting underwriting discounts and commissions and other estimated expenses of $ million payable by us. If the underwriters option to purchase additional shares in this offering is exercised in full we estimate that our net proceeds will be approximately $ million. We will not receive any proceeds from the sale of shares of our common stock by the selling stockholders.

We intend to use the net proceeds to us from this offering for working capital and other general corporate purposes, including financing our growth, developing new products and funding capital expenditures. We may seek to finance our growth by, for example, expanding our direct sales force in international markets and by hiring additional personnel beyond our current plans to bring products to market sooner. Some possible capital expenditures include, without limitation, (i) procuring and installing an enterprise resource planning system, (ii) purchasing additional development and testing equipment for our security lab and (iii) acquiring additional security-related technology for further development. In addition, we may choose to repay the equipment line portion of our credit facility with Silicon Valley Bank or expand our current business through acquisitions of other businesses, products or technologies. However, we do not have agreements or commitments for any specific repayments nor do we have any plans, proposals or arrangements with respect to any specific acquisitions at this time. As of September 30, 2006, the outstanding balance under the equipment line portion of our Silicon Valley Bank credit facility was $969,000, bearing interest at annual rates from 6.5% to 7.0% and maturing between November 2006 and August 2008. The outstanding balance, if any, under the working capital portion of the credit facility must be repaid on March 28, 2007. The proceeds of the equipment line portion of the credit facility were used for furniture, leasehold improvements, personal computers and equipment for our network security lab.

Pending any use, as described above, we plan to invest the net proceeds in short-term, interest-bearing investment grade securities.

A $1.00 increase (decrease) in the assumed initial public offering price of $ per share would increase (decrease) the net proceeds to us from this offering by $, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated expenses payable by us.

DIVIDEND POLICY

We intend to retain all future earnings, if any, for use in the operation of our business and to fund future growth. We have never declared or paid any dividend on our capital stock and do not anticipate paying any dividends for the foreseeable future and the loan and security agreement governing our working capital line of credit restricts our ability to pay dividends or other distributions on our capital stock. The decision whether to pay dividends will be made by our board of directors in light of conditions then existing, including factors such as our results of operations, financial condition and requirements, business conditions and covenants under any applicable contractual arrangements.

CAPITALIZATION

The following table sets forth our cash and cash equivalents and our capitalization (including long-term debt) as of September 30, 2006:

on an actual basis;

on a pro forma basis, giving effect to the conversion of all of the outstanding shares of our preferred stock into 23,226,683 shares of our common stock immediately prior to the completion of this offering; and

on a pro forma as adjusted basis, giving effect to the conversion of all of the outstanding shares of our preferred stock into 23,226,683 shares of our common stock immediately prior to the completion of this offering and our sale of shares of common stock in this offering, assuming an initial public offering price of $, the midpoint of the estimated price range set forth on the cover of this prospectus, after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The numbers of shares of common stock shown as issued and outstanding exclude:

4,457,866 shares that may be issued upon the exercise of options outstanding as of September 30, 2006;

59,998 shares that may be issued upon the exercise of warrants outstanding as of September 30, 2006;

1,044,194 shares that are reserved for issuance pursuant to our stock option plan as of September 30, 2006; and

45,000 shares that are subject to repurchase by us.

You should read this table in conjunction with the consolidated financial statements and the related notes, Management s Discussion and Analysis of Financial Condition and Results of Operations, and Description of Capital Stock included elsewhere in this prospectus.

	As of September 30, 2006		
	Actual	Pro forma (unaudited)	Pro forma as adjusted
	(dollars in thousands)		
Cash and cash equivalents	$ 25,137	$ 25,137	$
Long-term debt	$ 434	$ 434	$
Series A Convertible Preferred Stock, par value $.001 per share: 2,495,410 shares authorized, 2,475,410 shares issued and outstanding, actual; no shares authorized, no shares issued and outstanding, pro forma and pro forma as adjusted	10,130		
Series B Convertible Preferred Stock, par value $.001 per share: 7,132,205 shares authorized, 7,132,205 shares issued and outstanding, actual; no shares authorized, no shares issued and outstanding, pro forma and pro forma as adjusted	14,028		
Series C Convertible Preferred Stock, par value $.001 per share: 5,404,043 shares authorized, 5,404,043 shares issued and outstanding, actual; no shares authorized, no shares issued and outstanding, pro forma and pro forma as adjusted	17,969		
Series D Convertible Preferred Stock, par value $.001 per share: 3,264,449 shares authorized, 3,264,449 shares issued and outstanding, actual; no shares authorized, no shares issued and outstanding, pro forma and pro forma as adjusted	23,463		
Warrants to purchase Series A Convertible Preferred Stock	25		
Total convertible preferred stock and warrants	65,615		
Stockholders equity (deficit):			
Common Stock, par value $.001 per share: 36,500,000 authorized, 5,660,686 issued and outstanding, actual; shares authorized, 28,886,807 shares issued and outstanding, pro forma; shares authorized, shares issued and outstanding, pro forma as adjusted	6	29	
Preferred Stock, par value $.001 per share: no shares authorized, no shares issued and outstanding, actual and pro forma; shares authorized, no shares issued and outstanding, pro forma as adjusted			
Unearned compensation	(5)	(5)	
Additional paid-in capital		65,592	
Accumulated deficit	(40,277)	(40,277)	
Total stockholders equity (deficit)	(40,276)	25,339	
Total capitalization (including long-term debt)	$ 25,773	$ 25,773	$

DILUTION

Dilution is the amount by which the offering price paid by the purchasers of the common stock sold in the offering exceeds the net tangible book value per share of common stock after the offering. Net tangible book value per share is determined at any date by subtracting our total liabilities from the total book value of our tangible assets and dividing the difference by the number of shares of common stock deemed to be outstanding at that date.

Our pro forma net tangible book value as of September 30, 2006 was $25.3 million, or $0.88 per share, which gives effect to the conversion of all outstanding shares of our preferred stock into 23,226,683 shares of our common stock immediately prior to the completion of this offering. After giving effect to the receipt and our intended use of approximately $ million of estimated net proceeds from our sale of shares of common stock in this offering at an assumed offering price of $ per share, our pro forma as adjusted net tangible book value as of September 30, 2006 would have been approximately $ million, or $ per share. This represents an immediate increase in pro forma net tangible book value of $ per share to existing stockholders and an immediate dilution of $ per share to new investors purchasing shares of common stock in the offering. The following table illustrates this substantial and immediate per share dilution to new investors:

Assumed initial public offering price per share		$
Pro forma net tangible book value per share before this offering	$ 0.88	
Increase per share attributable to investors in this offering		
As adjusted pro forma net tangible book value per share after this offering		
Dilution per share to new investors		$

A $1.00 increase (decrease) in the assumed initial public offering price of $ per share would increase (decrease) our pro forma net tangible book value per share before this offering, by $, the as adjusted pro forma net tangible book value per share after this offering by $ and the dilution per share to new investors in this offering by $, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The following table summarizes on an as adjusted pro forma basis as of September 30, 2006.

the total number of shares of common stock purchased from us by our existing stockholders and by new investors purchasing shares in this offering;

the total consideration paid to us by our existing stockholders and by new investors purchasing shares in this offering, assuming an initial public offering price of $ per share (before deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us in connection with this offering); and

the average price per share paid by existing stockholders and by new investors purchasing shares in this offering:

	Shares purchased		Total consideration		Average price
	Number	Percent	Amount	Percent	per share
Existing stockholders	28,932,369	%	$ 56,874,105	%	$ 1.97
Investors in the offering					$
Total		100%	$	100%	

A $1.00 increase (decrease) in the assumed initial public offering price of $ per share would increase (decrease) total consideration paid by new investors and the average price per share by $ and $, respectively, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same, and without deducting the estimated underwriting discounts and commissions and estimated expenses payable by us.

The tables and calculations above assume no exercise of:

- stock options outstanding as of September 30, 2006 to purchase 4,457,866 shares of common stock at a weighted average exercise price of $1.06 per share; or

- the underwriters over-allotment option.

To the extent any of these options are exercised, there will be further dilution to new investors.

SELECTED CONSOLIDATED FINANCIAL DATA

The consolidated statement of operations data for the five years ended December 31, 2005 and the consolidated balance sheet data as of December 31, 2001, 2002, 2003, 2004 and 2005 have been derived from our audited consolidated financial statements. The statement of operations data for the nine months ended September 30, 2005 and 2006 and the balance sheet data as of September 30, 2006 were derived from our unaudited consolidated financial statements and related notes, which are included in this prospectus. The unaudited interim consolidated financial statements include, in the opinion of management, all adjustments that management considers necessary for the fair presentation of the financial information set forth in those statements. The selected consolidated financial data set forth below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations set forth below and our consolidated financial statements and related notes included elsewhere in this prospectus. The historical results are not necessarily indicative of the results to be expected in any future period and the results for the nine months ended September 30, 2006 should not be considered indicative of results expected for the full year.

	Year ended December 31,					Nine months ended September 30,	
	2001[(1)]	2002	2003	2004	2005	2005	2006
						(unaudited)	
	(in thousands, except share, per share and other operating data)						
Consolidated statement of operations data:							
Revenue:							
Products	$ 134	$ 1,704	$ 8,153	$ 12,738	$ 23,589	$ 14,889	$ 18,390
Services	25	197	1,328	3,955	9,290	6,335	10,544
Total revenue	159	1,901	9,481	16,693	32,879	21,224	28,934
Cost of revenue:							
Products	32	448	2,570	4,533	6,610	4,229	4,931
Services	12	155	436	872	1,453	981	2,016
Total cost of revenue	44	603	3,006	5,405	8,063	5,210	6,947
Gross profit	115	1,298	6,475	11,288	24,816	16,014	21,987
Operating expenses							
Research and development	84	1,261	3,751	5,706	6,831	4,934	6,334
Sales and marketing	40	3,179	9,002	12,585	17,135	12,131	14,512
General and administrative	76	1,234	2,141	2,905	5,120	3,123	3,587

Depreciation and amortization	3	153	441	752	1,103	846	912
Total operating expenses	203	5,827	15,335	21,948	30,189	21,034	25,345
Operating loss	(88)	(4,529)	(8,860)	(10,660)	(5,373)	(5,020)	(3,358)
Other income (expense), net	(12)	22	16	164	(85)	(50)	442
Net loss	(100)	(4,507)	(8,844)	(10,496)	(5,458)	(5,070)	(2,916)
Accretion of preferred stock		(356)	(1,262)	(2,451)	(2,668)	(2,001)	(2,687)
Net loss attributable to common stockholders	$ (100)	$ (4,863)	$ (10,106)	$ (12,947)	$ (8,126)	$ (7,071)	$ (5,603)
Net loss per common share: Basic and diluted	$ (.03)	$ (1.61)	$ (2.89)	$ (3.06)	$ (1.56)	$ (1.38)	$ (1.03)
Pro forma (unaudited)(2)					$ (0.22)	$	$ (0.11)
Shares used in per common share calculations: Basic and diluted	3,000,000	3,029,837	3,502,521	4,226,855	5,197,316	5,132,011	5,456,806
Pro forma (unaudited)(2)					25,159,550		26,944,685
Other operating data:							
Number of sales in excess of $500,000		1	2	5	9	4	6
Number of new customers			161	136	149	116	171
Cumulative number of Fortune 100 customers at end of period		3	10	17	24	22	27
	4	46	84	107	135	142	174

Number of full-time employees at end of period

	As of December 31,					As of September 30,
	2001	2002	2003	2004	2005	2006
Consolidated balance sheet data:						
Cash and cash equivalents	$ 132	$ 2,991	$ 5,315	$ 3,563	$ 1,106	$ 25,137
Held-to-maturity investments				5,751	2,005	1,401
Total assets	188	4,928	10,316	20,016	21,250	43,854
Long-term debt		336	110	181	476	434
Total liabilities	180	2,031	5,166	10,177	16,340	18,515
Total convertible preferred stock		7,716	19,958	37,339	40,007	65,615
Total stockholders equity (deficit)	8	(4,819)	(14,808)	(27,500)	(35,097)	(40,276)
Dividends declared per share						

(1) For the period January 22, 2001 (inception) to December 31, 2001.

(2) On a pro forma basis, giving effect to the conversion of all of the outstanding shares of our preferred stock into shares of our common stock immediately prior to the completion of this offering.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 prospectus. In addition to historical consolidated financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this prospectus, particularly in Risk Factors.

Overview

Sourcefire is a leading provider of intelligence driven, open source network security solutions that enable our customers to protect their computer networks in an effective, efficient and highly automated manner. We apply a comprehensive Discover, Determine and Defend, or 3D, approach to network security through which we: 1) discover potential threats and vulnerabilities, 2) determine the potential impact of those observations to the network and 3) defend the network through aggressive enforcement of security policies. We sell our security solutions to a diverse customer base that includes over 25 of the Fortune 100 companies and over half of the 30 largest U.S. government agencies. We also manage one of the security industry s leading open source initiatives, Snort.

Our Sourcefire 3D approach is comprised of three key components:

RNA. At the heart of the Sourcefire 3D security solution is Real-time Network Awareness, or RNA, our network intelligence product that provides persistent visibility into the composition, behavior, topology (the relationship of network components) and risk profile of the network. This information provides a platform for the Defense Center s automated decision-making and network policy compliance enforcement. The ability to continuously discover characteristics and vulnerabilities of any computing device communicating on a network such as a computer, printer or server, or endpoint intelligence, enables our Intrusion Prevention products to more precisely identify and block threatening traffic and to more efficiently classify threatening and/or suspicious behavior than products lacking network intelligence.

Intrusion Sensors. The Intrusion Sensors utilize open source Snort® and our proprietary technology to monitor network traffic. These sensors compare observed traffic to a set of Rules , or a set of network traffic characteristics, which can be indicative of malicious activity. Once the Intrusion Sensors match a Rule to the observed traffic, they block malicious traffic and/or send an alert to the Defense Center for further analysis, prioritization and possible action.

Defense Center. The Defense Center aggregates, correlates and prioritizes network security events from RNA Sensors and Intrusion Sensors to synthesize multipoint event correlation and policy compliance analysis. The Defense Center s policy and response subsystems are designed to leverage existing IT infrastructure such as firewalls, routers, trouble ticketing, and patch management systems for virtually any task, including alerting, blocking and initiating corrective measures.

Historical Development of our Business

We were organized as a Delaware corporation and began operations in January 2001, and we sold our first commercial product, a Sourcefire Intrusion Sensor, in the summer of 2001. In 2002, we released the first version of the Defense Center product, closed our first round of institutional financing, raising approximately $7.5 million from the sale of Series A convertible preferred stock, and hired senior executives including our CEO, COO, VP of Sales and VP of Business Development. In 2003, we closed our second round of institutional financing, raising $11 million from the sale of Series B convertible preferred stock, released our RNA product and hired our CFO and VP of Engineering. In 2004, we completed our third round of institutional financing, raising $15 million from the sale of Series C convertible preferred stock, exceeded 100 total employees, hired our chief marketing officer and introduced the Sourcefire 3D suite of products. In 2005, we leased approximately 40,000 square feet of office space for our corporate headquarters including a 4,000 square foot state-of-the-art security lab, received NSS gold certification for our intrusion detection product and released our enterprise class intrusion sensor product.

In October 2005 we entered into a definitive merger agreement to be acquired by Check Point Software Technologies Ltd., an Israeli company, for $225 million. As a result of the merger announcement and during the period following the announcement, our U.S. government business was curtailed as certain government agencies apparently became unwilling to buy products from a company being acquired by a foreign entity and instead purchased and installed products sold by our competitors. In April 2006, the proposed acquisition was mutually terminated in response to objections from the Committee on Foreign Investment in the United States. Our business, including our business with the U.S. government, continued to grow following the termination. We believe that, other than the curtailment of government business described above, the announcement, pendency and termination of the merger have not had a material adverse effect on our business or plans for this offering.

In 2006, we closed our fourth round of institutional financing, raising $23 million from the sale of Series D convertible preferred stock, and achieved our first quarter of cash flow positive results.

Key Financial Metrics and Trends

Pricing and Discounts

We maintain a standard price list for all our products and we have not changed our list pricing during the past. Additionally, we have a corporate policy that governs the level of discounting 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 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 solutions. Technical support entitles a customer to product updates, new Rules releases and both telephone and web assistance for using our products. Our professional services revenue includes optional on-site network security deployment consulting, and classroom and online training for managing a network security solution.

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 and original equipment manufacturers, or OEMs, we do not recognize revenue until we receive the monthly sales report which indicates the sell-through volume to end user customers. Revenue from services is recognized when the services are performed. For technical support services, revenue is recognized ratably over the term of the support arrangement, which is usually a 12-month agreement providing for payment in advance and automatic renewals.

We sell our network security solutions globally. However, over 80% of our revenue for 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 execute our strategy to strengthen our international presence. We also expect that our revenue from sales through OEMs and distributors will increase in amount and as a percentage of total revenue as we execute our strategy to expand such relationships. We manage our operations on a consolidated basis for purposes of assessing performance and making operating decisions. Accordingly, our business does not have reportable segments.

Revenue from product sales has been highly seasonal, with more than one-third of our total product revenue in recent fiscal years generated in the fourth quarter. The timing of our year-end shipments could materially affect our fourth quarter product revenue in any fiscal year and sequential 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. Although we do not expect these general seasonal patterns to change substantially in the future, 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 the period and cause us to fail to meet the financial performance expectations of securities industry research analysts or investors.

On April 20, 2006, we received a complaint filed by PredatorWatch, Inc. in Suffolk County, Massachusetts, alleging, among other things, that we misappropriated and incorporated the plaintiff s trade secrets and confidential information into our RNA technology. The plaintiff has sought to recover amounts to be ascertained and established, as well as double and treble damages and attorneys fees. While this litigation is at an early stage and we cannot reliably estimate the amount, if any, that the Plaintiff could recover, the potential range of remedies available to the Plaintiff, if successful, could include royalties on past and future sales of RNA and/or a permanent injunction prohibiting us from selling any products containing RNA technology.

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 go into 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. For the nine months ended September 30, 2006 and for the year ended December 31, 2005, cost of product revenue was 27% and 28% of total product revenue, respectively. Hardware costs, which are our most significant cost items, generally have not fluctuated materially as a percentage of revenue in recent years because competition among hardware platform suppliers has remained strong and, therefore, our hardware cost has remained consistent. Because of the competition among hardware suppliers and our outsourcing of the manufacture of our products to four 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 the manufacturing process. These costs are included as a component of our cost of product revenue, but they have not been material.

Cost of service revenue includes the direct labor costs of professionals and outside consultants engaged to furnish those services, as well as their travel and associated direct material costs. Additionally, we include in cost of service revenue an allocation of overhead expenses such as occupancy costs, fringe benefits and supplies. For the nine months ended September 30, 2006 and for the year ended December 31, 2005, cost of service revenue was 19% and 16% of total service revenue, respectively, and, although we anticipate incurring additional costs in the future for increased personnel to support and service our growing customer base, we do not expect the cost of service revenue as a percentage of service revenue to change materially in the future.

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 to continue 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 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. For the nine months ended September 30, 2006 and for the year ended December 31, 2005, gross profit was 76% and 75% of total revenue, respectively. Based on current market conditions, we do not expect these percentages to change significantly in the foreseeable future, although unexpected pricing pressures or an increase in hardware or other costs would cause our gross profit percentage to decline.

Operating Expenses

Research and Development. Research and development expenses consist primarily of payroll, benefits and related costs for our engineers, occupancy costs and other overhead, costs for sophisticated components used in product and prototype development and costs of test equipment used during product development.

We have significantly expanded our research and development capabilities and expect to continue to expand these capabilities in the future. All of our research and development is performed in the United States. 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 moderately as a percentage of total revenue as we expect to grow our sales more rapidly than our research and development expenditures. For the nine months ended September 30, 2006, and for the year ended December 31, 2005, research and development expense was $6.3 million and $6.8 million, or 22% and 21% of total revenue, respectively.

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.

For the nine months ended September 30, 2006, and for the year ended December 31, 2005, sales and marketing expense was $14.5 million and $17.1 million, or 50% and 52% of total revenue, respectively.

General and Administrative. General and administrative expenses consist primarily of: salaries, incentive compensation, benefits and related costs for executive, finance, information system and administrative personnel; legal, accounting and tax preparation and advisory fees; travel and related costs; information systems and infrastructure costs; and occupancy and other overhead costs.

We expect our general and administrative expenses to increase due to our preparations to become and to operate as a public company, including costs associated with compliance with Section 404 of the Sarbanes-Oxley Act, directors and officers liability insurance, increased professional services and a new investor relations function.

For the nine months ended September 30, 2006, and for the year ended December 31, 2005, general and administrative expense was $3.6 million and $5.1 million, or 13% and 16% of total revenue, respectively.

Stock-Based Compensation. Prior to January 1, 2006, our stock-based compensation expense consisted primarily of the amortization of unearned compensation related to grants of restricted shares of our common stock to certain officers and employees in 2002 and 2003, as well as the modification of certain fixed stock option awards subsequent to their grant date. Total stock-based compensation expenses recorded in our statements of operations for 2003, 2004 and 2005 were $72,000, $177,000 and $470,000, respectively.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of the Financial Accounting Standards Board s SFAS No. 123(R), Share-Based Payment, using the prospective transition method, which requires the Company 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 a result of adopting SFAS No. 123(R) on January 1, 2006, based on the estimated grant-date fair value of employee stock options subsequently granted or modified, the Company recognized aggregate stock-based compensation expense of $239,000 for the nine months ended September 30, 2006. The Company uses the Black-Scholes option pricing model to estimate the calculated 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.

The grant date fair value of options not yet recognized as expense as of September 30, 2006 aggregated approximately $761,000, net of estimated forfeitures, which will be recognized over a weighted-average period of approximately four years. We expect to record aggregate amortization of stock-based compensation of approximately $98,000 in the fourth quarter of 2006 from these outstanding awards, subject to continued vesting. In addition, we expect to record aggregate amortization of stock-based compensation of approximately $308,000, $217,000, $128,000, and $10,000 during fiscal years 2007, 2008, 2009 and 2010, respectively, from these outstanding awards, subject to continued vesting.

Critical Accounting Policies and Estimates

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

We believe that, of our significant accounting policies, which are described in Note 2 to the notes to our consolidated financial statements, 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. The Company recognizes substantially all of its revenue in accordance with Statement of Position No. 97-2, Software Revenue Recognition, or SOP 97-2, as amended by SOP 98-4 and SOP 98-9. We establish persuasive evidence of an arrangement for each type of revenue transaction based on:

- in the case of direct sales or indirect sales through some resellers or distributors, either a signed contract with the end user customer or a click-wrap contract embedded in the product, whereby the end user customer agrees to our standard terms and conditions,
- in the case of indirect sales through OEMs or some resellers or distributors, a signed distribution contract with OEMs and other resellers; or
- in the case of services, including support, training and other professional services, through the execution of a separate services arrangement.

For each arrangement, we defer revenue recognition until all of the following criteria have been met:

- persuasive evidence of an arrangement exists (*e.g.*, 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 value of the arrangement among each deliverable based on its fair value as determined by vendor-specific objective evidence, such as standard product discount levels, daily service rates and consistent support level renewal pricing. If vendor-specific objective evidence of fair value does not exist for each of the deliverables, all revenue from the arrangement is further deferred until the earlier of the point at which sufficient vendor-specific objective evidence of fair value can be determined or all elements of the arrangement have been delivered. However, if the only undelivered elements are technical support and/or professional services, elements for which we currently have established vendor specific objective evidence of fair value, we recognize revenue for the delivered elements using the residual method. Changes in judgments and estimates about these assumptions could materially impact the timing of revenue recognition.

Accounting for Stock-Based Compensation. Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, or APB No. 25, and related interpretations. Accordingly, compensation cost for stock options generally was measured as the excess, if any, of the estimated fair value of the Company s common stock over the amount an employee must pay to acquire the common stock on the date that both the exercise price and the number of shares to be acquired pursuant to the option are fixed. The Company had adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation, and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which was released in December 2002 as an amendment to SFAS No. 123, and used the minimum value method of valuing stock options as allowed for non-public companies.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R), Share-Based Payment, which revised SFAS No. 123 and supersedes APB No. 25. SFAS 123(R) focuses primarily on transactions in which an entity obtains employee services in exchange for share-based payments. Under SFAS 123(R), an entity is generally required to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award, with such cost recognized over the applicable requisite service period. In addition, SFAS 123(R) requires an entity to provide certain disclosures in order to assist in understanding the nature of share-based payment transactions and the effects of those transactions on the financial statements. The provisions of SFAS No. 123(R) are required to be applied as of the beginning of the first interim or annual reporting period of the entity s first fiscal year that begins after December 15, 2005.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R) using the prospective transition method, which requires the Company to apply the provisions of SFAS No. 123(R) 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 the Company had used the minimum value method for valuing its stock options under the disclosure requirements of SFAS 123, all options granted prior to January 1, 2006 continue to be accounted for under APB No. 25.

The Company did not issue any options to purchase shares of its common stock from July 2005 to October 2005 due to ongoing merger negotiations with Check Point Software Technologies Ltd. For the period October 2005 until March 2006, the Company was a party to a Merger Agreement with Check Point Software Technologies Ltd. The Company s management conducted a contemporaneous valuation using a market approach based on the Merger Agreement. In assessing the fair value of the Company s common stock, the board of directors considered management s contemporaneous valuation, market data for merger and acquisition transactions obtained from an investment bank engaged to represent the Company for the merger, and the Company s financial results and execution against its operating plan. Based on these factors the board determined that the fair value of the Company s common stock during the period it was a party to the Merger Agreement was $5.15. Options were issued with an exercise price equal to this value during that period. In early April 2006, our board of directors determined the fair value of our common stock on the basis of various factors, including our financial results for the first quarter of 2006, the downward revision of our 2006 operating plan, our limited capital resources, the recent failure to complete the merger with Check Point Software Technologies Ltd., the lack of other parties interested in acquiring us, our unknown ability to recover U.S. government customers lost when Check Point announced its proposed acquisition of us and a contemporaneous valuation by an independent appraiser. Based on these factors, the board used a valuation of $3.24 for issuing options at that time. In August 2006, our board of directors again determined the fair value of our common stock on the basis of various factors, including our financial results for the second quarter of 2006, the receipt of $23 million of proceeds from the issuance of Series D preferred stock at a valuation comparable to the consideration offered in the proposed Check Point merger, the beginning of a recovery of

U.S. government customers lost when Check Point announced its proposed acquisition of us, preliminary discussions with potential underwriters for an initial public offering and a contemporaneous valuation by an independent appraiser. Based on these factors, the board determined the fair value of our common stock was $4.70 per share at that time. We did not issue any options from May 2006 to September 2006.

The Company uses the Black-Scholes option pricing model to estimate the calculated 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. 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. Accordingly, the use of different estimates and assumptions can have a significant impact on the amount of stock-based compensation that is measured and recognized.

Accounting for Income Taxes. Deferred taxes are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. Valuation allowances are provided if, based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

To date, for U.S. federal income tax purposes, we have operated in a loss position. We have $26.6 million of net operating loss carry-forwards as of December 31, 2005, although the use of these net operating loss carry-forwards may be significantly limited by changes in our ownership. As of December 31, 2005, we recorded a full valuation allowance against net deferred tax assets, including deferred tax assets generated by net operating loss carry-forwards. These carry-forwards will begin to expire in 2022. We expect that, to the extent we have taxable income in years before their expiration, these net operating loss carry-forwards will impact our effective tax rate.

Warranty. We provide a one-year warranty against defects in materials and workmanship and will either repair the goods or provide replacement products at no charge to the customer. We record estimated warranty costs, currently at approximately 2.4% of product revenue, based on historical experience by product, at the time we recognize product revenue. As the complexity of our products increases, we could experience higher warranty claims relative to sales than we have previously experienced, and we may need to increase these estimated warranty reserves.

Bad Debt Reserve. We have historically used a rate of 1.0% of outstanding accounts receivable to estimate our reserve for bad debts based on analysis of past due balances and historical experiences of write-offs. As we expand our business, we expect our accounts receivable balance to grow. If our future experience of actual write-offs for bad debts exceeds 1.0% of our accounts receivable balance, we will have to increase our reserve accordingly.

Inventory Valuation. We outsource our manufacturing and our products are generally drop-shipped directly to our customers by the manufacturers. Therefore, we usually carry relatively little inventory. The inventory on our balance sheet primarily includes products that we use for demonstration purposes at customer locations. We value our inventory at the lower of the actual cost of our inventory or its current estimated market value. We write down inventory for obsolescence or lack of marketability based upon condition of the inventory and our view about future demand and market conditions. Because of the seasonality of our product sales, obsolescence of technology and product life cycles, we generally write down inventory to net realizable value based on forecasted product demand. Actual demand and market conditions may be lower than those that we project and this difference could have a material adverse effect on our gross profit if inventory write-downs beyond those initially recorded become necessary.

Results of Operations

The following table sets forth our results of operations for the periods shown:

	Year ended December 31,			Nine months ended September 30,	
	2003	2004	2005	2005	2006
				(unaudited)	
	(in thousands)				
Revenue:					
Products	$ 8,153	$ 12,738	$ 23,589	$ 14,889	$ 18,390
Services	1,328	3,955	9,290	6,335	10,544
Total revenue	9,481	16,693	32,879	21,224	28,934
Cost of revenue:					
Products	2,570	4,533	6,610	4,229	4,931
Services	436	872	1,453	981	2,016
Total cost of revenue	3,006	5,405	8,063	5,210	6,947
Gross profit	6,475	11,288	24,816	16,014	21,987
Operating expenses:					
Research and development	3,751	5,706	6,831	4,934	6,334
Sales and marketing	9,002	12,585	17,135	12,131	14,512
General and administrative	2,141	2,905	5,120	3,123	3,587
Depreciation and amortization	441	752	1,103	846	912
Total operating expenses	15,335	21,948	30,189	21,034	25,345
Operating loss	(8,860)	(10,660)	(5,373)	(5,020)	(3,358)
Other income (expense), net	16	164	(85)	(50)	442