ArcSight Inc
Form 10-Q
September 08, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended July 31, 2010

OR

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

For the Transition Period from __________ to __________

Commission File Number 001-33923

ArcSight, Inc.

(Exact name of the Registrant as Specified in its Charter)

Delaware	**52-2241535**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

5 Results Way
Cupertino, California 95014
(Address of Principal Executive Offices, including Zip Code)
(408) 864-2600
(Registrant s Telephone Number, including Area Code)

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

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

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

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

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

Shares of ArcSight, Inc. common stock, $0.00001 par value per share, outstanding as of September 1, 2010: 34,611,535 shares.

ARCSIGHT, INC.
FORM 10-Q
Quarterly Period Ended July 31, 2010
TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ARCSIGHT, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts and par value)

	As of July 31, 2010 (Unaudited)	As of April 30, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 130,743	$ 137,358
Marketable securities	19,991	12,013
Accounts receivable, net of allowance for doubtful accounts of $346 and $256, respectively	30,521	33,609
Deferred tax asset, current	9,547	8,807
Capitalized software licenses, current	1,913	2,303
Prepaid expenses and other current assets	4,638	6,557
Total current assets	197,353	200,647
Property and equipment, net	10,972	8,174
Deferred tax asset, non-current	11,025	10,649
Goodwill	5,746	5,746
Other long-term assets	648	987
Total assets	$ 225,744	$ 226,203
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 4,211	$ 5,039
Accrued compensation and benefits	8,579	13,633
Obligations for software licenses, current	2,264	2,832
Other accrued liabilities	7,996	5,696
Deferred revenues, current	45,789	49,674
Total current liabilities	68,839	76,874
Deferred revenues, non-current	10,168	11,237
Other long-term liabilities	2,828	2,516
Total liabilities	81,835	90,627
Commitments and contingencies (see Note 5)		
Stockholders equity:		
Preferred stock, $0.00001 par value per share, 10,000,000 shares authorized; no shares issued and outstanding		
Common stock, $0.00001 par value per share; 150,000,000 shares authorized; 34,452,675 and 34,322,543 issued and outstanding as of July 31, 2010 and April 30, 2010, respectively		
Additional paid-in capital	149,530	144,273

Accumulated other comprehensive loss	(243)	(290)
Accumulated deficit	(5,378)	(8,407)
Total stockholders equity	143,909	135,576
Total liabilities and stockholders equity	$ 225,744	$ 226,203

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

ARCSIGHT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

	Three Months Ended July 31, 2010	Three Months Ended July 31, 2009
Revenues:		
Products	$ 25,833	$ 18,265
Maintenance	16,649	11,919
Services	5,654	4,371
Total revenues	48,136	34,555
Cost of revenues:		
Products	3,108	1,944
Maintenance(1)	2,623	1,925
Services(1)	4,541	2,630
Total cost of revenues	10,272	6,499
Gross profit	37,864	28,056
Operating expenses(1):		
Research and development	7,406	5,598
Sales and marketing	17,996	14,785
General and administrative	7,513	6,018
Total operating expenses	32,915	26,401
Income from operations	4,949	1,655
Interest income	43	28
Other income (expense), net	(59)	(117)
Income before provision for income taxes	4,933	1,566
Provision for income taxes	1,904	551
Net income	$ 3,029	$ 1,015
Net income per common share, basic	$ 0.09	$ 0.03
Net income per common share, diluted	$ 0.08	$ 0.03
Shares used in computing basic net income per common share	34,380	32,685
Shares used in computing diluted net income per common share	36,854	35,249

(1)

Stock-based compensation expense included in above (see Note 8):		
Cost of maintenance revenues	$ 140	$ 80
Cost of services revenues	103	33
Research and development	846	429
Sales and marketing	1,177	612
General and administrative	1,213	776

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

ARCSIGHT, INC.
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(In thousands)
(Unaudited)

	Three months Ended July 31,	
	2010	**2009**
Cash flows from operating activities:		
Net income	$ 3,029	$ 1,015
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	603	609
Amortization of acquired intangibles	106	222
Stock-based compensation	3,479	1,930
Deferred tax assets	(1,116)	
Excess tax benefit from stock-based compensation	(778)	(162)
Provision for allowance for doubtful accounts	94	26
Changes in operating assets and liabilities:		
Accounts receivable	2,994	11,036
Prepaid expenses and other assets	2,542	299
Accounts payable	(833)	2,181
Accrued compensation and benefits	(5,005)	(5,180)
Other accrued liabilities	3,193	239
Deferred revenues	(4,954)	(3,225)
Net cash provided by operating activities	3,354	8,990
Cash flows from investing activities:		
Maturities of marketable securities	7,015	
Purchases of marketable securities	(14,993)	
Purchases of property and equipment	(3,169)	(1,339)
Net cash used in investing activities	(11,147)	(1,339)
Cash flows from financing activities:		
Excess tax benefit from stock-based compensation	778	162
Proceeds from exercise of stock options, net of repurchases	1,000	3,653
Payment of capital lease and software license obligations	(646)	(599)
Net cash provided by financing activities	1,132	3,216
Effect of exchange rate changes on cash	46	126
Net increase in cash and cash equivalents	(6,615)	10,993
Cash and cash equivalents at beginning of period	137,358	90,467
Cash and cash equivalents at end of period	$ 130,743	$ 101,460
Supplemental disclosure of cash flow information:		
Property and equipment acquired under capital lease	$ 231	$ 177
Capitalized software obligations		$ 4,606

See accompanying Notes to Condensed Consolidated Financial Statements.

ARCSIGHT, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Description of Business and Basis of Presentation

ArcSight, Inc. (ArcSight or the Company) is a leading provider of enterprise threat and risk management solutions that protect businesses and government agencies. The Company s enterprise threat and risk management platform collects, consolidates and correlates network and user activity data across the enterprise so that businesses can rapidly detect, diagnose and manage both internal and external threats and risks across the organization for activities associated with critical assets and processes. With the Company s enterprise threat and risk management platform and products, organizations can use the ArcSight platform to reduce risk, identify vulnerabilities, comply with regulations and protect their high-value digital assets from cyber-theft, cyber-fraud, cyber-warfare and cyber-espionage. The Company s SIEM products deliver a centralized, real-time view of all activity or events across geographically dispersed and heterogeneous business and technology infrastructures. The Company s log management products collect and store activity and event data for regulatory compliance, reporting and forensic analysis. Working together, these products collect, consolidate and correlate massive amounts of activity data, in the form of log events, from thousands of security point solutions, network and computing devices, databases and applications, enabling intelligent identification, prioritization and response to compliance and corporate policy violations, and external and insider threats. The Company s specialized software and application packages deliver pre-packaged analytics and reports tailored to specific compliance and security initiatives, such as Sarbanes-Oxley (SOX), PCI, user monitoring and fraud detection. The Company is headquartered in Cupertino, California, and was incorporated on May 3, 2000 under the laws of the state of Delaware.

Basis of Presentation and Consolidation

The condensed consolidated balance sheet as of April 30, 2010 is derived from audited financial statements as of that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company transactions have been eliminated on consolidation. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K, filed with the Securities and Exchange Commission (SEC) on July 9, 2010.

Unaudited Interim Financial Information

The accompanying interim consolidated balance sheet as of July 31, 2010, and the consolidated statements of income for the three months ended July 31, 2010 and 2009, and the consolidated statement of cash flows for the three months ended July 31, 2010 and 2009, are unaudited. The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in the opinion of management, reflect all adjustments, which include normal recurring adjustments, necessary to present fairly the Company s financial position as of July 31, 2010, its results of operations for the three months ended July 31, 2010 and 2009, and its statement of cash flows for the three months ended July 31, 2010 and 2009. The results of operations for the three months ended July 31, 2010 are not necessarily indicative of the results to be expected for fiscal 2011 or for any other interim period or for any other future year.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. The Company bases its estimates and judgments on its historical experience, knowledge of current conditions, and its beliefs on what could occur in the future, given available information. Estimates, assumptions and judgments, are used for, but are not limited to, revenue recognition, determination of fair value of stock and stock-based awards, valuation of goodwill and intangible assets acquired in business combinations, impairment of goodwill and other intangible assets, amortization of intangible assets, contingencies and litigation, accounting for income taxes, including the need for a valuation reserve on deferred tax assets and

uncertain tax positions, allowances for doubtful accounts, valuations of cash equivalents and marketable securities, and accrued liabilities such as bonus accruals. Actual results may differ from those estimates, and such differences may be material to the financial statements.

2. Significant Accounting Policies

Cash and Cash Equivalents and Marketable Securities

The Company maintains its cash and cash equivalents in accounts consisting of high-credit quality financial instruments. The Company considers all highly liquid investments purchased with a maturity of three months or less at the date of purchase to be cash equivalents. The Company s cash equivalents consist of money market accounts on deposit with two banks and are stated at cost, which approximates fair value.

Marketable securities were $20.0 million and $12.0 million as of July 31, 2010 and April 30, 2010, respectively. The Company determines the appropriate classification of the securities at the time of purchase and re-evaluates the designation as of each balance sheet date. As of July 31, 2010, all marketable securities are considered available-for-sale. Marketable securities consist principally of taxable, short-term marketable certificates of deposit and U.S. Treasury notes, with original maturities between three and nine months. Marketable securities are stated at estimated fair value with unrealized gains and losses reported in accumulated other comprehensive loss. Unrealized gain recorded net of tax benefit amounted to $7,000 and $3,000 for the three months ended July 31, 2010 and for fiscal 2010, respectively. A decline in the market value of any available-for sale security below cost that is deemed to be other-than-temporary results in an impairment which reduces the carrying amount of the security to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the costs of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reason for the impairment, the severity and duration of the impairment, changes in value subsequent to period-end, and the general market conditions. There were no other-than-temporary impairments for the three months ended July 31, 2010. The specific identification method is used to determine the costs of securities disposed of, with realized gains and losses reflected in other expense, net. Investments are anticipated to be used for current operations.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts for potential future estimated losses resulting from the inability or unwillingness of certain customers to make all of their required payments. The allowance for doubtful accounts is based on the Company s assessment of the collectibility of customer accounts. The Company regularly reviews the allowance by considering factors such as historical experience, credit quality, the age of the accounts receivable balances, and current economic conditions that may affect a customer s ability to pay. This assessment requires significant judgment. When facts and circumstances indicate the collection of specific amounts or from specific customers is at risk, the Company assesses the impact on amounts recorded for bad debts and, if necessary, records a charge in the period the determination is made. If the financial condition of its customers or any of the other factors the Company uses to analyze creditworthiness were to worsen, additional allowances may be required, resulting in future operating losses that are not included in the allowance for doubtful accounts as of July 31, 2010. The allowance for doubtful accounts was $0.3 million as of July 31, 2010 and April 30, 2010.

Concentration of Credit Risk and Business Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash equivalents, marketable securities, foreign currency forward contracts and accounts receivable. The Company is exposed to credit risk in the event of default by the financial institutions holding its cash, cash equivalents, marketable securities, and foreign currency forward contracts to the extent recorded on its balance sheet. Risks associated with cash equivalents, marketable securities, and foreign currency forward contracts are mitigated by banking with high-credit quality institutions. Cash deposits and investments may be in excess of insured limits. Management believes that the financial institutions that hold the Company s investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments. To date, the Company has not experienced any losses on its cash, cash equivalents and marketable securities and minimal losses attributable to mark-to-market adjustment on its foreign currency forward contracts. The Company performs periodic evaluations of the relative credit standing of the financial institutions.

The Company sells its products and maintenance and services directly to customers or through resellers in Asia Pacific, Europe, the Middle East and Africa (collectively, EMEA) and the Americas, with the majority of its sales in the United States. The Company monitors its exposure within accounts receivable and records an allowance against doubtful accounts as necessary. The Company performs ongoing credit evaluations of its customers and extends credit in the normal course of business and generally does not require collateral. Historically, the Company has not experienced significant credit losses on its accounts receivable. Management believes that any risk of loss for trade receivables is mitigated by the Company s ongoing credit evaluations of its customers.

One customer accounted for more than 10% of total revenues for the three months ended July 31, 2010. No customers or resellers accounted for more than 10% of total revenues for the three months ended July 31, 2009. The Company had two customers and one reseller with accounts receivable balances greater than 10% of the Company s net accounts receivable, with balances of 17% and 13%, and 13%, respectively, of net accounts receivable as of July 31, 2010. As of April 30, 2010, the Company had two resellers with accounts receivable balances greater than 10% of the Company s net accounts receivable, with balances of 15% and 10% of net accounts receivable. Reseller accounts receivable balances greater than 10% are comprised of multiple customers and often multiple transactions with those customers.

For the three months ended July 31, 2010 and July 31, 2009, the Company derived 31% and 28% of its revenues, respectively, from contracts with agencies of the U.S. federal government.

The majority of the Company s revenues are derived from sales of the Company s security and compliance management products, primarily ArcSight ESM and Logger, and the Company expects this to continue for the foreseeable future. The Company primarily uses one source for manufacturing and fulfillment for its Logger and other appliance products. Demand for the Company s products is affected by a number of factors, some of which are beyond the Company s control, including the timing of development and release of new products by the Company and its competitors, technological change, lower-than-expected growth or a contraction in the worldwide market for enterprise security and compliance management solutions and other risks.

Revenue Recognition

The Company derives its revenues from three sources: (1) sales of software licenses and related appliances (products); (2) fees for maintenance to provide unspecified upgrades and customer technical support (maintenance); and (3) fees for services, which includes services performed in connection with time-and-materials based consulting agreements (services).

For all sales, revenues are recognized in accordance with GAAP, subject to the guidance for Software Revenue Recognition under ASC Topic 985-605 (ASC 985-605), as amended.

The Company enters into software license agreements through direct sales to customers and through resellers. The license agreements include post-contract customer support and may include professional services deliverables. Post-contract customer support includes rights to receive unspecified software product updates and upgrades, maintenance releases and patches released during the term of the support period, and Internet and telephone access to technical support personnel and content. Professional services include installation and implementation of the Company s software, staffing and management services for customer security operation centers (SOCs) and customer training. Professional services are not essential to the functionality of the associated licensed software.

For all sales, revenues attributable to an element in a customer arrangement are recognized when persuasive evidence of an arrangement exists and delivery has occurred, provided the fee is fixed or determinable and collectibility is reasonably assured.

The Company typically uses a binding purchase order in conjunction with either a signed contract or reference on the purchase order to the terms and conditions of the Company s shrinkwrap or end-user license agreement as evidence of an arrangement. In circumstances where the customer does not issue purchase orders separate from a signed contract, the Company uses the signed contract as evidence of the arrangement. Sales through its significant resellers are evidenced by a master agreement governing the relationship.

Resellers, channel partners and systems integrators purchase products for specific end-users and do not hold inventory. Resellers and systems integrators perform functions that include delivery to the end customer, installation or integration and post-sales service and support. The agreements with these resellers and systems integrators have terms that are generally consistent with the standard terms and conditions for the sale of the Company s products and services to end-users and do not provide for product rotation or pricing allowances. For sales to direct end-users and systems integrators, the Company recognizes product revenue upon transfer of title and risk of loss, which is generally upon shipment, provided all other criteria for revenue recognition have been met. Where sales are made through resellers, revenue is generally recorded only upon shipment to the end-users, when all other criteria for revenue recognition have been met. In a limited number of instances, where delivery is to be made to a reseller upon the request of either the end-user or the reseller, and all other criteria for revenue recognition have been met, it is the Company s practice to recognize revenue on shipment to a reseller but only where an end-user has been identified prior to shipment. For end-users, resellers and system integrators, the Company generally has no significant obligations for future performance such as rights of return or pricing credits.

At the time of each transaction, the Company assesses whether the fees associated with the transaction are fixed or determinable. If a significant portion of a fee is due after the Company s normal payment terms, currently up to three months (payment terms beyond three months are considered to be extended terms), or if as a result of customer acceptance provisions, the price is subject to refund or forfeiture, concession or other adjustment, then the Company considers the fee to not be fixed or determinable. In the limited instances in which these cases occur, revenues are deferred and recognized when payments become due and payable, or the right to refund or forfeiture, concession or adjustment, if any, lapses upon customer acceptance.

The Company assesses whether collection is reasonably assured based on a number of factors including the creditworthiness of the customer as determined by credit checks and analysis, past transaction history, geographic location and financial viability. The Company generally does not require collateral from customers. If the determination is made at the time of the transaction that collection of the fee is not reasonably assured, then all of the related revenues are deferred until the time that collection becomes reasonably assured, which in some cases requires the collection of cash prior to recognition of the related revenues.

The Company uses shipping documents, contractual terms and conditions and customer acceptance, when applicable, to verify delivery to the customer. For software license fees in arrangements that do not include customization, or services that are not considered essential to the functionality of the licenses, delivery is deemed to occur when the product is delivered to the customer. Services and consulting arrangements that are not essential to the functionality of the licensed product are recognized as revenues as these services are provided. Delivery of maintenance agreements is considered to occur on a straight-line basis ratably over the life of the contract, typically 12 months.

Vendor-specific objective evidence of fair value (VSOE) for maintenance and support services is based on separate sales and/or renewals to other customers or upon renewal rates quoted in contracts when the quoted renewal rates are deemed substantive in both rate and term. VSOE for professional services is established based on prices charged to customers when such services are sold separately. For deliverables and multiple element arrangements subject to the guidance, when VSOE exists for all of the undelivered elements of the arrangement, but does not exist for the delivered elements in the arrangement, the Company recognizes revenues under the residual method. Under the residual method, at the outset of the arrangement with a customer, revenues are deferred for the fair value of the undelivered elements and revenues are recognized for the remainder of the arrangement fee attributable to the delivered elements (typically products) when all of the applicable criteria in the guidance have been met. In the event that VSOE for maintenance services does not exist, and this represents the only undelivered element, revenues for the entire arrangement are recognized ratably over the performance period. Revenues from maintenance and support agreements are recognized on a straight-line basis ratably over the life of the contract. Revenues from time-based (term) license sales that include ongoing delivery obligations throughout the term of the arrangement are recognized ratably over the term because the Company does not have VSOE for the undelivered elements.

Many of the Company s product contracts include implementation and training services. When products are sold together with consulting services, license fees are recognized upon delivery, provided that (i) the criteria of software revenue recognition have been met, (ii) payment of the license fees is not dependent upon the performance of the services, and (iii) the services do not provide significant customization of the products and are not essential to the functionality of the software that was delivered. The Company does not typically provide significant customization of its software products. These services are typically recognized on a time-and-materials basis.

The cost of providing the Company s products, maintenance and services consists primarily of direct material costs for products and the fully burdened cost of the Company s service organization for maintenance and services. Shipping and handling charges incurred and billed to customers for product shipments are recorded in product revenue and related cost of product revenues in the accompanying consolidated statements of income. If it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss is recognized.

Table of Contents

Deferred revenues consist primarily of deferred product revenues, deferred maintenance fees and deferred services fees. Deferred revenues are recorded net of pre-billed services, post-contract customer support billings for which the term has not commenced and invoices for cash basis customers. Deferred product revenues generally relate to product sales being recognized ratably over the term of the licensing arrangement, and, to a lesser extent, partial shipments when the Company does not have VSOE for the undelivered elements and products that have been delivered but await customer acceptance. Deferred maintenance fees and consulting services generally relate to payments for maintenance and consulting services in advance of the time of delivery of services. These deferred amounts are expected to be recognized as revenues based on the policy outlined above.

Stock-Based Compensation Expense

Effective May 1, 2006, the Company adopted the provisions and guidance under ASC Topic 718 Compensation-Stock Compensation (ASC 718), using the prospective-transition method. In accordance with the guidance, measurement and recognition of compensation expense for all awards made to employees and directors beginning on May 1, 2006 is recognized based on estimated fair values. In accordance with the guidance, the Company uses the Black-Scholes-Merton (Black-Scholes) pricing model to determine the fair value of the stock options on the grant dates, and the Company amortizes the fair value of compensation on a straight-line basis.

The Company s 2007 Employee Stock Purchase Plan (ESPP) became effective upon the effectiveness of the Company s initial public offering (IPO) on February 14, 2008. The ESPP is compensatory and results in compensation cost accounted for under the guidance. The Black-Scholes option pricing model is used to estimate the fair value of rights to acquire stock granted under the ESPP, and the Company amortizes the fair value over the offering period.

Comprehensive Income (Loss)

Comprehensive income (loss) includes certain unrealized gains and losses that are recorded as a component of stockholders equity and excluded from the determination of net income. The Company s accumulated other comprehensive income (loss) consisted of cumulative currency translation adjustments resulting from the translation of the financial statements of its foreign subsidiaries and unrealized losses on marketable securities. The tax effects on the foreign currency translation adjustments and unrealized gains and losses on marketable securities have not been significant.

Derivative Financial Instruments

The majority of the Company s sales are denominated in United States dollars; however, there are some sales transactions denominated in foreign currencies. In addition, the Company s foreign subsidiaries pay their expenses in local currency. Therefore, movements in exchange rates could cause net sales and expenses to fluctuate, affecting the Company s profitability and cash flows. The Company s general practice is to use foreign currency forward contracts to reduce its exposure to foreign currency exchange rate fluctuations. Unrealized gains and losses associated with these foreign currency contracts are reflected in the Company s balance sheet and recorded in prepaid expenses and other current assets or accrued expenses and other current liabilities. Changes in fair value and premiums paid for foreign currency contracts are recorded directly in other income and expense in the consolidated statements of income. Cash flows from such derivatives are classified as operating activities. The objective of these contracts is to reduce the impact of foreign currency exchange rate movements on the Company s net income. During the first quarter of fiscal 2011 and 2010, the Company considered the net results of the use of foreign currency forward contracts to be an effective mechanism to minimize the fluctuations and movements in exchange rates that affect the Company s profitability and cash flows. All of the Company s foreign currency forward contracts mature within 12 months from the balance sheet date. The Company does not use derivatives for speculative or trading purposes, nor does the Company designate its derivative instruments as hedging instruments, as defined by the Financial Accounting Standard Board (FASB) under Accounting Standards Codification (ASC) Topic 815, Accounting for Derivative Instruments in Hedging Activities (ASC 815).

As of July 31, 2010 and April 30, 2010, the notional amount of outstanding foreign currency derivatives classified as other current liabilities not designated as hedging instruments under the guidance was $1.8 million, and $0.3 million, respectively. As of July 31, 2010, approximately 81%, 14%, and 5% of the notional amount of the Company s outstanding foreign currency derivatives were attributable to the Canadian dollar, Euro and British Pound Sterling currencies, respectively, and are due to expire within 60 days of the balance sheet date. As of April 30, 2010, approximately 60%, 24%, and 15% of the notional amount of the Company s outstanding foreign currency derivatives were attributable to the Canadian dollar, Euro and British Pound Sterling currencies, respectively, and expired within 60 days of the balance sheet date. At July 31, 2010 and April 30, 2010, the fair value gain or (loss) adjustment to mark these instruments to market was $42,000 million and ($2,000), respectively, and are included in accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets. For both the three months ended July 31, 2010 and 2009, the Company recorded ($0.1) million, in other income (expense), net, associated with foreign currency derivative contracts.

Fair Value Measurement

In accordance with the guidance under ASC Topic 820-10 Fair Value Measurements and Disclosures (ASC 820-10), the Company measures its financial assets and liabilities at fair value. The carrying amounts of cash equivalents, marketable securities, trade accounts receivable, accounts payable, and other accrued liabilities approximate their respective fair values due to the relatively short-term maturities. The carrying amounts of marketable securities and derivative financial instruments approximate their respective fair values due to adjusting these investments to their respective market values each reporting period. On May 1, 2009, the Company adopted the guidance for non-financial assets and liabilities measured at fair value. Non-recurring non-financial assets and non-financial liabilities include those measured at fair value in goodwill impairment tests and intangible assets measured at fair value for impairment. The adoption of the guidance did not impact the condensed consolidated results of operations, financial condition or cash flows.

The guidance clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. The guidance establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1 observable inputs such as unadjusted quoted prices in active markets for identical assets and liabilities;

Level 2 observable inputs such as quoted prices for similar assets and liabilities in active markets that are observable either directly or indirectly; and

Level 3 unobservable inputs in which there is little or no market data, which require the Company to develop its own assumptions.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. A financial asset or liability s classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. On a recurring basis, the Company measures certain financial assets, comprised of money market accounts and certificates of deposit based on Level 1 inputs at fair value. The Company is required to measure and disclose the fair value of outstanding financial liabilities on a recurring basis. The fair value of financial obligations relating to the capitalized software licenses, based on quoted interest rates (Level 2 inputs) for the remaining duration of the liabilities, approximated carrying value.

Table of Contents

In accordance with the guidance, the following table represents the Company s fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of July 31, 2010 and April 30, 2010 (in thousands):

	Level 1	Level 2	Level 3	Total
As of July 31, 2010:				
Cash and cash equivalents	$ 130,743			$ 130,743
Marketable securities	19,991			19,991
Capitalized software license obligations		$ 2,264		2,264
Total	$ 150,734	$ 2,264		$ 152,998

	Level 1	Level 2	Level 3	Total
As of April 30, 2010:				
Cash and cash equivalents	$ 137,358	$	$	$ 137,358
Marketable securities	12,013			12,013
Capitalized software license obligations		2,832		2,832
Total	$ 149,371	$ 2,832		$ 152,203

As of July 31, 2010 there were approximately $5.0 million in U.S. treasury bills maturing within the next two months, and approximately $15.0 million in U.S. treasury bills maturing within the next five months. As of April 30, 2010, there were approximately $15.0 million in U.S. Treasury bills maturing in less than 3 months and included in cash and cash equivalents, approximately $7.0 million in certificates of deposit maturing within the next three months, and approximately $5.0 million in U.S. treasury bills maturing within the next five months. Unrealized gains attributable to interest rate changes considered temporary in nature, were immaterial for all periods presented.

Recent Accounting Pronouncements

In May 2009, the FASB issued revised guidance under ASC Topic 855-10, Subsequent Events (ASC 855-10), which establishes principles and requirements for subsequent events. Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. There are two types of subsequent events: (i) the first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet and (ii) the second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. An entity shall recognize in its financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements**.** This guidance was effective for interim or annual financial periods ending after June 15, 2009. The Company adopted this guidance effective May 1, 2009.

In February 2010, the FASB issued ASU No. 2010-09, amending Subsequent Events (Topic 855) Certain Recognition and Disclosure Requirements (ASU 2010-09). This guidance addresses the interaction between Topic 855 and related SEC reporting requirements. The amendment removes the requirement for SEC filers to disclose a date through which subsequent events have been evaluated. The amendment is effective upon issuance and has been adopted by the Company for the fiscal quarter ended January 31, 2010, the adoption of which did not impact the condensed consolidated results of operations, financial condition or cash flows.

In June 2009, the FASB issued ASC Topic 105-10 The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (ASC 105-10), which approved the FASB Accounting Standards Codification (Codification) as the single source of authoritative United States accounting and reporting standards for all non-governmental entities, except for guidance issued by the SEC. The Codification, which changes the referencing of financial standards, is effective for interim or annual financial periods ending after September 15, 2009. The Company adopted the guidance effective August 1, 2009. All references made to generally accepted accounting principles in the United States (U.S. GAAP) will use the new Codification numbering system prescribed by the FASB. As the Codification is not intended to change or alter existing U.S. GAAP, it did not have any impact on the Company s condensed consolidated results of operations, financial condition or cash flows.

In October 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-13, Revenue Recognition (Topic 605)

Table of Contents

Multiple-Deliverable Element Arrangements a consensus of the FASB Emerging Issues Task Force (ASU 2009-13). This guidance impacts the determination of when the individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. Additionally, this guidance modifies the manner in which the transaction consideration is allocated across the separately identified deliverables by no longer permitting the residual method of allocating arrangement consideration. This revised guidance is effective for annual financial periods beginning after June 15, 2010, and early adoption is permitted. The Company is currently evaluating the potential impact, if any, the adoption of this new guidance will have on its consolidated results of operations, financial condition or cash flows.

In October 2009, the FASB issued ASU No. 2009-14, Software (Topic 985) Certain Arrangements That Contain Software Elements a consensus of the FASB Emerging Issues Task Force (ASU 2009-14). This guidance amends the scope of pre-existing software revenue guidance by removing from the guidance non-software components of tangible products and certain software components of tangible products. This revised guidance is effective for annual financial periods beginning after June 15, 2010, and early adoption is permitted. The Company is currently evaluating the potential impact, if any, the adoption of this new guidance will have on its consolidated results of operations, financial condition or cash flows.

3. Net Income Per Common Share

Basic and diluted net income per common share is computed using the weighted-average number of shares of common stock outstanding during the period. Diluted net income per share is computed giving effect to all potentially dilutive common shares that were outstanding during the period on a weighted average basis. Potentially dilutive common shares consist of various employee stock awards including, common shares issuable upon exercise of stock options, and shares purchasable under the ESPP.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	Three Months Ended July 31,	
	2010	**2009**
Numerator for basic and diluted net income per share:		
Net income	$ 3,029	$ 1,015
Denominator for basic net income per share:		
Weighted-average common shares, net of weighted-average shares subject to repurchase, used in computing net income per common share-basic	34,380	32,685
Denominator for diluted net income per share:		
Shares used above, basic	34,380	32,685
Stock options	2,474	2,520
Shares purchasable under employee stock purchase plan		44
Denominator for diluted net income per share:	36,854	35,249
Net income per common share:		
Net income per common share, basic	$ 0.09	$ 0.03
Net income per common share, diluted	$ 0.08	$ 0.03

The following table sets forth the weighted-average number of shares subject to potentially dilutive outstanding securities, including the Company s common stock options, that were excluded from the computation of diluted net income per share for the periods presented because including them would have had an anti-dilutive effect (in thousands):

	Three Months Ended July 31,	
	2010	2009
Options to purchase common stock	795	594

13

4. Balance Sheet Details

Property and Equipment, Net

Property and equipment consisted of the following (in thousands):

	As of July 31, 2010	As of April 30, 2010
Computers and equipment	$ 8,509	$ 7,341
Furniture and fixtures	2,013	1,595
Software	4,952	3,784
Leasehold improvements	2,895	2,538
	18,369	15,258
Less: accumulated depreciation and amortization	(7,397)	(7,084)
Property and equipment, net	$ 10,972	$ 8,174

Depreciation expense was $0.5 million for both the three months ended July 31, 2010 and 2009. Amortization expense was $0.1 million for both the three months ended July 31, 2010 and 2009. Assets acquired under capital lease obligations, reflected in computers and equipment balances as of July 31, 2010 and April 30, 2010 amount to $0.2 million and $0.8 million, respectively. As of July 31, 2010, remaining capital lease obligations for the remainder of fiscal 2011, 2012, 2013, and 2014 are $0.3 million, $0.3 million, $0.2 million and $16,000, respectively. Amortization of assets acquired under capital lease obligations is included in depreciation and amortization.

Capitalized Software Licenses Obligations

On May 31, 2009, the Company renewed the software license agreement with Oracle USA, Inc. that authorizes the Company to integrate Oracle database software with the ArcSight ESM products and distribute ArcSight ESM products with the embedded database software as a component of the product. The agreement has a two year term that commenced on May 31, 2009 when the prior agreement with Oracle expired. The supporting royalty and technical support payments total $4.8 million over the license term. These software licenses represent purchases by the Company of the right to utilize and incorporate as a component of its product, the intellectual property of certain third parties. As a result of these purchases, the Company is contractually obligated to pay minimum royalties on fixed and determinable dates over a two-year period regardless of product sales being generated. These purchases have been recorded on the accompanying condensed consolidated balance sheets based on the discounted present value of the Company s contractual payment obligations. During the three months ended July 31, 2010 and July 31, 2009, payments under these agreements amounted to $0.6 million each with related interest expense of $19,000 and $12,000, respectively.

The capitalized software licenses are being amortized ratably over the respective two-year terms of the agreements and are included as a component of cost of product revenues and cost of maintenance revenues in the amount of $0.4 million and $0.2 million for the three months ended July 31, 2010 and 2009, respectively.

Cost of Computer Software Developed or Obtained for Internal Use

The Company capitalizes certain costs incurred for computer software developed or obtained for internal use, which are incurred during the application development stage. These capitalized costs are to be amortized on a straight-line basis over the expected useful life of the software. Costs related to preliminary project activities and post-implementation activities are expensed as incurred. For the three months ended July 31, 2010 and July 31, 2009, ArcSight has capitalized software costs for the development of internal use software amounting to $4.0 million and $1.0 million, respectively. Amortization of these costs capitalized in accordance with the guidance will begin when the new software is ready for its intended use, which is expected during the second quarter of fiscal 2011, and will be amortized over the estimated useful life of the software generally on a straight-line basis unless another systematic and rational basis is more representative of the software s use.

14

Table of Contents

Goodwill and Intangible Assets, Net

The estimated useful lives, gross carrying amount, accumulated amortization and net book value of goodwill and intangible assets as of July 31, 2010 and April 30, 2010 are as follows (dollars in thousands):

As of July 31, 2010:	**Estimated Weighted-Average Useful Lives in Years**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Core and developed technologies	5.00	$ 1,970	$ (1,701)	$ 269
Customer installed-base relationships	6.00	80	(68)	12
Employee non-compete agreements	5.00	1,160	(1,117)	43
Total		$ 3,210	$ (2,886)	$ 324
Goodwill				$ 5,746

As of April 30, 2010:	**Estimated Weighted-Average Useful Lives in Years**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Core and developed technologies	5.00	$ 1,970	$ (1,611)	$ 359
Customer installed-base relationships	6.00	80	(66)	14
Employee non-compete agreements	5.00	1,160	(1,103)	57
Total		$ 3,210	$ (2,780)	$ 430
Goodwill				$ 5,746

Acquired intangible assets other than goodwill are amortized over their respective estimated useful lives to match the amortization to the benefits received. The total amortization expense related to intangible assets was $0.1 million and $0.2 million for the three months ended July 31, 2010 and 2009, respectively.

There was no impairment of goodwill or intangible assets for the three months ended July 31, 2010 or in fiscal 2010.

As of July 31, 2010, future estimated amortization costs for the Company s existing intangible assets other than goodwill are $0.3 million for the remainder of fiscal 2011, and $5,000 for fiscal 2012.

Table of Contents

Accrued Compensation and Benefits

Accrued compensation and benefits consist of the following (in thousands):

	As of July 31, 2010	As of April 30, 2010
Accrued bonus	$ 2,015	$ 5,264
Accrued commissions	1,379	3,985
Accrued vacation	3,005	2,832
Accrued payroll taxes	359	727
Accrued ESPP	1,449	520
Other compensation and benefits	845	731
Total accrued compensation and benefits	$ 9,052	$ 14,059
Less accrued compensation and benefits, current portion	(8,579)	(13,633)
Accrued compensation and benefits, non-current	$ 473	$ 426

Deferred Revenues

Deferred revenues consist of the following (in thousands):

	As of July 31, 2010	As of April 30, 2010
Deferred product revenues	$ 8,593	$ 10,757
Deferred maintenance revenues	43,380	46,675
Deferred services revenues	3,984	3,479
Total deferred revenues	55,957	60,911
Less deferred revenues, current portion	(45,789)	(49,674)
Deferred revenues, non-current	$ 10,168	$ 11,237

5. Commitments and Contingencies

The Company and its subsidiaries operate from leased premises in the United States, Asia and Europe with lease periods expiring through fiscal 2018. In November 2009, the Company entered into a lease extension through May 2017, adding additional office space to the lease for its corporate headquarters. This lease agreement includes a rent escalation clause of 3% per annual lease term through expiration in May 2017. The Company recognizes expense for scheduled rent increases on a straight-line basis over the lease term beginning with the date the Company takes possession of the leased space.

Future minimum lease payments under the Company s noncancelable operating leases as of July 31, 2010 are as follows (in thousands):

As of July 31, 2010:	Amount of Payments
Remainder of 2011	$ 2,638
2012	3,131
2013	3,053
2014	3,145

2015 and thereafter		10,297
Total future minimum lease payments	$	22,264

Rent expense under all operating leases was approximately $1.2 million and $0.9 million for the three months ended July 31, 2010 and 2009, respectively.

From time to time, the Company is subject to various claims, complaints and legal actions in the normal course of business. The Company does not believe it is party to any currently pending litigation, the outcome of which will have a material adverse effect on its operations or financial position.

Table of Contents

6. Indemnification and Warranties

The Company from time to time enters into certain types of contracts that contingently require it to indemnify various parties against claims from third parties. These contracts primarily relate to (i) certain real estate leases under which the Company may be required to indemnify property owners for environmental and other liabilities and other claims arising from the Company s use of the applicable premises, (ii) the Company s bylaws, under which it must indemnify directors and executive officers, and may indemnify other officers and employees, for liabilities arising out of their relationship, (iii) contracts under which the Company must indemnify directors and certain officers for liabilities arising out of their relationship, (iv) contracts under which the Company may be required to indemnify customers or resellers against certain claims, including claims that a Company product infringes a patent, copyright or other intellectual property right, and (v) procurement, consulting, or license agreements under which the Company may be required to indemnify vendors, consultants or licensors for certain claims, including claims that may be brought against them arising from the Company s acts or omissions with respect to the supplied products or technology.

In the event that one or more of these matters were to result in a claim against the Company, an adverse outcome, including a judgment or settlement, may cause a material adverse effect on the Company s future business, operating results or financial condition. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

The Company maintains director and officer insurance, which may cover certain liabilities arising from its obligation to indemnify its directors.

From time to time, the Company may receive indemnification claims in the normal course of business. The Company does not believe it is party to any currently pending claims the outcome of which will have a material adverse effect on its operations or financial position.

The Company generally provides a warranty for its products and services to its customers. To date, the Company s product warranty expense has not been significant. Accordingly, the Company has not recorded a warranty reserve as of July 31, 2010 or April 30, 2010.

7. Stockholders Equity

Common Stock Reserved for Issuance

Number of shares of common stock reserved for future issuance is as follows:

	As of July 31, 2010
Options available for future grant under the 2007 Equity Incentive Plan	3,099,929
Options outstanding under the stock option plans	7,726,532
ESPP shares reserved for future issuance	1,068,798
Total shares reserved	11,895,259

Stock Plans

2007 Equity Incentive Plan. A total of 4,569,015 shares of the Company s common stock were originally authorized for future issuance under the 2007 Equity Incentive Plan, including shares that became available for grant upon the concurrent termination of the Company s 2002 Stock Plan. Since inception, the Company has registered 2,618,006 additional shares of the Company s common stock to be issuable under the 2007 Equity Incentive Plan. In addition, shares subject to outstanding grants under the Company s 2000 Stock Option Plan and the Company s 2002 Stock Plan that expire or are otherwise forfeited automatically roll into and are made available for issuance under the 2007 Equity Incentive Plan. As of July 31, 2010, since adoption of the 2007 Equity Incentive Plan, an aggregate of 971,560 of additional shares issued under the Company s prior stock option plans have become available for grant and issuance as a result of forfeitures or repurchases by the Company.

Table of Contents

2007 Employee Stock Purchase Plan. A total of 1,000,000 shares of the Company s common stock were originally authorized. Since inception, a total of 654,501 additional shares were registered for issuance under the ESPP.

Stock Plan Activity

A summary of the option activity under the 2007 Equity Incentive Plan, the 2002 Stock Plan and the 2000 Stock Incentive Plan for the three months ended July 31, 2010, is as follows:

		Outstanding Options			
	Shares Available for Grant	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (In thousands)
Options outstanding as of April 30, 2010	4,222,243	6,734,350	10.41	7.34	83,505
Options granted	(1,179,375)	1,179,375	21.62		
Options exercised		(130,132)	7.69		
Options canceled	57,061	(57,061)	14.40		
Options outstanding as of July 31, 2010	3,099,929	7,726,532	12.14	7.51	99,462
Vested and expected to vest as of July 31, 2010, net of anticipated forfeitures		6,714,358	12.14	7.51	86,432
Vested and exercisable as of July 31, 2010		3,903,831	7.15	6.35	69,708

The aggregate intrinsic values shown in the table above are equal to the difference between the per share exercise price of the underlying stock options and the fair value of the Company s common stock as of the respective dates in the table.

The following table summarizes additional information regarding outstanding options as of July 31, 2010:

	Options Outstanding		Options Vested and Exercisable	
Exercise Price	Number Outstanding	Weighted-Average Remaining Contractual Life (Years)	Number of Shares	Weighted-Average Exercise Price per Share
$0.12-0.80	606,985	3.50	606,985	$ 0.47
$4.00-5.98	655,185	6.28	477,779	4.14
$6.08-8.95	2,577,349	6.86	1,885,383	7.00
$9.00-13.32	860,862	7.27	568,387	9.88
$14.15-19.68	1,166,218	8.91	296,137	17.83

$21.63-28.15	1,859,933	9.36	69,160		22.67
	7,726,532	7.51	3,903,831	$	7.15

Total intrinsic value of options exercised for the three months ended July 31, 2010 was $2.1 million, determined at the date of option exercise.

Table of Contents

8. Stock-Based Compensation

During the three months ended July 31, 2010 and 2009, the Company recorded stock-based compensation under ASC 718 as described below (in thousands):

	Three Months Ended July 31,	
	2010	2009
Stock-based compensation under stock option plans	$ 3,189	$ 1,683
Stock-based compensation under employee stock purchase plan	290	247
Total	$ 3,479	$ 1,930

Accounting for Stock-Based Compensation

The Company used the Black-Scholes option pricing model to determine the fair value of option awards granted. The Black-Scholes model requires, among other inputs, an estimate of the fair value of the underlying common stock on the date of grant and assumptions as to volatility of the Company s stock over the term of the related options, the expected term of the options, the risk-free interest rate and the option forfeiture rate. These assumptions used in the pricing model are determined by the Company at each grant date. The expected volatility of options granted is determined using a combination of weighted-average measures of the peer group of companies of the implied volatility and the historical volatility for a period equal to the expected life of the option, and the Company s historical volatility. The expected life of options has been determined considering the expected life of options granted by a group of peer companies and the average vesting and contractual term of the Company s options. The risk-free interest rate is based on a zero coupon United States treasury instrument whose term is consistent with the expected life of the stock options. As the Company has not paid and does not anticipate paying cash dividends on outstanding shares of common stock, the expected dividend yield is assumed to be zero. In addition, the guidance requires companies to utilize an estimated forfeiture rate when calculating the expense for the period. The Company applies an estimated annual forfeiture rate of 5%, based on its historical forfeiture experience during the previous six years, in determining the expense recorded in its consolidated statement of operations.

Cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those option exercises are classified as financing cash flows. For the quarter ended July 31, 2010 and fiscal 2010, the Company recorded excess tax benefits resulting from tax deductions in excess of the compensation cost recognized amounting to $0.8 million and $8.3 million, respectively.

Valuation and Expense Information

The weighted-average fair value calculations for options granted within the period are based on the following weighted-average assumptions set forth in the table below and assume no dividends will be paid. Options that were granted in prior periods are based on assumptions prevailing at the date of grant.

	Three Months Ended July 31,	
	2010	2009
Risk free interest rate	2.71%	2.26%
Expected volatility	56.0%	58%
Expected life (years)	5.70 years	5.66 years

Table of Contents

Based on these calculations, the weighted-average fair value per option granted to acquire a share of common stock was $11.56 and $9.60 per share for the three months ended July 31, 2010 and 2009, respectively. The compensation costs that have been included in the Company s results of operations for these stock-based compensation arrangements for the three months ended July 31, 2010 and 2009, as a result of the Company s adoption of ASC 718, were as follows (in thousands):

	Three Months Ended July 31,	
	2010	2009
Cost of maintenance revenues	$ 113	$ 55
Cost of services revenues	84	26
Stock based compensation expense included in cost of revenues	197	81
Operating expenses:		
Research and development	731	306
Sales and marketing	1,078	539
General and administrative	1,183	757
Stock based compensation expense included in operating expenses	2,992	1,602
Stock based compensation expense included in net income	$ 3,189	$ 1,683

Because the amount of stock-based compensation associated with the Company s cost of products is not significant, no amounts have been capitalized for any of the periods presented.

As of July 31, 2010 and April 30, 2010, there was $30.1 million and $21.1 million, respectively, of total unrecognized stock based compensation expenses under ASC 718, net of estimated forfeitures, that the Company expects to recognize over the requisite service period. As of July 31, 2010 and April 20, 2010, total unrecognized stock based compensation expenses related to non-vested awards are expected to be recognized over a weighted-average period of 3.13 years and 2.85 years, respectively. The total fair value of all shares vested during the quarter ended July 31, 2010 was $4.6 million. The total fair value of all shares vested during fiscal 2010 was $6.5 million.

During the three months ended July 31, 2010, the Company granted 1,179,375 options. These options have exercise prices equal to the closing price of the Company s common stock as quoted on the NASDAQ on the day of grant (or the most recent trading day if the date of grant is not a NASDAQ trading day), with exercise prices ranging from $19.01 to $24.70 per share at a weighted-average per share price of $21.62.

Employee Stock Purchase Plan

The ESPP is compensatory and results in compensation cost accounted for under ASC 718. The Black-Scholes option pricing model is used to estimate the fair value of rights to acquire stock granted under the ESPP. The weighted-average fair value calculations for rights to acquire stock under the ESPP within the period are based on the following weighted-average assumptions set forth in the table below, assuming no dividends will be paid, and based on assumptions prevailing as of the enrollment date of the offering period.

	Three Months Ended July 31,	
	2010	2009
Risk-free interest rate	0.24%	0.46%
Expected volatility	49.1%	79%
Expected life (years)	0.50 years	0.50 years

Based on these calculations, the weighted-average fair value per right to acquire shares of common stock was $7.59 and $4.37 per share for the three months ended July 31, 2010 and 2009, respectively. For the three months ended July 31, 2010 and 2009, the Company recorded stock-based compensation expense associated with its ESPP of $0.3 million and $0.2 million, respectively. As of July 31, 2010, there was $0.2 million of total unrecognized compensation expenses under the guidance, net of expected forfeitures, related to common stock purchase rights that the Company expects to amortize over the remaining offering period ending September 15, 2010.

Table of Contents

During fiscal 2010 and 2009, 212,335 and 373,368 shares respectively were purchased under the ESPP at a weighted average purchase price per share of $9.77. Total cash proceeds from the purchase of shares under the ESPP were $3.0 million and $2.8 million, respectively. No shares were purchased under the ESPP during the period ended July 31, 2010. As of July 31, 2010 there was an aggregate of 1,068,798 shares of common stock available for issuance pursuant to future rights to acquire stock under the ESPP.

9. Segment Information

The Company operates in one industry segment selling security and compliance management solutions.

Operating segments are defined as components of an enterprise for which separate financial information is available and is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company s chief operating decision maker is the Chief Executive Officer (CEO). The CEO reviews financial information presented on a consolidated basis for evaluating financial performance and allocating resources. There are no segment managers who are held accountable for operations below the consolidated financial statement level. Accordingly, the Company has determined that it operates in a single reportable segment.

The CEO evaluates performance based primarily on revenues in the geographic locations in which the Company operates. Revenues are attributed to geographic locations based on the ship-to location of the Company s customers. The Company s assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for total revenues. As of July 31, 2010 and 2009, long-lived assets, which represent property, plant and equipment, goodwill and intangible assets, net of accumulated depreciation and amortization, located outside the Americas were immaterial and less than one percent of the total net assets as of these dates.

Total revenues by geographical region are based on the ship-to location and are as follows (in thousands):

	Three Months Ended July 31,	
	2010	**2009**
Total revenues by geography:		
United States:		
Products	$ 18,428	$ 14,726
Maintenance	12,149	8,931
Services	4,638	3,230
Total	35,215	26,887
EMEA:		
Products	3,896	2,612
Maintenance	2,805	1,644
Services	750	515
Total	7,451	4,771
Asia Pacific:		
Products	1,207	490
Maintenance	662	524
Services	64	48
Total	1,933	1,062
Other Americas:		

Products	2,302	437
Maintenance	1,033	820
Services	202	578
Total	3,537	1,835
Total revenues	$ 48,136	$ 34,555

Table of Contents

10. Income Taxes

The provision for income taxes is calculated in accordance with ASC 740, Accounting for Income Taxes, Interim Financial Reporting, and FASB interpretation under ASC 740 related to Accounting for Income Taxes in the Interim Period, as amended. The Company estimates income taxes for each of the jurisdictions in which it operates. This involves estimating actual current tax exposures and assessing temporary differences resulting from differing treatment of items, such as reserves and accruals, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the Company s consolidated balance sheet. Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and future taxable income for purposes of assessing the Company s ability to realize any future benefit from its deferred tax assets. In the event that actual results differ from these estimates or the Company adjusts these estimates in future periods, operating results and financial position could be materially affected.

The Company s provision for income taxes differs from the tax computed at the U.S. federal statutory income tax rate due primarily to state taxes, non-deductible stock-based compensation, the Domestic Manufacturing Deduction, and various discrete items. The Company s effective tax rate for the three months ended July 31, 2010 and July 31, 2009 was 38.6% and 35.4%, respectively.

As of April 30, 2010 and in accordance with ASC 740, the Company evaluated its need for a valuation allowance based on historical evidence, trends in profitability and expectations of future taxable income, and determined that its valuation allowance was no longer necessary. As such, the Company released $18.6 million of the valuation allowance as an offset against all of its U.S. and state deferred tax assets resulting in a net benefit to the provision for income taxes.

The Company continuously monitors the circumstances impacting the expected realization of its deferred tax assets for each jurisdiction. The Company considers all available evidence, both positive and negative, including historical levels of income in each jurisdiction, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. If the Company determines it is more likely than not that some or all of its deferred tax assets will not be realized in the foreseeable future, the Company will consider the need for a valuation allowance at such time. A change in the Company s assessment regarding the realization of its deferred tax assets will impact its effective tax rate in the period the Company revises its assessment and in subsequent periods.

Table of Contents

ITEM 2. 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 the (1) unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q, and (2) the audited consolidated financial statements and notes thereto and management s discussion and analysis of financial condition and results of operations for the fiscal year ended April 30, 2010 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, or the SEC, on July 9, 2010. This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are often identified by the use of words such as may, will, expect, believe, anticipate, intend, could, estimate, or continue, and similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified herein, and those discussed in the section titled Risk Factors, set forth in Part II, Item 1A of this Form 10-Q and in our other SEC filings, including our Annual Report on Form 10-K for the fiscal year ended April 30, 2010. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

We are a leading provider of enterprise threat and risk management solutions (ETRM) that protect businesses and government agencies. Our enterprise threat and risk management platform collects, consolidates and correlates network and user activity data across the enterprise so that businesses can rapidly detect, diagnose and manage both internal and external threats and risks across the organization for activities associated with critical assets and processes. With our enterprise threat and risk management platform and products, organizations can use the ArcSight platform to reduce risk, identify vulnerabilities, comply with regulations and protect their high-value digital assets from cyber-theft, cyber-fraud, cyber-warfare and cyber-espionage.

Our SIEM products, ArcSight ESM and ArcSight Express, deliver a centralized, real-time view of all activity or events across geographically dispersed and heterogeneous business and technology infrastructures. Our log management products collect and store activity and event data for regulatory compliance, reporting and forensic analysis. Working together, these products collect, consolidate and correlate massive amounts of activity data, in the form of log events, from thousands of security point solutions, network and computing devices, databases and applications, enabling intelligent identification, prioritization and response to compliance and corporate policy violations, and external and insider threats. Our specialized software and application packages deliver pre-packaged analytics and reports tailored to specific compliance and security initiatives, such as Sarbanes-Oxley (SOX), PCI, user monitoring and fraud detection.

We were founded in May 2000 and first sold our initial ESM product in June 2002. We initially funded our operations primarily through convertible preferred stock financings that raised a total of $26.8 million. Our revenues have grown from $32.8 million in fiscal 2005 to $181.4 million in fiscal 2010, and were $48.1 million in our first quarter of fiscal 2011.

In February 2008, we completed our IPO in which we sold 6,000,000 shares of common stock, at an issue price of $9.00 per share. We raised a total of $54.0 million in gross proceeds from our IPO, or $45.9 million in net proceeds after deducting underwriting discounts of $3.8 million and offering expenses of $4.3 million.

We achieved positive cash flows from operations in fiscal 2004 through 2010. We generated $3.4 million and $9.0 million in cash from our operating activities during the three months ended July 31, 2010 and 2009, respectively, and we generally expect to continue to generate positive cash flows from operating activities on an annual basis. As of July 31, 2010, we had cash, cash equivalents and marketable securities of $150.7 million, net accounts receivable of $30.5 million, and an aggregate of $25.9 million in accounts payable and accrued liabilities.

Important Factors Affecting Our Operating Results and Financial Condition

We believe that the market for our products is still in the early stages of development, but may be entering a stage of more widespread adoption. We have identified factors that we expect to play an important role in our future growth and profitability. These factors are:

Development and Introduction of New Products. We believe it is important that we continue to develop or acquire new products and services that will help us capitalize on opportunities in the enterprise threat and risk management market. An example of a new product introduced in fiscal 2010 is ArcSight FraudView, an appliance product that detects online fraud by evaluating and scoring financial transactions. We continue the enhancement of our SIEM and log management products and solutions, such as enhanced location-based intelligence for our ESM products in May 2009, an updated version of our ArcSight Express product in March 2010, version 4.5 of our ArcSight Logger product in June 2010, and making ArcSight Logger available as a software product, in July 2010. In addition, we continue to develop and release updates to complementary solution packages for our SIEM and log management products.

Sales of Products to New Customers and Continued Sales to Our Installed Base. The market for enterprise threat and risk management solutions is growing, with initial purchases often driven by corporate compliance initiatives, and federal government cyber-security spending priorities. A key component of our growth will depend on our ability to sell our products to new customers. An initial sale typically involves the sale of our SIEM or log management products, in combination with each other or with our complementary solution packages to address a specific compliance or security use case, such as SOX, PCI, user monitoring or fraud detection. Many customers make an initial purchase from us and then decide whether to use our products with respect to a larger portion of their business and technology infrastructure or buy additional complementary products from us. Thus, another key component of our growth will be our ability to ensure initial customer success and successfully maintain and further develop the relationships with our existing customers to cover additional use cases. While historically our initial sale to a customer has involved our ESM products, we anticipate that a growing proportion of future new customers will be a result of initial sales of our ArcSight Logger products, our ArcSight Express product and our other products sold in an appliance form factor. We may not be able to generate the level of subsequent sales that we have historically experienced with our ESM customers.

Further Development of Our Channel Network and Our Relationships with System Integrators. Historically, we have sold our products primarily through our direct sales force, with sales to government or international customers through systems integrators and resellers. In recent years, we expanded our sales channel to assist us in penetrating the mid-market, particularly as we expanded our appliance-based offerings. We believe that our current and any new appliance-based products that we develop will be sold more effectively through resellers and, if we are successful in introducing these new products, we will become more dependent on the development of an effective channel network. In addition to continuing to develop additional channel-ready products and versions of our products designed for use by smaller enterprises, further training, certification and development of our existing channel partners to improve their effectiveness will be a key factor in the success of this strategy. Further, we believe that strong relationships with major system integrators will facilitate sales to large enterprises and governmental customers, particularly for use cases beyond traditional security and compliance.

Sources of Revenues, Cost of Revenues and Operating Expenses

Our sales transactions typically include the following elements: license fees paid for the use of our software and appliance products in perpetuity or, in limited circumstances, for a specified term; an arrangement for first-year support and maintenance, which includes unspecified software updates and upgrades; and professional services for installation, implementation and training. The majority of our revenues are derived from sales of our enterprise threat and risk management products, primarily ArcSight ESM and Logger, and we expect this to continue for the foreseeable future. We sell our products and services through our direct sales force, channel partners and system integrator partners, although the emphasis varies from region to region. For example, we primarily sell through resellers and other channel partners internationally, while our sales to U.S. federal government customers are typically through our direct sales force, resellers and system integrators.

Our strategy is to make our products available in the form factor desired by the customer. Consequently, our SIEM, log management and related products are available as software, as appliances or as packages of software and appliances. However, our appliance products generally have lower gross margins than our software products.

We recognize revenues pursuant to generally accepted accounting principles or GAAP, in accordance with Accounting Standards Codification, or ASC, Topic 985-605, *Software Revenue Recognition*, as amended, or ASC 985-605. ASC 985-605 provides that, if revenues are to be recognized upon product delivery, among other things vendor-specific objective evidence of fair value, or VSOE, for each undelivered element of multiple element customer contracts is required. In addition, if we determine that collectibility is not reasonably assured, we defer the revenues until collectibility becomes reasonably assured, generally upon receipt of cash.

Deferred revenue and accounts receivable are reported net of adjustments for sales transactions invoiced during the period that are recognized as revenue in a future period once cash is received and all other revenue recognition criteria have been met, which are sometimes referred to as net-down adjustments. Accordingly, we believe that in order to understand the change in both deferred revenue and accounts receivable from one period to another, the impact of these net-down adjustments should be considered.

Historically sales to U.S. commercial and governmental entities have represented a majority of our revenues, while international sales, including sales to agencies of foreign governments, have represented a smaller portion of our revenues. While the vertical make-up of our revenues will vary from period to period, over the long term we expect revenues from sales to U.S. commercial and governmental entities and sales to customers outside of the United States to each continue to grow in absolute dollars.

Product Revenues

Product revenues consist of license fees for our software products and sales of our appliance products. License fees are based on a number of factors, including the type and number of devices that a customer intends to monitor using our software as well as the number of users and locations. In addition to our core solution, some of our customers purchase additional licenses for optional extension modules that provide enhanced discovery and analytics capabilities. Sales of our appliance products consist of sales of the appliance hardware and associated perpetual licenses to the embedded software. We introduced our first appliance products in June 2006 and our first ArcSight Logger product, our most widely adopted appliance product to date, in December 2006. Appliance fees are based on the number of appliances purchased and, in some cases, on the number of network devices with which our customer intends to use the appliances. We generally recognize product revenues at the time of product delivery, provided all other revenue recognition criteria have been met.

Historically, we have engaged in long sales cycles with our customers, typically three to six months and more than a year for some sales, and many customers make their purchase decisions in the last month of a fiscal quarter, following procurement trends in the industry. Further, average deal size can vary considerably depending on our customers configuration requirements, implementation plan and budget availability. As a result, it is difficult to predict timing or size of product sales on a quarterly basis. In addition, we may fail to forecast sufficient production of our appliance products, or we may be unable to physically deliver appliances within the quarter, depending on the proximity of the order to the end of the quarter. These situations may lead to delay of revenues until we can deliver products. The loss or delay of one or more large sales transactions in a quarter could impact our operating results for that quarter and any future quarters into which revenues from that transaction are delayed.

In addition, we believe that our product revenue has been somewhat seasonal historically, increasing in each quarter through the fiscal year, but with the first quarter of our fiscal year typically having relatively lower product revenue compared to the prior fourth fiscal quarter. However, we believe that there are significant seasonal factors that may cause the second and fourth quarters of our fiscal year to have relatively higher product revenue (with the first and third fiscal quarters each potentially having lower revenue than the immediately preceding fiscal quarter). We believe that this seasonality results from a number of factors, including:

- the timing of our annual sales club for top performers and annual training for our entire sales force in our first fiscal quarter;
- the fiscal year end procurement cycle of our government customers;
- the budgeting, procurement and work cycles of our customers, including customers in the public sector;
- seasonal reductions in business activity during the summer months in the United States, Europe and certain other regions; and
- the structure of our direct sales incentive and compensation program, which may reinforce the tendency of our direct sales team to book the largest volume of deals toward the end of our fiscal year.

We believe that our rapid historical growth and the required timing of new compliance mandates may have overshadowed the nature or magnitude of seasonal or cyclical factors that might have influenced our business to date. In addition, the timing of one or more large transactions may overshadow seasonal factors in any particular quarterly period. In the future, we may experience growth from additional compliance and cybersecurity mandates that could continue to mask underlying seasonal purchasing decisions by our customers. Seasonal or cyclical variations in our operations may become more pronounced over time and may materially affect our results of operations in the future.

For example, as noted above, the timing of our fiscal quarters and the U.S. federal government s September 30 fiscal year end may impact product sales to governmental agencies in the second quarter of our fiscal year, offsetting the otherwise seasonal downturn in later summer months. Government spending on cybersecurity and new compliance mandates may drive customer demand at different times throughout our fiscal year, the timing of which we may not be able to anticipate and may cause fluctuations in our operating results. In addition, sales to customers with a standard December 31 fiscal year end may have a positive impact on our license revenue in the third quarter of our fiscal year, potentially offsetting the impact of the major holidays during the period. We expect seasonality to continue to impact our business in the future.

As of July 31, 2010 and April 30, 2010, deferred product revenues were $8.6 million and $10.8 million, respectively, and are primarily related to product revenues to be recognized ratably over the term of the maintenance arrangements, prepayments in advance of delivery and other delivery deferrals. Deferred revenue and accounts receivable are reported net of adjustments for sales transactions invoiced during the period that are recognized as revenue in a future period once cash is received and all other revenue recognition criteria have been met. These net-down adjustments decrease both accounts receivable and deferred revenue. Accordingly, we believe that in order to understand the change in both deferred revenue and accounts receivable from one period to another the impact of these net-down adjustments should be considered. As of July 31, 2010 and April 30, 2010, deferred product revenues of $8.6 million and $10.8 million, respectively, were reduced by net-down adjustments of $7.7 million and $10.1 million, respectively. See Critical Accounting Policies, Significant Judgments and Estimates Revenue Recognition and Note 2 to our Consolidated Financial Statements (Significant Accounting Policies Revenue Recognition) elsewhere in this report.

Maintenance Revenues

Maintenance includes rights to unspecified software product updates and upgrades, maintenance releases and patches released during the term of the support period, and internet and telephone access to maintenance personnel. Maintenance revenues are generated both from maintenance that we agree to provide in connection with initial sales of software and hardware products and from maintenance renewals. We generally sell maintenance on an annual basis. We offer two levels of maintenance standard and premium. The premium level is for customers that require 24-hour coverage seven days a week. In most cases, we provide maintenance for sales made through channel partners. In addition, we sell an enhanced maintenance offering that provides frequent security content updates for our software. Maintenance fees are treated as deferred revenue at the time the maintenance agreement is initiated and recognized ratably over the term of the maintenance agreement. As our customer base expands, we expect maintenance revenues to continue to grow, as maintenance is sold to new customers and existing customers renew.

As of July 31, 2010 and April 30, 2010, deferred maintenance revenues were $43.4 million and $46.7 million, of which $36.2 million and $39.1 million represented current deferred maintenance revenues, respectively. Deferred maintenance revenues relate to advanced payments for support contracts that are recognized ratably. As of July 31, 2010 and April 30, 2010, the deferred maintenance revenues of $43.4 million and $46.7 million, respectively, were reduced by net-down adjustments of $5.0 million and $3.9 million, respectively. Net-down adjustments decrease both accounts receivable and deferred revenue and typically relate to billed but unpaid customer transactions for maintenance renewal support terms where services have not yet been provided, or where revenue from the customer is only recognized when cash has been paid and all other revenue recognition criteria have been met. See Critical Accounting Policies, Significant Judgments and Estimates Revenue Recognition and Note 2 to our Consolidated Financial Statements (Significant Accounting Policies Revenue Recognition) elsewhere in this report.

Services Revenues

Services revenues are generated from sales of services to our customers, including installation and implementation of our software, consulting and training. Professional services are not essential to the functionality of the associated software products. During fiscal 2010 and continuing through the first quarter of fiscal 2011, we continued to enter into an increasing number of service engagements to staff and manage the security operations center, or SOCs, of certain large customers. SOC engagements are typically longer in duration than other services engagements and support the day-to-day monitoring of customer SOC environments. We generally sell our services on a time-and-materials basis and recognize revenues as the services are performed. Services revenues have generally increased over time as we have sold and delivered installation and training services to our new customers and continued to sell training and consulting services to our existing customers, including our new SOC services.

As of July 31, 2010 and April 30, 2010, deferred service revenues were $4.0 million and $3.4 million, respectively, in each case all of which represented current deferred services revenues. Deferred services revenues relate to customer payments in advance of services being performed. As of July 31, 2010 and April 30, 2010, the deferred service revenues of $4.0 million and $3.4 million, respectively were reduced by net-down adjustments of $0.9 million and $1.0 million, respectively. Net-down adjustments decrease both accounts receivable and deferred revenue and typically relate to billed but unpaid customer transactions for service engagements where services have not yet been provided, or where revenue from the customer is only recognized when cash has been paid and all other revenue recognition criteria have been met. See Critical Accounting Policies, Significant Judgments and Estimates Revenue Recognition and Note 2 to our Consolidated Financial Statements (Significant Accounting Policies Revenue Recognition) elsewhere in this report.

Cost of Revenues

Cost of revenues for our software products consists of third-party royalties and license fees for licensed technology incorporated into our software product offerings. Cost of revenues for appliance products consists of the hardware costs of the appliances and third-party royalties for licensed technology. The cost of product revenues is primarily impacted by the mix of software and appliance products as well as the relative ratio of third-party royalty bearing products included in software sales transactions. Sales of our appliance products are generally at a lower gross margin than sales of our software products.

Cost of maintenance revenues consists primarily of salaries and benefits related to maintenance personnel, royalties and other out-of-pocket expenses, and facilities and other related overhead.

Cost of services revenues consists primarily of the salaries and benefits of personnel, travel and other out-of-pocket expenses, facilities and other related overhead that are allocated based on the portion of the efforts of such personnel that are related to performance of professional services, and cost of services provided by subcontractors for professional services. Services gross margin may fluctuate as a result of periodic changes in our use of third party service providers, resulting in lower or higher gross margins for these services.

Gross margins may fluctuate from period to period as a result of the mix of software, appliances and services as components of revenue.

Operating and Non-Operating Expenses

Research and Development Expenses. Research and development expenses consist primarily of salaries and benefits of personnel engaged in the development of new products, the enhancement of existing products, quality assurance activities and, to a lesser extent, facilities costs and other related overhead. We expense all of our research and development costs as they are incurred. We expect research and development expenses to increase in absolute dollars for the foreseeable future as we continue to invest in the development of our products.

Sales and Marketing Expenses. Sales and marketing expenses consist primarily of salaries, commissions and benefits related to sales and marketing personnel and consultants; travel and other out-of-pocket expenses; expenses for marketing programs, such as for trade shows and our annual users conference, marketing materials and corporate communications; and facilities costs and other related overhead. Commissions on sales of products and maintenance are typically accrued and expensed when the respective revenue elements are ordered. Commissions on sales of services are typically accrued and expensed when the services were ordered. We pay commissions for channel sales not only to our channel sales force but also to our direct sales force in an effort to minimize channel conflicts as we develop our channel network. We intend to hire additional sales personnel, initiate additional marketing programs and further develop and build additional relationships with resellers and systems integrators on a global basis. Accordingly, we expect that our sales and marketing expenses will continue to increase for the foreseeable future in absolute dollars.

General and Administrative Expenses. General and administrative expenses consist primarily of salaries and benefits related to general and administrative personnel and consultants; accounting and legal fees; insurance costs and facilities costs and other related overhead. We expect that, in the future, general and administrative expenses will increase in absolute dollars as we add personnel and incur additional costs related to the growth of our business and additional legal, accounting and other expenses in connection with our reporting and compliance obligations as a public company.

Other Income (Expense), Net. Other income (expense), net consists of interest earned on our cash investments and foreign currency-related gains and losses. Our interest income will vary each reporting period depending on our average cash balances during the period and the current level of interest rates. Our foreign currency-related gains and losses will also vary depending upon movements in underlying exchange rates.

Accounting for Income Taxes. Our provision for income taxes is calculated in accordance with ASC 740, *Accounting for Income Taxes*, (including ASC 740-270, *Interim Financial Reporting)*, and FASB interpretation under ASC 740 related to *Accounting for Income Taxes in the Interim Period*, as amended, and other related guidance, and generally consists of tax expense related to current period earnings. We estimate income taxes in each of the jurisdictions in which we operate. Deferred income taxes are recorded for the expected tax consequences of temporary differences between the tax bases of assets and liabilities for financial reporting purposes and amounts recognized for income tax purposes. Deferred tax assets are recognized for deductible temporary differences, along with net operating loss and tax credit carry-forwards, if it is more likely than not that the tax benefits will be realized. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. These deferred tax assets and liabilities are included within the consolidated balance sheets.

To the extent a deferred tax asset cannot be recognized a valuation allowance is established to reduce our deferred tax assets to the amount that is more likely than not to be realized. A valuation allowance is maintained until sufficient evidence exists to support the reversal of all or some portion of these allowances. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted. As of April 30, 2010, and in accordance with ASC 740, we evaluated our need for a valuation allowance based on historical evidence, trends in profitability and expectations of future taxable income, and determined that a valuation allowance against deferred tax assets was no longer necessary. As such, we released $18.6 million of the valuation allowance as an offset against all of our U.S. and state deferred tax assets resulting in a net benefit in our provision for income taxes.

As of July 31, 2010, based on all available evidence, we have determined a valuation allowance is not necessary. We continuously monitor the circumstances impacting the expected realization of our deferred tax assets for each jurisdiction. We consider all available evidence, including historical levels of income in each jurisdiction, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. If we determine it is more likely than not that some or all of our deferred tax assets will not be realized in the foreseeable future, we will consider the need for a valuation allowance at such time. A change in our assessment regarding the realization of our deferred tax assets will impact our effective tax rate in the period in which we revise our assessment and in subsequent periods.

Critical Accounting Policies, Significant Judgments and Estimates

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, which requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. We base our estimates and judgments on our historical experience, knowledge of current conditions and our beliefs regarding likely occurrences in the future, given available information. Estimates are used for, but are not limited to, revenue recognition, determination of fair value of stock and stock-based awards, valuation of goodwill and intangible assets acquired in business combinations, impairment of goodwill and other intangible assets, amortization of intangible assets, accounting for income taxes, accounting for uncertainties in income taxes, contingencies and litigation, allowances for doubtful accounts, and accrued liabilities. Actual results may differ from those estimates, and any differences may be material to our financial statements. Further, if we apply different factors, or change the method by which we apply the various factors that are used, in making our critical estimates and judgments, our reported operating results and financial condition could be materially affected.

Revenue Recognition

We recognize revenues in accordance with ASC 985-605. Accordingly, we exercise judgment and use estimates in connection with the determination of the amount of product, maintenance and services revenues to be recognized in each accounting period.

We derive revenues primarily from three sources: (i) sales of our software and hardware products, (ii) fees for maintenance to provide unspecified upgrades and customer technical support, and (iii) fees for services, including professional services for product installation, implementation, staffing and management services for SOCs and training. Our appliance products contain software that is more than incidental to the functionality of the product. In accordance with the guidance, we recognize revenues when the following conditions have been met:

- persuasive evidence of an arrangement exists;
- the fee is fixed or determinable;
- product delivery has occurred or services have been rendered; and
- collection is considered probable.

We typically use a binding purchase order in conjunction with either a signed contract or reference on the purchase order to the terms and conditions of our shrinkwrap or end-user license agreement as evidence of an arrangement. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or forfeiture, concession or other adjustment. We do not generally grant rights of return or price protection to our distribution partners or end users, other than limited rights of return during the warranty period in some cases. We use shipping documents, contractual terms and conditions and customer acceptance, when applicable, to verify product delivery to the customer. For perpetual software license fees in arrangements that do not include customization, or services that are not considered essential to the functionality of the licenses, delivery is deemed to occur when the product is delivered to the customer. Services and consulting arrangements that are not essential to the functionality of the licensed product are recognized as revenues as these services are provided. Delivery of maintenance is considered to occur on a straight-line basis ratably over the life of the contract. We consider probability of collection based on a number of factors, such as creditworthiness of the customer as determined by credit checks and analysis, past transaction history, the geographic location and financial viability. We do not require, nor do we request, collateral from customers. If we determine that collectibility is not reasonably assured, we defer the revenues until collectibility becomes reasonably assured, generally upon receipt of cash. A net-down adjustment may be recorded in cases where sales transactions have been invoiced but are recognized on cash receipt, for invoiced but unpaid sales transactions related to post-contract customer support obligations for which the term has not commenced, or for invoiced but unpaid service engagements where services have not yet been provided. Net-down adjustments decrease both accounts receivable and deferred revenue. Any such transactions included in accounts receivable and deferred revenue at period end are reflected on the balance sheet on a net basis.

Our sales of software products to date have typically been multiple element arrangements, which have included software licenses and corresponding maintenance, and have also generally included some amount of professional services. Our sales of appliance products to date have been multiple element arrangements as well, which included hardware, software licenses and corresponding maintenance, and have also generally included some amount of professional services. We allocate the total arrangement fee among these multiple elements based upon their respective fair values as determined by VSOE or, if applicable, by the residual method under the guidance. VSOE for maintenance and support services is based on separate sales and/or renewals to other customers or upon renewal rates quoted in contracts when the quoted renewal rates are deemed substantive in both rate and term. VSOE for professional services is established based on prices charged to customers when those services are sold separately. If we cannot objectively determine the fair value of any undelivered element in a multiple element arrangement, we defer revenues for each element until all elements have been delivered, or until VSOE can objectively be determined for any remaining undelivered element. If VSOE for maintenance does not exist, and this represents the only undelivered element, then revenues for the entire arrangement are recognized ratably over the performance period. When VSOE of a delivered element has not been determined, but the fair value for all undelivered elements has, we use the residual method to record revenues for the delivered element. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered element and recognized immediately as revenues. Revenues from time-based (term) license sales that include ongoing delivery obligations throughout the term of the arrangement are recognized ratably over the term.

Our agreements generally do not include acceptance provisions. However, if acceptance provisions exist, we deem delivery to have occurred upon customer acceptance.

Resellers, channel partners and systems integrators purchase products for specific end-users and do not hold inventory. Resellers and systems integrators perform functions that include delivery to the end customer, installation or integration and post-sales service and support. The agreements with these resellers and systems integrators have terms that are generally consistent with the standard terms and conditions for the sale of our products and services to end-users and do not provide for product rotation or pricing allowances. For sales to direct end-users, system integrators and channel partners, we recognize product revenue once either we or our system integrator or channel partner has a contractual agreement in place and upon transfer of title and risk of loss, which is generally upon shipment, provided all other criteria for revenue recognition have been met. Where sales are made through resellers, revenue is generally recorded upon shipment to the end-users, when all other criteria for revenue recognition have been met. In a limited number of instances, when delivery is to be made to a reseller upon the request of either the end-user or the reseller, and when all other criteria for revenue recognition have been met, it is our practice to recognize revenue on shipment to a reseller but only where an end-user has been identified prior to shipment. For end-users, resellers and systems integrators, we generally have no significant obligations for future performance such as rights of return or pricing credits.

We assess whether fees are collectible and fixed or determinable at the time of the sale, and recognize revenues if all other revenue recognition criteria have been met. Our standard payment terms are net 30 days and are considered normal up to net three months, while payment terms beyond three months are considered to be extended terms. Payments that are due within three months are generally deemed to be fixed or determinable based on our successful collection history on these agreements.

Stock-Based Compensation

Effective May 1, 2006, we adopted ASC Topic 718, *Compensation-Stock Compensation*, or ASC 718, which requires companies to expense the fair value of employee stock options and other forms of stock-based compensation. The guidance requires nonpublic companies that used the minimum value method, for either recognition or pro forma disclosures to apply the guidance using the prospective-transition method. As such, we continued to apply the minimum value method in future periods to unvested equity awards outstanding at the date of adoption of ASC 718 that were measured using the minimum value method. In addition, we continued to amortize those awards granted prior to May 1, 2006 utilizing an accelerated amortization schedule. As of April 30, 2009, amortization under the minimum value method was complete. In accordance with the guidance, we will recognize the compensation cost of employee stock-based awards granted subsequent to April 30, 2006 in the statement of operations using the straight-line method over the vesting period of the award.

To determine the fair value of stock options granted after May 1, 2006, we have elected to use the Black-Scholes-Merton option pricing model, which requires, among other inputs, an estimate of the fair value of the underlying common stock on the date of grant and assumptions as to volatility of our stock over the expected term of the related options, the expected term of the options, the risk-free interest rate and the option forfeiture rate. As there had been no public market for our common stock prior to our IPO in February 2008, we have determined the volatility for options granted for fiscal 2008 and fiscal 2007 based on an analysis of reported data for a peer group of companies that issued options with substantially similar terms. The expected volatility of options granted has been determined using weighted-average measures of the implied volatility and the historical volatility for this peer group of companies for a period equal to the expected life of the option. The weighted-average expected volatility for options granted for the three months ended July 31, 2010 and 2009 was 56% and 58%, respectively. The expected life of options has been determined considering the expected life of options granted by a group of peer companies and the average vesting and contractual terms of options granted to our employees. The weighted-average expected life of options granted for the three months ended July 31, 2010 and 2009 was 5.70 years and 5.66 years, respectively. For the three months ended July 31, 2010 and 2009, the weighted-average risk-free interest rate used was 2.71% and 2.26%, respectively. The risk-free interest rate is based on a zero coupon United States treasury instrument whose term is consistent with the expected life of the stock options. We have not paid and do not anticipate paying cash dividends on our shares of common stock; therefore, the expected dividend yield is assumed to be zero. In addition, ASC 718 requires companies to utilize an estimated forfeiture rate when calculating the expense for the period, whereas the former SFAS 123 guidance permitted companies to record forfeitures based on actual forfeitures, which was our historical policy prior to the adoption of ASC 718. We apply an estimated annual forfeiture rate of 5%, based on our historical forfeiture experience during the previous six years, in determining the expense recorded in our consolidated statement of operations.

We recorded expense of $3.2 million and $1.7 million, for the three months ended July 31, 2010 and 2009, respectively, in connection with stock-based awards accounted for under ASC 718. As of July 31, 2010 and 2009, unrecognized stock-based compensation expense of non-vested stock options was $30.1 million and $19.6 million, respectively. As of July 31, 2010, the unrecognized stock-based compensation expense is expected to be recognized using the straight-line method over the required service period of the options. The actual amount of stock-based compensation expense we record in any fiscal period will depend on a number of factors, including the number of stock options issued and the volatility of our stock price over time. In future periods, stock-based compensation expense may increase as we issue additional equity-based awards to continue to attract and retain key employees. Additionally, the guidance requires that we recognize compensation expense only for the portion of stock options that are expected to vest. If the actual number of forfeitures differs from that estimated by management, we will be required to record adjustments to stock-based compensation expense in future periods.

Our 2007 Employee Stock Purchase Plan, or ESPP, became effective on the effectiveness of our IPO on February 14, 2008. The ESPP provides for consecutive six-month offering periods, except for the first offering period, which commenced on February 14, 2008 and ended on September 15, 2008. The ESPP is compensatory and results in compensation cost accounted for under ASC 718.

Table of Contents

We use the Black-Scholes-Merton option pricing model to estimate the fair value of rights to acquire stock granted under the ESPP. For the three months ended July 31, 2010 and 2009, we recorded stock-based compensation expense associated with the ESPP of $0.3 million and $0.2 million, respectively. As of July 31, 2010, unrecognized stock-based compensation expense associated with rights to acquire shares of common stock under the ESPP was $0.2 million.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts based on a periodic review of customer accounts, payment patterns and specific collection issues. Where account-specific collection issues are identified, we record a specific allowance based on the amount that we believe will not be collected. For accounts where specific collection issues are not identified, we record a reserve based on the age of the receivables. As of July 31, 2010, we had two customers and one reseller with accounts receivable balances greater than 10% of the Company s net accounts receivable, with a balance of 17% and 13%, and 13%, respectively. As of April 30, 2010, we had two customers that accounted for 15% and 10%, respectively, of our net accounts receivable.

Accounting for Income Taxes

Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets.

Our provision for income taxes is calculated in accordance with ASC 740, *Accounting for Income Taxes* (including ASC 740-270,*Interim Financial Reporting*), and FASB interpretation under ASC 740 related to *Accounting for Income Taxes in the Interim Period*, as amended, and other related guidance, and generally consists of tax expense related to current period earnings. As part of the process of preparing our consolidated financial statements, we continuously monitor the circumstances impacting the expected realization of our deferred tax assets for each jurisdiction. We consider all available evidence, including historical levels of income in each jurisdiction, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. We determine our income tax expense together with calculating the deferred income tax expense or benefit related to temporary differences resulting from the differing treatment of items for tax and accounting purposes, such as deferred revenue or deductibility of certain intangible assets. These temporary differences result in deferred tax assets and liabilities. We must then assess the likelihood that the deferred tax assets may be recovered through carry back to prior year s income or through the generation of future taxable income after consideration of tax planning strategies. Changes in these estimates may result in significant increases or decreases to our tax provision in a period in which such estimates are changed which in turn would affect net income.

As of April 30, 2010, and in accordance with ASC 740, we evaluated our need for a valuation allowance based on historical evidence, trends in profitability and expectations of future taxable income, and determined that a valuation allowance against deferred tax assets was no longer necessary. As such, we released $18.6 million of the valuation allowance as an offset against all of our U.S. and state deferred tax assets resulting in a net benefit in our provision for income taxes.

We adopted ASC 740-10-50, *Accounting for Uncertainty in Income Taxes,* an interpretation of the guidance under ASC 740, on May 1, 2007. ASC 740-10-50 prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a company s income tax return. The pronouncement also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition with respect to income tax uncertainty. Management judgment is required to determine if the weight of available evidence indicates that a tax position is more likely than not to be sustained, as well as the largest amount of benefit from each sustained position that is more likely than not to be realized.

We file income tax returns in the U.S. federal jurisdiction, California and various state and foreign tax jurisdictions in which we have a subsidiary or branch operation. During the fourth quarter of fiscal 2010, the IRS notified us of its intent to audit fiscal years 2007 to 2009. During the quarter ended July 31, 2010, the IRS completed its audit and we effectively resolved positions related to research credits. In connection with the settlement of this audit, we reduced the balance of our unrecognized tax benefits that resulted in a tax benefit during the quarter of approximately $0.2 million. Tax years 2001 to 2010 remain open to examination by state tax authorities, and the tax years 2005 to

2010 remain open to examination by the foreign tax authorities.

Results of Operations

The following table presents our results of operations as a percentage of total revenues for the periods indicated:

	Three Months Ended July 31, 2010	Three Months Ended July 31, 2009
Revenues:		
Products	53.7%	52.9%
Maintenance	34.6	34.5
Services	11.7	12.6
Total revenues	100.0	100.0
Cost of revenues:		
Products	6.5	5.6
Maintenance	5.4	5.6
Services	9.4	7.6
Total cost of revenues	21.3	18.8
Gross margin	78.7	81.2
Operating expenses:		
Research and development	15.4	16.2
Sales and marketing	37.4	42.8
General and administrative	15.6	17.4
Total operating expenses	68.4	76.4
Income from operations	10.3%	4.8%

Comparison of the Three Months Ended July 31, 2010 and 2009

Revenues

Revenues for the three-months ended July 31, 2010 and 2009 were as follows (in thousands, except percentages):

	Three Months Ended July 31, 2010	Three Months Ended July 31, 2009	Change in Dollars	Change in Percent
Products	$ 25,833	$ 18,265	$ 7,568	41.4%
Percentage of total revenues	*53.7%*	*52.9%*		
Maintenance	16,649	11,919	4,730	39.7%
Percentage of total revenues	*34.6%*	*34.5%*		
Services	5,654	4,371	1,283	29.4%
Percentage of total revenues	*11.7%*	*12.6%*		
Total revenues	$ 48,136	$ 34,555	$ 13,581	39.3%

Product Revenues. Product revenues for the three months ended July 31, 2010 included revenues of $8.5 million from 75 new customers and revenues of $17.3 million from existing customers. New customer revenues from 75 customers for the three months ended July 31, 2010 increased by $1.0 million compared to new customer revenues from 35 customers for the three months ended July 31, 2009. The increase in the number of new customers from the first quarter of fiscal 2010 to the first quarter of fiscal 2011 was primarily driven by a significant increase in the number of new customers in Europe Middle East and Africa, or EMEA. Many of these new customers purchased our logger products to meet newly effective data privacy compliance requirements. EMEA transactions are typically sold through our channel partners and are smaller in transaction size relative to transactions with the Americas, with average transaction sizes that have remained relatively consistent from period to period. The increase in new customer revenue from the first quarter of fiscal 2010 to the first quarter of fiscal 2011 was primarily due to the increased success of our channel business in EMEA. Existing customer revenues for the three months ended July 31, 2010 increased by $6.6 million compared to existing customer revenues for the three months ended July 31, 2009. The increase was driven primarily by strength from our existing customers in the Americas as these customers continue to expand their deployments of our ESM product and our logger product as well as purchases focused on the expansion of the deployment of our products more broadly across their IT infrastructure. We anticipate that the mix of product revenues from new and existing customers could fluctuate from period to period as a result of the transaction size, product mix, impact of the recovering economic environment and related geography of each revenue transaction.

Maintenance Revenues. Maintenance revenues increased $4.7 million for the three months ended July 31, 2010 compared to July 31, 2009, as a result of providing support services to a larger installed base as well as the incremental maintenance revenues from increased product sales.

Services Revenues. Services revenues increased by $1.3 million for the three months ended July 31, 2010 compared to July 31, 2009, primarily due to SOC staffing and management engagements, in addition to increased consulting service billings related to a larger installed base of customers.

Geographic Regions. We sell our product in three geographic regions: Americas; EMEA; and Asia Pacific. Revenues, which include product, maintenance and service revenues in absolute amounts and as a percentage of total revenues for each region are summarized in the following table (in thousands, except percentages):

	Three Months Ended July 31,		Change in Dollars	Change in Percent
	2010	2009		
Americas	$ 38,752	$ 28,722	$ 10,030	34.9%
Percentage of total revenue	*80.5%*	*83.1%*		
EMEA	7,451	4,771	2,680	56.2%
Percentage of total revenue	*15.5%*	*13.8%*		
Asia Pacific	1,933	1,062	871	82.0%
Percentage of total revenue	*4.0%*	*3.1%*		
Total revenue	$ 48,136	$ 34,555	$ 13,581	39.3%

Revenues from the EMEA region increased in both absolute dollars and as a percentage of total revenues, during the three months ended July 31, 2010 as a result of the improved economic conditions in that region, compliance with newly effective regulatory mandates, and the larger number of transactions sold through our channel partners. We experienced an increase in revenues in the Americas region in absolute dollars, but a decrease in percentage of total revenues year over year, primarily due to the significantly higher growth in the EMEA region. Asia Pacific increased in absolute dollars as well as in percentage of revenue, as a result of improved sales execution in this territory.

Cost of Revenues and Gross Margin

The following table is a summary of cost of product, maintenance, and services revenues in absolute amounts (in thousands, except percentages):

	Three Months Ended July 31,		Change in Dollars	Change in Percent
	2010	2009		
Products	$ 3,108	$ 1,944	$ 1,164	59.9%
Maintenance	2,623	1,925	698	36.3%
Services	4,541	2,630	1,911	72.7%
Total cost of revenues	$ 10,272	$ 6,499	$ 3,773	58.1%

Table of Contents

The following table is a summary of gross profit for products, maintenance, and services and their respective gross margins (in thousands, except percentages):

	Three Months Ended July 31,	
	2010	**2009**
Gross margin		
Products	$ 22,725	$ 16,321
Percentage of product revenues	*88.0%*	*89.4%*
Maintenance	14,026	9,994
Percentage of maintenance revenues	*84.2%*	*83.8%*
Services	1,113	1,741
Percentage of services revenues	*19.7%*	*39.8%*
Total gross margin	$ 37,864	$ 28,056
Percentage of total revenues	78.7%	81.2%

Cost of Product Revenues and Gross Margin. Cost of product revenues increased by $1.2 million for the three months ended July 31, 2010, compared to the three months ended July 31, 2009, primarily due to increased ArcSight Logger product cost of goods of $1.1 million related to increased ArcSight Logger product sales. Product gross margin as a percentage of product revenues decreased by 1.4% as a percentage of product revenues for the three months ended July 31, 2010 compared to the three months ended July 31, 2009, due to lower margin appliance revenue contributing a higher percentage of product revenues than the prior year. While we expect appliance revenues to generally represent less than half of product revenues going forward, the mix of software and appliance product revenues will likely fluctuate from quarter to quarter, potentially negatively impacting product gross margins in the quarter.

Cost of Maintenance Revenues and Gross Margin. Cost of maintenance revenues increased by $0.7 million for the three months ended July 31, 2010 compared to July 31, 2009, due primarily to increased compensation-related expenses of $0.5 million related to increased head count and cost per employee. Maintenance gross margin as a percentage of maintenance revenues remained relatively consistent increasing slightly by 0.4% for the three months ended July 31, 2010 compared to July 31, 2009, due primarily to our installed base growing more quickly than corresponding growth in our support organization and associated costs.

Cost of Services Revenues and Gross Margin. Cost of services revenues increased by $1.9 million for the three months ended July 31, 2010 compared to July 31, 2009, due primarily to increased compensation-related expenses of $1.1 million related to increased head count and cost per employee. Additionally, the use of external consultants and consultant travel and entertainment increased by $0.4 million and $0.3 million, respectively. Services gross margin as a percentage of services revenues decreased by 20.1 percentage points to 19.7% for the three months ended July 31, 2010 from 39.8% for the three months ended July 31, 2009, due primarily to the increase in fixed infrastructure costs to manage and grow this service offering and the use of higher cost external consultants to staff such engagements, while we continue to hire internally to staff our growing services business. In addition, differences in the timing of costs incurred and related revenue recognition on our SOC engagements negatively impacted our gross margins in the three months ended July 31, 2010. Our SOC services business is still in its early growth phase and accordingly we are incurring fixed incremental costs ahead of the potential revenue opportunity thereby realizing lower gross margins. We expect that as the number of SOC engagement increases in the future that the larger amount of revenue from these engagements will more than offset these fixed costs resulting in higher gross margins.

Table of Contents

Operating Expenses

The following table is a summary of research and development, sales and marketing, and general and administrative expenses in absolute amounts and as a percentage of total revenues (in thousands, except percentages):

	Three Months Ended July 31, 2010	Three Months Ended July 31, 2009	Change in Dollars	Change in Percent
Research and Development	$ 7,406	$ 5,598	$ 1,808	32.3%
Percentage of total revenues	*15.4%*	*16.2%*		
Sales and Marketing	17,996	14,785	3,211	21.7%
Percentage of total revenues	*37.4%*	*42.8%*		
General and Administrative	7,513	6,018	1,495	24.8%
Percentage of total revenues	*15.6%*	*17.4%*		
Total operating expenses	$ 32,915	$ 26,401	$ 6,514	24.7%
Percentage of total revenues	68.4%	76.4%		

Research and Development Expenses. The increase in research and development expenses for the three months ended July 31, 2010 of $1.8 million compared to the three months ended July 31, 2009 was primarily attributable to an increase of $1.1 million in compensation and an increase of $0.4 million in stock-based compensation expense, associated with an increase in research and development personnel from 115 to 131 at the respective period ends. We plan to continue hiring to extend our product platform. We expect research and development expenses to continue to increase in absolute dollars.

Sales and Marketing Expenses. The increase in sales and marketing expenses for the three months ended July 31, 2010 of $3.2 million compared to the three months ended July 31, 2009, was primarily attributable to an increase of $2.6 million in compensation-related expense of which $0.2 million related to commission plan expenses associated with increased sales orders generated. Of this compensation expense, an increase of $2.0 million was due to an increase in sales and marketing personnel from 158 to 183 at the respective period ends, associated with significant growth across our sales organization. We plan to continue hiring in line with our growth opportunities. The increase also includes an increase in travel and entertainment and conference and department offsite expenses of $0.4 million. As a result, we expect sales and marketing expenses to continue to increase in absolute dollars.

General and Administrative Expenses. The increase in general and administrative expenses of $1.5 million for the three months ended July 31, 2010, compared to the three months ended July 31, 2009, was associated with an increase of $1.0 million in compensation-related expenses attributed to an increase in general administrative personnel from 57 to 74 at the respective period ends, due primarily to hiring in our Information Technology and Finance and Accounting areas in support of infrastructure growth. The increase also includes an increase in external consultants and temporary help of $0.2 million related to IT infrastructure projects, an increase of $0.3 million in third-party software support and maintenance expenses, and a net decrease of $0.3 million in legal, audit and tax advisory service fees.

Table of Contents

Non-Operating Expenses

The following table is a summary of interest income and other expenses, net (in thousands, except percentages):

	Three Months Ended July 31,		Change in Dollars	Change in Percent
	2010	2009		
Interest income	$ 43	$ 28	$ 15	53.6%
Percentage of total revenues	*0.1%*	*0.1%*		
Other income (expense), net	(59)	(117)	58	49.6%
Percentage of total revenues	*(0.1)%*	*(0.4)%*		
Provision for (benefit from) income taxes	1,904	551	1,353	245.6%
Percentage of total revenues	*4.0%*	*1.6%*		
Total non-operating income (expense)	$ (1,920)	$ (640)	$ (1,280)	(200.0)%
Percentage of total revenues	(4.0)%	(1.9)%		

Interest Income. The slight increase in interest income of $15,000 for the three months ended July 31, 2010 compared to July 31, 2009 was primarily attributable to an increased cash, cash equivalents and marketable securities balance during the first quarter of fiscal 2011.

Other Expense, Net. Other expense, net, for the three months ended July 31, 2010 compared to July 31, 2009 improved as a result of a slight decrease in interest expense as well as decreased foreign currency losses due to economic improvements.

Provision for Income Taxes. For the three months ended July 31, 2010, we recorded a provision for income taxes of $1.9 million. The effective tax rate for the three months ended July 31, 2010 is 38.6%, and is based on our estimated taxable income for the year, plus certain discrete items recorded during the quarter, namely the tax benefit of stock option transactions and income tax uncertainties. Our provision for income taxes differs from the tax computed at the U.S. federal statutory income tax rate due primarily to state taxes, non-deductible stock-based compensation, the Domestic Manufacturing Deduction, and various discrete items.

For the three months ended July 31, 2009, we recorded a provision for income taxes of $0.6 million. The effective tax rate for the three months ended July 31, 2009 was 35.4% and was based on our estimated taxable income for the year, plus certain discrete items recorded during the quarter. The difference between the provision for income taxes that would be derived by applying the statutory rate to our income before tax and the income tax provision actually recorded is primarily due to the impact of nondeductible ASC 718 stock-based compensation expenses, offset by the use of net operating loss carry-forwards and tax credits.

Liquidity and Capital Resources

From our inception in May 2000 through October 2002, we funded our operations primarily through convertible preferred stock financings that raised a total of $26.8 million. We achieved positive cash flows from operations in fiscal 2004 through 2009, and generated $45.7 million of cash from our operating activities during fiscal 2010 compared to $16.8 million of cash from our operating activities during fiscal 2009. We generated $3.4 million of cash from our operations during the first quarter of fiscal 2011. We generally expect to continue generating positive operating cash flows on an annual basis. There may be individual quarters in which we use cash as a result of the timing of receipts or payments such as receipt of a large receivable from a customer whose revenue is recognized on a cash basis or payment of annual bonuses in the first quarter of a fiscal year. As we have continued to generate cash, we invested $15.0 million and $25.0 million into marketable security investments during the first quarter of fiscal 2011 and fiscal 2010, respectively, of which $20.0 million remains invested as of July 31, 2010. These marketable securities consist of certificates of deposit and U.S. Treasury notes invested with financial institutions that we believe to be financially sound, in order to minimize our credit risk. Additionally in February 2008, we completed our IPO in which we sold 6,000,000 shares of common stock at an issue price of $9.00 per share. We raised a total of

$54.0 million in gross proceeds from our IPO, or $45.9 million in net proceeds after deducting underwriting discounts and offering expenses.

At July 31, 2010, we had cash, cash equivalent and marketable securities totaling $150.7 million and accounts receivable of

$30.5 million, compared to $149.4 million of cash, cash equivalents and marketable securities and $33.6 million of accounts receivable at April 30, 2010.

Historically our principal uses of cash have consisted of payroll and other operating expenses and purchases of property and equipment to support our growth. In fiscal 2007, we used $7.2 million in cash to purchase the assets of Enira Technologies, LLC and pay acquisition costs.

The following table shows our cash flows from operating activities, investing activities and financing activities for the stated periods:

	Three months Ended July 31,	
	2010	2009
Net cash provided by operating activities	$ 3,354	$ 8,990
Net cash used in investing activities	(11,147)	(1,339)
Net cash provided by financing activities	1,132	3,216

Operating Activities

We have reported net income for both the three months ended July 31, 2010 and three months ended July 31, 2009. Our operating activities have provided positive cash flows, primarily due to cash received from collections from customers. Our cash flows from operating activities in any period will continue to be significantly influenced by our results of operations, changes in deferred revenues, as well as changes in other components of our working capital.

While we may report negative cash flows from operating activities from time to time in particular quarterly periods, we generally expect to continue to generate positive cash flows from operating activities on an annual basis. Future cash from operations will depend on many factors, including:

- the growth in our sales transactions and associated cash collections or growth in receivables;
- the level of our sales and marketing activities, including expansion into new territories;
- the timing and extent of spending to support product development efforts; and
- the timing of the growth in general and administrative expenses as we further develop our administrative infrastructure to support the business as a public company.

We generated $3.4 million of cash from operating activities during the three months ended July 31, 2010, primarily as a result of a decrease of $3.0 million in accounts receivable due to strong collections efforts, an increase in other accrued liabilities of $3.2 million, and a decrease of $2.5 million in prepaid expenses and other assets, offset by a decrease of $5.0 million in accrued compensation and benefits related to payments of sales commission and performance bonuses earned during fiscal 2010, a reduction in deferred revenue of $5.0 million, and further offset by a decrease of $0.8 million in accounts payable due to the timing of payments. In addition, we had a net income of $3.0 million for this period, which included non-cash charges of $3.5 million for stock-based compensation expense and $0.7 million of depreciation and amortization.

We generated $9.0 million of cash from operating activities during the three months ended July 31, 2009, primarily as a result of a $11.0 million decrease in accounts receivable due to strong collections efforts associated with our relatively high accounts receivable balance as of April 30, 2009, an increase of $2.2 million in accounts payable due to the timing of payments, offset by a decrease of $5.2 million in accrued compensation and benefits related to payments of sales commission and performance bonuses earned during fiscal 2009, and a reduction in deferred revenue of $3.2 million. In addition, we had a net income of $1.0 million for this period, which included non-cash charges of $1.9 million for stock-based compensation expense and $0.8 million of depreciation and amortization.

Table of Contents

Investing Activities

During the three months ended July 31, 2010, we used $11.1 million in cash for investing activities, comprised primarily of net purchases of $8.0 million in short-term held to maturity investments and $3.1 million in capital expenditures primarily associated with software acquired in support of our ERP software implementation. During the three months ended July 31, 2009, we used $1.3 million in cash for investing activities, comprised primarily of capital expenditures associated with software acquired in support of our enterprise resource planning (ERP) software implementation.

Financing Activities

During the three months ended July 31, 2010, $1.1 million of cash was provided by financing activities, comprised primarily of $1.0 million of net proceeds from the exercise of stock options, and $0.8 million from tax benefits related to disqualifying dispositions associated with stock-based compensation, offset by $0.6 million in payments for prepaid software licenses used as a component in our product sales. During the three months ended July 31, 2009, $3.2 million of cash was provided by financing activities, comprised primarily of $3.7 million of net proceeds from the exercise of stock options, and $0.2 million from tax benefits related to disqualifying dispositions associated with stock-based compensation, offset by $0.6 million in payments for prepaid software licenses used as a component in our product sales.

Other Factors Affecting Liquidity and Capital Resources

We believe that our cash and cash equivalents and any cash flow from operations will be sufficient to meet our anticipated cash needs, including for working capital purposes, capital expenditures and various contractual obligations, for at least the next 12 months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments or acquisitions we may decide to pursue. If these sources are insufficient to satisfy our cash requirements, we may seek to sell debt securities or additional equity securities or to obtain a credit facility. The sale of additional equity securities could result in additional dilution to our stockholders. The incurrence of indebtedness would result in debt service obligations and could result in operating and financial covenants that would restrict our operations. In addition, there can be no assurance that any additional financing will be available on acceptable terms, if at all. We anticipate that, from time to time, we may evaluate acquisitions of complementary businesses, technologies or assets. However, there are no current understandings, commitments or agreements with respect to any acquisitions.

Off-Balance Sheet Arrangements

As of July 31, 2010, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the SEC s Regulation S-K.

Contractual Obligations and Commitments

There have been no material changes in our contractual obligations during the three months ended July 31, 2010 as compared to the contractual obligations disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II, Item 7, of our Annual Report on Form 10-K for the fiscal year ended April 30, 2010

Recent Accounting Pronouncements

Refer to the discussion of recent accounting pronouncements in Note 2 Summary of Significant Accounting Policies in the Notes to the Condensed Consolidated Financial Statements in this Quarterly Report, which information is incorporated herein by reference.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in our market risk exposures during the three months ended July 31, 2010 as compared to the market risk exposures disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II, Item 7A, of our Annual Report on Form 10-K for the fiscal year ended April 30, 2010.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation and supervision of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Exchange Act. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the potential benefits of possible controls and procedures relative to their costs.

Based on the aforementioned evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of July 31, 2010, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

Regulations under the Exchange Act require public companies, including our company, to evaluate any change in our internal control over financial reporting as such term is defined in Rule 13a-15(f) and Rule 15d-15(f) of the Exchange Act. In connection with their evaluation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report, our Chief Executive Officer and Chief Financial Officer did not identify any changes in our internal control over financial reporting during the fiscal quarter covered by this Quarterly Report that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are subject to various claims, complaints and legal actions in the normal course of business. We do not believe we are party to any currently pending litigation, the outcome of which will have a material adverse effect on our operations or financial position.

ITEM 1A. RISK FACTORS

Risk Related to Our Business and Industry

Our future operating results may fluctuate significantly and our current operating results may not be a good indication of our future performance.

Our revenues and operating results could vary significantly from period to period as a result of a variety of factors, many of which are outside of our control. As a result, comparing our revenues and operating results on a period-to-period basis may not be meaningful, and you should not rely on our past results as an indication of our future performance. We may not be able to accurately predict our future revenues or results of operations. We base our current and future expense levels on our operating plans and sales forecasts, and our operating costs are relatively fixed in the short-term. As a result, we may not be able to reduce our costs sufficiently to compensate for an unexpected shortfall in revenues, and even a small shortfall in revenues could disproportionately and adversely affect financial results for that quarter. In addition, we recognize revenues from sales to some customers or resellers when cash is received, which may be delayed because of changes or issues with those customers or resellers. If our revenues or operating results fall below the expectations of investors or any securities analysts that cover our stock, the price of our common stock could decline substantially.

Table of Contents

In addition to other risk factors listed in this section, factors that may affect our operating results include:

- the timing of our sales during the quarter, particularly since a large portion of our sales occurs in the last few weeks of the quarter and loss or delay of a few large contracts may have a significant adverse impact on our operating results;
- changes in the mix of revenues attributable to higher-margin revenues from ESM products as opposed to lower-margin revenues from sales of our appliance products;
- the timing of satisfying revenue recognition criteria, including, for example, establishing vendor-specific objective evidence of fair value, or VSOE, for new products and maintaining VSOE for maintenance and services, particularly where we accrue the associated commission expense in a different period;
- changes in the renewal rate of maintenance agreements;
- our ability to estimate warranty claims accurately;
- general economic conditions, both domestically and in our foreign markets, and economic conditions specifically affecting industries in which our customers participate, such as the impact of the continuing instability in global and U.S. economic and financial market conditions; and
- the impact of Accounting Standards Codification, or ASC, Topic ASC 740-10, *Accounting for Uncertainty in Income Taxes*, which requires us to establish reserves for uncertain tax positions and accrue potential tax penalties and interest.

Our sales cycle is long and unpredictable, and our sales efforts require considerable time and expense. As a result, our revenues are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

Our operating results may fluctuate, in part, because of the intensive nature of our sales efforts, the length and variability of the sales cycle of our ESM products and the short-term difficulty in adjusting our operating expenses. Because decisions to purchase products such as our ESM products involve significant capital commitments by customers, potential customers generally have our products evaluated at multiple levels within an organization, each often having specific and conflicting requirements. Enterprise customers make product purchasing decisions based in part on factors not directly related to the features of the products, including but not limited to the customers projections of business growth, uncertainty regarding economic conditions, capital budgets and anticipated cost savings from implementation of the software. As a result of these factors, selling our products often requires an extensive effort throughout a customer s organization. The continuing instability in global and U.S. economic and financial market conditions has increased the duration of our sales cycle and requires greater intensity of our sales efforts as customers review their spending decisions. In addition, we have less experience with sales of ArcSight Express and some of our other appliance products. As a result, the sales cycle for these products may be lengthy or may vary significantly. Our sales efforts involve educating our customers, who are often relatively unfamiliar with our products and their technical capabilities, as well as the value of our products, including the potential cost savings to the organization that our products may generate. We spend substantial time, effort and money in our sales efforts without any assurance that our efforts will produce any sales.

The length of our sales cycle, from initial evaluation to delivery of products, tends to be long and varies substantially from customer to customer. Our sales cycle is typically three to six months but can extend to more than a year for some sales. We typically recognize a large portion of our product revenues in the last few weeks of a quarter. It is difficult to predict exactly when, or even if, we will actually make a sale with a potential customer. As a result, large individual sales have, in some cases, occurred in quarters subsequent to those we anticipated, or have not occurred at all. The loss or delay of one or more large product transactions in a quarter could impact our operating results for that quarter and any future quarters for which revenues from that transaction are delayed. As a result of these factors, it is difficult for us to accurately forecast product revenues in any quarter. Because a substantial portion of our expenses are relatively fixed in the short-term, our operating results will suffer if revenues fall below our expectations in a particular quarter, which could cause the price of our common stock to decline significantly.

Table of Contents

If we fail to enhance and manage our distribution channels, our revenues could decline and our growth prospects could suffer.

We derive a portion of our revenues from sales of our products and related services through channel partners, such as resellers and systems integrators. In particular, systems integrators are an important source of sales leads for us in the U.S. public sector, as government agencies often rely on them to meet information technology, or IT, needs. We also use resellers to augment our internal resources in international markets and domestically. We may be required by our U.S. government customers to utilize particular resellers that may not meet our criteria for creditworthiness, and revenues from those resellers may not be recognizable until receipt of payment. We have derived, and anticipate that in the future we will continue to derive, a substantial portion of the sales of ArcSight Logger and other appliance products through channel partners, including parties with which we have not yet developed relationships. We expect that channel sales will represent a substantial portion of our revenues for the foreseeable future. In order to scale our channel program to support growth in our business, it is important that we continue to help our partners enhance their ability to independently sell and deploy our products. We may be unable to continue to successfully expand and improve the effectiveness of our channel sales program. If we do not successfully execute our strategy to increase channel sales, particularly to further develop relationships with systems integrators to facilitate sales to large enterprises and agencies of the U.S. government, penetrate the mid-market and sell our appliance products, our growth prospects may be materially and adversely affected.

Our agreements with our channel partners are generally non-exclusive and many of our channel partners have more established relationships with our competitors. If our channel partners do not effectively market and sell our products, if they choose to place greater emphasis on products of their own or those offered by our competitors, or if they fail to meet the needs of our customers, our ability to grow our business and sell our products may be adversely affected. Similarly, the loss of a substantial number of our channel partners, who may cease marketing our products and services with limited or no notice and with little or no penalty, and our possible inability to replace them, the failure to recruit additional channel partners, or any reduction or delay in their sales of our products and services or conflicts between channel sales and our direct sales and marketing activities could materially and adversely affect our results of operations. In addition, increases in the proportion of our revenues attributable to sales by channel partners, which are more likely than direct sales to involve collectability concerns at the time of contract execution and product delivery, in particular with channel partners in developing markets, may cause our operating results to fluctuate from period to period.

We have a history of losses, and we may not be profitable in the future.

We believe that the market for our products is still in the early stages of development, but may be entering a stage of more widespread adoption. Because the market for our products is rapidly evolving and has not yet reached widespread adoption, it is difficult for us to predict our operating results and the ultimate size of the market for our products. Although we recorded net income of $3.0 million, $28.4 million and $9.9 million for the three months ended July 31, 2010 and the fiscal years ended April 30, 2010 and April 30, 2009, respectively, we have a history of losses from operations, incurring losses from operations of $1.4 million, $0.3 million and $16.8 million for the fiscal years ended April 30, 2008, 2007 and 2006, respectively. As of July 31, 2010, our accumulated deficit was $5.4 million. We expect our operating expenses to increase over the next several years as we hire additional sales and marketing personnel, expand and improve the effectiveness of our distribution channel program and develop our technology and new products. In addition, we have incurred, and anticipate that we will continue to incur, significant legal, accounting and other expenses relating to being a public company. If our revenues do not increase to offset these expected increases in operating expenses, we may not continue to be profitable in future periods. Our historical revenue growth has been inconsistent and should not be considered indicative of our future performance. See the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations Sources of Revenue, Cost of Revenues and Operating Expenses. Further, in future periods, our revenues could decline and, accordingly, we may not be able to sustain or increase profitability on a consistent basis, which may result in a decline in our common stock price.

If we are unable to successfully develop and market new products, make enhancements to our existing products or expand our offerings into new markets, our business may not grow and our operating results may suffer.

We introduced our most recent ArcSight ESM product in June 2010 and we are currently developing new versions of this product and our Logger product, as well as developing new products in our ETRM platform and new complementary products. Our growth strategy and future financial performance will depend, in part, on our ability to market and sell these products and to diversify our offerings by successfully developing, timely introducing and gaining customer acceptance of new products.

The software in our products, particularly our ArcSight ESM and ArcSight Express products, is especially complex because it must recognize, effectively interact with and manage a wide variety of devices and applications, and identify and respond to new and increasingly sophisticated security threats and other risks, while not impeding the high network performance demanded by our customers. The typical development cycle for a patch to our ESM software is one to three months, a service pack is usually four to six months and a new version or major sub-version is generally 12 to 18 months, and are released when and if available. Customers and industry analysts expect speedy introduction of software to respond to new threats and risks and to add new functionality, and we may be unable to meet these expectations. Since developing new products or new versions of, or add-ons to, existing products is complex, the timetable for their commercial release is difficult to predict and may vary from our historical experience, which could result in delays in their introduction from anticipated or announced release dates. We may not offer updates as rapidly as new threats affect our customers. 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, business and growth prospects will be harmed.

Diversifying our product offerings and expanding into new markets will require significant investment and planning, will bring us more directly into competition with software providers that may be better established or have greater resources than we do, will require additional investment of time and resources in the development and training of our channel and strategic partners and will entail significant risk of failure. Sales of our ArcSight Logger and ArcSight Express products and other products that we may develop and market may reduce revenues of our flagship ESM product and our overall margin by offering a subset of features or capabilities of our flagship ESM product at a reduced price with a lower gross margin. If the average selling price for orders of such alternate products is lower, we may need to sell to a larger number of customers to achieve equivalent revenues, potentially incurring increased sales, marketing and general and administrative expenses in support of those sales. Moreover, increased emphasis on the sale of our appliance products, add-on products or new product lines could distract us from sales of our core ArcSight ESM offering, negatively affecting our overall sales. If we fail or delay in diversifying our existing offerings or expanding into new markets, or we are unsuccessful competing in these new markets, our business, operating results and prospects may suffer.

Our business depends, in part, on sales to the public sector, and significant changes in the contracting or fiscal policies of the public sector could have a material adverse effect on our business.

We derive a portion of our revenues from contracts with federal, state, local and foreign governments and government agencies, and we believe that the success and growth of our business will continue to depend on our successful procurement of government contracts. For example, we have historically derived, and expect to continue to derive, a significant portion of our revenues from sales to agencies of the U.S. federal government, either directly by us or through systems integrators and other resellers. In the three months ended July 31, 2010 and the fiscal years ended April 30, 2010, 2009 and 2008, we derived 31%, 32%, 22% and 20% of our revenues, respectively, from contracts with agencies of the U.S. federal government. Accordingly:

- changes in fiscal or contracting policies or decreases in available government funding;
- changes in government programs or applicable requirements;
- the adoption of new laws or regulations or changes to existing laws or regulations;
- changes in political or social attitudes with respect to security issues; and
- potential delays or changes in the government appropriations process, including actions such as spending freezes implemented to address political or fiscal policy concerns,

could cause governments and governmental agencies to delay or refrain from purchasing the products and services that we offer in the future or otherwise have an adverse effect on our business, financial condition and results of operations.

We face intense competition in our market, and we may be unable to simultaneously compete effectively for enterprise threat and risk management opportunities at both the large enterprise level and for smaller mid-size

customers.

The market for enterprise threat and risk management products is intensely competitive, and we expect competition to increase in the future. We believe that there are three primary sources of competition or potential competition for our products and related professional services:

- custom internal efforts;
- specialized startup companies; and
- large software companies.

A significant source of competition, is represented by custom efforts undertaken by potential customers to analyze and manage the information produced from their existing devices and applications to identify and remediate threats and satisfy compliance requirements. While we believe that over the last several years a declining portion of potential customers are undertaking such custom efforts, that apparent trend may not continue. In addition, some organizations have outsourced these functions to managed security services providers.

For customers that choose to purchase a commercial product rather than developing their own solution, a significant number of specialized, privately-held companies, such as LogLogic, netForensics, NitroSecurity, Q1 Labs and SenSage, have developed, or are developing, products that currently, or in the future are likely to, compete with some or all of our products. This includes companies with log management products that are adding SIEM functionality to their offerings and SIEM companies adding some form of log management product to their offerings, as the two fields converge.

We also continue to experience competition from several larger security-focused software vendors, such as EMC, that offer functionality such as ours, primarily SIEM, as a component of suites of products that include software applications for security and compliance and enterprise management, and in some cases as a point solution. Further, as the market for our enterprise threat and risk management platform continues to grow, we expect that large diversified enterprise software and hardware vendors may seek to enter this market, either by way of the organic development of a competing product line or through the acquisition of a competitor. Competitors that offer a large array of security or software products may be able to offer products or functionality similar to ours at a more attractive price than we can by integrating or bundling them with their other product offerings.

We anticipate that mergers, acquisitions or consolidations by and among actual and potential competitors will continue to accelerate. For example, in the last five years, Intel has recently announced an agreement to acquire McAfee, IBM has acquired Internet Security Systems, Inc., Micromuse and Consul, Novell acquired e-Security, EMC acquired Network Intelligence and Archer Technologies and TrustWave acquired Intellitactics. Acquisitions such as these present heightened competitive challenges to our business. The consolidation in our industry increases the likelihood of competition based on integration or bundling, particularly where their products and offerings are effectively integrated, and we believe that consolidation in our industry may increase the competitive pressures we face on all our products. If we are unable to sufficiently differentiate our products from the integrated or bundled products of our competitors, such as by offering enhanced functionality, performance or value, we may see a decrease in demand for those products, which would adversely affect our business, operating results and financial condition. Further, it is possible that continued industry consolidation may impact customers perceptions of the viability of smaller or even medium-sized software firms and consequently customers willingness to purchase from such firms. Similarly, if customers seek to concentrate their software purchases in the product portfolios of a few large providers, we may be at a competitive disadvantage notwithstanding the superior performance that we believe our products can deliver. We believe that in order to remain competitive at the large enterprise level, we will need to develop and expand relationships with the large system integrators that provide broad ranging products and services for these governmental and civilian customers.

A number of our existing and potential competitors enjoy substantial competitive advantages, such as:

- greater name recognition and longer operating histories;
- larger sales and marketing budgets and resources;
- the capacity to leverage their sales efforts and marketing expenditures across a broader portfolio of products;
- broader distribution and established relationships with distribution partners;

access to larger customer bases;

greater customer support;

greater resources to make acquisitions;

wider geographic presence;

lower labor and development costs; and

substantially greater financial, technical and other resources.

As a result, they may be able to adapt more quickly and effectively to new or emerging technologies and changing opportunities, standards or customer requirements. In addition, these companies have reduced, and could continue to reduce, the price of their enterprise security and compliance management, log collection and storage products and managed security services, resulting in intensified pricing pressures within our market.

We may not compete successfully against our current or potential competitors. Companies competing with us may introduce products that have greater performance or functionality, are easier to implement or use, or incorporate technological advances that we have not yet developed or implemented. In addition, companies competing with us may price their products more competitively than ours, or have an entirely different pricing or distribution model, such as making introductory versions with limited functionality available as freeware products. Further, wide adoption of our Common Event Format, which we are promoting as a standard for event logs generated by security and other products, may facilitate development by our competitors and potential competitors.

Increased competition could result in fewer customer orders, price reductions, reduced operating margins and loss of market share. Our larger competitors and potential competitors may be able to provide customers with different or greater capabilities or benefits than we can provide in areas such as technical qualifications or geographic presence, or to provide customers a broader range of services and products and price. In addition, large competitors may have more extensive relationships within large enterprises, the federal government or foreign governments, which relationships may provide them with an advantage in competing for business with those potential customers. We may be required to make substantial additional investments in research, development, marketing and sales in order to respond to competition, and we cannot assure you that we will be able to compete successfully in the future.

We may not be able to compete effectively with companies that integrate or bundle products similar to ours with their other product offerings.

Many large, integrated software companies offer suites of products that include software applications for security and compliance management. In addition, hardware vendors, including diversified, global concerns, offer products that address the security and compliance needs of the enterprises and government agencies that comprise our target market. Further, several companies currently sell software products that our customers and potential customers have broadly adopted, providing them a substantial advantage when they sell products that perform functions substantially similar to some of our products. Competitors that offer a large array of security or software products may be able to offer products or functionality similar to ours at a more attractive price than we can by integrating or bundling them with their other product offerings. The consolidation in our industry increases the likelihood of competition based on integration or bundling. Customers may also increasingly seek to consolidate their enterprise-level software purchases with a small number of larger companies that can purport to satisfy a broad range of their requirements. If we are unable to sufficiently differentiate our products from the integrated or bundled products of our competitors, such as by offering enhanced functionality, performance or value, we may see a decrease in demand for our products, which would adversely affect our business, operating results and financial condition. Similarly, if customers seek to concentrate their software purchases with a few large providers, we may be at a competitive disadvantage.

If we are unable to maintain and further develop our relationships with our existing customers, our operating results may decline.

In recent years, the majority of our product revenues has come from sales to existing customers. Many customers make an initial purchase from us and then decide to use our products with respect to a larger portion of their business and technology infrastructure or buy additional complementary products from us. Part of our strategy is to further penetrate our existing customers by expanding their use of our platform across the enterprise and extending their use of our products to new use cases. 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 and services from us, or make follow-on purchases at lower than historical levels.

If we are not able to maintain and enhance our brand, our business and operating results may be harmed.

We believe that maintaining and enhancing our brand identity is critical to our relationships with, and to our ability to attract, new customers and partners. The successful promotion of our brand will depend largely upon our marketing and public relations efforts, our ability to continue to offer high-quality products and services, and our ability to successfully differentiate our products and services from those of our competitors, especially to the extent that our competitors integrate or bundle competitive offerings with a broader array of products and services that they may offer. Our brand promotion activities may not be successful or yield increased revenues. In addition, extension of our brand to products and uses different from our traditional products and services may dilute our brand, particularly if we fail to maintain the quality of our products and services in these new areas. Moreover, it may be difficult to maintain and enhance our brand in connection with sales through channel or strategic partners. The promotion of our brand requires us to make substantial expenditures, and we anticipate that the expenditures will increase as our market becomes more competitive and as we expand into new markets and as more sales are through our channel partners. To the extent that these activities yield increased revenues, these revenues may not offset the expenses we incur. If we do not successfully maintain and enhance our brand, our business may not grow, we may have reduced pricing power relative to competitors with stronger brands, and we could lose customers and channel partners, all of which would harm our business, operating results and financial condition.

In addition, independent industry analysts often provide reviews of our products and services, as well as those of our competitors, and perception of our products in the marketplace may be significantly influenced by these reviews. We have no control over what these industry analysts report, and because industry analysts may influence current and potential customers, our brand could be harmed if they do not provide a positive review of our products and services or view us as a market leader.

We may have difficulty forecasting demand for our appliance products and, because we primarily rely on a single contract manufacturer for manufacture and fulfillment of our appliance products, we may be unable to fulfill orders for these appliance products.

Fulfillment of sales of our appliance products involves hardware manufacturing, inventory, import certification and return merchandise authorization processes. If we fail to accurately predict demand and as a result our manufacturers maintain insufficient hardware inventory or excess inventory, we may be unable to timely deliver ordered products or may have substantial inventory expense. Because our channel partners do not purchase our products in advance of customer orders, we may face additional difficulty in accurately forecasting demand for our hardware products. This difficulty in forecasting could increase as the number of sales transactions that do not directly involve our sales force increases, which is one of the goals of our channel program, since we have limited historical experience upon which to base forecasts for these types of sales transactions. Further, as the size of individual orders increases, we may be unable to cause delivery of unforecasted orders, particularly near the end of quarterly periods. In addition, we primarily use one source for the manufacture and fulfillment of our appliance products. If this equipment vendor fails to manufacture our appliance products or fulfill orders in required volumes, in a timely manner, at a sufficient level of quality, or at all, if it is no longer financially viable or for other reasons, we may be unable to fulfill customer orders and our operating results may fluctuate from period to period, particularly if a disruption occurs near the end of a fiscal period. Disruptions in the manufacture and fulfillment of our products could damage our reputation and relationships with our customers and result in revenue declines and a negative effect on our growth prospects. In addition, if we change our hardware configuration or manufacturer, some countries may require us to reinitiate their import certification process. If we are unable to successfully perform these functions or maintain a relationship with a fulfillment partner that does so for us, our sales, operating results and financial condition may be harmed. In addition, the process of obtaining additional or alternative capacity with a different contract manufacturer would likely result in an increase of cost of goods sold, which could negatively impact our financial performance if we are unable to offset such increases with increases in the prices we charge our customers.

We face risks related to customer outsourcing to managed security service providers.

Some of our customers have outsourced the management of their IT departments or the network security operations function to large systems integrators or managed security service providers, or MSSPs. If this trend continues, our established customer relationships could be disrupted and our products could be displaced by alternative system and network protection solutions offered by systems integrators or MSSPs. Significant product displacements could impact our revenues and have a negative effect on our business. While to date we have developed a number of successful relationships with MSSPs, they may develop or acquire their own technologies rather than purchasing our products for use in provision of managed security services.

Seasonality may cause fluctuations in our operating results.

We believe that our product revenue has been seasonal historically, increasing in each quarter through the fiscal year, but with the first quarter of our fiscal year having relatively lower product revenue compared to the prior fourth fiscal quarter. However, we believe that there are significant seasonal factors that may cause the second and fourth quarters of our fiscal year to have relatively

Table of Contents

higher product revenue (with the first and third fiscal quarters each potentially having lower revenue than the immediately preceding fiscal quarter). We believe that this seasonality results from a number of factors, including:

- the timing of our annual sales club for top performers and annual training for our entire sales force in our first fiscal quarter;
- the fiscal year end procurement cycle of our government customers;
- the budgeting, procurement and work cycles of our customers, including customers in the public sector;
- seasonal reductions in business activity during the summer months in the United States, Europe and certain other regions; and
- the structure of our direct sales incentive and compensation program, which may reinforce the tendency of our direct sales team to book the largest volume of deals toward the end of our fiscal year.

We believe that our rapid historical growth and the required timing of new compliance mandates may have overshadowed the nature or magnitude of seasonal or cyclical factors that might have influenced our business to date. In addition, the timing of one or more large transactions may overshadow seasonal factors in any particular quarterly period. In the future, we may experience growth from additional compliance and cybersecurity mandates that could continue to mask underlying seasonal purchasing decisions by our customers. Seasonal or cyclical variations in our operations may become more pronounced over time and may materially affect our results of operations in the future.

For example, as noted above, the timing of our fiscal quarters and the U.S. federal government s September 30 fiscal year end may impact product sales to governmental agencies in the second quarter of our fiscal year, offsetting the otherwise seasonal downturn in later summer months. Government spending on cybersecurity and new compliance mandates may drive customer demand at different times throughout our fiscal year, the timing of which we may not be able to anticipate and may cause fluctuations in our operating results. In addition, sales to customers with a standard December 31 fiscal year end may have a positive impact on our license revenue in the third quarter of our fiscal year, potentially offsetting the impact of the major holidays during the period. We expect seasonality to continue to impact our business in the future.

Failure to comply with laws or regulations applicable to our business could cause us to lose U.S. government customers or our ability to contract with the U.S. government.

We must comply with laws and regulations relating to the formation, administration and performance of U.S. government contracts, which affect how we and our channel partners do business with U.S. government agencies. These laws and regulations may impose added costs on our business, and failure to comply with these or other applicable regulations and requirements, including non-compliance in the past, could lead to claims for damages from our channel partners, and penalties, termination of contracts and suspension or debarment from government contracting for a period of time with U.S. government agencies. Any such damages, penalties, disruption or limitation in our ability to do business with the U.S. government could have a material adverse effect on our business, operating results and financial condition.

Our government contracts may limit our ability to move development activities overseas and to source components from some countries, which may impair our ability to optimize our product development costs and compete for non-government contracts.

Increasingly, product development and component sourcing are being shifted to lower-cost countries, such as India and China. However, some contracts with U.S. government agencies require that at least 50% of the components of each of our products be of U.S. origin or that each product be substantially transformed in the U.S. or in a country on the U.S. government s list of designated countries. Consequently, our ability to optimize our product development by conducting it overseas and to lower our costs of goods sold by sourcing from lower cost regions may be hampered. Some of our competitors do not rely on contracts with the U.S. government to the same degree as we do and may develop product or source components offshore, or may have the scale to permit them to separately source versions of their competing products for sale to customers other than U.S. government agencies. If we are unable to develop product or source components as cost-effectively as our competitors, our ability to compete for our non-government customers may be reduced and our customer sales may decline, resulting in decreased revenues.

Table of Contents

Real or perceived errors, failures or bugs in our products could adversely affect our operating results and growth prospects.

Because we offer very complex products, undetected errors, failures or bugs may occur, especially when products are first introduced or when new versions are released. Our products are often installed and used in large-scale computing environments with different operating systems, system management software and equipment and networking configurations, which may cause errors or failures in our products or may expose undetected errors, failures or bugs in our products. Despite testing by us, errors, failures or bugs may not be found in new products or releases until after commencement of commercial shipments. In the past, we have discovered software errors, failures and bugs in some of our product offerings after their introduction.

In addition, our products could be perceived to be ineffective for a variety of reasons outside of our control. Hackers could circumvent our customers security measures, and customers may misuse our products resulting in a security breach or perceived product failure. We provide a top-level enterprise security and compliance management solution that integrates a wide variety of other elements in a customer s IT and security infrastructure, and we may receive blame for a security breach that was the result of the failure of one of the other elements.

Real or perceived errors, failures or bugs in our products could result in negative publicity, loss of or delay in market acceptance of our products, loss of competitive position or claims by customers for losses sustained by them. In such an event, we may be required, or may choose, for customer relations or other reasons, to expend additional resources in order to help correct the problem. Our product liability insurance may not be adequate. Further, provisions in our license agreements with end users that limit our exposure to liabilities arising from such claims may not be enforceable in some circumstances or may not fully protect us against such claims and related liabilities and costs. Defending a lawsuit, regardless of its merit, could be costly and could limit the amount of time that management has available for day-to-day execution and strategic planning or other matters.

Many of our end-user customers use our products in applications that are critical to their businesses and may have a greater sensitivity to defects in our products than to defects in other, less critical, software products. In addition, if an actual or perceived breach of information integrity or availability occurs in one of our end-user customer s systems, regardless of whether the breach is attributable to our products, the market perception of the effectiveness of our products could be harmed. Alleviating any of these problems could require significant expenditures of our capital and other resources and could cause interruptions, delays or cessation of our product licensing, which could cause us to lose existing or potential customers and could adversely affect our operating results and growth prospects.

In addition, because we are a leading provider of enterprise security products and services, hackers and others may try to access our data or compromise our systems. If we are the subject of a successful attack, then our reputation in the industry and with current and potential customers may be compromised and our sales and operating results could be adversely affected.

Incorrect or improper use of our complex products, our failure to properly train customers on how to utilize our products or our failure to properly provide consulting and implementation services could result in customer dissatisfaction and negatively affect our results of operations and growth prospects.

Our ESM products are complex and are deployed in a wide variety of network environments. The proper use of our products, particularly our ESM products, requires training of the end user. If our products are not used correctly or as intended, inadequate performance may result. For example, among other things, deployment of our ESM products requires categorization of IT assets and assignment of business or criticality values for each, selection or configuration of one of our pre-packaged rule sets, user interfaces and network utilization parameters, and deployment of connectors for the various devices and applications from which event data are to be collected. Our customers or our professional services personnel may incorrectly implement or use our products. Our products may also be intentionally misused or abused by customers or their employees or third parties who obtain access and use of our products. Similarly, our ArcSight Express and Logger products, while less complex than our ESM products, are often distributed through channel partners and sold to customers with smaller or less sophisticated IT departments, potentially resulting in sub-optimal installation. This may result in performance that is less than the level anticipated by the end user. Because our customers rely on our product, service and maintenance offerings to manage a wide range of sensitive security, network and compliance functions, the incorrect or improper use of our products, our failure to properly train customers on how to efficiently and effectively use our products, our failure to properly provide consulting and implementation services and maintenance to our customers or our failure to properly provide services for customer SOCs, may result in negative publicity or legal claims against us. For example, as we continue to expand our provision of SOC services, any failure by us to properly provide these high profile services will likely result in lost opportunities for follow-on sales of our software and appliance products in addition to loss of any opportunity to renew the SOC services arrangement.

In addition, if customer personnel are not well trained in the use of our products, customers may defer the deployment of our products, may deploy them in a more limited manner than originally anticipated or may not deploy them at all. If there is substantial turnover of the customer personnel responsible for implementation and use of our products, our product may go unused and our ability to make additional sales may be substantially limited.

If we are unable to maintain effective relationships with our technology partners, we may not be able to support the interoperability of our software with a wide variety of security and other products and our business may be harmed.

A key feature of ArcSight ESM is that it provides out-of-the-box support for many third-party devices and applications that the customer may use in its business and technology infrastructure. To provide effective interoperability, we work with individual product vendors to develop our SmartConnectors, which allow our ArcSight ESM, ArcSight Logger and ArcSight Express products to interface with third party products. In addition, we are promoting the adoption of our Common Event Format as a standard way to format system log events. Some of these technology partners are current or potential competitors of ours. If we are unable to develop and maintain effective relationships with a wide variety of technology partners, if companies adopt more restrictive policies with respect to, or impose unfavorable terms and conditions on, access to their products, or if our Common Event Format is not widely adopted, we may not be able to continue to provide our customers with a high degree of interoperability with their existing IT and business infrastructure, which could reduce our sales and adversely affect our business, operating results and financial condition.

Our international sales and operations subject us to additional risks that can adversely affect our operating results.

In the three months ended July 31, 2010 and the fiscal years ended April 30, 2010, 2009 and 2008, we derived 27%, 29%, 27% and 33% of our revenues, respectively, from customers outside the United States, and we are continuing to expand our international operations as part of our growth strategy. We currently have sales personnel and sales and support operations in Australia, Brazil, Canada, China, Dubai, France, Germany, Hong Kong, India, Italy, Japan, Mexico, the Netherlands, Poland, Singapore, Spain and the United Kingdom. Our international operations subject us to a variety of risks, including:

- increased management, travel, infrastructure and legal compliance costs associated with having multiple international operations;
- longer payment cycles and difficulties in collecting accounts receivable, especially in emerging markets, and the likelihood that revenues from international resellers and customers may need to be recognized when cash is received, at least until satisfactory payment history has been established;
- the need to localize our products and licensing programs for international customers;
- differing regulatory and legal requirements and possible enactment of additional regulations or restrictions on the use, import or export of encryption technologies and our appliance-based products, which could delay or prevent the sale or use of our products in some jurisdictions;
- weaker protection of intellectual property rights in some countries; and
- overlapping of different tax regimes.

Any of these risks could harm our international operations and reduce our international sales, adversely affecting our business, operating results and financial condition and growth prospects.

Our business in countries with a history of corruption and transactions with foreign governments increase the risks associated with our international activities.

As we operate and sell internationally, we are subject to the U.S. Foreign Corrupt Practices Act, or the FCPA, and other laws that prohibit improper payments or offers of payments to foreign governments and their officials and political parties by U.S. and other business entities for the purpose of obtaining or retaining business. We have operations, deal with and make sales to governmental or quasi-governmental customers in countries known to experience corruption, particularly certain emerging countries in East Asia, Eastern Europe, the Middle East, Russia and South America. Our activities in these countries create the risk of unauthorized payments or offers of payments by one of our employees, consultants, sales agents or channel partners that could be in violation of various laws, including the FCPA, even though these parties are not always subject to our control. We have implemented safeguards to discourage these practices by our employees, consultants, sales agents and channel partners. However, our existing safeguards and any future improvements may prove to be less than effective, and our employees, consultants, sales agents or channel partners may engage in conduct for which we might be held responsible. Violations of the FCPA may result in severe criminal or civil sanctions, including suspension or debarment from U.S. government contracting, and we may be subject to other liabilities, which could negatively affect our business, operating results and financial condition.

Failure to protect our intellectual property rights could adversely affect our business.

Our success depends, in part, on our ability to protect proprietary methods and technologies that we develop under patent and other intellectual property laws of the United States, so that we can prevent others from using our inventions and proprietary information. If we fail to protect our intellectual property rights adequately, our competitors might gain access to our technology, and our business might be harmed. In addition, defending our intellectual property rights might entail significant expenses. Any of our patents, copyrights, trademarks or other intellectual property rights may be challenged by others or invalidated through administrative process or litigation. We have thirteen issued patents and a number of patent applications pending in the United States, internationally and in specific foreign countries. Our issued patents may not provide us with any competitive advantages or may be challenged by third parties, and our patent applications may never be granted at all. Additionally, the process of obtaining patent protection is expensive and time-consuming, and we may not be able to prosecute all necessary or desirable patent applications at a reasonable cost or in a timely manner. Even if issued, there can be no assurance that these patents will adequately protect our intellectual property, as the legal standards relating to the validity, enforceability and scope of protection of patent and other intellectual property rights are uncertain.

Any patents that are issued may subsequently be invalidated or otherwise limited, enabling other companies to better develop products that compete with ours, which could adversely affect our competitive business position, business prospects and financial condition. In addition, issuance of a patent does not guarantee that we have a right to practice the patented invention. Patent applications in the U.S. are typically not published until 18 months after filing, or in some cases not at all, and publications of discoveries in industry-related literature lag behind actual discoveries. We cannot be certain that we were the first to make the inventions claimed in our issued patents or pending patent applications or otherwise used in our products, that we were the first to file for protection in our patent applications, or that third parties do not have blocking patents that could be used to prevent us from marketing or practicing our patented products or technology. Effective patent, trademark, copyright and trade secret protection may not be available to us in every country in which our products and services are available. The laws of some foreign countries may not be as protective of intellectual property rights as those in the United States, and mechanisms for enforcement of intellectual property rights may be inadequate. Accordingly, despite our efforts, we may be unable to prevent third parties from infringing upon or misappropriating our intellectual property.

We might be required to spend significant resources to monitor and protect our intellectual property rights. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel, which may adversely affect our business, operating results and financial condition.

Confidentiality agreements with employees and others may not adequately prevent disclosure of trade secrets and other proprietary information.

In order to protect our proprietary technology, processes and methods, we rely in part on confidentiality agreements with our partners, employees, consultants, advisors and others. These agreements may not effectively prevent disclosure of confidential information and may not provide an adequate remedy in the event of unauthorized disclosure of confidential information. In addition, others may independently discover trade secrets and proprietary information, and in these cases we would not be able to assert any trade secret rights against those parties. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain trade secret protection could adversely affect our competitive business position.

Table of Contents

We may in the future be subject to intellectual property rights claims, which are extremely costly to defend, could require us to pay significant damages and could limit our ability to use certain technologies.

Companies in the software, networking and technology industries, including some of our current and potential competitors, own large numbers of patents, copyrights, trademarks and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. In addition, many of these companies have the capability to dedicate substantially greater resources to enforce their intellectual property rights and to defend claims that may be brought against them. The litigation may involve patent holding companies or other adverse patent owners who have no relevant product revenues and against whom our potential patents may provide little or no deterrence. We have received, and may in the future receive, notices that claim we have misappropriated or misused other parties intellectual property rights, and, to the extent we gain greater visibility, we face a higher risk of being the subject of intellectual property infringement claims, which is not uncommon with respect to software technologies in general and network security technology in particular. There may be third-party intellectual property rights, including issued or pending patents, that cover significant aspects of our technologies or business methods. Any intellectual property claims, with or without merit, could be very time-consuming, could be expensive to settle or litigate and could divert our management s attention and other resources. These claims could also subject us to significant liability for damages, potentially including treble damages if we are found to have willfully infringed patents or copyrights. These claims could also result in our having to stop using technology found to be in violation of a third party s rights. We might be required to seek a license for the intellectual property, which may not be available on reasonable terms or at all. Even if a license were available, we could be required to pay significant royalties, which would increase our operating expenses. As a result, we may be required to develop alternative non-infringing technology, which could require significant effort and expense. If we cannot license or develop technology for any infringing aspect of our business, we would be forced to limit or stop sales of one or more of our products or product features and may be unable to compete effectively. Any of these results would harm our business, operating results and financial condition.

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 in order to provide certain elements of our product offering. For example, we license database software from Oracle that we integrate with our ESM product. Our agreement with Oracle permits us to distribute Oracle software in our products to our customers and partners worldwide through May 2011. See the section entitled Item 1. Business Intellectual Property Oracle License Agreement in Part I of our Annual Report on Form 10-K for the fiscal year ended April 30, 2010. Any errors or defects in this third-party software could result in errors that could harm our business. In addition, licensed software may not continue to be available on commercially reasonable terms, or at all. While we believe that there are currently adequate replacements for third-party software, any loss of the right to use any of this software could result in delays in producing or delivering our software until equivalent technology is identified and integrated, which delays could harm our business. 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 to 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.

If we are unable to attract and retain personnel, our business would be harmed.

We depend on the continued contributions of our senior management and other key personnel, in particular Tom Reilly and Hugh Njemanze, the loss of whom could harm our business. All of our executive officers and key employees are at-will employees, which means they may terminate their employment relationship with us at any time. We do not maintain a key-person life insurance policy on any of our officers or other employees.

Our future success also depends on our ability to identify, attract and retain highly skilled technical, managerial, finance and other personnel, particularly in our sales and marketing, research and development and professional service departments. We face intense competition for qualified individuals from numerous security, software and other technology companies. In addition, competition for qualified personnel is particularly intense in the San Francisco Bay Area, where our headquarters are located. Often, significant amounts of time and resources are required to train technical, sales and other personnel. Qualified individuals are in high demand. We may incur significant costs to attract and retain them, and we may lose new employees to our competitors or other technology companies before we realize the benefit of our investment in recruiting and training them. We may be unable to attract and retain suitably qualified individuals who are capable of meeting our growing technical, operational and managerial requirements, on a timely basis or at all, and we may be required to pay increased compensation in order to do so. If we are unable to attract and retain the qualified personnel we need to succeed, our business would suffer.

Volatility or lack of performance in our stock price may also affect our ability to attract and retain our key employees. Many of our senior management personnel and other key employees have become, or will soon become, vested in a substantial amount of stock or stock options. Employees may be more likely to leave us if the shares they own or the shares underlying their vested options have significantly appreciated in value relative to the original purchase prices of the shares or the exercise prices of the options, or if the exercise prices of the options that they hold are significantly above the market price of our common stock. If we are unable to retain our employees, our business, operating results and financial condition would be harmed.

If we fail to manage future growth effectively, our business would be harmed.

We operate in an emerging market and have experienced, and may continue to experience, significant expansion of our operations. In particular, we grew from 400 employees as of April 30, 2009 to 512 employees as of April 30, 2010, and then to 526 employees as of July 31, 2010. This growth has placed, and will continue to place, a strain on our employees, management systems and other resources. Managing our growth will require significant expenditures and allocation of valuable management resources. If we fail to achieve the necessary level of efficiency in our organization as it grows, our business, operating results and financial condition would be harmed.

Some of our products contain open source software, and any failure to comply with the terms of one or more of these open source licenses could negatively affect our business.

Certain of our products are distributed with software licensed under open source licenses. Some of these licenses contain requirements that we make available source code for modifications or derivative works we create based upon the open source software, and that we license these modifications or derivative works under the terms of a particular open source license or other license granting third parties certain rights of further use. If we combine our proprietary software with open source software in a certain manner, we could, under certain provisions of the open source licenses, be required to release the source code of our proprietary software. In addition to risks related to license requirements, usage of open source software can lead to greater risks than use of third-party commercial software, as open source licensors generally do not provide warranties or controls on origin of the software. We have established processes to help alleviate these risks, including a review process for screening requests from our development organization for the use of open source software, but we cannot be sure that all open source software is submitted for approval prior to use in our products. In addition, open source license terms may be ambiguous and many of the risks associated with usage of open source software cannot be eliminated, and could, if not properly addressed, negatively affect our business. If we were found to have inappropriately used open source software, we may be required to re-engineer our products, to release proprietary source code, to discontinue the sale of our products in the event re-engineering could not be accomplished on a timely basis or to take other remedial action that may divert resources away from our development efforts, any of which could adversely affect our business, operating results and financial condition.

Indemnity provisions in various agreements potentially expose us to substantial liability for intellectual property infringement and other losses.

Our agreements with customers and channel partners include indemnification provisions under which we agree to indemnify them for losses suffered or incurred as a result of claims of intellectual property infringement and, in some cases, for damages caused by us to property or persons. The term of these indemnity provisions is generally perpetual after execution of the corresponding product sale agreement. Large indemnity payments could harm our business, operating results and financial condition.

Changes or reforms in the law or regulatory landscape could diminish the demand for our solutions, and could have a negative impact on our business.

One factor that drives demand for our products and services is the legal and regulatory framework in which our customers operate. Laws and regulations are subject to drastic changes, and these could either help or hurt the demand for our products. Thus, some changes in the law and regulatory landscape, such as legislative reforms that limit corporate compliance obligations, could significantly harm our business.

51

Table of Contents

Future acquisitions could disrupt our business and harm our financial condition and results of operations.

We have expanded by acquisition in the past, and we may pursue additional acquisitions in the future, any of which could be material to our business, operating results and financial condition. Our ability as an organization to successfully acquire and integrate technologies or businesses on a larger scale is unproven. Acquisitions involve many risks, including the following:

- an acquisition may negatively impact our results of operations because it may require us to incur charges and substantial debt or liabilities, may cause adverse tax consequences, substantial depreciation or deferred compensation charges, may result in acquired in-process research and development expenses or in the future may require the amortization, write-down or impairment of amounts related to deferred compensation, goodwill and other intangible assets, or may not generate sufficient financial return to offset acquisition costs;
- we may encounter difficulties or unforeseen expenditures in integrating the business, technologies, products, personnel or operations of any company that we acquire, particularly if key personnel of the acquired company decide not to work for us;
- an acquisition may disrupt our ongoing business, divert resources, increase our expenses and distract our management;
- an acquisition may result in a delay or reduction of customer purchases for both us and the company acquired due to customer uncertainty about continuity and effectiveness of service from either company;
- we may encounter difficulties in, or may be unable to, successfully sell any acquired products; and
- an acquisition may involve the entry into geographic or business markets in which we have little or no prior experience.

If we fail to maintain an effective system of internal controls, our ability to produce accurate financial statements or comply with applicable regulations could be impaired.

As a public company, we are subject to the reporting requirements of the Exchange Act, the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, and the rules and regulations of The NASDAQ Stock Market. We expect that the requirements of these rules and regulations will continue to increase our legal, accounting and financial compliance costs, make some activities more difficult, time-consuming and costly and place undue strain on our personnel, systems and resources.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and internal control over financial reporting. We are continuing to develop and refine our disclosure controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file with the SEC is recorded, processed, summarized and reported within the time periods specified in SEC s rules and forms. As part of this effort, we have licensed, and are in the process of completing the first phase of the implementation of, a new company-wide integrated enterprise resource planning, or ERP, system to handle our various business, operating and financial processes. In addition, we are in the process of planning and implementing additional phases of our full ERP system. The implementation of the ERP system has been and will continue to be an extremely complex and time-consuming project. If we failed to properly implement the first phase, or we experience delays in or improper implementation of future phases, of the new ERP system, we may fail to maintain effective internal control over financial reporting and our operating results may suffer.

Our current controls and any new controls that we develop may become inadequate because of changes in conditions, and the degree of compliance with the policies or procedures may deteriorate. Further, weaknesses in our internal controls may be discovered in the future. Any failure to develop or maintain effective controls, or any difficulties encountered in their implementation or improvement, could harm our operating results or cause us to fail to meet our reporting obligations and may result in a restatement of our prior period financial statements. Any failure to implement and maintain effective internal controls also could adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding the effectiveness of our internal control over financial reporting that we are required to include in our periodic reports filed with the SEC under Section 404 of the Sarbanes-Oxley Act. Ineffective disclosure controls and procedures and internal control over financial reporting could also cause investors to lose confidence in our reported financial and other information, which would likely have a negative effect on the trading price of our common stock.

In order to maintain and improve the effectiveness of our disclosure controls and procedures and internal control over financial

Table of Contents

reporting, we have expended, and anticipate that we will continue to expend, significant resources and provide significant management oversight, which involve substantial accounting-related costs. Any failure to maintain the adequacy of our internal controls, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and could materially impair our ability to operate our business. In the event that we are not able to continue to demonstrate compliance with Section 404 of the Sarbanes-Oxley Act in a timely manner, that our internal controls are perceived as inadequate or that we are unable to produce timely or accurate financial statements, investors may lose confidence in our operating results and our stock price could decline. In addition, if we are unable to continue to meet these requirements, we may not be able to remain listed on The NASDAQ Global Market.

We have not yet implemented a complete disaster recovery plan or business continuity plan for our accounting and related information technology systems. Any disaster could therefore materially impair our ability to maintain timely accounting and reporting.

We may not be able to utilize a significant portion of our net operating loss carry-forwards, which could adversely affect our operating results.

Due to prior period losses, we have generated significant federal and state net operating loss carry-forwards, which expire beginning in fiscal 2020 and fiscal 2015, respectively. U.S. federal and state income tax laws limit the amount of these carry-forwards we can utilize upon a greater than 50% cumulative shift of stock ownership over a three-year period, including shifts due to the issuance of additional shares of our common stock, or securities convertible into our common stock. We have previously experienced a greater than 50% shift in our stock ownership, which has limited our ability to use a portion of our net operating loss carry-forwards, and we may experience subsequent shifts in our stock ownership. Accordingly, there is a risk that our ability to use our existing carry-forwards in the future could be further limited and that existing carry-forwards would be unavailable to offset future income tax liabilities, adversely affecting our operating results.

Governmental export or import controls could subject us to liability or limit our ability to compete in foreign markets.

Our products incorporate encryption technology and may be exported outside the U.S. only if we obtain an export license or qualify for an export license exception. Compliance with applicable regulatory requirements regarding the export of our products may prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export of our products to some countries altogether. In addition, various countries regulate the import of encryption technology and our appliance-based products and have enacted laws that could limit our ability to distribute products, could create delays in the introduction of our products in those countries or could limit our customers ability to implement our products in those countries. Any new export or import restrictions, new legislation or shifting approaches in the enforcement or scope of existing regulations, or in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by existing customers with international operations, declining adoption of our products by new customers with international operations and decreased revenues. If we fail to comply with export and import regulations, we may be denied export privileges, be subjected to fines or other penalties and our products may be denied entry into other countries.

We may become a party to litigation that may negatively affect our business results of operations or financial condition.

From time to time, we may become involved in various legal proceedings relating to matters incidental to the ordinary course of our business, including employment litigation. Such matters can be expensive and disruptive to normal business operations. In addition, the outcome of litigation is highly uncertain and an unfavorable outcome in such litigation could have a negative effect on our business, results of operations or financial condition.

Risks Related to Ownership of Our Common Stock

Our stock price may be volatile or may decline regardless of our operating performance.

The trading prices of the securities of technology companies have been highly volatile. The market price of our common stock may fluctuate significantly in response to numerous factors, many of which are beyond our control, including:

actual or anticipated fluctuations in our operating results;

- the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;
- failure of securities analysts to maintain coverage of us, changes in financial estimates by any securities analysts who follow our company, or our failure to meet these estimates or the expectations of investors;
- ratings or other changes by any securities analysts who follow our company or our industry;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- changes in operating performance and stock market valuations of other technology companies generally, or those in our industry in particular;
- price and volume fluctuations in the overall stock market, including as a result of trends in the economy as a whole, such as the continuing volatility in the financial markets;
- rumors and market speculation involving ArcSight or other companies in our industry;
- lawsuits threatened or filed against us; and
- other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

In addition, the stock markets, and in particular The NASDAQ Global Market on which our common stock is listed, have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies, particularly technology companies. Broad market fluctuations such as these may have and could continue to adversely affect the market price of our common stock. Even prior to the continuing volatility in the financial markets, stock prices of many technology companies had fluctuated in a manner unrelated or disproportionate to the operating performance of those companies. In the past, stockholders have instituted securities class action litigation following periods of market volatility. If we were to become involved in securities litigation, it could subject us to substantial costs, divert resources and the attention of management from our business and adversely affect our business, operating results and financial condition.

If securities or industry analysts cease publishing research or publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. Securities analysts and industry analysts that currently cover us may cease to do so, negatively impacting the trading price for our stock. If one or more of the analysts who cover us or our industry downgrade our stock or the stock of other companies in our industry, or publish inaccurate or unfavorable research about our business or industry, our stock price would likely decline. If one or more of these analysts fail to publish reports on us regularly, demand for our stock could decrease, which might cause our stock price and trading volume to decline.

Delaware law, provisions in our restated certificate of incorporation and amended and restated bylaws and the concentration of our ownership could make a merger, tender offer or proxy contest difficult, thereby depressing the trading price of our common stock.

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change of control would be beneficial to our existing stockholders. In addition, our restated certificate of incorporation and amended and restated bylaws contain provisions that may make the acquisition of our company more difficult without the approval of our board of directors, including the following:

- our board of directors is classified into three classes of directors with staggered three-year terms;
- currently only our president and chief executive officer, our lead independent director or a majority of our board of directors is authorized to call a special meeting of stockholders;

our stockholders are only able to take action at a meeting of stockholders and not by written consent;
vacancies on our board of directors are able to be filled only by our board of directors and not by stockholders;
directors may be removed from office only for cause;
our restated certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established, and shares of which may be issued, without stockholder approval; and
advance notice procedures will apply for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

In addition, as of September 1, 2010 our directors and executive officers, together with their affiliates, beneficially own in the aggregate 19.8% of our outstanding common stock (including options exercisable by those holders within 60 days of that date). Further, holders that together with their affiliates, hold 5% or more of our outstanding common stock, but who are not affiliated with our directors and executive officers, beneficially own in the aggregate an additional 20.1% of our outstanding common stock as of September 1, 2010. As a result, our directors and officers and their affiliates, collectively, or our largest stockholders, acting together, may be able to impede a merger, consolidation or sale of all or substantially all of our assets.

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

Use of Proceeds from Public Offering of Common Stock

The Form S-1 Registration Statement (Registration No. 333-145974) relating to our IPO was declared effective by the SEC on February 14, 2008, and the offering commenced that day. Morgan Stanley & Co. Incorporated acted as the sole book-running manager for the offering, and Lehman Brothers Inc., Wachovia Capital Markets, LLC and RBC Capital Markets Corporation acted as co-managers of the offering.

The net proceeds to us of our IPO after deducting underwriters discounts and offering expenses were $45.9 million. Through July 31, 2010, we did not use any of the net proceeds. We expect to use the net proceeds for general corporate purposes, including working capital and potential capital expenditures and acquisitions. Although we may also use a portion of the net proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business, we have no present understandings, commitments or agreements to enter into any acquisitions or make any investments using the net proceeds from our IPO.

Our management will retain broad discretion in the allocation and use of the net proceeds of our IPO, and investors will be relying on the judgment of our management regarding the application of the net proceeds. Pending specific utilization of the net proceeds as described above, we have invested the net proceeds of the offering in short-term, interest-bearing obligations. The goal with respect to the investment of the net proceeds will be capital preservation and liquidity so that such funds are readily available to fund our operations.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

Not applicable.

Table of Contents

ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description
10.01	Amended Fiscal Year 2011 Management Bonus Plan.
10.02	Amended Sales Commission Plan FY 2011 (Kevin P. Mosher).
31.01	Certification of Principal Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
31.02	Certification of Principal Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
32.01	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*
32.02	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*

* This certification is not deemed filed for purposes of Section 18 of the Securities Exchange Act, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that ArcSight Inc. specifically incorporates it by reference.

Table of Contents

SIGNATURES

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

	ARCSIGHT, INC.
Date: September 7, 2010	By: /s/ Thomas J. Reilly Thomas J. Reilly President and Chief Executive Officer (Principal Executive Officer)
Date: September 7, 2010	By: /s/ Stewart Grierson Stewart Grierson Chief Financial Officer (Principal Financial Officer)

Table of Contents

EXHIBIT INDEX

Exhibit Number	Exhibit Description
10.01	Amended Fiscal Year 2011 Management Bonus Plan.
10.02	Amended Sales Commission Plan FY 2011 (Kevin P. Mosher).
31.01	Certification of Principal Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
31.02	Certification of Principal Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
32.01	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*
32.02	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*

* This certification is not deemed filed for purposes of Section 18 of the Securities Exchange Act, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that ArcSight Inc. specifically incorporates it by reference.