ArcSight Inc
Form 10-Q
March 12, 2009

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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 January 31, 2009

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

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

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

Shares of ArcSight, Inc. common stock, $0.00001 par value per share, outstanding as of March 1, 2009: 31,728,078 shares.

ARCSIGHT, INC.
FORM 10-Q
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	As of January 31, 2009 (Unaudited)	As of April 30, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 82,891	$ 71,946
Accounts receivable, net of allowance for doubtful accounts of $278 and $133, respectively	22,223	26,658
Other prepaid expenses and current assets	3,176	5,565
Total current assets	108,290	104,169
Property and equipment, net	4,749	4,834
Goodwill	5,746	5,746
Acquired intangible assets, net	1,530	2,161
Other long-term assets	1,391	1,669
Total assets	$ 121,706	$ 118,579
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,230	$ 3,115
Accrued compensation and benefits	7,757	11,864
Other accrued liabilities	6,485	5,967
Deferred revenues, current	33,524	36,512
Total current liabilities	48,996	57,458
Deferred revenues, non-current	3,970	4,754
Other long-term liabilities	1,687	1,598
Total liabilities	54,653	63,810
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; 31,629,422 and 31,022,190 issued and outstanding as of January 31, 2009 and April 30, 2008, respectively		
Additional paid-in capital	108,531	101,574
Deferred stock-based compensation		(53)
Accumulated other comprehensive loss	(349)	(45)
Accumulated deficit	(41,129)	(46,707)

Total stockholders equity	67,053	54,769
Total liabilities and stockholders equity	$ 121,706	$ 118,579

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended January 31, 2009	Three Months Ended January 31, 2008	Nine Months Ended January 31, 2009	Nine Months Ended January 31, 2008
Revenues:				
Products	$ 21,775	$ 17,698	$ 56,746	$ 45,573
Maintenance	10,004	7,380	28,102	19,627
Services	4,613	2,593	12,042	6,969
Total revenues	36,392	27,671	96,890	72,169
Cost of revenues:				
Products	2,637	1,487	6,136	3,301
Maintenance(1)	1,637	1,456	4,931	4,083
Services(1)	2,587	1,454	7,017	3,894
Total cost of revenues	6,861	4,397	18,084	11,278
Gross profit	29,531	23,274	78,806	60,891
Operating expenses(1):				
Research and development	5,201	5,063	15,939	14,170
Sales and marketing	12,298	12,760	41,521	37,367
General and administrative	4,943	2,939	14,155	9,927
Total operating expenses	22,442	20,762	71,615	61,464
Income (loss) from operations	7,089	2,512	7,191	(573)
Interest income	154	158	909	422
Other income and (expense), net	3	(60)	(107)	(284)
Income (loss) before provision for income taxes	7,246	2,610	7,993	(435)
Provision for income taxes	2,183	257	2,415	514
Net income (loss)	$ 5,063	$ 2,353	$ 5,578	$ (949)
Net income (loss) per common share, basic	$ 0.16	$ 0.22	$ 0.18	$ (0.09)
Net income (loss) per common share, diluted	$ 0.15	$ 0.09	$ 0.17	$ (0.09)
Shares used in computing basic net income (loss) per common share	31,499	10,829	31,115	10,609
Shares used in computing diluted net income (loss) per common share	33,494	27,458	33,324	10,609

(1) Stock-based compensation expense included in above (see Note 8):

Cost of maintenance revenues	$ 56	$ 24	$ 156	$ 62
Cost of services revenues	34	23	106	69
Research and development	322	293	995	940
Sales and marketing	466	771	1,969	1,912
General and administrative	786	171	1,366	432

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Nine Months Ended January 31,	
	2009	**2008**
Cash flows from operating activities:		
Net income (loss)	$ 5,578	$ (949)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,871	1,364
Amortization of acquired intangibles	631	430
(Gain) loss on disposal of property and equipment	15	(7)
Stock-based compensation	4,592	3,415
Provision for allowance for doubtful accounts	157	33
Changes in operating assets and liabilities:		
Accounts receivable	4,278	6,122
Prepaid expenses and other assets	2,667	1,047
Accounts payable	(1,885)	(2,012)
Accrued compensation and benefits	(4,107)	(524)
Other accrued liabilities	2,297	731
Deferred revenues	(3,772)	1,824
Net cash provided by operating activities	12,322	11,474
Cash flows from investing activities:		
Proceeds from sales of property and equipment		13
Purchase of property and equipment	(1,809)	(3,524)
Net cash used in investing activities	(1,809)	(3,511)
Cash flows from financing activities:		
Initial public offering preparation costs		(3,002)
Proceeds from issuance of common stock, net of repurchases	2,395	839
Payment of capital lease and software license obligations	(1,667)	(1,425)
Net cash provided by (used in) financing activities	728	(3,588)
Effect of exchange rate changes on cash	(296)	(61)
Net increase in cash and cash equivalents	10,945	4,314
Cash and cash equivalents at beginning of period	71,946	16,917
Cash and cash equivalents at end of period	$ 82,891	$ 21,231
Supplemental disclosure of cash flow information:		
Income taxes paid	$ 493	$ 284
Interest expense paid	$ 97	$ 169

See accompanying Notes to Condensed Consolidated Financial Statements.

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

1. Description of Business

ArcSight, Inc. (ArcSight or the Company) is a leading provider of compliance and security management solutions that protect enterprises and government agencies. The Company helps customers comply with corporate and regulatory policy, safeguard their assets and processes and control risk. The Company s platform collects and correlates user activity and event data across the enterprise so that businesses can rapidly identify, prioritize and respond to compliance violations, policy breaches, cybersecurity attacks and insider threats. The Company s ESM products correlate massive numbers of events from thousands of security point solutions, network and computing devices and applications, enabling intelligent identification, prioritization and response to external threats, insider threats and compliance and corporate policy violations. The Company also provides complementary software that delivers pre-packaged analytics and reports tailored to specific compliance and security initiatives, as well as appliances that streamline event log archiving. The Company is headquartered in Cupertino, California, and was incorporated on May 3, 2000 under the laws of the state of Delaware.

Initial Public Offering

In February 2008, the Company completed an initial public offering (IPO), in which it sold 6,000,000 shares of common stock, at an issue price of $9.00 per share. The Company raised a total of $54.0 million in gross proceeds from the IPO, or $45.9 million in net proceeds after deducting underwriters discounts of $3.8 million and other offering expenses of $4.3 million. Upon the completion of the IPO, all shares of convertible preferred stock outstanding automatically converted into 14,000,441 shares of common stock.

2. Significant Accounting Policies

Basis of Presentation and Consolidation

The condensed consolidated balance sheet as of April 30, 2008 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 22, 2008.

On November 20, 2007, the board of directors and the Company s stockholders approved a 1-for-4 reverse stock split of the Company s outstanding shares of common stock and convertible preferred stock (the Reverse Split). All authorized, reserved, issued and outstanding common stock, convertible preferred stock and per share amounts contained in these notes and the accompanying condensed consolidated financial statements have been retroactively adjusted to reflect the Reverse Split.

Unaudited Interim Financial Information

The accompanying interim consolidated balance sheet as of January 31, 2009, the consolidated statements of operations for the three and nine months ended January 31, 2009 and 2008, and the consolidated statements of cash flows for the nine months ended January 31, 2009 and 2008, 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 January 31, 2009, its results of operations for the three and nine months ended January 31, 2009 and 2008, and its statement of cash flows for the nine months ended January 31, 2009 and 2008. The results of operations for the three and nine months ended January 31, 2009 are not necessarily indicative of the results to be expected for fiscal 2009 or for any other interim period or for any other future year.

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Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 and uncertain tax positions, allowances for doubtful accounts, valuations of cash equivalents, and accrued liabilities. Actual results may differ from those estimates, and such differences may be material to the financial statements.

Cash and Cash Equivalents

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 one primary bank and are stated at cost, which approximates fair value.

Fair Value of Financial Instruments

The carrying amounts of cash equivalents, trade accounts receivable, accounts payable, and other accrued liabilities approximate their respective fair values due to their relatively short-term maturities. The carrying amounts of derivative financial instruments approximate their respective fair values due to adjusting these investments to their respective market values each reporting period.

Foreign Currency Translation/Transactions

The functional currency of the Company s foreign subsidiaries is the local currency. Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars are recorded as a separate component of accumulated other comprehensive income (loss). Income and expense accounts are translated into U.S. dollars at average rates of exchange prevailing during the periods presented. All assets and liabilities denominated in a foreign currency are translated into U.S. dollars at the exchange rates in effect on the balance sheet dates.

Net foreign currency transaction gains (losses) of approximately $26,000 and $2,000 for the three months ended January 31, 2009 and 2008, respectively, and ($3,000) and ($0.1 million) for the nine months ended January 31, 2009 and 2008, respectively, were primarily the result of the settlement of inter-company transactions and are included in other expense.

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 (expense), net, in the consolidated statements of operations. The objective of these contracts is to reduce the impact of foreign currency exchange rate movements on the Company s operating results. During the three and nine months ended January 31, 2009 and 2008, 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 Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities

(SFAS 133).

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Concentration of Credit Risk and Business Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash equivalents and accounts receivable. The Company is exposed to credit risk in the event of default by the primary financial institution holding its cash and cash equivalents to the extent recorded on its balance sheet. Risks associated with cash equivalents are mitigated by banking with high-credit quality institutions. Such deposits 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 and cash equivalents. The Company performs periodic evaluations of the relative credit standing of the financial institutions that hold the Company s investments.

The Company sells its products and maintenance and services directly to customers or through resellers in Asia Pacific, Europe, 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.

The Company had no customers or resellers that accounted for more than 10% of total revenues for the three months ended January 31, 2009. The Company had one customer that accounted for 14% of total revenues for the three months ended January 31, 2008. No customer or reseller accounted for more than 10% of total revenues for the nine months ended January 31, 2009 or 2008. The Company had one customer with an accounts receivable balance greater than 10% of the Company s net accounts receivable, with a balance of 15% of net accounts receivable as of January 31, 2009. As of April 30, 2008, the Company had two customers with accounts receivable balances greater than 10% of the Company s net accounts receivable, with balances of 25% and 15% of net accounts receivable.

The majority of the Company s revenues are derived from sales of the ESM product and related products and services, and the Company expects this to continue for the foreseeable future. As a result, although the Company introduced complementary appliance products in fiscal 2008 for which the Company uses a single source for manufacturing and fulfillment, the Company s revenues and operating results will continue to depend significantly on the demand for the ArcSight ESM product. Demand for ArcSight ESM 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 compliance and security management solutions and other risks. If the Company is unable to continue to meet customer demands or achieve more widespread market acceptance of ArcSight ESM, its business, operating results, financial condition and growth prospects will be adversely affected.

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 subject to the guidance and requirements of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, Software Revenue Recognition (SOP 97-2), as amen by SOP No. 98-9, Software Revenue Recognition with Respect to Certain Arrangements (SOP 98-9).

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, 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 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, resellers 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 systems 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 SOP 97-2, as amended by SOP 98-9, 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 attributed to the delivered elements (typically products) under the residual method when all of the applicable criteria in SOP 97-2 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 engagement 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 and 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 Operations. 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 pursuant to SFAS No. 5, Accounting for Contingencies (SFAS 5).

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.

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 January 31, 2009 and April 30, 2008.

The following describes activity in the allowance for doubtful accounts for fiscal 2008 and the nine months ended January 31, 2009 (in thousands):

Period	Balance at Beginning of Period	Addition Charged to Costs and Expenses	Deductions(1)	Balance at End of Period
Fiscal 2008	$ 123	$ 33	$ (23)	$ 133
Nine months ended January 31, 2009	$ 133	$ 158	$ (13)	$ 278

(1) Uncollectible amounts written off, net of recoveries.

Impairment of Long-Lived Assets

Long-lived assets, such as property, plant and equipment and acquired intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). Among the factors and circumstances considered by management in determining assessments of recoverability are: (i) a significant decrease in the market price of a long-lived asset; (ii) a significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition; (iii) a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator; (iv) an accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset; (v) current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset; and (vi) a current expectation that, more likely than not, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. Under SFAS 144, recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge

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is recognized in the amount by which the carrying amount of the asset group exceeds the fair value of the asset. There have been no indicators of impairment and no impairment losses have been recorded by the Company in any period presented.

Property and Equipment, Net

Property and equipment are carried at cost, net of accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the property and equipment, typically ranging from two to five years. Leasehold improvements are recorded at cost with any reimbursement from the landlord being accounted for as an offset to rent expense using the straight-line method over the lease term. Leasehold improvements are amortized over the shorter of the remaining operating lease term or the useful lives of the assets.

Business Combinations

The Company accounts for business combinations in accordance with SFAS No. 141, Business Combinations (SFAS 141), which requires the purchase method of accounting for business combinations. In accordance with SFAS 141, the Company determines the recognition of intangible assets based on the following criteria: (i) the intangible asset arises from contractual or other rights; or (ii) the intangible is separable or divisible from the acquired entity and capable of being sold, transferred, licensed, returned or exchanged. In accordance with SFAS 141, the Company allocates the purchase price of its business combinations to the tangible assets, liabilities and intangible assets acquired based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill.

The Company must make valuation assumptions that require significant estimates, especially with respect to intangible assets. Critical estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from customer contracts, customer lists, distribution agreements and discount rates. The Company estimates fair value based upon assumptions the Company believes to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates.

Goodwill

Goodwill is not amortized, but rather it is periodically assessed for impairment.

The Company tests goodwill for impairment annually on November 1 of each fiscal year, and more frequently if events merit. The Company performs this fair-value based test in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. Future goodwill impairment tests could result in a charge to earnings.

Software Development Costs

In accordance with SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, costs incurred for the development of new software products are expensed as incurred until technological feasibility is established. Development costs are capitalized beginning when a product s technological feasibility has been established and ending when the product is available for general release to customers. Technological feasibility is reached when the product reaches the beta stage using the working model approach. To date, the period of time between the establishment of a technologically feasible working model and the subsequent general release of the product have been of a relatively short duration of time and have resulted in insignificant amounts of costs qualifying for capitalization for all years presented. Thus, all software development costs have been expensed as incurred in research and development expense.

Research and Development Expenses

The Company expenses research and development expenses in the period in which these costs are incurred.

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Advertising Expenses

Advertising costs are expensed as incurred. The Company incurred $7,000 and $0.1 million in advertising expenses for the three months ended January 31, 2009 and 2008, respectively. The Company incurred $0.1 million and $0.2 million in advertising expenses for both the nine months ended January 31, 2009 and 2008.

Income Taxes

Provision for (benefit from) income taxes is calculated in accordance with SFAS No. 109 Accounting for Income Taxes (SFAS 109) and Accounting Principles Board Opinion (APB) No. 28, Interim Financial Reporting, (APB 28 Beginning in fiscal 2009, and for the period ended January 31, 2009, based in part on historical evidence, trends in profitability and current expectations of future taxable income, the Company transitioned from using the actual effective tax rate for the year to date as the best estimate of the annual effective tax rate under FASB Interpretation No. 18, Accounting for Income Taxes in the Interim Period (FIN 18) as amended by SFAS 109, to determining the Company s tax provision (benefit) based on an estimated annual tax rate also in compliance with SFAS 109 and APB 28. Significant components affecting the tax rate for fiscal 2009 include the utilization of net operating losses, research and development credits, foreign tax credits, the composite state tax rate, and non-deductible stock-based compensation expense.

The Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of SFAS 109 (FIN 48), on May 1, 2007. FIN 48 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. FIN 48 also provides guidance on de-recognition, 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.

Stock-Based Compensation Expense

Prior to May 1, 2006, the Company accounted for its stock-based awards to employees using the intrinsic value method prescribed in APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations as permitted by SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, compensation expense is measured on the date of the grant as the difference between the deemed fair value of the Company s common stock and the exercise or purchase price multiplied by the number of stock options or restricted stock awards granted. The Company amortizes deferred stock-based compensation using the multiple option method as prescribed by FASB Interpretation No. 28 Accounting for Stock Appreciation Rights and Other Variable Stock Option Award Plans (FIN 28) over the option vesting period using an accelerated amortization schedule, which results in amortization to expense over the grant s vesting period, which is generally four years.

Effective May 1, 2006, the Company adopted the provisions of SFAS No. 123(R) (revised 2004), Share-Based Payment (SFAS 123R), using the prospective transition method. In accordance with SFAS 123R, measurement and recognition of compensation expense for all share-based payment awards made to employees and directors beginning on May 1, 2006 is recognized based on estimated fair values. SFAS 123R requires nonpublic companies that used the minimum value method under SFAS 123 for either recognition or pro forma disclosures to apply SFAS 123R using the prospective-transition method. As such, the Company continues to apply APB 25 in future periods to unvested equity awards outstanding at the date of adoption of SFAS 123R that were measured using the intrinsic value method. In addition, the Company continues to amortize those awards granted prior to May 1, 2006 using the multiple option method as prescribed by FIN 28, as described above. In accordance with SFAS 123R, the Company uses the Black-Scholes pricing model to determine the fair value of the stock options on the grant dates for stock awards made on or after May 1, 2006, and the Company amortizes the fair value of share-based payments on a straight-line basis.

The Company s 2007 Employee Stock Purchase Plan (ESPP) became effective upon the effectiveness of the IPO on February 14, 2008. The ESPP provides for consecutive six-month offering periods, except for the first such 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 SFAS 123R. The Black-Scholes option pricing model is used to estimate the fair value of rights to acquire stock granted under the ESPP.

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Comprehensive Loss

The Company reports comprehensive loss in accordance with SFAS No. 130, Reporting Comprehensive Income. Comprehensive 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 loss consisted solely of cumulative currency translation adjustments resulting from the translation of the financial statements of its foreign subsidiaries. The tax effects on the foreign currency translation adjustments have not been significant.

Adoption of New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. In February 2008, the FASB adopted FASB Staff Position (FSP) on SFAS No. 157-2, Effective Date of FASB Statement No. 157 (FSP 157-2), delaying the effective date of SFAS 157 for one year for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. The remaining provisions of SFAS 157 are effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. On May 1, 2008, the Company adopted SFAS 157, except as it applies to those non-financial assets and liabilities as described in FSP 157-2. Non-recurring non-financial assets and non-financial liabilities for which the Company has not applied the provisions of SFAS 157 include those measured at fair value in goodwill impairment tests and intangible assets measured at fair value for impairment.

SFAS 157 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. SFAS 157 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;

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 based on Level 1 inputs, at fair value. In accordance with SFAS No. 107, Disclosures about Fair Value of Financial Instruments (SFAS 107), 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.

In accordance with SFAS 157, the following table represents the Company s fair value hierarchy for its financial assets (cash and cash equivalents) and liabilities measured at fair value on a recurring basis as of January 31, 2009 (in thousands):

	Level 1	**Level 2**	**Level 3**	**Total**
Cash and cash equivalents	$ 82,891			$ 82,891
Restricted cash	842			842
Capitalized software license obligations		$ 472		472

Total	$ 83,733	$ 472	$ 84,205

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159), including an amendment of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, which allows an entity to choose to measure certain financial instruments and liabilities at fair value. Subsequent measurements for the financial instruments and liabilities an entity elects to measure at fair value will be recognized in earnings. SFAS 159 also establishes additional disclosure requirements. SFAS 159 is effective for fiscal years beginning after November 15, 2007. On May 1, 2008, the

Company evaluated its existing financial instruments and liabilities and elected not to adopt the fair value option on its financial instruments. However, because the SFAS 159 election is based on an instrument-by-instrument election at the time the Company first recognizes an eligible item or enters into an eligible firm commitment, the Company may decide to exercise the option on new items when business reasons support doing so in the future. As a result, SFAS 159 did not have any impact on the Company s financial condition or results of operations for the nine months ended January 31, 2009.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (SFAS 141R) which replaces SFAS No. 141. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and non-controlling interests in the acquiree and the goodwill acquired, in connection with a business combination. SFAS 141R also establishes disclosure requirements. SFAS 141R is effective for fiscal years beginning after December 15, 2008. The Company will adopt SFAS 141R at the beginning of its 2010 fiscal year which is May 1, 2009. The impact of SFAS 141R will depend on the nature, terms, and size of any acquisition the Company may consummate after the effective date.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS 160). The statement changes how noncontrolling interests in subsidiaries are measured to initially be measured at fair value and classified as a separate component of equity. SFAS 160 establishes a single method of accounting for changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation. No gains or losses will be recognized on partial disposals of a subsidiary where control is retained. In addition, in partial acquisitions, where control is obtained, the acquiring company will recognize and measure at fair value all of the assets and liabilities, including goodwill, as if the entire target company had been acquired. The statement is to be applied prospectively for fiscal years beginning on or after December 15, 2008. The Company does not expect the adoption of SFAS 160 to have a material effect on its consolidated results of operations, financial condition, or cash flows.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedge items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 161 on its consolidated results of operations, financial condition or cash flows.

In April 2008, the FASB issued an FSP on SFAS No. 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under Statement 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141 (revised 2007), Business Combinations*,* and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and early adoption is not permitted. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS 142-3 on its consolidated results of operations, financial condition or cash flows.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS 162 will become effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The Company does not expect the adoption of SFAS 162 to have a material effect on its consolidated results of operations, financial condition or cash flows.

In October 2008, the FASB issued an FSP on SFAS No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP 157-3). FSP 157-3 clarified the application of SFAS 157. FSP 157-3 demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have an impact on the Company s consolidated results of operations, financial condition or cash flows.

In February 2009, the FASB issued an FSP on SFAS No. 141(R)-a, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination (FSP 141R-a). FSP 141R-a amends the provisions related to the initial recognition and measurement, subsequent measurement and disclosure of assets and liabilities arising from contingencies in a business combination under SFAS 141R. FSP 141R-a establishes principles and requirements for preacquisition contingencies and an acquiree s pre-existing contingent consideration arrangement in a business combination measured under SFAS 141R. In addition, FSP 141R-a requires separate disclosure of recognized and unrecognized contingencies. FSP 141R-a has the same effective date as SFAS 141R, and is effective for fiscal years beginning after December 15, 2008. The Company will adopt FSP 141R-a at the beginning of its 2010 fiscal year which is May 1, 2009. The impact of FSP 141R-a will depend on the nature, terms, and size of any acquisition the Company may consummate after the effective date.

3. Net Income (Loss) Per Common Share

On February 20, 2008, the closing date of the IPO, and pursuant to the amended and restated certificate of incorporation, all outstanding shares of convertible preferred stock converted into an aggregate of 14,000,441 shares of common stock. Additionally, in connection with the conversion of the shares of convertible preferred stock, warrants to purchase shares of convertible preferred stock and common stock were also converted to a net 19,202 shares of common stock.

Basic and diluted net income (loss) per common share is computed using the weighted-average number of shares of common stock outstanding during the period. Potentially dilutive securities consisting of convertible preferred stock, stock options, shares purchasable under employee stock purchase plan, common stock subject to repurchase and warrants were not included in the diluted loss per common share computation for the nine months ended January 31, 2008 because the inclusion of such shares would have had an anti-dilutive effect.

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

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2009	**2008**	**2009**	**2008**
Numerator for basic and diluted net income (loss) per share:				
Net income (loss)	$ 5,063	$ 2,353	$ 5,578	$ (949)
Denominator for basic net income (loss) per share:				
Weighted-average common shares, net of weighted-average shares subject to repurchase, used in computing net income (loss) per common share-basic	31,499	10,829	31,115	10,609
Denominator for diluted net income (loss) per share:				
Shares used above, basic	31,499	10,829	31,115	10,609
Stock options	1,994	2,493	2,150	
Warrants to purchase common stock and convertible preferred stock		14		
Convertible preferred stock (as converted)		13,993		
Shares purchasable under employee stock purchase plan			8	
Shares subject to repurchase	1	129	51	
Denominator for diluted net income (loss) per share:	33,494	27,458	33,324	10,609

Net income (loss) per common share:								
Basic	$	0.16	$	0.22	$	0.18	$	(0.09)
Diluted	$	0.15	$	0.09	$	0.17	$	(0.09)

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

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2009	**2008**	**2009**	**2008**
Convertible preferred stock (as converted)				13,989
Options to purchase common stock	2,926	13	2,382	4,291
Common stock subject to repurchase				174
Warrants to purchase common stock and convertible preferred stock (as converted)				17
Total	2,926	13	2,382	18,471

4. Balance Sheet Details

Property and Equipment, Net

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

	As of January 31, 2009	As of April 30, 2008
Computers and equipment	$ 6,968	$ 6,135
Furniture and fixtures	1,073	1,071
Software	771	754
Leasehold improvements	2,337	2,080
	11,149	10,040
Less: accumulated depreciation and amortization	(6,400)	(5,206)
Property and equipment, net	$ 4,749	$ 4,834

Depreciation expense was $0.5 million and $0.4 million for the three months ended January 31, 2009 and 2008, respectively, and $1.5 million and $1.2 million for the nine months ended January 31, 2009 and 2008, respectively. Amortization expense was $0.1 million and $0.1 million for the three months ended January 31, 2009 and 2008, respectively, and $0.3 million and $0.2 million for the nine months ended January 31, 2009 and 2008, respectively.

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 January 31, 2009 and April 30, 2008 are as follows (dollars in thousands):

As of January 31, 2009:	Estimated Weighted-Average Useful Lives in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Core and developed technologies	5.00	$ 1,970	$ (829)	$ 1,141
Customer installed-base relationships	6.00	80	(49)	31

Employee non-compete agreements	5.00	1,160	(803)	357
Total		$ 3,210	$ (1,681)	$ 1,529
Goodwill				$ 5,746

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As of April 30, 2008:	Estimated Weighted-Average Useful Lives in Years	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Core and developed technologies	5.00	$ 1,970	$ (434)	$ 1,536
Customer installed-base relationships	6.00	80	(37)	43
Employee non-compete agreements	5.00	1,160	(578)	582
Total		$ 3,210	$ (1,049)	$ 2,161
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 $0.2 million and $0.1 million for the three months ended January 31, 2009 and 2008, respectively, and $0.6 million and $0.4 million for the nine months ended January 31, 2009 and 2008, respectively.

There was no impairment of goodwill or intangible assets for the nine months ended January 31, 2009 or in fiscal 2008.

As of January 31, 2009, future estimated amortization costs per year for the Company s existing intangible assets other than goodwill are estimated as follows (in thousands):

As of January 31, 2009:	Estimated Amortization Expense
Remainder of fiscal 2009	$ 211
Fiscal 2010	889
Fiscal 2011	425
Fiscal 2012	5
Total	$ 1,530

Deferred Revenues

Deferred revenues consist of the following (in thousands):

	As of January 31, 2009	As of April 30, 2008
Deferred product revenues	$ 7,522	$ 13,627
Deferred maintenance revenues	26,916	24,256
Deferred services revenues	3,056	3,383
Total deferred revenues	37,494	41,266
Less deferred revenues, current portion	(33,524)	(36,512)
Deferred revenues, non-current	$ 3,970	$ 4,754

5. Commitments and Contingencies

Contractual Commitments

The Company and its subsidiaries operate from leased premises in the United States, Asia Pacific and Europe with lease periods expiring through fiscal 2014. In April 2007, the Company entered into a lease extension through October 2013, and added additional office space to the lease for the corporate headquarters. This lease agreement includes a rent escalation clause of 4% per annual lease term through expiration in October 2013. The lease agreement includes leasehold improvement allowances in the amount of $0.7 million which is recorded as deferred rent and amortized as reductions to rent expense on a straight line basis over the remainder of the lease term. The lease agreement also includes a renewal period at the Company s option for an additional 5 years at the then current fair market value. 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.

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Future minimum lease payments under the Company s noncancelable operating leases as of January 31, 2009 are as follows (in thousands):

As of January 31, 2009:	Amount of Payments
Remainder of fiscal 2009	$ 559
Fiscal 2010	2,250
Fiscal 2011	1,988
Fiscal 2012	2,068
Fiscal 2013	2,151
Thereafter	1,118
Total future minimum lease payments	$ 10,134

Rent expense under all operating leases was approximately $0.8 million for both the three months ended January 31, 2009 and 2008, respectively, and $2.4 million and $2.0 million for the nine months ended January 31, 2009 and 2008, respectively.

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 third-party claims, including claims that a Company product infringes a patent, copyright or other intellectual property right, and (v) procurement, consulting, partner or license agreements under which the Company may be required to indemnify vendors, consultants, partners 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. To date, the Company has not been required to make any payment resulting from infringement claims asserted against its customers and has not recorded any related accruals.

The Company generally provides a warranty for its products and services to its customers and accounts for its warranties under SFAS 5. To date, the Company s product warranty expense has not been significant. Accordingly, the Company has not recorded a warranty reserve as of January 31, 2009 or April 30, 2008.

7. Stockholders Equity

Preferred Stock

The Company s board of directors is authorized, subject to limitations prescribed by Delaware law, to issue at its discretion preferred stock in one or more series, to establish from time to time the number of shares to be included in each series and to fix the designation, powers, preferences and rights of the shares of each series and any of its qualifications, limitations or restrictions. The board of directors also can increase or decrease the number of authorized shares of any series, but not below the number of shares of that series then outstanding, without any further vote or action by the Company s stockholders.

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Common Stock Reserved for Issuance

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

	As of January 31, 2009
Options available for future grant under the 2007 Equity Incentive Plan	4,437,828
Options outstanding under the stock option plans	7,460,889
ESPP shares reserved for future issuance	1,122,808
Total shares reserved	13,021,525

Stock Plans

2007 Equity Incentive Plan. In November 2007, the board of directors and the Company s stockholders approved the 2007 Equity Incentive Plan, which became effective on the effective date of the Company s IPO on February 14, 2008. 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. In addition, shares subject to outstanding grants under the Company s 2000 Stock Incentive Plan and the 2002 Stock Plan on February 14, 2008, and any shares issued thereunder that are forfeited or repurchased by the Company or that are issuable upon exercise of options that expire or become unexercisable for any reason without having been exercised in full, will be available for grant and issuance under the 2007 Equity Incentive Plan. An aggregate of 1,748,749 of such additional shares have become available for grant and issuance under the 2007 Equity Incentive Plan. In January 2009, the Company registered with the SEC 1,260,416 additional shares of the Company s common stock to be issuable under the 2007 Equity Incentive Plan pursuant to the plan s evergreen provision.

2007 Employee Stock Purchase Plan. In November 2007, the board of directors and the Company s stockholders approved the 2007 Employee Stock Purchase Plan, which became effective on the effective date of the Company s IPO on February 14, 2008. 1,000,000 shares of the Company s common stock were originally authorized for future issuance under the 2007 Employee Stock Purchase Plan. In January 2009, the Company registered 315,104 additional shares of the Company s common stock to be issuable under the 2007 Employee Stock Purchase Plan pursuant to the plan s evergreen provision.

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 nine months ended January 31, 2009, 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, 2008	4,366,192	6,687,045	5.43	7.89	$ 15,142
Options authorized	1,260,416				
Options granted	(1,682,925)	1,682,925	7.60		
Options exercised		(415,171)	2.34		

Options canceled	493,910	(493,910)	8.37		
Shares repurchased	235				
Options outstanding as of January 31, 2009	4,437,828	7,460,889	5.89	7.45	25,189
Vested and expected to vest as of January 31, 2009, net of anticipated forfeitures		5,900,071	5.89	7.45	20,038
Vested and exercisable as of January 31, 2009		3,953,301	4.16	6.64	20,298

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.

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The following table summarizes additional information regarding outstanding options as of January 31, 2009:

	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
\$0.12-0.40	663,467	4.29	663,467	\$ 0.21
\$0.48-0.80	976,810	5.95	961,347	0.74
\$4.00	664,460	6.41	588,368	4.00
\$4.74-5.98	346,800	9.80		
\$6.08-6.80	1,980,315	7.75	1,173,308	6.53
\$7.17-8.95	1,328,012	8.20	19,196	7.93
\$9.00-9.95	286,000	8.68	93,831	9.23
\$10.00	1,172,650	8.67	453,784	10.00
\$11.08-12.97	42,375	9.48		
Total	7,460,889	7.45	3,953,301	\$ 4.16

Total intrinsic value of options exercised for the nine months ended January 31, 2009 was \$2.6 million, determined at the date of option exercise.

8. Stock-Based Compensation

During the three and nine months ended January 31, 2009 and 2008, the Company recorded stock-based compensation as described below (in thousands):

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2009	2008	2009	2008
Stock-based compensation under SFAS 123R	\$ 1,433	\$ 1,162	\$ 3,813	\$ 3,035
Stock-based compensation under prospective transition method for option awards granted prior to the adoption of SFAS 123R	3	19	19	77
Amortization of restricted stock awards in connection with the acquisition of Enira Technologies, LLC		101	33	303
Stock-based compensation under Employee Stock Purchase Plan	228		727	
Total	\$ 1,664	\$ 1,282	\$ 4,592	\$ 3,415

Adoption of SFAS 123R

See Note 2 for a description of the Company s adoption of SFAS 123(R) Share-Based Payment, on May 1, 2006. Effective with the adoption of SFAS 123R, the fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model. 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. As there was no public market for the Company s common stock prior to the IPO, the Company determined the volatility for options granted in fiscal periods prior to the IPO, based on an analysis of reported data for a peer group of companies that issued options with substantially similar terms. Since the IPO, the expected volatility of options granted has been 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, SFAS 123R requires companies to utilize an estimated forfeiture rate when calculating the expense for the period, whereas SFAS 123 permitted companies to record forfeitures based on actual forfeitures, which was the Company s historical policy under SFAS 123. The Company applied 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.

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SFAS 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash flows. Due to the Company s historical loss position and current valuation allowance, no tax benefits have been realized or recorded for any of the periods presented. Prior to the adoption of SFAS 123R those benefits would have been reported as operating cash flows had the Company received any tax benefits related to stock option exercises.

Valuation and Expense Information under SFAS 123R

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 January 31,		**Nine Months Ended January 31,**	
	2009	**2008**	**2009**	**2008**
Risk-free interest rate	2.90%	4.04%	3.19%	4.48%
Expected volatility	53%	54%	52%	56%
Expected life (years)	5.74 years	5.28 years	5.75 years	5.26 years

Based on these calculations, the weighted-average fair value per option granted to acquire a share of common stock was $2.53 and $5.24 per share for the three months ended January 31, 2009 and 2008, respectively, and $3.91 and $5.36 per share for the nine months ended January 31, 2009 and 2008, respectively. There were 361,100 and 332,874 options granted during the three months ended January 31, 2009 and 2008, respectively, and 1,682,925 and 1,459,926 options granted during the nine months ended January 31, 2009 and 2008, respectively. The compensation costs that have been included in the Company s results of operations for these stock-based compensation arrangements for the three and nine months ended January 31, 2009 and 2008, as a result of the Company s adoption of SFAS 123R, were as follows (in thousands):

	Three Months Ended January 31,		**Nine Months Ended January 31,**	
	2009	**2008**	**2009**	**2008**
Cost of maintenance revenues	$ 36	$ 24	$ 98	$ 63
Cost of services revenues	26	23	77	68
SFAS 123R expense included in cost of revenues	62	47	175	131
Operating expenses:				
Research and development	226	200	653	658
Sales and marketing	387	759	1,721	1,869
General and administrative	758	156	1,264	377
SFAS 123R expense included in operating expenses	1,371	1,115	3,638	2,904
SFAS 123R expense included in net income	$ 1,433	$ 1,162	$ 3,813	$ 3,035

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.

On September 25, 2008, in connection with the impending retirement and resignation of the Company s former CEO, and in connection with his continued service as chairman of the Company s board of directors, the Company agreed to accelerate the vesting on certain of his existing stock option grants to the extent that he continues as the chairman of the Company s board of directors until September 30, 2009. As of January 31, 2009, the Company expects to record the remaining unrecognized stock-based compensation attributable to the modified grants of $0.2 million, ratably over the remaining service period ending September 30, 2009.

As of January 31, 2009 and 2008, there was $11.0 million and $11.5 million, respectively, of total unrecognized stock based compensation expenses under SFAS 123R, net of estimated forfeitures, that the Company expects to amortize. As of January 31, 2009, total unrecognized stock based compensation expenses related to non-vested awards are expected to be recognized over a weighted-average period of 2.75 years.

During the nine months ended January 31, 2009, the Company granted 1,682,925 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

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the date of grant is not a NASDAQ trading day), with exercise prices ranging from $4.74 to $12.97 per share at a weighted-average per share price of $7.60.

Employee Stock Purchase Plan

In November 2007, the board of directors and the Company s stockholders approved the 2007 Employee Stock Purchase Plan (the ESPP), which became effective upon the effectiveness of the IPO on February 14, 2008. A total of 1,315,104 shares of the Company s common stock have been reserved for issuance under the ESPP, including the annual increase in January 2009 pursuant to its evergreen provision. Under the ESPP, employees may purchase shares of common stock at a price that is 85% of the lesser of the fair market value of the Company s common stock as of beginning or the end of each offering period. The ESPP provides for consecutive offering periods of six months each, except for the first such 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 SFAS 123R. 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 January 31, 2009	Nine Months Ended January 31, 2009

Based on these calculations, the weighted-average fair value per right to acquire shares of common stock was $2.47 and $2.61 per share for the three and nine months ended January 31, 2009, respectively. For the three and nine months ended January 31, 2009, the Company recorded stock-based compensation expense associated with its ESPP of $0.2 million and $0.7 million, respectively. As of January 31, 2009, there was $0.1 million of total unrecognized compensation expenses under SFAS 123R, net of expected forfeitures, related to common stock purchase rights that the Company expects to amortize over the remaining offering period ending March 15, 2009.

9. Segment Information

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

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for reporting information about operating segments. 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 January 31, 2009 and 2008, 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.

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

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2009	2008	2009	2008
Total revenues by geography:				
United States:				
Products	$ 14,813	$ 9,615	$ 40,574	$ 29,204
Maintenance	7,345	5,515	20,864	15,223
Services	3,444	1,828	9,345	5,056
Total	25,602	16,958	70,783	49,483
EMEA:				
Products	3,638	3,111	9,056	7,809
Maintenance	1,581	1,146	4,342	2,675
Services	618	480	1,637	1,090
Total	5,837	4,737	15,035	11,574
Asia Pacific:				
Products	1,414	770	3,496	2,182
Maintenance	477	288	1,345	810
Services	205	151	487	407
Total	2,096	1,209	5,328	3,399
Other Americas:				
Products	1,910	4,202	3,620	6,378
Maintenance	601	431	1,550	919
Services	346	134	574	416
Total	2,857	4,767	5,744	7,713
Total revenues	$ 36,392	$ 27,671	$ 96,890	$ 72,169

10. Income Taxes

For the three and nine months ended January 31, 2009, the Company recorded a provision for income taxes of $2.2 million and $2.4 million, respectively. The effective tax rate for the three and nine months ended January 31, 2009 was 30.1% and 30.2%, respectively, and was based on the Company s estimated taxable income for the year, plus certain discrete items recorded during the period. The difference between the provision for income taxes that would be derived by applying the statutory rate to the Company s income before tax and the income tax provision actually recorded is primarily due to the impact of nondeductible SFAS 123R stock-based compensation expenses, offset by the use of net operating loss carry-forwards and tax credits. For the three and nine months ended January 31, 2008, the Company recorded a provision for income taxes of $0.3 million and $0.5 million, respectively. The effective tax rate for the three and nine months ended January 31, 2008 was 9.8% and (118.6%), respectively. The effective tax rate for the three and nine months ended January 31, 2008 differs from the U.S. federal statutory rate primarily due to the Company s inability during this period to record a tax benefit for all or a portion of the domestic tax loss as a result of the Company s valuation allowance on its deferred tax assets, and to a lesser extent other non-deductible items such as state and foreign taxes.

The Company intends to continue maintaining a full valuation allowance on its deferred tax assets until sufficient evidence exists to support the reversal of all or some portion of these allowances. Should the actual amounts differ from the Company s estimates, the amount of its valuation allowance could be materially impacted.

11. Related-Party Transactions

The Company has previously entered into various agreements with M-Factor to provide event planning and hosting of the Company s corporate events. A member of the Company s board of directors is also a director and 10% shareholder of M-Factor. The Company recorded no expenses for either the three months ended January 31, 2009 and 2008, respectively, related to such activities. For the nine months ended January 31, 2009 and 2008, the Company recorded expenses of approximately $1,463,000 and $1,375,000, respectively related to such activities. All such activities were provided in the ordinary course of business at prices and on terms and conditions that the Company believes are the same as those that would result from arm s-length negotiations between unrelated parties.

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, 2008 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission, or the SEC, on July 22, 2008. 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, 2008. 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 compliance and security management solutions that protect enterprises and government agencies. Our products help customers comply with corporate and regulatory policy, safeguard their assets and processes and control risk. Our platform collects and correlates user activity and event data across the enterprise so that businesses can rapidly identify, prioritize and respond to compliance violations, policy breaches, cybersecurity attacks and insider threats. Our ESM products correlate massive numbers of events from thousands of security point solutions, network and computing devices and applications, enabling intelligent identification, prioritization and response to external threats, insider threats and compliance and corporate policy violations. We also provide complementary software that delivers pre-packaged analytics and reports tailored to specific compliance and security initiatives, as well as appliances that streamline event log archiving.

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 $101.5 million in fiscal 2008, and were $96.9 million in the first three quarters of our fiscal 2009.

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 2008. We generated $12.3 million in cash from our operating activities during the nine months ended January 31, 2009, and we generally expect to continue to generate positive cash flows from operating activities on an annual basis. As of January 31, 2009, we had cash and cash equivalents and accounts receivable of $105.1 million, and an aggregate of $15.5 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 in the early stages of development. We have identified factors that we expect to play an important role in our future growth and profitability. These factors are:

Sales of ESM Platform and Appliance Products to New Customers. The market for compliance and security management software solutions is rapidly expanding, with new purchases often driven by corporate compliance initiatives. We typically engage in a proof of concept with our customers to demonstrate the capabilities of our ESM platform in their specific environment. A new sale usually involves the sale of licenses for one or more ESM Managers, licenses for the number and type of devices the customer intends to manage with ArcSight ESM, licenses for our console and web interfaces, installation services, training and an initial maintenance arrangement. In many cases, customers will also purchase one of our complementary software modules which enable them to implement specific sets of off-the-shelf rules for our event correlation engine that address specific compliance and security issues and business risks. In addition, customers may purchase our Logger appliances to address their log archiving needs. Our continued growth in new customers is partly a result of sales of our Logger products to mid-market companies. We anticipate that future growth in customer count will similarly be in large part a result of initial sales of Logger and our other products sold in an appliance form factor, which is the preferred packaging for our channel partners and mid-market companies. A key component of our growth will depend on our ability to sell our products to new customers.

Continued Sales to Our Installed Base. 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, a key component of our growth will be our ability to successfully maintain and further develop the relationships with our existing customers.

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 compliance and security management market. Examples of new product introductions in fiscal 2008 included our ArcSight ESM Management Solution, ArcSight Log Management Suite and ArcSight Connector Appliance products. We continue the enhancement of our ESM platform and solutions, such as the May 2007 introduction of features such as identity correlation and role-based management and from a global perspective, the July 2007 introduction of a new compliance solution package for the Japanese analogue of Sarbanes-Oxley (JSOX). In addition, we continue to develop and release appliance versions of our software products and updates to complementary solution packages for our Logger product as well.

Development of Our Channel Network. Historically, we have sold our products primarily through our direct sales force, with sales to government purchasers and internationally made through resellers and systems integrators. We recently 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. Further training, certification and development of our existing channel partners will be a key factor in the success of this strategy.

Sources of Revenues, Cost of Revenues and Operating Expenses

Our sales transactions typically include the following elements: a software license fee paid for the use of our 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. We derive the majority of our revenues from sales of software products. We introduced complementary appliance products in fiscal 2007. We sell our products and services primarily through our direct sales force. Additionally, we utilize resellers and systems integrators, particularly in sales to government agencies and international customers.

We recognize revenues pursuant to American Institute of Certified Public Accountants, or AICPA, Statement of Position, or SOP, No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements*, or collectively, SOP 97-2, which, if revenues are to be recognized upon product delivery, requires among other things vendor-specific objective evidence of fair value, or VSOE, for each undelivered element of multiple element customer contracts.

Revenues in fiscal 2007 and prior years were impacted by multiple element sales transactions consummated for which the revenues were deferred because we did not have vendor-specific objective evidence of fair value, or VSOE, for some product elements that were not delivered in the fiscal year of the transaction. Following identification in mid-fiscal 2007 of transactions with such undelivered elements, with respect to some of these transactions, we and our customers amended the contractual terms to remove the undelivered product elements and in other instances we have since delivered such product elements. The net impact of these transactions increased revenues in the nine months ended January 31, 2009 and 2008, by $0.7 million and $2.6 million, respectively. In each case, the net impact caused our fiscal period-to-period revenue growth rate to appear lesser or greater, as applicable, than it otherwise would. As of January 31, 2009 and April 30, 2008, deferred revenues included $1.7 million and $2.5 million, respectively, related to transactions such as these.

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 the U.S. government have represented a significant portion of our revenues, while international sales have represented a smaller portion of our revenues. While we expect revenues from sales to agencies of the U.S. federal government to continue to grow in absolute dollars, we believe that such sales will continue to decrease as a percentage of revenues in future periods. In addition, we expect that sales to customers outside of the United States will continue to grow both in absolute dollars and as a percentage of revenues in future periods.

Product Revenues

Product revenues consist of license fees for our software products and, beginning in fiscal 2007, also includes revenues for 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 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 due to our limited experience with them, 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.

As of January 31, 2009 and April 30, 2008, deferred product revenues were $7.5 million and $13.6 million, respectively. Included in deferred product revenues as of January 31, 2009 and April 30, 2008 was $1.5 million and $2.2 million, respectively, related to multiple element arrangements where one or more product elements for which we did not have VSOE remained undelivered. The remainder of deferred product revenues as of January 31, 2009 and April 30, 2008 was $6.0 million and $11.4 million, respectively, and 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 January 31, 2009 and April 30, 2008, deferred product revenues of $7.5 million and $13.6 million, respectively, were reduced by net-down adjustments of $4.7 million and $3.3 million, respectively. See Critical Accounting Policies, Significant Judgments and Estimates Revenue Recognition and Note 2 to our Condensed 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 and content. 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. Premium 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 deferred 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 January 31, 2009, deferred maintenance revenues were $26.9 million, of which $23.2 million represented current deferred maintenance revenues. As of April 30, 2008, deferred maintenance revenues were $24.3 million, of which $20.0 million represented current deferred maintenance revenues. Included in deferred maintenance revenues as of January 31, 2009 and April 30, 2008 was $0.2 million and $0.3 million, respectively, related to multiple element arrangements where one or more product elements for which we did not have VSOE remained undelivered. Deferred maintenance revenues relate to advanced payments for support contracts that are recognized ratably. As of January 31, 2009 and April 30, 2008, the deferred maintenance revenues of $26.9 million and $24.3 million, respectively, were reduced by net-down adjustments of $2.3 million and $1.5 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 Condensed 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. During fiscal 2009, we entered into an increasing number of service engagements to staff and manage the security operation centers, or SOCs, of certain large customers. These SOC engagements are typically longer in duration than other services engagements and support the day to day monitoring of customer SOC environments. Professional services are not essential to the functionality of the associated software products. 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 January 31, 2009 and April 30, 2008, deferred service revenues were $3.1 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 January 31, 2009 and April 30, 2008, the deferred service revenues of $3.1 million and $3.4 million, respectively were reduced by net-down adjustments of $0.8 million and $0.7 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 Condensed 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.

We intend to increase sales to the mid-market, a goal that we believe will be aided by our recent introduction of additional appliance products. We expect the percentage of our mid-market sales made through our distribution channel will be greater than it has been to date. We also expect a high percentage of our international sales to continue to be made through our distribution channel.

Sales through the channel tend to be at a lower gross margin than direct sales. As a result, we may report lower gross margins in future periods than has been the case for prior periods.

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, maintenance and services are typically accrued and expensed when the respective revenue elements are ordered. We also 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 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 insurance 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. Following our IPO, we had additional cash and cash equivalents of approximately $45.9 million resulting from the net proceeds of our IPO, after deducting the underwriting discounts and other offering expenses. Our foreign currency-related gains and losses will also vary depending upon movements in underlying exchange rates.

Provision for Income Taxes. For the three and nine months ended January 31, 2009, we recorded a provision for income taxes of $2.2 million and $2.4 million, respectively. The effective tax rate for the three and nine months ended January 31, 2009 was 30.1% and 30.2%, and is based on our projected 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 non-deductible Statement of Financial Accounting Standards, or SFAS, No. 123(R) (revised 2004), *Share-Based Payment*, or SFAS 123R, stock-based compensation expenses, offset by the use of tax operating loss carry-forwards and tax credits.

Critical Accounting Policies, Significant Judgments and Estimates

Our condensed 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 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.

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Revenue Recognition

We recognize revenues in accordance with SOP 97-2. 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 SOP 97-2, 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 SOP 97-2. 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.

For sales to direct end-users and channel partners, we recognize product revenue once either we or our 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. This refinement to our revenue recognition policy had no impact on revenue recorded for the current or prior periods. 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

Prior to May 1, 2006, we accounted for our stock-based awards to employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25 and related interpretations. Under the intrinsic value method, compensation expense is measured on the date of the grant as the difference between the fair value of our common stock and the exercise or purchase price multiplied by the number of stock options or restricted stock awards granted. We amortize deferred stock-based compensation using the multiple option method as prescribed by Financial Accounting Standards Board, or FASB, Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, or FIN 28, over the option vesting period using an accelerated amortization schedule. We amortized deferred stock-based compensation of $19,000 and $0.1 million for the nine months ended January 31, 2009 and 2008, respectively.

Effective May 1, 2006, we adopted SFAS 123R, which requires companies to expense the fair value of employee stock options and other forms of stock-based compensation. SFAS 123R requires nonpublic companies that used the minimum value method under SFAS No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, for either recognition or pro forma disclosures to apply SFAS 123R using the prospective-transition method. As such, we will continue to apply Accounting Principles Board Opinion, or APB, No. 25, *Accounting for Stock Issued to Employees*, or APB 25, in future periods to unvested equity awards outstanding at the date of adoption of SFAS 123R that were measured using the minimum value method. In addition, we are continuing to amortize those awards granted prior to May 1, 2006 utilizing an accelerated amortization schedule. In accordance with SFAS 123R, 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 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 the three and nine months ended January 31, 2008 based on an analysis of reported data for a peer group of companies that issued options with substantially similar terms. Since the IPO, the expected volatility of options granted has been 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 our historical volatility. The weighted-average expected volatility for options granted for the three months ended January 31, 2009 and 2008 was 53% and 54%, respectively. The weighted-average expected volatility for options granted for the nine months ended January 31, 2009 and 2008 was 52% and 56%, 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 January 31, 2009 and 2008 was 5.74 years and 5.28 years, respectively. The weighted-average expected life of options granted for the nine months ended January 31, 2009 and 2008 was 5.75 years and 5.26 years, respectively. For the three months ended January 31, 2009 and 2008, the weighted-average risk-free interest rate used was 2.90% and 4.04%, respectively. For the nine months ended January 31, 2009 and 2008, the weighted-average risk-free interest rate used was 3.19% and 4.48%, 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, SFAS 123R requires companies to utilize an estimated forfeiture rate when calculating the expense for the period, whereas SFAS 123 permitted companies to record forfeitures based on actual forfeitures, which was our historical policy under SFAS 123. As a result, we applied an estimated annual forfeiture rate of 5% for the three and nine months ended January 31, 2009 and 2008, in determining the expense recorded in our consolidated statement of operations.

We recorded expense of $1.4 million and $1.2 million the three months ended January 31, 2009 and 2008, and $3.8 million and $3.0 million for the nine months ended January 31, 2009 and 2008, respectively, in connection with stock-based awards accounted for under SFAS 123R. As of January 31, 2009, unrecognized stock-based compensation expense of non-vested stock options was $11.0 million, which is expected to be recognized using the straight line method over the required service period of the options. We expect stock-based compensation expense to increase in absolute dollars as a result of the adoption of SFAS 123R. 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, SFAS 123R 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 upon 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 SFAS 123R. We use the Black-Scholes option pricing model to estimate the fair value of rights to acquire stock granted under the ESPP. For the three and nine months ended January 31, 2009, we recorded stock-based compensation expense associated with the ESPP of $0.2 million and $0.7 million, respectively. As of January 31, 2009, unrecognized stock-based compensation expense associated with rights to acquire shares of common stock under the ESPP was $0.1 million.

Business Combinations

We account for business combinations in accordance with SFAS No. 141, *Business Combinations*, or SFAS 141, which requires the purchase method of accounting for business combinations. In accordance with SFAS 141, we determine the recognition of intangible assets based on the following criteria: (i) the intangible asset arises from contractual or other rights; or (ii) the intangible asset is separable or divisible from the acquired entity and capable of being sold, transferred, licensed, returned or exchanged. In accordance with SFAS 141, we allocate the purchase price of our business combinations to the tangible assets, intangible assets and liabilities acquired based on their estimated fair values. We record the excess of the purchase price over the total of those fair values as goodwill.

Our valuations require significant estimates, especially with respect to intangible assets. Critical estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from customer contracts, customer lists and distribution agreements and discount rates. We estimate fair value based upon assumptions we believe to be reasonable, but which are inherently uncertain and unpredictable, and, as a result, actual results may differ from our estimates.

Goodwill and Intangible Assets

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, or SFAS 142, we do not amortize goodwill or other intangible assets with indefinite lives but rather test them for impairment. SFAS 142 requires us to perform an impairment review of our goodwill balance at least annually, which we intend to perform on November 1 of each fiscal year, and also whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. The allocation of the acquisition cost to intangible assets and goodwill requires the extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets and amortization of intangible assets, other than goodwill. Further, when impairment indicators are identified with respect to previously recorded intangible assets, the values of the assets are determined using discounted future cash flow techniques. Significant management judgment is required in the forecasting of future operating results that are used in the preparation of the projected discounted cash flows, and should different conditions prevail, material write-downs of net intangible assets could occur. We review periodically the estimated remaining useful lives of our acquired intangible assets. A reduction in our estimate of remaining useful lives, if any, could result in increased amortization expense in future periods. Future goodwill impairment tests could result in a charge to earnings.

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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 January 31, 2009, we had one customer that accounted for 15% of our net accounts receivable.

Accounting for Income Taxes

Provision for (benefit from) income taxes is calculated in accordance with SFAS No. 109, *Accounting for Income Taxes*, or SFAS 109, and APB No. 28, *Interim Financial Reporting*, or APB 28. Beginning in fiscal 2009, and for the period ended January 31, 2009, based in part on historical evidence, trends in profitability and current expectations of future taxable net income, we transitioned from using the actual effective tax rate for the year to date as the best estimate of the annual effective tax rate under FIN 18, as amended by SFAS 109, to determining our tax provision (benefit) based on an estimated annual tax rate also in compliance with SFAS 109 and APB 28. Significant components affecting the tax rate for fiscal 2009 include the utilization of net operating losses, research and development credits, foreign tax credits, the composite state tax rate, and non-deductible stock-based compensation expense.

We adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of SFAS 109*, or FIN 48, on May 1, 2007. FIN 48 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. FIN 48 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.

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Results of Operations

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

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2009	2008	2009	2008
Revenues:				
Products	59.8%	64.0%	58.6%	63.1%
Maintenance	27.5	26.6	29.0	27.2
Services	12.7	9.4	12.4	9.7
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Products	7.3	5.4	6.3	4.6
Maintenance	4.5	5.3	5.1	5.6
Services	7.1	5.2	7.3	5.4
Total cost of revenues	18.9	15.9	18.7	15.6
Gross margin	81.1	84.1	81.3	84.4
Operating expenses:				
Research and development	14.3	18.3	16.4	19.6
Sales and marketing	33.8	46.1	42.9	51.8
General and administrative	13.5	10.6	14.6	13.8
Total operating expenses	61.6	75.0	73.9	85.2
Income (loss) from operations	19.5%	9.1%	7.4%	(0.8)%

Comparison of the Three Months Ended January 31, 2009 and 2008

Revenues

Revenues for the three months ended January 31, 2009 and 2008 was as follows (in thousands, except percentages):

	Three Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Products	$21,775	$17,698	$ 4,077	23.0%
Percentage of total revenues	*59.8%*	*64.0%*		
Maintenance	10,004	7,380	2,624	35.6%
Percentage of total revenues	*27.5%*	*26.6%*		
Services	4,613	2,593	2,020	77.9%
Percentage of total revenues	*12.7%*	*9.4%*		
Total revenues	$36,392	$27,671	$ 8,721	31.5%

Product Revenues. Product revenues for the three months ended January 31, 2009 included revenues of $6.8 million from 59 new customers and revenues of $14.9 million from existing customers. New customer revenues for the three months ended January 31, 2009 decreased by $5.9 million compared to new customer revenues for the three months ended January 31, 2008. The decrease was primarily attributable to large initial purchases by two new customers that amounted to $5.1 million of total new customer revenues during the three months ended January 31, 2008. In addition, the increase in the number of new customers purchasing our Logger product at lower average sales prices in the three months ended January 31, 2009 compared to the same period in the prior year, contributed to the remainder of the decrease in revenues from new customers. Existing customer revenues for the three months ended January 31, 2009 increased by $10.0 million compared to existing customer revenues for the three months ended January 31, 2008. The increase was primarily attributable to increased sales of our appliance products. We anticipate that the mix of product revenue from new and existing customers could fluctuate from quarter to quarter as a result of the transaction size, product mix and related geography of each revenue transaction. In addition, there was a net recognition of $0.3 million and $1.0 million of product revenues in the three months ended January 31, 2009 and 2008, respectively, related to sales transactions that initially included an undelivered product element for which we did not have VSOE. As of January 31, 2009, deferred product revenues included $1.5 million related to similar transactions. See the related discussion in Sources of Revenues, Cost of Revenues and Operating Expenses.

Maintenance Revenues. Maintenance revenues increased $2.6 million for the three months ended January 31, 2009 compared to the three months ended January 31, 2008, 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 $2.0 million for the three months ended January 31, 2009 compared to the three months ended January 31, 2008, as a result of a greater number of SOC engagements entered into during the period, which are typically larger and are longer in duration than other services engagements. In addition, the increase was due to increased service billings to a larger installed base of customers.

Geographic Regions. We sell our product in three geographic regions: Americas; Europe, Middle East, and Africa, or EMEA; and Asia Pacific. Net sales, which include product, maintenance and service revenue, for each region are summarized in the following table (in thousands, except percentages):

	Three Months Ended January 31,			
	2009	**2008**	**Change in Dollars**	**Change in Percent**
Americas	$28,459	$21,725	$ 6,734	31.0%
Percentage of total revenue	*78.2%*	*78.5%*		
EMEA	5,837	4,737	1,100	23.2%
Percentage of total revenue	*16.0%*	*17.1%*		
Asia Pacific	2,096	1,209	887	73.4%
Percentage of total revenue	*5.8%*	*4.4%*		
Total revenue	$36,392	$27,671	$ 8,721	31.5%

Cost of Revenues and Gross Margin

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

	Three Months Ended January 31,			
	2009	**2008**	**Change in Dollars**	**Change in Percent**
Products	$2,637	$1,487	$ 1,150	77.3%
Maintenance	1,637	1,456	181	12.4%
Services	2,587	1,454	1,133	77.9%
Total cost of revenues	$6,861	$4,397	$ 2,464	56.0%

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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 January 31,	
	2009	2008
Gross margin		
Products	$19,138	$16,211
Percentage of product revenues	*87.9%*	*91.6%*
Maintenance	8,367	5,924
Percentage of maintenance revenues	*83.6%*	*80.3%*
Services	2,026	1,139
Percentage of services revenues	*43.9%*	*43.9%*
Total gross margin	$29,531	$23,274
Percentage of total revenues	81.1%	84.1%

Cost of Product Revenues and Gross Margin. Cost of product revenues increased by $1.2 million for the three months ended January 31, 2009, primarily due to increased Logger appliance cost of revenues of $1.1 million related to increased Logger appliance sales, as well as a $0.1 million increase related to royalty obligations. Product gross margin decreased by 3.7% as a percentage of product revenues for the three months ended January 31, 2009 compared to the three months ended January 31, 2008, due to increased sales of lower margin Logger and connector appliance products and increases in royalty fees related to increased sales of products that include licensed technology. To the extent revenues from our appliance products continue to increase as a percentage of product mix, gross product margin will decline marginally.

Cost of Maintenance Revenues and Gross Margin. Cost of maintenance revenues increased by $0.2 million for the three months ended January 31, 2009 compared to the three months ended January 31, 2008 due primarily to increased compensation-related expense of $0.2 million related to increased headcount in our technical support organization. Maintenance gross margin increased by 3.3% as a percentage of maintenance revenues for the three months ended January 31, 2009 compared to the three months ended January 31, 2008, 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 $1.1 million for the three months ended January 31, 2009 compared to the three months ended January 31, 2008 due to increased compensation-related expense of $0.4 million related to increased head count and cost per employee. In addition, there was an increase in the use of third party contractors and external consultants of $0.6 million, and an increase in training and materials expense of $0.1 million. Services gross margin remained unchanged at 43.9% of services revenues for the three months ended January 31, 2009 compared to the three months ended January 31, 2008.

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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 January 31,			
	2009	**2008**	**Change in Dollars**	**Change in Percent**
Research and development	$ 5,201	$ 5,063	138	2.7%
Percentage of total revenues	*14.3%*	*18.3%*		
Sales and marketing	12,298	12,760	(462)	(3.6)%
Percentage of total revenues	*33.8%*	*46.1%*		
General and administrative	4,943	2,939	2,004	68.2%
Percentage of total revenues	*13.6%*	*10.6%*		
Total operating expenses	$22,442	$20,762	$ 1,680	8.1%
Percentage of total revenues	61.7%	75.0%		

Given the recent deterioration in global and U.S. economic and financial market conditions, we tightly managed expenses and maintained strict spending controls over our internal budgeting process. While our operating results for the period reflect our efforts, these results are not sustainable in the near to intermediate term given the investments required to expand our market opportunity. We plan to resume expansion of our investment in our infrastructure going forward, and expect future quarterly operating expenses to reflect this investment. Although our quarterly operations were favorably impacted by our management and focus on controlling our spending, we don t expect this trend to continue as we invest in our infrastructure on a go forward basis.

Research and Development Expenses. The increase in research and development expenses for the three months ended January 31, 2009 of $0.1 million compared to the three months ended January 31, 2008, was primarily attributable to an increase of $0.2 million in compensation-related expense, associated with an increase in research and development personnel from 99 to 109 at the respective period ends, offset by a reduction in recruiting and legal fee expense of $0.1 million.

Sales and Marketing Expenses. The decrease in sales and marketing expenses for the three months ended January 31, 2009 of $0.5 million compared to the three months ended January 31, 2008 was primarily attributable to a decrease of $0.8 million in variable compensation and decrease of $0.3 million in stock-based compensation related expense, attributable to structural changes in our variable compensation programs and internal organizational headcount movement. The decrease was offset by an increase of $0.8 million in other compensation-related expense, associated with an increase in sales and marketing personnel from 116 to 132 at the respective period ends. Sales and marketing expense as a percentage of total revenue decreased by 12.3% for the three months ended January 31, 2009 compared to the three months ended January 31, 2008, due primarily to lower sales commissions as a result of changes in compensation plan structure. In addition, the decrease is attributable to a growing contribution from maintenance and service revenues without a corresponding sales and marketing expense. We expect sales and marketing expenses to increase in absolute dollars and as a percentage of revenue in future quarters.

General and Administrative Expenses. The increase in general and administrative expenses of $2.0 million for the three months ended January 31, 2009 compared to the three months ended January 31, 2008 was primarily associated with an increase of $0.6 million in stock-based compensation and compensation-related expense, partially due to an increase in general and administrative personnel from 43 to 50 at the respective period ends. The increase also included an increase of $0.7 million in professional service expense, an increase in outside consulting expense of $0.1 million, an increase in bad debt expense of $0.2 million and an increase in liability insurance premium expense of $0.1 million.

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Non-Operating Expenses

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

	Three Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Interest income	$ 154	$ 158	$ (4)	(2.5)%
Percentage of total revenues	*0.4%*	*0.6%*		
Other income (expense), net	3	(60)	63	105.0%
Percentage of total revenues	*0.0%*	*(0.2)%*		
Provision for income taxes	2,183	257	1,926	749.4%
Percentage of total revenues	*6.0%*	*0.9%*		
Total non-operating expenses	$2,340	$ 355	$ 1,985	559.2%
Percentage of total revenues	6.4%	1.3%		

Interest Income. Interest income remained relatively unchanged for the three months ended January 31, 2009 compared to the three months ended January 31, 2008. Although cash and cash equivalents increased, interest earned was lower due to lower interest rates during the three months ended January 31, 2009.

Other Income (Expense), Net. The increase in other income (expense) of $0.1 million, net for the three months ended January 31, 2009 compared to the three months ended January 31, 2008 was primarily attributable to a reduction in interest expense related to capitalized software licenses, offset by foreign currency losses.

Provision for Income Taxes. For the three months ended January 31, 2009, we recorded a provision for income taxes of $2.2 million. The effective tax rate for the three months ended January 31, 2009 is 30.1%, and is 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 SFAS 123R stock-based compensation expenses, offset by the use of net operating loss carry-forwards and tax credits. For the three months ended January 31, 2008, we recorded a provision for income taxes of $0.3 million primarily related to foreign corporate income taxes. The effective tax rate for the three months ended January 31, 2008 was 9.8%. The effective tax rate for the third quarter of fiscal 2008 differs from the U.S. federal statutory rate primarily due to our inability during this period to record a tax benefit for all or a portion of the domestic tax loss as a result of the valuation allowance on our deferred tax assets, and to a lesser extent other non-deductible items such as state and foreign taxes.

Comparison of the Nine Months Ended January 31, 2009 and 2008

Revenues

Revenues for the nine months ended January 31, 2009 and 2008 was as follows (in thousands, except percentages):

	Nine Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Products	$56,746	$45,573	$ 11,173	24.5%
Percentage of total revenues	*58.6%*	*63.1%*		
Maintenance	28,102	19,627	8,475	43.2%
Percentage of total revenues	*29.0%*	*27.2%*		
Services	12,042	6,969	5,073	72.8%
Percentage of total revenues	*12.4%*	*9.7%*		

Total revenues	$96,890	$72,169	$ 24,721	34.3%

Product Revenues. Product revenues for the nine months ended January 31, 2009 included revenues of $24.6 million from 159 new customers and revenues of $32.1 million from existing customers. New customer revenues for the nine months ended January 31, 2009 increased by $0.6 million compared to new customer revenues for the nine months ended January 31, 2008. This was primarily attributable to an increase in the number of new customers purchasing our Logger product in the nine months ended January 31, 2009 compared to the same period in the prior year, offset by large initial purchases by two new customers during the nine months ended January 31, 2008. Existing customer revenues for the nine months ended January 31, 2009 increased by $10.6 million compared to existing customer revenues for the nine months ended January 31, 2008. The increase was primarily attributable to increased sales of our appliance products. We anticipate that the mix of product revenue from new and existing customers could fluctuate from period to period as a result of the transaction size, product mix and related geography of each revenue transaction. In addition, there was a net recognition of $0.7 million and $2.4 million of product revenues in the nine months ended January 31, 2009 and 2008, respectively, related to sales transactions that initially included an undelivered product element for which we did not have VSOE. As of January 31, 2009, deferred product revenues included $1.5 million related to similar transactions. See the related discussion in Sources of Revenues, Cost of Revenues and Operating Expenses.

Maintenance Revenues. Maintenance revenues increased $8.5 million for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008, 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 $5.1 million for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008, as a result of a greater number of SOC engagements entered into during the period, which are typically longer in duration than other services engagements. In addition, the increase was due to increased service billings to a larger installed base of customers.

Geographic Regions. We sell our product in three geographic regions: Americas; EMEA; and Asia Pacific. Net sales, which include product, maintenance and service revenue, for each region are summarized in the following table (in thousands, except percentages):

	Nine Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Americas	$76,527	$57,196	$ 19,331	33.8%
Percentage of total revenue	*79.0%*	*79.3%*		
EMEA	15,035	11,574	3,461	29.9%
Percentage of total revenue	*15.5%*	*16.0%*		
Asia Pacific	5,328	3,399	1,929	56.8%
Percentage of total revenue	*5.5%*	*4.7%*		
Total revenue	$96,890	$72,169	$ 24,721	34.30%

Cost of Revenues and Gross Margin

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

	Nine Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Products	$ 6,136	$ 3,301	$ 2,835	85.9%
Maintenance	4,931	4,083	848	20.8%
Services	7,017	3,894	3,123	80.2%

Total cost of revenues	$18,084	$11,278	$ 6,806	60.3%

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

	Nine Months Ended January 31,	
	2009	2008
Gross margin		
Products	$ 50,610	$ 42,272
Percentage of product revenues	*89.2%*	*92.8%*
Maintenance	23,171	15,544
Percentage of maintenance revenues	*82.5%*	*79.2%*
Services	5,025	3,075
Percentage of services revenues	*41.7%*	*44.1%*
Total gross margin	$ 78,806	$ 60,891
Percentage of total revenues	81.3%	84.4%

Cost of Product Revenues and Gross Margin. Cost of product revenues increased by $2.8 million for the nine months ended January 31, 2009 primarily due to increased Logger appliance cost of revenues of $2.4 million related to increased Logger appliance sales, as well as a $0.3 million increase related to royalty obligations. Product gross margin decreased by 3.6% as a percentage of product revenues for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008 due in part to increased sales of lower margin Logger and connector appliance products and increases in royalty fees related to increased sales of products that include licensed technology. To the extent revenues from our appliance products continue to increase as a percentage of product mix, gross product margin will decline marginally.

Cost of Maintenance Revenues and Gross Margin. Cost of maintenance revenues increased by $0.8 million for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008 due primarily to increased compensation-related expense of $0.7 million related to increased head count in our technical support organization, and increases in third-party royalty support and maintenance expenses of $0.1 million. Maintenance gross margin increased by 3.3% as a percentage of maintenance revenues for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008 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 $3.1 million for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008 due to increased compensation-related expense of $1.5 million related to increased head count and cost per employee. Additionally, use of third party contractors and external consultants increased by $1.2 million, training and materials expense increased by $0.3 million and travel and entertainment expense increased by $0.1 million. Services gross margin decreased by 2.4% as a percentage of services revenues for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008, due primarily to an increase in headcount and related cost per employee, partially offset by increased employee productivity in relation to revenue growth.

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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):

	Nine Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Research and development	$15,939	$14,170	$ 1,769	12.5%
Percentage of total revenues	*16.5%*	*19.6%*		
Sales and Marketing	41,521	37,367	4,154	11.1%
Percentage of total revenues	*42.8%*	*51.8%*		
General and administrative	14,155	9,927	4,228	42.6%
Percentage of total revenues	*14.6%*	*13.8%*		
Total operating expenses	$71,615	$61,464	$ 10,151	16.5%
Percentage of total revenues	73.9%	85.2%		

Research and Development Expenses. The increase in research and development expenses for the nine months ended January 31, 2009 of $1.8 million compared to the nine months ended January 31, 2008 was primarily attributable to an increase of $1.6 million in compensation-related expense, associated with an increase in research and development personnel from 99 to 109 at the respective period ends, an increase in outside consulting expense of $0.1 million, and to an increase of facilities-related expense of $0.1 million as a result of our expansion of our headquarters in Cupertino, California.

Sales and Marketing Expenses. The increase in sales and marketing expenses for the nine months ended January 31, 2009 of $4.2 million compared to the nine months ended January 31, 2008, was primarily attributable to an increase of $3.1 million in compensation-related expense associated with an increase in sales and marketing personnel from 116 to 132 at the respective period ends. The increase also included an increase of $0.4 million in marketing program expense, an increase of $0.6 million in travel and entertainment expenses, an increase in facilities expense of $0.2 million, and offset by a decrease of $0.2 million in outside consulting fees. Sales and marketing expense as a percentage of total revenue decreased by 9.0% for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008, due primarily to lower sales commissions as a result of changes in compensation plan structure, and to a lesser extent because we recorded revenue for a large transaction during the second quarter of fiscal 2009, where we recorded the related commission expense during the fourth quarter of fiscal 2008. In addition, this decrease is attributable to a growing contribution from maintenance and service revenues without a corresponding sales and marketing expense.

General and Administrative Expenses. The increase in general and administrative expenses of $4.2 million for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008, was primarily associated with an increase of $1.9 million in compensation-related expense, partially due to an increase in general and administrative personnel from 43 to 50 at the respective period ends. The increase also included an increase in professional service expenses of $1.4 million, an increase in liability insurance premium expense of $0.3 million, an increase in investor relations expense of $0.1 million, an increase in depreciation expense of $0.1 million, an increase in bad debt expense of $0.1 million, and an increase of $0.2 million in expensed software, support and maintenance.

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Non-Operating Expenses

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

	Nine Months Ended January 31,			
	2009	2008	Change in Dollars	Change in Percent
Interest income	$ 909	$ 422	$ 487	115.4%
Percentage of total revenues	*0.9%*	*0.6%*		
Other income (expense), net	(107)	(284)	177	62.3%
Percentage of total revenues	*(0.1)%*	*(0.4)%*		
Provision for income taxes	2,415	514	1,901	369.8%
Percentage of total revenues	*2.5%*	*0.7%*		
Total non-operating expenses	$3,217	$ 652	$ 2,565	393.4%
Percentage of total revenues	3.3%	0.9%		

Interest Income. The increase in interest income of $0.5 million for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008 was primarily attributable to increased cash and cash equivalents related to net proceeds received from our IPO. The increase was offset by lower interest rates during the nine months ended January 31, 2009.

Other Income (Expense), Net. The decrease in other income (expense) of $0.2 million, net for the nine months ended January 31, 2009 compared to the nine months ended January 31, 2008 was primarily a result of a reduction in interest expense related to capitalized software licenses, offset by a reduction in foreign currency losses.

Provision for Income Taxes. For the nine months ended January 31, 2009, we recorded a provision for income taxes of $2.4 million. The effective tax rate for the nine months ended January 31, 2009 is 30.2%, and is 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 SFAS 123R stock-based compensation expenses, offset by the use of net operating loss carry-forwards and tax credits. For the nine months ended January 31, 2008, we recorded a cumulative provision for income taxes of $0.5 million, primarily related to foreign corporate income taxes. The cumulative effective tax rate for the nine months ended January 31, 2008 was (118.6%). The effective tax rate for the nine months ended January 31, 2008 differs from the U.S. federal statutory rate primarily due to our inability during this period to record a tax benefit for all or a portion of the domestic tax loss as a result of the valuation allowance on our deferred tax assets, and to a lesser extent other non-deductible items such as state and foreign taxes.

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 2008, and generated $12.3 million of cash from our operating activities during the nine months ended January 31, 2009 compared to generating $11.5 million of cash from our operating activities for the nine months ended January 31, 2008. 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. 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 January 31, 2009, we had cash and cash equivalents totaling $82.9 million and accounts receivable of $22.2 million, compared to $71.9 million of cash and cash equivalents and $26.7 million of accounts receivable at April 30, 2008.

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.

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

	Nine Months Ended January 31,	
	2009	2008
Net cash provided by operating activities	$12,322	$11,474
Net cash used in investing activities	(1,809)	(3,511)
Net cash provided by (used in) financing activities	728	(3,588)

Operating Activities

Our operating activities have provided positive cash flows, primarily due to net income generated from operations, the significant non-cash charges associated with stock-based compensation and depreciation and amortization reflected in operating expenses and 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, these non-cash charges and 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 $12.3 million of cash from operating activities during the nine months ended January 31, 2009, primarily as a result of a $4.3 million decrease in accounts receivable due to strong collections efforts partially attributable to our relatively high accounts receivable balance as of April 30, 2008, a $2.7 million decrease in prepaid expenses, an increase of $2.3 million in other accrued liabilities offset by a decrease in accounts payable of $1.9 million, a decrease in accrued compensation and benefits of $4.1 million related to payments of sales commissions and performance bonuses earned in fiscal 2008, and reduction in deferred revenue of $3.8 million. In addition, we had a net income of $5.6 million for this period, which included non-cash charges of $4.6 million for stock-based compensation expense and $2.5 million of depreciation and amortization.

We generated $11.5 million of cash from operating activities during the nine months ended January 31, 2008, primarily as a result of a $6.1 million decrease in accounts receivable due to strong collections, a $1.0 million decrease in prepaid expenses, a $0.7million increase in other accrued liabilities, and a $1.8 million increase in deferred revenues, offset by a $0.5 million decrease in our accrued compensation and benefits as a result of our payment of sales commissions and performance bonuses earned during the period, and further offset by a $2.0 million decrease in our accounts payable due to the timing of our payment obligations. In addition, we had a net loss of $0.9 million for this period, which included non-cash charges of $3.4 million for stock-based compensation expense and $1.8 million of depreciation and amortization.

Investing Activities

During the nine months ended January 31, 2009 and 2008, we used $1.8 million and $3.5 million in cash, respectively, for investing activities, all of which was related to capital expenditures associated with computer equipment and furniture and fixtures in support of the expansion of our infrastructure and work force.

Financing Activities

During the nine months ended January 31, 2009, we generated $0.7 million of cash from financing activities, comprised primarily of $2.4 million from net proceeds from the exercise of stock options, offset by $1.7 million in payments for prepaid software licenses used as a component in our product sales. During the nine months ended January 31, 2008, cash used in financing activities was $3.6 million, comprised primarily of $1.4 million in payments for capital lease obligations and prepaid licenses for software used as a component in some of our products, and $3.0 million in payments related to our IPO preparation costs, offset by $0.8 million from net proceeds from the exercise of stock options.

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 January 31, 2009, 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

We lease facilities for our corporate headquarters, subsidiaries and regional sales offices. We lease our principal facility in Cupertino, California under a non-cancelable operating lease agreement that expires in October 2013. We also have leases for our regional sales offices that are for 13 months or less. There were no material changes to our contractual obligations and commitments during the three or nine months ended January 31, 2009.

The following table is a summary of our contractual obligations as of January 31, 2009:

	Payments Due by Period					
	Total	Remainder of FY 2009	FY 2010	FY 2011	FY 2012	Thereafter
	(in thousands)					
Operating lease obligations	$ 10,134	$ 559	$ 2,250	$ 1,988	$ 2,068	$ 3,269
Accrued contractual obligations.	517	488	26	3		
Total	$ 10,651	$ 1,047	$ 2,276	$ 1,991	$ 2,068	$ 3,269

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

Market Risk. Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. Our market risk exposure is primarily a result of fluctuations in foreign exchange rates and interest rates. We do not hold or issue financial instruments for trading purposes.

Foreign Currency Exchange Risk. To date, substantially all of our international sales have been denominated in U.S. dollars, and therefore the majority of our net revenues are not subject to foreign currency risk. Our operating expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, but historically have had relatively little impact on our operating results and cash flows. We utilize foreign currency forward and option contracts to manage our currency exposures as part of our ongoing business operations. We do not expect to enter into foreign currency exchange contracts for trading or speculative purposes.

Interest Rate Risk. Our investment policy is intended to preserve principal, provide liquidity and maximize income by limiting default risk, market risk and reinvestment risk. To minimize these risks, we primarily invest in money market funds. We had cash and cash equivalents totaling $82.9 million as of January 31, 2009, including the $45.9 million net proceeds from our IPO, which are primarily held for working capital and general corporate purposes. The fair value of our investment portfolio would not be significantly impacted by either a 100 basis point increase or decrease in market interest rates due mainly to the short-term nature of the majority of our investment portfolio. As a result, we do not believe that we have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. Declines in interest rates, however, will reduce future interest income. We do not enter into investments for trading or speculative purposes.

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 January 31, 2009, 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.

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ITEM 1A. RISK FACTORS

Risk Related to Our Business and Industry

We have a limited operating history in an emerging market and a history of losses, and we are unable to predict the extent of any future losses or when, if ever, we will achieve profitability in the future.

We launched our ESM products in January 2002 and our first Logger product in December 2006. Because we have a limited operating history, and the market for our products is rapidly evolving, 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 $5.6 million for the nine months ended January 31, 2009, we do have a history of losses from operations, incurring losses from operations of $2.0 million, $0.3 million, and $16.8 million for the fiscal years ended April 30, 2008, 2007, and 2006, respectively. As of January 31, 2009, our accumulated deficit was $41.1 million. We expect our operating expenses to increase over the next several years as we hire additional sales and marketing personnel, expand 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 will continue to incur significant losses and will not become profitable. Our historical revenue growth has been inconsistent, reflects fluctuations not related to performance and should not be considered indicative of our future performance. See 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 achieve profitability and our losses may increase. Even if we do achieve profitability, 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.

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. For example, revenues in fiscal 2006 and prior years excluded revenues related to multiple element sales transactions consummated in that year that were deferred because we did not have vendor-specific objective evidence of fair value, or VSOE, for some product elements that were not delivered in the fiscal year of the transaction. In fiscal 2008 and 2007, we either delivered these product elements, or we and our customers amended the contractual terms of these sales transactions to remove the undelivered product elements. Fiscal 2007 revenues included a substantial portion of the revenues so deferred from fiscal 2006, as well as a small amount of revenues similarly deferred from prior years, and fiscal 2008 revenues included $2.9 million of revenues that were deferred from prior years. See Management s Discussion and Analysis of Financial Condition and Results of Operations Sources of Revenues, Cost of Revenues and Operating Expenses. We expect that in future periods the comparison of revenues period-to-period will not be favorably impacted to the same extent by similar transactions consummated in fiscal 2007 and prior periods. 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 may choose to cover our stock, the price of our common stock could decline substantially.

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;

changes in the renewal rate of maintenance agreements;

our ability to estimate warranty claims accurately;

the timing of satisfying revenue recognition criteria, including establishing VSOE for new products and maintaining VSOE for maintenance and services, particularly where we accrue the associated commission expense in a different period;

the budgeting, procurement and work cycles of our customers, including customers in the public sector, which may cause seasonal variation as our business and the market for compliance and security management software solutions matures;

general economic conditions, both domestically and in our foreign markets, and economic conditions specifically affecting industries in which our customers participate, such as financial services and retail, such as the recent and continuing severe deterioration in global and U.S. economic and financial market conditions; and

the impact of FIN 48, a recently adopted accounting interpretation 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 product and the short-term difficulty in adjusting our operating expenses. Because decisions to purchase products such as our ESM product 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, customer 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 recent deterioration in global and U.S. economic and financial market conditions has increased the duration and intensity of our sales efforts as customers enhance their review of spending decisions. In addition, we have less experience with sales of Logger and 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 the value of our products, including their technical capabilities and potential cost savings to the organization. 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.

If we fail to further develop 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, to a lesser extent, 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 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 U.S. government and international revenues for the foreseeable future and, we believe, a growing portion of our U.S. commercial revenues. We may be unable to recruit additional channel partners and successfully expand our channel sales program. If we do not successfully execute our strategy to increase channel sales, particularly to further 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, particularly in the public sector, the mid-market and internationally. 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, changes in the proportion of our revenues attributable to sales by channel partners, which are more likely than direct sales to involve collectibility concerns at the time of contract execution and product delivery, may cause our operating results to fluctuate from period to period.

We have less experience with sale, manufacture, delivery, service and support of Logger and our other appliance products and rely on a single contract manufacturer for manufacture and fulfillment of our appliance products, and as a result we may be unable to successfully forecast demand or fulfill orders for these appliance products.

We introduced our first Logger product in fiscal 2007. Prior to June 2006, we offered only software products and related services, and as a result have less experience with sales of appliance-based products than we have with our flagship ESM products. Fulfillment of sales of our appliance products involves hardware manufacturing, inventory, import certification and return merchandise authorization processes with which we have less experience. For example, if we fail to accurately predict demand and as a result our manufacturer maintains insufficient hardware inventory or excess inventory, we may be unable to timely deliver ordered products or may have substantial inventory expense. As the size of individual orders increases, we may be unable to cause delivery, particularly near the end of quarterly periods, of large unforecasted orders. In addition, we use a single source for manufacture and fulfillment of our appliance products and if our 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, in particular 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 develop 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 another 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.

Because we derive a majority of our revenues from ArcSight ESM and related products and services, any failure of this product to satisfy customer demands or to achieve increased market acceptance will harm our business, operating results, financial condition and growth prospects.

We have derived a majority of our product revenues from ArcSight ESM and related products. Demand for ArcSight ESM is affected by a number of factors beyond our control, including the timing of development and release of new products by us and our competitors, technological change, and lower-than-expected growth or a contraction in the worldwide market for enterprise compliance and security management solutions or other risks described in this Quarterly Report on Form 10-Q. If we are unable to continue to meet customer demands or to achieve more widespread market acceptance of ArcSight ESM, our business, operating results, financial condition and growth prospects will be adversely affected.

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 first Logger product in fiscal 2007 and are currently developing new versions of this product and our ESM platform, as well as 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 is especially complex because it must recognize, effectively interact with and manage a wide variety of devices and applications, and effectively 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 four to six months and a new version or major sub-version is 12 to 18 months. 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, may complicate our relationships with channel and strategic partners and will entail significant risk of failure. Sales of our Logger product 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 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.

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

The market for enterprise compliance and security management and log archiving products is intensely competitive, and we expect competition to increase in the future. A significant number of companies have developed, or are developing, products that currently, or in the future are likely to, compete with some or all of our products. We may not compete successfully against our current or potential competitors, especially those with significantly greater financial resources or brand name recognition. Companies competing with us may introduce products that are more competitively priced, or with an entirely different pricing or distribution model, have greater performance or functionality or incorporate technological advances that we have not yet developed or implemented.

Our competitors include large software companies, software or hardware network infrastructure companies, smaller software companies offering more narrowly focused enterprise compliance and security management, log archiving and response products and small and large companies offering point solutions that compete with components of our platform or individual products offered by us. Existing competitors for a compliance and security management software platform solution such as our ESM platform primarily are specialized, privately-held companies, such as Intellitactics and netForensics, as well as larger companies such as CA, Cisco, Symantec, EMC (through its acquisition of Network Intelligence), IBM (through its acquisition of Micromuse and Consul) and Novell (through its acquisition of e-Security). Current competitors for sales of our Logger product include specialized, privately-held companies, such as LogLogic and SenSage. In addition to these current competitors, we expect to face competition for our appliance products from existing large, diversified software and hardware companies, from specialized, smaller companies and from new companies that may seek to enter this market.

Another source of competition is represented by the custom efforts undertaken by potential customers to analyze and manage the information produced from their existing devices and applications to identify and remediate threats. Many companies, in particular large corporate enterprises, have developed internally software that is an alternative to our enterprise compliance and security management and log archiving products. 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 this internal development. It may also allow our competitors to offer products with a degree of compatibility similar to ours or may facilitate new entrants into our business. New competitors may emerge and rapidly acquire significant market share due to factors such as greater brand name recognition, larger installed customer bases and significantly greater financial, technical, marketing and other resources and experience. If these new competitors are successful, we would lose market share and our revenues would likely decline.

Mergers or consolidations among these competitors, or acquisitions of our competitors by large companies, present heightened competitive challenges to our business. For example, in recent years IBM has acquired Internet Security Systems, Inc., Micromuse and Consul, Novell acquired e-Security and EMC acquired Network Intelligence. We believe that the trend toward consolidation in our industry will continue. These acquisitions will make these combined entities potentially more formidable competitors to us if their products and offerings are effectively integrated. 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 those firms.

Many 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;
- 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 compliance and security management, log archiving and response products and managed security services, which intensifies pricing pressures within our market.

Increased competition could result in fewer customer orders, price reductions, reduced operating margins and loss of market share. Our larger competitors also may be able to provide customers with different or greater capabilities or benefits than we can provide in areas such as technical qualifications, geographic presence, the ability to provide 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 may provide them with an advantage in competing for business with those potential customers. Our ability to compete will depend upon our ability to provide better performance than our competitors at a competitive price. 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.

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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 compliance and security management. In addition, hardware vendors, including diversified, global concerns, offer products that address the compliance and security 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, which may provide 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 trend toward 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 those products, which would adversely affect our business, operating results and financial condition. 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.

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.

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 nine months ended January 31, 2009 and in fiscal years ended April 30, 2008, 2007 and 2006 we derived 18%, 20%, 32% and 38% 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;
- potential delays or changes in the government appropriations process; and
- delays in the payment of our invoices by government payment offices

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.

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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 in connection with U.S. federal 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, penalties, termination of contracts and suspension or debarment from government contracting for a period of time. Any such damages, penalties, disruption or limitation in our ability to do business with the U.S. federal 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.

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 compliance and security 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.

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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 platform, 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 platform 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 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, which may result in sub-optimal installation and consequently performance that is less than the level anticipated by the end user. Because our customers rely on our product, services 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 or our failure to properly provide consulting and implementation services and maintenance to our customers may result in negative publicity or legal claims against us.

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 ESM platform to interface with these 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 nine months ended January 31, 2009 and in fiscal years ended April 30, 2008, 2007 and 2006, we derived 27%, 33%, 23% and 21% 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, Austria, Canada, China, France, Germany, Hong Kong, India, Japan, 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;

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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;

reduced protection for 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 customers in countries known to experience corruption, particularly certain emerging countries in East Asia, Eastern Europe and the Middle East, and further expansion of our international selling efforts may involve additional regions, including Africa, 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 propriety 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 six 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 issue 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 corporate 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.

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 2009. See Business Intellectual Property Oracle License Agreement in our Annual Report on Form 10-K for the fiscal year ended April 30, 2008. 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 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.

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 by its authors or other third parties 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 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, and we plan to implement the use of software tools to review our source code for potential inclusion of open source, but we cannot be sure that all open source is submitted for approval prior to use in our products or that such software tools will be effective. In addition, open source license terms may be ambiguous and many of the risks associated with usage of open source 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.

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 287 employees as of April 30, 2007 to 383 employees as of January 31, 2009. 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.

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. During the audit of our financial statements for fiscal 2004, 2005, 2006 and 2007, material weaknesses in our internal control over financial reporting were identified. While we did not identify any material weaknesses in connection with the audit of our financial statements for fiscal 2008, in the future, additional material weaknesses or other areas of our internal control over financial reporting may be identified that need improvement. Given our history of material weaknesses, achieving and maintaining effective controls may be particularly challenging for us.

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. 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, additional 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 will be required to include in our periodic reports filed with the SEC beginning with our annual report for our fiscal year ending April 30, 2009 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 reporting, we are expending significant resources and providing significant management oversight. We have a substantial effort ahead of us to maintain the processes that we have added and to implement additional processes, document our system of internal control over relevant processes, assess their design, remediate any deficiencies identified and test their operation. As a result, management s attention may be diverted from other business concerns, which could harm our business, operating results and financial condition. These efforts will also involve substantial accounting-related costs. 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.

Implementing any appropriate changes to our internal controls may require specific compliance training of our directors, officers and employees, entail substantial costs in order to modify our existing accounting systems, and take a significant period of time to complete. These changes may not, however, be effective in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, 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 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.

We also 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.

The Sarbanes-Oxley Act and the rules and regulations of The NASDAQ Stock Market will make it more difficult and more expensive for us to maintain directors and officers liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to maintain or increase coverage. If we are unable to maintain adequate directors and officers insurance, our ability to recruit and retain qualified directors, especially those directors who may be considered independent for purposes of The NASDAQ Stock Market rules, and officers may be curtailed.

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 2022 and fiscal 2013, 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, which would adversely affect 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, including new releases of our products, may create delays in the introduction of our products in international markets, 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 our appliance-based products and have enacted laws that could limit our ability to distribute products 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.

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 initiate or 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 recent and continuing unprecedented volatility in the financial markets;
- 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 recent unprecedented 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 do not publish 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 will depend in part on the research and reports that securities or industry analysts publish about us or our business. We currently have limited, and may not obtain additional, research coverage by securities analysts, and industry analysts that currently cover us may cease to do so. If no securities analysts commence coverage of our company, or if industry analysts cease coverage of our company, the trading price for our stock would be negatively impacted. In the event we obtain securities analyst coverage, 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 cease coverage of our company or fail to publish reports on us regularly, demand for our stock could decrease, which might cause our stock price and trading volume to decline.

Our directors, executive officers and principal stockholders have substantial control over us and could delay or prevent a change in corporate control.

Our directors and executive officers, together with their affiliates, beneficially own in the aggregate 34.7% of our outstanding common stock as of March 1, 2009, including options exercisable by those holders within 60 days of that date. In addition holders that together with their affiliates hold 5% or more of our common stock, but who are not affiliated with our directors and executive officers, beneficially own in the aggregate an additional 31.5% of our outstanding common stock as of that date. As a result, these stockholders, acting together, would have the ability to control the outcome of matters submitted to our stockholders for approval, including the election of directors and any merger, consolidation or sale of all or substantially all of our assets. In addition, these stockholders, acting together, would have the ability to control the management and affairs of our company. Accordingly, this concentration of ownership might harm the market price of our common stock by:

- delaying, deferring or preventing a change in control of us;
- impeding a merger, consolidation, takeover or other business combination involving us; or
- discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of us.

Delaware law and provisions in our restated certificate of incorporation and amended and restated bylaws 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;
- only our chairman of the board, our chief executive officer, our president, a majority of our board of directors or our lead independent director, if any (none currently), 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.

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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 January 31, 2009, 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.

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. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

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ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description
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.

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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: March 12, 2009	By: /s/ Thomas J. Reilly Thomas J. Reilly President and Chief Executive Officer (Principal Executive Officer)
Date: March 12, 2009	By: /s/ Stewart Grierson Stewart Grierson Chief Financial Officer (Principal Financial Officer)

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