FORTINET INC
Form 10-Q
August 08, 2012

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

FORM 10-Q

(Mark One)
[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2012
or

[ ] 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: 001-34511

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

Delaware (State or other jurisdiction of incorporation or organization)	77-0560389 (I.R.S. Employer Identification No.)
1090 Kifer Road Sunnyvale, California (Address of principal executive offices)	94086 (Zip Code)

(408) 235-7700
(Registrant's telephone number, including area code)

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

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

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.

Large accelerated filer[x]		Accelerated filer	[ ]
Non-accelerated filer [ ]	(Do not check if a smaller reporting company)	Smaller reporting company	[ ]

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

As of July 31, 2012, there were 158,222,830 shares of the registrant's common stock outstanding.

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FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended June 30, 2012
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Part I

ITEM 1. Financial Statements
FORTINET, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands)

	June 30, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$81,226	$71,990
Short-term investments	320,403	318,283
Accounts receivable, net of allowance for doubtful accounts of $229 and $336 at June 30, 2012 and December 31, 2011, respectively	95,351	95,522
Inventory	20,828	16,249
Deferred tax assets	7,063	7,578
Prepaid expenses and other current assets	19,640	13,948
Total current assets	544,511	523,570
PROPERTY AND EQUIPMENT—Net	10,247	7,966
DEFERRED TAX ASSETS—Non-current	46,003	46,523
LONG-TERM INVESTMENTS	242,769	148,414
OTHER ASSETS	7,715	8,274
TOTAL ASSETS	$851,245	$734,747
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$24,101	$19,768
Accrued liabilities	17,280	15,971
Accrued payroll and compensation	27,086	24,197
Deferred revenue	226,510	206,928
Total current liabilities	294,977	266,864
DEFERRED REVENUE—Non-current	104,858	87,905
OTHER LIABILITIES	24,766	21,624
Total liabilities	424,601	376,393
COMMITMENTS AND CONTINGENCIES (Note 7)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value - 300,000 shares authorized; 159,166 and 156,401 shares issued and 157,757 and 154,992 shares outstanding at June 30, 2012 and December 31, 2011, respectively	159	156
Additional paid-in-capital	356,438	317,026
Treasury stock	(2,995)	(2,995)
Accumulated other comprehensive income	1,154	402
Retained earnings	71,888	43,765
Total stockholders' equity	426,644	358,354
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$851,245	$734,747

See notes to condensed consolidated financial statements.

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FORTINET, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited, in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
REVENUE:				
Product	$61,692	$46,687	$114,896	$86,852
Services	65,412	52,671	127,550	101,357
Ratable and other revenue	1,858	3,665	3,763	8,080
Total revenue	128,962	103,023	246,209	196,289
COST OF REVENUE:				
Product	23,935	16,591	43,003	30,666
Services	12,467	8,596	23,680	16,377
Ratable and other revenue	725	1,371	1,487	2,931
Total cost of revenue	37,127	26,558	68,170	49,974
GROSS PROFIT:				
Product	37,757	30,096	71,893	56,186
Services	52,945	44,075	103,870	84,980
Ratable and other revenue	1,133	2,294	2,276	5,149
Total gross profit	91,835	76,465	178,039	146,315
OPERATING EXPENSES:				
Research and development	20,388	15,942	40,055	30,363
Sales and marketing	44,259	35,896	86,295	68,614
General and administrative	6,238	5,848	12,023	11,114
Total operating expenses	70,885	57,686	138,373	110,091
OPERATING INCOME	20,950	18,779	39,666	36,224
INTEREST INCOME	1,203	863	2,287	1,656
OTHER INCOME (EXPENSE)—Net	73	(207)	3	(302)
INCOME BEFORE INCOME TAXES	22,226	19,435	41,956	37,578
PROVISION FOR INCOME TAXES	8,276	4,941	13,833	9,497
NET INCOME	$13,950	$14,494	$28,123	$28,081
Net income per share:				
Basic	$0.09	$0.10	$0.18	$0.19
Diluted	$0.08	$0.09	$0.17	$0.17
Weighted-average shares outstanding:				
Basic	157,474	152,267	156,742	151,293
Diluted	166,061	163,887	165,808	163,393

See notes to condensed consolidated financial statements.

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FORTINET, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited, in thousands)

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Net income	$13,950	$14,494	$28,123	$28,081
Other comprehensive income:				
Foreign currency translation	(783)	269	(225)	923
Unrealized gains (losses) on investments	(326)	159	1,473	154
Unrealized gains (losses) on cash flow hedges	19	—	19	(74)
Tax provision related to items of other comprehensive income	114	—	(515)	—
Net change in accumulated other comprehensive income	(976)	428	752	1,003
Comprehensive income	$12,974	$14,922	$28,875	$29,084

See notes to condensed consolidated financial statements.

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FORTINET, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Six Months Ended	
	June 30, 2012	June 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$28,123	$28,081
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,077	3,336
Loss on disposal of fixed assets	31	—
Amortization of investment premiums	6,528	6,291
Stock-based compensation	15,098	6,940
Excess tax benefit from employee stock option plans	(5,158)	(4,491)
Changes in operating assets and liabilities:		
Accounts receivable—net	171	63
Inventory	(7,952)	(1,455)
Deferred tax assets	520	(5,546)
Prepaid expenses and other current assets	(152)	(1,000)
Other assets	941	(887)
Accounts payable	4,337	355
Accrued liabilities	703	3,660
Accrued payroll and compensation	3,119	357
Other liabilities	(818)	3,170
Deferred revenue	36,492	20,544
Income taxes payable	5,743	14,826
Net cash provided by operating activities	92,803	74,244
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(355,025)	(287,659)
Sales of investments	44,255	75,582
Maturities of investments	209,242	136,263
Purchases of property and equipment	(3,855)	(1,450)
Payment made in connection with business acquisition	(550)	(2,623)
Net cash used in investing activities	(105,933)	(79,887)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	17,650	11,219
Excess tax benefit from employee stock option plans	5,158	4,491
Net cash provided by financing activities	22,808	15,710
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(442)	1,093
NET INCREASE IN CASH AND CASH EQUIVALENTS	9,236	11,160
CASH AND CASH EQUIVALENTS—Beginning of period	71,990	66,859
CASH AND CASH EQUIVALENTS—End of period	$81,226	$78,019
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (refunded) for income taxes	$6,380	$(1,017)
NON-CASH INVESTING ACTIVITIES:		
Purchases of property and equipment not yet paid	$580	$124
Liability incurred in connection with business acquisition	$400	$—

See notes to condensed consolidated financial statements.

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation

The unaudited condensed consolidated financial statements of Fortinet and its wholly owned subsidiaries (collectively, the "Company," "we," "us," or "our") have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information as well as the instructions to Form 10-Q and the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the fiscal year ended December 31, 2011, contained in our Annual Report on Form 10-K ("Form 10-K") filed with the SEC on February 28, 2012. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the operating results for any subsequent quarter, for the full year or any future periods.

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

There have been no substantial changes in our significant accounting policies since the fiscal year ended December 31, 2011.

Revenue Recognition—In October 2009, the Financial Accounting Standards Board ("FASB") amended the Accounting Standards Codification ("ASC") as summarized in Accounting Standards Update ("ASU") No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements ("ASU 2009-13"), and ASU No. 2009-14, Software (Topic 985): Certain Revenue Arrangements That Include Software Elements ("ASU 2009-14"). ASU 2009-13 amended the accounting for multiple-element arrangements to provide guidance on how the deliverables in an arrangement should be separated and eliminates the use of the residual method. ASU 2009-13 also requires an entity to allocate revenue using the relative selling price method. The standard establishes a hierarchy of evidence to determine the stand-alone selling price of a deliverable based on vendor-specific objective evidence ("VSOE"), third party evidence ("TPE"), and the best estimated selling price ("BESP"). If VSOE is available, it would be used to determine the selling price of a deliverable. If VSOE is not available, the entity would determine whether TPE is available. If so, TPE must be used to determine the selling price. If TPE is not available, then the BESP would be used. ASU 2009-14 amended industry specific revenue accounting guidance for software and software related transactions to exclude from its scope tangible products containing software components and non-software components that function together to deliver the product's essential functionality.

This guidance does not generally change the units of accounting for our revenue transactions. Most non-software products and services qualify as separate units of accounting because they have value to the customer on a standalone basis and our revenue arrangements generally do not include a right of return relative to delivered products.

The majority of our products are hardware appliances containing software components that function together to provide the essential functionality of the product, therefore, our hardware appliances are considered non-software deliverables and are no longer within the scope of ASC 985-605.

Our product revenue also includes software products that may operate on the hardware appliances, but are not considered essential to the functionality of the hardware and continue to be subject to the guidance at ASC 985-605, which remains unchanged. Certain of our software, when sold with our appliances, is considered essential to its functionality and as a result is no longer accounted for under ASC 985-605; however, this same software if sold separately is accounted for under the guidance at ASC 985-605.

For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with ASU 2009-13. Certain arrangements with multiple deliverables may continue to have software deliverables that are subject to ASC 985-605 along with non-software deliverables that are subject to ASU 2009-13. When a sales arrangement contains multiple elements, such as hardware appliances, software, customer support services, and/or professional services, we

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

allocate revenue to each element based on the aforementioned selling price hierarchy. In multiple element arrangements where software is more-than-incidental, revenue is allocated to each separate unit of accounting for each of the non-software deliverables and to the software deliverables as a group using the relative selling prices of each of the deliverables in the arrangement based on the selling price hierarchy in ASU 2009-13.

VSOE of fair value for elements of an arrangement is based upon the normal pricing and discounting practices for those services when sold separately. In determining VSOE, we require that a substantial majority of the selling prices for a service fall within a reasonably narrow pricing range, generally evidenced by a substantial majority of such historical stand-alone transactions falling within a reasonably narrow range of the median rates. In addition, we consider major segments, geographies, customer classifications, and other variables in determining VSOE.

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

For our hardware appliances, we use BESP as our selling price. For our support and other services, we generally use VSOE as our selling price. When we are unable to establish a selling price using VSOE for our support and other services, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels. We review our BESP estimates on a quarterly basis to coincide with our VSOE review process.

We recognize revenue for our software sales based on software revenue recognition guidance pursuant to ASC 985-605. Under ASC 985-605, we use the residual method to recognize revenue when a product agreement includes one or more elements to be delivered and VSOE of fair value for all undelivered elements exists. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is generally deferred and recognized when delivery of those elements occurs or when fair value can be established. When the undelivered element for which we do not have VSOE of fair value is support, revenue for the entire arrangement is recognized ratably over the support period.

We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. Our appliances include operating system software that is integrated into the appliance hardware and is deemed essential to its functionality. As a result, we account for revenue in accordance with ASU 2009-13 and all related interpretations.

Revenue is recognized when all of the following criteria have been met:

- Persuasive evidence of an arrangement exists. Binding contracts or purchase orders are generally used to determine the existence of an arrangement.

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- Delivery has occurred. Delivery occurs when we fulfill an order and title and risk of loss has been transferred or upon delivery of the service contract registration code.

- The fee is fixed or determinable. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. In the event payment terms differ from our standard business practices, the fees are deemed to be not fixed or determinable and revenue is recognized when the payments become due, provided the remaining criteria for revenue recognition have been met.

- Collectability is probable. We assess collectability based primarily on creditworthiness as determined by credit checks and analysis, as well as payment history. Payment terms generally range from 30 to 90 days from invoice date.

For arrangements which include end-customer acceptance criteria, revenue is recognized upon acceptance. We recognize product revenue on sales to distributors that have no general right of return and direct sales to end-customers upon

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

shipment, once all other revenue recognition criteria have been met. We also recognize revenue upon sell-through for distributor agreements that allow for rights of return. Such returns are estimated and recorded as a reduction to revenue. Substantially all of our products have been sold in combination with services, which consist of subscriptions and/or support. Subscription services provide access to our antivirus, intrusion prevention, web filtering, and anti-spam functionality. Support services include rights to unspecified software upgrades, maintenance releases and patches, telephone and Internet access to technical support personnel, and hardware support.

The subscription and support services start on the date the customer registers the appliance. The customer is then entitled to service for the stated contractual period beginning on the registration date.

We offer certain sales incentives to channel partners. We reduce revenue for estimates of sales returns and allowances. Additionally, in limited circumstances we may permit end-customers, distributors and resellers to return our products, subject to varying limitations, for a refund within a reasonably short period from the date of purchase. We estimate and record reserves for sales incentives and sales returns based on historical experience.

Recently Adopted Accounting Pronouncements

In May 2011, the FASB issued ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (Topic 820) - Fair Value Measurement (“ASU 2011-04”), to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. We adopted ASU 2011-04 in the first quarter of 2012. The measurement provisions of this guidance did not impact our condensed consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220)-Presentation of Comprehensive Income (“ASU 2011-05”), to require an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of stockholders' equity. We adopted ASU 2011-05 in the first quarter of 2012 and applied it retrospectively. We elected to present the comprehensive income in two separate but consecutive statements within the condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

2. INVESTMENTS AND FAIR VALUE MEASUREMENTS

The following table summarizes our investments ($ amounts in 000's):

	June 30, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	7,601	4	—	7,605
Corporate debt securities	457,349	490	(621)	457,218
Commercial paper	50,725	7	(1)	50,731
Municipal bonds	37,352	48	(28)	37,372
Certificates of deposit and term deposits	10,246	—	—	10,246
Total available-for-sale securities	563,273	549	(650)	563,172

	December 31, 2011			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	38,900	10	(2)	38,908
Corporate debt securities	339,110	219	(1,832)	337,497
Commercial paper	51,025	7	(5)	51,027
Municipal bonds	20,473	36	(5)	20,504
Certificates of deposit and term deposits	18,762	1	(2)	18,761
Total available-for-sale securities	468,270	273	(1,846)	466,697

The following table shows the gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position, at June 30, 2012 ($ amounts in 000's):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	255,719	(530)	11,423	(91)	267,142	(621)
Commercial paper	8,986	(1)	—	—	8,986	(1)
Municipal bonds	23,822	(28)	—	—	23,822	(28)
Total available-for-sale securities	288,527	(559)	11,423	(91)	299,950	(650)

The following table shows the gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position, at December 31, 2011 ($ amounts in 000's):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government and agency securities	10,996	(2)	—	—	10,996	(2)
Corporate debt securities	258,159	(1,832)	—	—	258,159	(1,832)
Commercial paper	9,279	(5)	—	—	9,279	(5)

Municipal bonds	8,067	(5)	—	—	8,067	(5)
Certificates of deposit and term deposits	7,499	(2)	—	—	7,499	(2)
Total available-for-sale securities	294,000	(1,846)	—	—	294,000	(1,846)

The contractual maturities of our investments are as follows ($ amounts in 000's):

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(Unaudited)

	June 30, 2012	December 31, 2011
Due within one year	320,403	318,283
Due within one to three years	242,769	148,414
Total	563,172	466,697

Realized gains or losses from the sale of available-for-sale securities were not significant for any of the periods presented.

The following table presents the fair value of our financial assets measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011 ($ amounts in 000's):

	June 30, 2012			December 31, 2011		
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)
Assets:						
U.S. government and agency securities	7,605	—	7,605	38,908	—	38,908
Corporate debt securities	457,218	—	457,218	337,497	—	337,497
Commercial paper	65,205	—	65,205	64,890	—	64,890
Municipal bonds	37,372	—	37,372	20,504	—	20,504
Certificates of deposit and term deposits	10,246	—	10,246	18,761	—	18,761
Money market funds	8,168	8,168	—	31,438	31,438	—
Foreign currency contracts	19	—	19	—	—	—
Total	585,833	8,168	577,665	511,998	31,438	480,560
Reported as:						
Cash equivalents	22,642			45,301		
Short-term investments	320,403			318,283		
Prepaid expenses and other current assets	19			—		
Long-term investments	242,769			148,414		
Total	585,833			511,998		

We did not hold financial assets or liabilities which were recorded at fair value using inputs in the Level 3 category as of June 30, 2012 or December 31, 2011. There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the three and six months ended June 30, 2012.

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3. INVENTORY

Inventory consisted of the following ($ amounts in 000's):

	June 30, 2012	December 31, 2011
Raw materials	4,166	3,447
Finished goods	16,662	12,802
Inventory	20,828	16,249

4. PROPERTY AND EQUIPMENT—Net

Property and equipment consisted of the following ($ amounts in 000's):

	June 30, 2012	December 31, 2011
Evaluation units	16,521	13,912
Computer equipment and software	15,130	12,219
Furniture and fixtures	1,345	1,307
Leasehold improvements and tooling	4,745	4,381
Total property and equipment	37,741	31,819
Less: accumulated depreciation	(27,494)	(23,853)
Property and equipment—net	10,247	7,966

Depreciation expense was $2.4 million and $1.7 million during the three months ended June 30, 2012 and June 30, 2011 respectively. Depreciation expense was $4.5 million and $3.3 million during the six months ended June 30, 2012 and June 30 2011, respectively.

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

5. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding, plus the dilutive effects of stock options and the employee stock purchase plan ("ESPP"). Potentially dilutive common shares are determined by applying the treasury stock method to the assumed exercise of outstanding stock options and ESPP.

A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income per share is as follows ($ and share amounts in 000's, except per share amounts):

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Numerator:				
Net income	13,950	14,494	28,123	28,081
Denominator:				
Basic shares:				
Weighted-average common shares outstanding - basic	157,474	152,267	156,742	151,293
Diluted shares:				
Weighted-average common shares outstanding - basic	157,474	152,267	156,742	151,293
Effect of potentially dilutive securities:				
Employee stock option and purchase plans	8,587	11,620	9,066	12,100
Weighted-average shares used to compute diluted net income per share	166,061	163,887	165,808	163,393
Net income per share:				
Basic	0.09	0.10	0.18	0.19
Diluted	0.08	0.09	0.17	0.17

The following weighted-average shares of common stock were excluded from the computation of diluted net income per share for the periods presented as their effect would have been antidilutive (in 000's):

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Options to purchase common stock	7,475	3,571	6,767	2,598
ESPP	311	—	298	—
	7,786	3,571	7,065	2,598

6. DEFERRED REVENUE

Deferred revenue consisted of the following ($ amounts in 000's):

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

	June 30, 2012	December 31, 2011
Product	7,544	5,817
Services	311,414	272,843
Ratable and other revenue	12,410	16,173
Total deferred revenue	331,368	294,833
Reported As:		
Current	226,510	206,928
Non-current	104,858	87,905
Total deferred revenue	331,368	294,833

7. COMMITMENTS AND CONTINGENCIES

Leases—We lease our facilities under various non-cancelable operating leases, which expire through 2015. Rent expense was $2.2 million and $2.1 million for the three months ended June 30, 2012 and June 30, 2011, respectively. Rent expense was $4.4 million and $4.0 million for the six months ended June 30, 2012 and June 30, 2011, respectively.

The aggregate future non-cancelable minimum rental payments on operating leases as of June 30, 2012 are as follows ($ amounts in 000's):

	Rental Payment
Fiscal years:	
2012 (remainder)	6,547
2013	8,723
2014	4,795
2015	1,653
Total	21,718

Contract Manufacturer and Other Commitments—Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of June 30, 2012, we had $26.9 million of open purchase orders with our independent contract manufacturers that are not cancelable.

In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations associated with our ordinary course of business for which we have not received goods or services. As of June 30, 2012, we had $3.1 million in other purchase commitments.

Warranties—We generally provide a one-year warranty on hardware products and a 90-day warranty on software. Accrued warranty activities are summarized as follows ($ amounts in 000's).

	For The Six Months Ended And As Of June 30, 2012	For The Year Ended And As Of December 31, 2011
Accrued warranty balance - beginning of the period	2,582	1,878
Warranty costs incurred	(1,141)	(1,778)
Provision for warranty	764	2,103
Adjustments to previous estimates	(265)	379
Accrued warranty balance - end of the period	1,940	2,582

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Litigation—In August 2009, Enhanced Security Research, LLC and Security Research Holdings LLC (collectively "ESR"), a non-practicing entity, filed a complaint against us in the United States District Court for the District of Delaware alleging infringement by us and other defendants of two patents. The plaintiffs are claiming unspecified damages and requesting an injunction against the alleged infringement. In June 2010, the Court granted our motion to stay pending the outcome of reexamination proceedings on both asserted patents. The U.S. Patent and Trademark Office ("PTO") has rejected all of the claims of the patents in the suit and ESR has appealed this result to the Board of Patent Appeals and Interferences ("BPAI"). We have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us claiming unspecified damages in the California Superior Court for the County of Los Angeles alleging violation of various California Corporations Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company. In September 2010, the Court granted our motion to transfer the case to the California Superior Court for Santa Clara County and the plaintiff has filed several amended complaints in the Superior Court to add individual defendants, among other amendments. The Superior Court will be hearing motions for summary judgment in November 2012 and has set a trial date for December 2012. We have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

In July 2010, Network Protection Sciences, LLC ("NPS"), a non-practicing entity, filed a complaint in the United States District Court for the Eastern District of Texas alleging patent infringement by us and other defendants. NPS is claiming unspecified damages, including treble damages for willful infringement, and requests an injunction against such alleged infringement. In December 2011, the United States District Court for the Eastern District of Texas ordered the case to be transferred to the Northern District of California. In June 2012, the United States District Court for the Northern District of California dismissed the other defendants for misjoinder, and the case is proceeding with the company as the sole defendant. Currently the case remains in the early stages, and we have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

In June 2012, we received a letter from SRI International ("SRI") claiming that we infringed certain SRI patents. Subsequently, we filed a complaint in the United States District Court for the Northern District of California seeking declaratory relief and a judgment that the SRI patents were invalid, unenforceable and/or not infringed by any of our products or services. The case is currently in the very early stages, and we have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

Indemnification—Under the indemnification provisions of our standard sales contracts, we agree to defend our customers against third-party claims asserting infringement of certain intellectual property rights, which may include patents, copyrights, trademarks, or trade secrets, and to pay judgments entered on such claims. Our exposure under these indemnification provisions is generally limited by the terms of our contracts to the total amount paid by our customer under the agreement. However, certain agreements include indemnification provisions that could potentially expose us to losses in excess of the amount received under the agreement. To date, there have been no claims under such indemnification provisions.

8. STOCKHOLDERS' EQUITY

Stock Options

The following table summarizes the weighted-average assumptions relating to our employee stock options as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Expected term in years	4.6	4.6	4.6	4.6
Volatility (%)	46.4	43.4	46.4 - 51.9	40.4 - 43.4
Risk-free interest rate (%)	0.9	2.0	0.7 - 0.9	1.8 - 2.0
Dividend rate (%)	—	—	—	—
Estimated fair value ($)	9.81	8.93	11.42	7.31

A summary of the option activity under our stock plans and changes during the reporting periods are presented below (in

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

000's, except per share amounts and contractual life):

		Options Outstanding			
	Shares Available For Grant	Number Of Shares	Weighted-Average Exercise Price ($)	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value ($)
Balance-December 31, 2011	17,399	21,389	9.14		
Authorized	7,750	—	—		
Granted	(3,401)	3,401	26.38		
Forfeited	714	(714)	18.76		
Exercised (aggregate intrinsic value of $50,690)	—	(2,476)	5.09		
Balance—June 30, 2012	22,462	21,600	12.00		
Options vested and expected to vest—June 30, 2012		20,773	11.74	4.55	248,197
Options vested and exercisable—June 30, 2012		11,389	5.47	3.54	202,151

As of June 30, 2012, total compensation cost related to unvested stock-based awards granted to employees under our stock plans but not yet recognized was $83.6 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of 2.9 years. Future option grants will increase the amount of compensation expense to be recorded in these periods.

Employee Stock Purchase Plan

In June 2011, our Board of Directors approved and authorized the issuance of 8,000,000 shares of common stock. Under the ESPP, we can grant stock purchase rights to all eligible employees during a six-month offering period with purchase dates at the end of each offering period. Shares are purchased through employees' payroll deductions, up to a maximum of 15% of employees' compensation for each purchase period, at purchase prices equal to 85% of the lesser of the fair market value of our common stock at the first trading date of the applicable offering period or the purchase date. No participant may purchase more than 4,000 shares of common stock in any one offering period.

The following table summarizes the weighted-average assumptions relating to our ESPP:

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Expected term in years	0.5	—	0.5	—
Volatility (%)	58.2	—	58.2	—
Risk-free interest rate (%)	0.2	—	0.2	—
Dividend rate (%)	—	—	—	—
Estimated fair value ($)	8.08	—	8.08	—

Stock-based Compensation Expense

Stock-based compensation expense is included in costs and expenses as follows ($ amounts in 000's):

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Cost of product revenue	88	43	152	65
Cost of services revenue	941	362	1,686	560
Research and development	2,292	985	4,249	1,438
Sales and marketing	3,475	1,681	6,918	3,581
General and administrative	1,056	799	2,093	1,296
	7,852	3,870	15,098	6,940

The following table summarizes stock-based compensation expense by award type ($ amounts in 000's):

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Options—employee	6,649	3,776	12,682	6,684
Options—non-employee	32	94	315	256
ESPP	1,171	—	2,101	—
	7,852	3,870	15,098	6,940

9. INCOME TAXES

The effective tax rate was 37% for the three months ended June 30, 2012, compared to an effective tax rate of 25% for the three months ended June 30, 2011. The effective tax rate was 33% for the six months ended June 30, 2012, compared to an effective tax rate of 25% for the six months ended June 30, 2011. The provision for income taxes for the three months ended June 30, 2012 and June 30, 2011 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The provision for income taxes for the six months ended June 30, 2012 and June 30, 2011 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax.

As of June 30, 2012 and December 31, 2011, unrecognized tax benefits were $23.1 million and $19.3 million, respectively. The total amount of unrecognized tax benefits, if recognized, would favorably impact the effective tax rate.

It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of June 30, 2012, we had approximately $0.5 million accrued for estimated interest related to uncertain tax positions. We do not expect any material unrecognized tax benefits to expire within the next twelve months.

10. EMPLOYEE BENEFIT PLAN

The 401(k) tax-deferred savings plan (the “401(k) Plan”) permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code of 1986, as amended. Under the 401(k) Plan, participating employees may defer a portion of their pre-tax earnings, up to the IRS annual contribution limit. In Canada, we have a Group Registered Retirement Savings Plan program (the “RRSP Plan”) which permits participants to make tax deductible contributions up to the maximum contribution limits under the Income Tax Act. Our aggregate matching contributions to the 401(k) Plan and RRSP Plan for the three and six months ended June 30, 2012 were $0.5 million and $0.9 million, respectively.

11. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

Our chief operating decision maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. We have one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, we are considered to be in a single reportable segment and operating unit structure.

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Revenue by geographic region is based on the billing address of the customer. The following tables set forth revenue, and property and equipment—net, by geographic region ($ amounts in 000's):

Revenue	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Americas:				
United States	34,190	28,103	65,309	52,273
Other Americas	17,732	12,438	33,044	23,913
Total Americas	51,922	40,541	98,353	76,186
Europe, Middle East and Africa (“EMEA”)	43,664	36,633	84,550	70,274
Asia Pacific and Japan (“APAC”)	33,376	25,849	63,306	49,829
Total revenue	128,962	103,023	246,209	196,289

During the three and six months ended June 30, 2012, one distributor, Exclusive Networks, accounted for 11% and 12% of revenue, respectively. During the three and six months ended June 30, 2011, no single customer accounted for more than 10% of revenue.

Property and Equipment—Net	June 30, 2012	December 31, 2011
Americas:		
United States	3,374	2,225
Canada	4,690	4,062
Other Americas	41	33
Total Americas	8,105	6,320
EMEA	1,242	805
APAC	900	841
Total property and equipment—net	10,247	7,966

12. FOREIGN CURRENCY DERIVATIVES

The notional value of our outstanding forward exchange contracts that were entered into in order to hedge balance sheet accounts and cash flows as of June 30, 2012 consisted of the following ($ amounts in 000's):

	Buy/Sell	Notional
Balance Sheet Contracts:		
Currency		
CAD	Buy	14,456
EUR	Buy	5,259
GBP	Buy	2,441
Cash Flow Hedges:		
Currency		
CAD	Buy	4,907

EUR	Buy	2,517

13. ACQUISITION

On March 8, 2012, we completed the acquisition of IntruGuard Devices (“IntruGuard”), a leading supplier of Intelligent Availability Protection Systems, for a total consideration of $950,000. Of the total consideration, $400,000 is being withheld in

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escrow as security for IntruGuard's indemnification obligations. We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price has been allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair market values as of the acquisition date. The purchase price allocation resulted in purchased tangible assets of $53,000 and liabilities of $43,000, and purchased identifiable intangible assets of $940,000. Identifiable intangible assets consist of purchased technology. The fair value assigned to identifiable intangible assets acquired was determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by us. Purchased identifiable intangible assets are being expensed as Cost of revenue on a straight-line basis over three years.

14. INTANGIBLE ASSETS

The following table presents the detail of our intangible assets with definite lives included in other assets ($ amounts in 000's):

	June 30, 2012			December 31, 2011		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Existing technology	3,041	867	2,174	1,772	394	1,378

Amortization expense was $0.3 million and $0.1 million for the three months ended June 30, 2012 and June 30, 2011, respectively, and $0.6 million and $0.1 million for the six months ended June 30, 2012 and June 30, 2011, respectively. The following table summarizes estimated future amortization expense of intangible assets with definite lives as of June 30, 2012 ($ amounts in 000's):

	Amount
Fiscal Years:	
2012 (remainder)	557
2013	964
2014	540
2015	108
2016	5
Total	2,174

15. SUBSEQUENT EVENT

In August 2012, we purchased certain real property in Sunnyvale, California, for a total cash consideration of $14.5 million, to serve as the future corporate headquarters office for the Company.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

These statements include, among other things, statements concerning our expectations regarding:

- variability in sales in certain product categories from year to year and between quarters;
- expected impact on sales of certain products;
- continued sales into large enterprises;
- mix of billings between products and services;
- mix of service sales containing multi-year support and subscription contracts;

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- the significance of stock compensation as an expense;
- the proportion of our revenue that consists of our product and service revenues and future trends with respect to service revenue as we renew existing services contracts and expand our customer base;
- the impact of our product innovation strategy;
- trends in revenue, costs of revenue, and gross margin;
- trends in our operating expenses, including personnel costs, research and development expense, sales and marketing expense and general and administrative expense;
- our effective tax rate; and
- the sufficiency of our existing cash and investments to meet our cash needs for at least the next 12 months;

as well as other statements regarding our future operations, financial condition and prospects and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and, in particular, the risks discussed under the heading “Risk Factors” included elsewhere in this Quarterly Report on Form 10-Q and in our other SEC filings, including our Form 10-K. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Business Overview

We provide network security solutions, which enable broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and governmental entities worldwide. As of June 30, 2012, we had shipped nearly 950,000 appliances to more than 10,000 channel partners and to more than 125,000 end-customers worldwide, including a majority of the Fortune Global 100.

Our core Unified Threat Management (“UTM”) product line of FortiGate physical and virtual appliances ships with a set of security and networking capabilities, including firewall, VPN, application control, antivirus, intrusion prevention, Web filtering, antispam and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-20, designed for small businesses, to the FortiGate-5000 series for large enterprises, telecommunications carriers, and service providers. Sales of FortiGate products are generally balanced across entry-level (FortiGate-20 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately one-third of FortiGate sales. Our UTM solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to the intrusion prevention and application control, antivirus, Web filtering, vulnerability management and antispam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. End-customers also often use FortiManager and FortiAnalyzer products in conjunction with a FortiGate deployment to provide centralized management, analysis and reporting capabilities. We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web application firewalls, databases, employee computers and mobile devices. Sales of these complementary products have grown in recent quarters, although these products still represent less than 10% of our revenue.

Financial Highlights

- We recorded revenue of $129.0 million and $246.2 million during the three and six months ended June 30, 2012, respectively. This represents an increase of 25% during the three and six months ended June 30, 2012 compared to the same periods last year. Within total revenue, product revenue was $61.7 million and $114.9 million during the three and six months ended June 30, 2012, respectively, an increase of 32% during the three and six months ended June 30, 2012 compared to the same periods last year. Services revenue was $65.4 million and $127.6 million during the three and six months ended June 30, 2012, respectively, an increase of 24% and 26% during the three and six months ended June 30, 2012, respectively, compared to the same periods last year.

- We generated cash flows from operating activities of $92.8 million during the six months ended June 30, 2012, an increase of 25% compared to the same period last year.

- Cash, cash equivalents and investments were $644.4 million as of June 30, 2012, an increase of $105.7 million from December 31, 2011.

- Deferred revenue was $331.4 million as of June 30, 2012, an increase of $36.5 million from December 31, 2011.

During the three months ended June 30, 2012, revenues grew as a result of the successful execution of our global sales strategy and the continued product innovation that has strengthened our technology advantages and resulted in market share gains. The recent introduction of several new FortiGate entry-level appliances such as the FortiGate-20C and -40C with their WIFI counterparts and the FortiGate-100D; the FortiGate-600C in the mid-range appliance; and the FortiGate-1000C and FortiGate-3240C for large enterprises continued to gain traction and contributed to the revenue growth. We also recently released new FortiGate models including the FortiGate-800C, and FortiGate-5101C which we expect to drive sales in future quarters.

We continue to invest in research and development to strengthen our technology leadership position, as well as sales and marketing to expand brand awareness, strengthen our value proposition, and expand our global sales team and distribution channels. We experienced healthy deal volumes driven by traction in enterprise data center deployments, large enterprise deals, and continued strength in the retail and telecommunications sectors. The number of deals involving sales greater than $100,000 was 168 in the three months ended June 30, 2012, compared to 127 in the three months ended June 30, 2011. The number of deals involving sales greater than $250,000 was 55 in the three months ended June 30, 2012, compared to 37 in the three months ended June 30, 2011. The number of deals involving sales greater than $500,000 was 19 in the three months ended June 30, 2012, compared to 11 in the three months ended June 30, 2011. We expect some variability in this metric, and remain focused on investing in our sales and research and development resources in order to expand our reach into new high-growth verticals and emerging markets, and meet increasing customer expectations about the quality and functionality of our products, as we continue to sell to large customers, such as enterprise and service providers. While we have experienced some success selling into certain vertical customer segments, such as service providers and enterprise, we have experienced less traction selling into other verticals such as the U.S. federal government and there can be no assurance we will be successful selling into certain vertical customer segments.

During the three months ended June 30, 2012, operating expenses increased by 23% compared to the same period last year. The increase was primarily driven by additional headcount to support our growth as we continued to invest in the development of new products and expand our sales coverage. We continued to see improvements in productivity and efficiencies in our overall headcount during the three months ended June 30, 2012, compared to the three months ended June 30, 2011. Headcount increased to 1,762 at June 30, 2012 from 1,475 at June 30, 2011. Our pace of hiring accelerated this quarter, particularly in support, sales and marketing and research and development.

Key Metrics

We monitor the key financial metrics set forth below on a quarterly basis to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. Our total deferred revenue increased by $16.8 million from $314.6 million at March 31, 2012 to $331.4 million at June 30, 2012. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the quarterly revenue that we recognize. We also ended the three months ended June 30, 2012 with $644.4 million in cash, cash equivalents and investments and have had positive cash flow from operations for every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under “Other Non-GAAP Financial Measures,” and we discuss our cash, cash equivalents, and investments under “Liquidity and Capital Resources.” Deferred revenue and cash flow from operations are discussed immediately below the following table.

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	For The Three Months Ended Or As Of			
	June 30, 2012		June 30, 2011	
	($ amounts in 000's)			
Revenue	128,962		103,023	
Gross margin	71	%	74	%
Operating income[(1)]	20,950		18,779	
Operating margin	16	%	18	%
Total deferred revenue	331,368		273,199	
Increase in total deferred revenue over prior quarter	16,796		7,170	
Cash, cash equivalents and investments	644,398		468,498	
Cash flows from operating activities	44,285		34,068	
Free cash flow[(2)]	42,054		33,312	

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(1) Includes:		
Stock-based compensation expense	7,852	3,870
Patent settlement income	478	478

(2) Free cash flow is a non-GAAP financial measure, which is defined as net cash provided by operating activities less capital expenditures, as further described below.

Deferred revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. The majority of our deferred revenue balance consists of the unamortized portion of services revenue from subscription and support service contracts. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods. The following table reflects the calculation of billings as discussed in the paragraph above. For a discussion of the limitations of non-GAAP financial measures, see "—Other Non-GAAP Financial Measures" below.

	Three Months Ended	
	June 30, 2012	June 30, 2011
	($ amounts in 000's)	
Billings:		
Revenue	128,962	103,023
Increase in deferred revenue	16,796	7,170
Total billings (Non-GAAP)	145,758	110,193

Cash flow from operations. We monitor cash flow from operations as a measure of our overall business performance. Our cash flow from operations is driven in large part by advance payments for both new and renewal contracts for subscription and support services, consistent with our billings for the period. Monitoring cash flow from operations and free cash flow enables us to analyze our financial performance excluding the non-cash effects of certain items such as depreciation, amortization and stock-based compensation expenses, thereby allowing us to better understand and manage the cash needs of our business. Free cash flow, an alternative non-GAAP financial measure of liquidity, is defined as net cash provided by operating activities less capital expenditures. For a discussion of the limitations of non-GAAP financial measures, see "—Other Non-GAAP Financial Measures" below.

	Three Months Ended	
	June 30, 2012	June 30, 2011
	($ amounts in 000's)	

Free Cash Flow:		
Net cash provided by operating activities	44,285	34,068
Less purchases of property and equipment	(2,231)	(756)
Free cash flow (Non-GAAP)	42,054	33,312

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Other Non-GAAP Financial Measures

To supplement our condensed consolidated financial statements presented in accordance with U.S. GAAP, we consider certain financial measures that are not prepared in accordance with GAAP, including billings and free cash flow discussed above as well as non-GAAP gross margin, non-GAAP income from operations and non-GAAP operating margin, non-GAAP operating expenses and non-GAAP net income. These non-GAAP financial measures are not based on any standardized methodology prescribed by GAAP and are not necessarily comparable to similar measures presented by other companies.

We use these non-GAAP financial measures internally in analyzing our financial results and believe they are useful to investors, as a supplement to GAAP measures, in evaluating our ongoing operational performance and enhancing an overall understanding of our past financial performance, as they help illustrate underlying trends in our business that could otherwise be masked by the effect of the expenses that we exclude in these non-GAAP financial measures. Furthermore, we use many of these measures to establish budgets and operational goals for managing our business and evaluating our performance. We also believe that the use of these non-GAAP financial measures provides an additional tool for investors to use in comparing our recurring core business operating results over multiple periods with other companies in our industry, many of which present similar non-GAAP financial measures to investors.

These non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information prepared in accordance with GAAP. There are a number of limitations related to the use of these non-GAAP financial measures versus the nearest GAAP equivalent of these financial measures. First, these non-GAAP financial measures exclude certain recurring, non-cash charges such as stock-based compensation expense and a patent settlement. Stock-based compensation has been, and will continue to be for the foreseeable future, a significant recurring expense in our business and is an important part of our employees' overall compensation. Second, the expenses that we exclude in our calculation of these non-GAAP financial measures may differ from the expenses, if any, that our peer companies may exclude when they report their results of operations. We compensate for these limitations by providing the nearest GAAP equivalents of these non-GAAP financial measures and describing these GAAP equivalents in our Results of Operations below.

Non-GAAP gross margin is gross margin as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense, which is a non-cash charge. Non-GAAP income from operations is operating income, as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense and the income from a patent settlement. Non-GAAP operating margin is non-GAAP income from operations divided by revenue. The following tables reconcile GAAP gross margin, income from operations, and operating margin to non-GAAP gross margin, non-GAAP income from operations, and non-GAAP operating margin for the three months ended June 30, 2012 and June 30, 2011.

	Three Months Ended			
	June 30, 2012		June 30, 2011	
	Amount	% of Revenue	Amount	% of Revenue
	($ amounts in 000's)			
Total revenue	128,962		103,023	
GAAP gross profit and margin	91,835	71	76,465	74
Stock-based compensation expense	1,029	1	405	1
Non-GAAP gross profit and margin	92,864	72	76,870	75
GAAP income from operations and margin	20,950	16	18,779	18

Stock-based compensation expense:				
Cost of revenue	1,029	1	405	1
Research and development	2,292	2	985	1
Sales and marketing	3,475	2	1,681	2
General and administrative	1,056	1	799	1
Total stock-based compensation	7,852	6	3,870	5
Patent settlement	(478)	—	(478)	(1)
Non-GAAP income from operations and margin	28,324	22	22,171	22

Non-GAAP operating expenses exclude the impact of stock-based compensation expense and the income from a patent settlement. The following tables reconcile GAAP operating expenses to non-GAAP operating expenses for the three months

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ended June 30, 2012 and June 30, 2011.

	Three Months Ended							
	June 30, 2012				June 30, 2011			
	Amount		% of Revenue		Amount		% of Revenue	
	($ amounts in 000's)							
Operating Expenses:								
Research and development expenses:								
GAAP research and development expenses	20,388		16		15,942		16	
Stock-based compensation	(2,292	)	(2	)	(985	)	(1	)
Non-GAAP research and development expenses	18,096		14		14,957		15	
Sales and marketing expenses:								
GAAP sales and marketing expenses	44,259		34		35,896		35	
Stock-based compensation	(3,475	)	(2	)	(1,681	)	(2	)
Non-GAAP sales and marketing expenses	40,784		32		34,215		33	
General and administrative expenses:								
GAAP general and administrative expenses	6,238		5		5,848		5	
Stock-based compensation	(1,056	)	(1	)	(799	)	(1	)
Patent settlement	478		—		478		1	
Non-GAAP general and administrative expenses	5,660		4		5,527		5	
Total operating expenses:								
GAAP operating expenses	70,885		55		57,686		56	
Stock-based compensation	(6,823	)	(5	)	(3,465	)	(4	)
Patent settlement	478		—		478		1	
Non-GAAP operating expenses	64,540		50		54,699		53	

Non-GAAP net income is net income, as reported in our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense and income from a patent settlement. The following tables reconcile GAAP net income as reported on our condensed consolidated statements of operations to non-GAAP net income for the three months ended June 30, 2012 and June 30, 2011.

	Three Months Ended			
	June 30, 2012		June 30, 2011	
	($ amounts in 000's)			
Net Income:				
GAAP net income	13,950		14,494	
Stock-based compensation expense(1)	7,852		3,870	
Patent settlement(2)	(478	)	(478	)
Provision for income taxes(3)	8,276		4,941	
Non-GAAP income before provision for income taxes	29,600		22,827	
Tax effects related to non-GAAP adjustments(4)	(10,064	)	(7,533	)
Non-GAAP net income	19,536		15,294	
Non-GAAP net income per share - diluted	0.12		0.09	

Shares used in per share calculation - diluted	166,061	163,887

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(1) Stock-based compensation expense is added back to GAAP net income to reconcile to non-GAAP income before taxes.

(2) The patent settlement income is removed from GAAP net income to reconcile to non-GAAP income before taxes.

(3) Provision for income taxes is our GAAP provision that must be added to GAAP net income to reconcile to non-GAAP

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income before taxes.

(4) Tax provision related to non-GAAP income before tax reflects 34% and 33% effective tax rates in the three months ended June 30, 2012 and June 30, 2011, respectively. Based on the annual estimate for geographic split of income, as well as various tax credits we expect to achieve in various locations, we currently plan to use a 34% tax rate for the year, subject to discrete items that may occur in a particular quarter.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with U.S. GAAP. These principles require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, cash flow and related disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, stock-based compensation, valuation of inventory, warranty liabilities and accounting for income taxes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

There have been no significant changes to our critical accounting policies and estimates since the fiscal year ended December 31, 2011.

Revenue Recognition—In October 2009, the Financial Accounting Standards Board (“FASB”) amended the Accounting Standards Codification (“ASC”) as summarized in ASU No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (“ASU 2009-13”), and ASU No. 2009-14, Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (“ASU 2009-14”). ASU 2009-13 amended the accounting for multiple-element arrangements to provide guidance on how the deliverables in an arrangement should be separated and eliminates the use of the residual method. ASU 2009-13 also requires an entity to allocate revenue using the relative selling price method. The standard establishes a hierarchy of evidence to determine the stand-alone selling price of a deliverable based on vendor-specific objective evidence (“VSOE”), third party evidence (“TPE”), and the best estimated selling price (“BESP”). If VSOE is available, it would be used to determine the selling price of a deliverable. If VSOE is not available, the entity would determine whether TPE is available. If so, TPE must be used to determine the selling price. If TPE is not available, then the BESP would be used. ASU 2009-14 amended industry specific revenue accounting guidance for software and software related transactions to exclude from its scope tangible products containing software components and non-software components that function together to deliver the product's essential functionality.

This guidance does not generally change the units of accounting for our revenue transactions. Most non-software products and services qualify as separate units of accounting because they have value to the customer on a standalone basis and our revenue arrangements generally do not include a right of return relative to delivered products.

The majority of our products are hardware appliances containing software components that function together to provide the essential functionality of the product, therefore, our hardware appliances are considered non-software deliverables and are no longer within the scope of ASC 985-605.

Our product revenue also includes software products that may operate on the hardware appliances, but are not considered essential to the functionality of the hardware and continue to be subject to the guidance at ASC 985-605, which remains unchanged. Certain of our software, when sold with our appliances, is considered essential to its functionality and as a result is no longer accounted for under ASC 985-605; however, this same software if sold separately is accounted for under the guidance at ASC 985-605.

For all transactions originating or materially modified after December 31, 2010, we recognize revenue in accordance with ASU 2009-13. Certain arrangements with multiple deliverables may continue to have software deliverables that are subject to ASC 985-605 along with non-software deliverables that are subject to ASU 2009-13. When a sales arrangement contains multiple elements, such as hardware appliances, software, customer support services, and/or professional services, we allocate revenue to each element based on the aforementioned selling price hierarchy. In multiple element arrangements where software is more-than-incidental, revenue is allocated to each separate unit of accounting for each of the non-software deliverables and to the software deliverables as a group using the relative selling prices of each of the deliverables in the arrangement based on the selling price hierarchy in ASU 2009-13.

VSOE of fair value for elements of an arrangement is based upon the normal pricing and discounting practices for those services when sold separately. In determining VSOE, we require that a substantial majority of the selling prices for a

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service fall within a reasonably narrow pricing range, generally evidenced by a substantial majority of such historical stand-alone transactions falling within a reasonably narrow range of the median rates. In addition, we consider major segments, geographies, customer classifications, and other variables in determining VSOE.

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

For our hardware appliances, we use BESP as our selling price. For our support and other services, we generally use VSOE as our selling price. When we are unable to establish a selling price using VSOE for our support and other services, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels. We review our BESP estimates on a quarterly basis to coincide with our VSOE review process.

We recognize revenue for our software sales based on software revenue recognition guidance pursuant to ASC 985-605. Under ASC 985-605, we use the residual method to recognize revenue when a product agreement includes one or more elements to be delivered and VSOE of fair value for all undelivered elements exists. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is generally deferred and recognized when delivery of those elements occurs or when fair value can be established. When the undelivered element for which we do not have VSOE of fair value is support, revenue for the entire arrangement is recognized ratably over the support period.

We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. Our appliances include operating system software that is integrated into the appliance hardware and is deemed essential to its functionality. As a result, we account for revenue in accordance with ASU 2009-13 and all related interpretations.

Revenue is recognized when all of the following criteria have been met:

- Persuasive evidence of an arrangement exists. Binding contracts or purchase orders are generally used to determine the existence of an arrangement.

- Delivery has occurred. Delivery occurs when we fulfill an order and title and risk of loss has been transferred or upon delivery of the service contract registration code.

- The fee is fixed or determinable. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. In the event payment terms differ from our standard business practices, the fees are deemed to be not fixed or determinable and revenue is recognized when the payments become due, provided the remaining criteria for revenue recognition have been met.

- Collectability is probable. We assess collectability based primarily on creditworthiness as determined by credit checks and analysis, as well as payment history. Payment terms generally range from 30 to 90 days from invoice date.

For arrangements which include end-customer acceptance criteria, revenue is recognized upon acceptance. We recognize product revenue on sales to distributors that have no general right of return and direct sales to end-customers upon shipment, once all other revenue recognition criteria have been met. We also recognize revenue upon sell-through for distributor agreements that allow for rights of return. Such returns are estimated and recorded as a reduction to revenue. Substantially all of our products have been sold in combination with services, which consist of subscriptions and/or support. Subscription services provide access to our antivirus, intrusion prevention, web filtering, and anti-spam functionality. Support services include rights to unspecified software upgrades, maintenance releases and patches, telephone and Internet access to technical support personnel, and hardware support.

The subscription and support services start on the date the customer registers the appliance. The customer is then entitled to service for the stated contractual period beginning on the registration date.

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We offer certain sales incentives to channel partners. We reduce revenue for estimates of sales returns and allowances. Additionally, in limited circumstances we may permit end-customers, distributors and resellers to return our products, subject to varying limitations, for a refund within a reasonably short period from the date of purchase. We estimate and record reserves for sales incentives and sales returns based on historical experience.

Recently Adopted Accounting Pronouncements

See Note 1 of notes to condensed consolidated financial statements for a full description of recently adopted accounting pronouncements.

Subsequent Event

In August 2012, we purchased certain real property in Sunnyvale, California, for a total cash consideration of $14.5 million, to serve as the future corporate headquarters office for the Company.

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Results of Operations

Three months ended June 30, 2012 and June 30, 2011

Revenue

	Three Months Ended					
	June 30, 2012		June 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	61,692	48	46,687	45	15,005	32
Services	65,412	51	52,671	51	12,741	24
Ratable and other revenue	1,858	1	3,665	4	(1,807)	(49)
Total revenue	128,962	100	103,023	100	25,939	25
Revenue by Geography:						
Americas	51,922	40	40,541	39	11,381	28
EMEA	43,664	34	36,633	36	7,031	19
APAC	33,376	26	25,849	25	7,527	29
Total revenue	128,962	100	103,023	100	25,939	25

Total revenue increased by $25.9 million, or 25%, during the three months ended June 30, 2012 compared to the three months ended June 30, 2011. The Americas and APAC regions contributed the largest portion of our revenue growth on a percentage basis. Product revenue increased by $15.0 million, or 32%, compared to the three months ended June 30, 2011, as we experienced higher sales volumes and increased demand for our mid-range and high-end products from our enterprise and service provider customers. Strong demand for the FortiGate-200B, Fortigate-300C and FortiGate-600C mid-range models and the FortiGate-1000C, 3950B and 5000-series high-end appliance products all contributed to the growth. Services revenue increased by $12.7 million, or 24%, during the three months ended June 30, 2012 compared to the three months ended June 30, 2011 due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decline in ratable and other revenue was primarily due to the decline in amortization of ratable revenue. Excluding the decline in ratable and other revenue, product and services revenue combined together increased by 28% compared to the three months ended June 30, 2011.

Cost of revenue and gross margin

	Three Months Ended			
	June 30, 2012	June 30, 2011	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	23,935	16,591	7,344	44
Services	12,467	8,596	3,871	45
Ratable and other revenue	725	1,371	(646)	(47)
Total cost of revenue	37,127	26,558	10,569	40
Gross margin (%):				
Product	61.2	64.5	(3.3)	

Services	80.9	83.7	(2.8)
Ratable and other revenue	61.0	62.6	(1.6)
Total gross margin	71.2	74.2	(3.0)

Total gross margin decreased by 3.0 percentage points during the three months ended June 30, 2012 as both product and services gross margins declined. Product gross margin decreased by 3.3 percentage points during the three months ended June 30, 2012 compared to the three months ended June 30, 2011, primarily related to a higher quantity of mid-range products purchased by a large retail customer with lower than average gross margins. Overall, the average selling price for FortiGate

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related products remained consistent compared to the three months ended June 30, 2011, while unit volume increased to drive the growth. We also experienced the impact from cost increases related to higher material costs incurred to support higher density storage requirements for our upcoming release of FortiOS 5.0, our next generation operating system. We expect these product cost increases to be temporary as we begin to bring costs down in the future. From time to time, we have experienced sales of previously reserved inventory. During the three months ended June 30, 2012, we experienced a positive impact to gross margin of 0.3 of a percentage point due to the sale of fully reserved inventory compared to a positive impact to gross margin of 0.4 of a percentage point during the three months ended June 30, 2011. The 2.8 percentage points' decrease in services gross margin was primarily due to our continued investment in our technical support organization to accommodate our expanding customer base and higher demands from large enterprise customers. In addition, we experienced growth in our professional consulting services which have lower gross margins than our support and subscription services. A $3.9 million increase in services costs consisted primarily of a $2.0 million increase in cash-based personnel costs related to headcount growth, a $0.3 million increase in warranty costs, a $0.2 million increase in travel expenses, a $0.2 million increase in occupancy-related costs, and a $0.6 million increase in depreciation and other expenses. Higher stock-based compensation expense of $0.6 million also reduced services gross margin by 0.6 of a percentage point compared to the three months ended June 30, 2011.

Operating Expenses

	Three Months Ended					
	June 30, 2012		June 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Operating expenses:						
Research and development	20,388	16	15,942	15	4,446	28
Sales and marketing	44,259	34	35,896	35	8,363	23
General and administrative	6,238	5	5,848	6	390	7
Total operating expenses	70,885	55	57,686	56	13,199	23

Research and development expense

Research and development expense increased by $4.4 million, or 28%, during the three months ended June 30, 2012 compared to the three months ended June 30, 2011, primarily due to an increase in personnel costs. Cash-based personnel costs increased by $2.0 million primarily due to increased headcount to support the development of new products and continued enhancements of our existing products. In addition, stock-compensation expense increased by $1.3 million; product development and certification expenses increased by $0.5 million; and depreciation and other expenses increased by $0.6 million. We intend to continue to invest in our research and development organization but expect expense as a percentage of revenue to remain comparable or decline in the second half of fiscal 2012.

Sales and marketing expense

Sales and marketing expense increased by $8.4 million, or 23%, in the three months ended June 30, 2012 compared to the three months ended June 30, 2011, primarily due to increased personnel costs. Cash-based personnel costs increased by $5.5 million due to higher salaries, commissions, and benefits resulting from increased headcount in order to expand our sales infrastructure. We also incurred a $1.8 million increase in stock-based compensation expense, a $0.6 million increase in marketing related activities, a $0.2 million increase in occupancy-related costs, and a $0.3 million increase in depreciation and other expenses. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth but expect sales and marketing expense as a percentage of revenue to decline in the second half of fiscal 2012.

General and administrative expense

General and administrative expense increased by $0.4 million, or 7% in the three months ended June 30, 2012, compared to the three months ended June 30, 2011. The increase was primarily due to a $0.3 million increase in stock-based compensation expense and a $0.1 million increase in professional services. We expect general and administrative expense as a percentage of revenue to remain at comparable levels during the remainder of fiscal 2012.

Interest income and other income (expense), net

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	Three Months Ended			
	June 30, 2012	June 30, 2011	Change	% Change
	($ amounts in 000's)			
Interest income	1,203	863	340	39
Other income (expense), net	73	(207)	280	(135)

The $0.3 million increase in interest income in the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was due to interest earned on higher invested balances. The $0.3 million change in other income (expense), net for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 was due to foreign exchange gains.

Provision for income taxes

	Three Months Ended			
	June 30, 2012	June 30, 2011	Change	% Change
	($ amounts in 000's)			
Provision for income taxes	8,276	4,941	3,335	67
Effective tax rate (%)	37	25	12	—

Our effective tax rate was 37% for the three months ended June 30, 2012, compared to an effective tax rate of 25% for the three months ended June 30, 2011.

The provision for income taxes for the three months ended June 30, 2012 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax, and includes the benefit from adjustments in our intercompany transfer pricing associated with the benefit of stock options exercised by employees in various foreign subsidiaries. During the three months ended June 30, 2012, we paid $5.4 million for income taxes. During the three months ended June 30, 2011, we received a refund of $0.2 million for income taxes.

The increase in the effective tax rate for the three months ended June 30, 2012, compared to the three months ended June 30, 2011, is primarily due to the expiration of the U.S. federal research tax credit and a decrease in benefit from adjustments in our intercompany transfer pricing associated with stock options exercised by employees in various foreign subsidiaries.

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Six months ended June 30, 2012 and June 30, 2011

Revenue

	Six Months Ended					
	June 30, 2012		June 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	114,896	47	86,852	44	28,044	32
Services	127,550	52	101,357	52	26,193	26
Ratable and other revenue	3,763	1	8,080	4	(4,317)	(53)
Total revenue	246,209	100	196,289	100	49,920	25
Revenue by Geography:						
Americas	98,353	40	76,186	39	22,167	29
EMEA	84,550	34	70,274	36	14,276	20
APAC	63,306	26	49,829	25	13,477	27
Total revenue	246,209	100	196,289	100	49,920	25

Total revenue increased by $49.9 million, or 25%, during the six months ended June 30, 2012 compared to the six months ended June 30, 2011, with all three regions growing over the prior year. Product revenue increased by $28.0 million, or 32%, compared to the six months ended June 30, 2011. The increase in product revenue was primarily driven by strong growth in the mid-range product line, driven by increased sales to large enterprise customers. Services revenue increased by $26.2 million, or 26%, during the six months ended June 30, 2012 compared to the six months ended June 30, 2011, due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable and other revenue was primarily due to the decline in amortization of ratable revenue. Excluding the decline in ratable and other revenue, product and services revenue combined together increased by 29% compared to the six months ended June 30, 2011.

Cost of revenue and gross margin

	Six Months Ended			
	June 30, 2012	June 30, 2011	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	43,003	30,666	12,337	40
Services	23,680	16,377	7,303	45
Ratable and other revenue	1,487	2,931	(1,444)	(49)
Total cost of revenue	68,170	49,974	18,196	36
Gross margin (%):				
Product	62.6	64.7	(2.1)	
Services	81.4	83.8	(2.4)	
Ratable and other revenue	60.5	63.7	(3.2)	
Total gross margin	72.3	74.5	(2.2)	

Total gross margin decreased by 2.2 percentage points during the six months ended June 30, 2012 compared to the six months ended June 30, 2011, as both product and services gross margins declined. Product gross margin decreased 2.1 percentage points during the six months ended June 30, 2012 compared to the six months ended June 30, 2011, primarily related to a higher quantity of mid-range products purchased by a large retail customer with lower than average gross margins. We also experienced the impact from cost increases related to higher material costs incurred to support higher density storage requirements for our upcoming release of FortiOS 5.0, our next generation operating system. We expect these product cost increases to be temporary as we begin to bring costs down in the future. From time to time, we have experienced sales of

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previously reserved inventory. During the six months ended June 30, 2012, we experienced a positive impact to gross margin of 0.2 of a percentage point due to the sale of fully reserved inventory compared to a positive impact to gross margin of 0.4 of a percentage point in the same period of the prior year. Services gross margin decreased by 2.4 percentage points during the six months ended June 30, 2012 primarily due to our continued investment in our technical support organization to accommodate our expanding customer base and higher demands from enterprise customers. In addition, we experienced growth in our professional consulting services which has lower gross margins than our support and subscription businesses. Cost of services revenue increased by $7.3 million primarily due to a $3.9 million increase in cash-based personnel costs, an increase in warranty costs of $0.8 million, an increase in professional services of $0.4 million, an increase in travel expenses of $0.3 million, an increase in occupancy-related costs of $0.3 million, and an increase in depreciation and other expenses of $0.5 million. In addition, stock-based compensation increased by $1.1 million.

Operating Expenses

	Six Months Ended					
	June 30, 2012		June 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Operating expenses:						
Research and development	40,055	16	30,363	15	9,692	32
Sales and marketing	86,295	35	68,614	35	17,681	26
General and administrative	12,023	5	11,114	6	909	8
Total operating expenses	138,373	56	110,091	56	28,282	26

Research and development expense

Research and development expense increased by $9.7 million, or 32%, in the six months ended June 30, 2012 compared to the six months ended June 30, 2011, primarily due to an increase of $4.3 million in cash-based personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, we incurred higher stock-based compensation expense of $2.8 million, product development expenses of $1.2 million, supplies of $0.4 million, occupancy-related costs of $0.2 million, and depreciation and other expenses of $0.8 million. We intend to continue to invest in our research and development organization but expect expense as a percentage of revenue to remain comparable or decline in the second half of fiscal 2012.

Sales and marketing expense

Sales and marketing expense increased by $17.7 million, or 26%, in the six months ended June 30, 2012 compared to the six months ended June 30, 2011, primarily due to an increase of $11.6 million in cash-based personnel costs as we continued to increase our sales headcount in order to expand our global footprint. In addition, we incurred higher stock-based compensation expense of $3.3 million, marketing-related expenses of $1.5 million, travel expenses of $0.3 million, occupancy-related costs of $0.3 million, product development expenses of $0.2 million, and depreciation and other expenses of $0.5 million. As a percentage of revenue, sales and marketing expenses remained flat as we accelerated the investment in our sales force during the past year to support future growth. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth but expect sales and marketing expense as a percentage of revenue to decline in the second half of fiscal 2012.

General and administrative expense

General and administrative expense increased by $0.9 million, or 8%, in the six months ended June 30, 2012 compared to the six months ended June 30, 2011. The increase was primarily due to a $0.8 million increase in stock-based compensation expense. We expect general and administrative expense as a percentage of revenue to remain at comparable levels during the remainder of fiscal 2012.

Interest income and other income (expense), net

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	Six Months Ended June 30, 2012	June 30, 2011	Change	% Change
	($ amounts in 000's)			
Interest income	2,287	1,656	631	38
Other income (expense), net	3	(302)	305	(101)

The $0.6 million increase in interest income in the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was due to interest earned on higher invested balances. The $0.3 million change in other income (expense), net for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was due to lower foreign exchange losses.

Provision for income taxes

	Six Months Ended June 30, 2012	June 30, 2011	Change	% Change
	($ amounts in 000's)			
Provision for income taxes	13,833	9,497	4,336	46
Effective tax rate (%)	33	25	8	—

Our effective tax rate was 33% for the six months ended June 30, 2012, compared with an effective tax rate of 25% for the six months ended June 30, 2011. The provision for income taxes for the six months ended June 30, 2012 was comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The increase in the effective tax rate for the six months ended June 30, 2012 is primarily due to the expiration of the U.S. federal research tax credit and a decrease in benefit from adjustments in our intercompany transfer pricing associated with stock options exercised by employees in various foreign subsidiaries. During the six months ended June 30, 2012, we paid $6.4 million for income taxes. During the six months ended June 30, 2011, we received a refund of $1.0 million for income taxes.

Liquidity and Capital Resources

	June 30, 2012	December 31, 2011
	($ amounts in 000's)	
Cash and cash equivalents	81,226	71,990
Investments	563,172	466,697
Total cash, cash equivalents and investments	644,398	538,687
Working capital	249,534	256,706

As of June 30, 2012, our cash, cash equivalents and investments of $644.4 million were invested primarily in money market funds, commercial paper, corporate debt securities, municipal bonds, certificates of deposit and term deposits, and U.S. government and agency securities. As of June 30, 2012, $21.5 million of our cash was held by our international subsidiaries and is therefore not immediately available to fund domestic operations unless the cash is repatriated. We do not enter into investments for trading or speculative purposes. We believe that our cash from operations together with existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending necessary to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure the continuing market acceptance of our products, and any capital for acquisitions. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we were unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

Summary of Cash Flows

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	Six Months Ended June 30, 2012	June 30, 2011
	($ amounts in 000's)	
Cash provided by operating activities	92,803	74,244
Cash used in investing activities	(105,933)	(79,887)
Cash provided by financing activities	22,808	15,710
Effect of exchange rates on cash and cash equivalents	(442)	1,093
Net increase in cash and cash equivalents	9,236	11,160

	Six Months Ended June 30, 2012	June 30, 2011
	($ amounts in 000's)	
Net income	28,123	28,081
Adjustments for non-cash charges(1)	21,576	12,076
Net income before non-cash charges	49,699	40,157
Increase in deferred revenue	36,492	20,544
Increase in accounts payable and accrued liabilities, net	5,040	4,015
Increase in accrued payroll and compensation	3,119	357
Increase in income taxes payable and deferred tax assets, net	6,263	9,280
Decrease (increase) in prepaid expenses and other assets, net	789	(1,887)
Decrease in accounts receivable—net	171	63
Increase in inventory	(7,952)	(1,455)
(Decrease) increase in other liabilities	(818)	3,170
Net cash provided by operating activities	92,803	74,244

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(1) Non-cash charges consist of depreciation and amortization, loss on disposal of fixed assets, amortization of investment premiums, stock-based compensation, and excess tax benefit from employee stock option plans.

Operating Activities

Cash generated by operating activities is our primary source of liquidity. Our operating activities during the six months ended June 30, 2012 provided $92.8 million in cash as a result of net income of $28.1 million, increased by non-cash adjustments of $21.6 million and sources of cash of $51.9 million partially offset by uses of cash of $8.8 million. Non-cash adjustments consisted of stock-based compensation of $15.1 million, amortization of investment premiums of $6.5 million, and depreciation and amortization of $5.1 million, offset partially by an excess tax benefit from employee stock option exercises of $5.2 million. Sources of cash were related to a $36.5 million increase in deferred revenue which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized as income, a $5.0 million increase in accounts payable and accrued liabilities, a $3.1 million increase in accrued payroll and compensation, a $5.7 million increase in income tax payable and a $0.5 million decrease related to the change in deferred tax assets, a $0.8 million decrease in prepaid expenses and other assets, net, and a $0.2 million decrease in accounts receivable, net . Uses of cash were primarily related to an $8.0 million increase in inventory to ensure adequate level of inventory to support high-turnover channel driven products to reduce the risk of product stockouts and a $0.8 million decrease in other liabilities.

Our operating activities during the six months ended June 30, 2011 provided $74.2 million in cash as a result of net income of $28.1 million, increased by non-cash adjustments of $12.1 million and sources of cash of $37.4 million partially offset by uses of cash of $3.3 million. Non-cash adjustments consisted of stock-based compensation of $6.9 million, amortization of investment premiums of $6.3 million, and depreciation and amortization of $3.3 million, offset partially by an excess tax benefit from employee stock option exercises of $4.5 million. Sources of cash were related to a $20.5 million increase in deferred revenue which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized as income, a $4.0 million increase in accounts payable and accrued liabilities, a $3.2 million increase

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in other liabilities, mainly due to the deferral of the patent litigation settlement, which is being amortized over three years, a $0.4 million increase in accrued payroll and compensation, a $9.3 million increase in income tax payable and deferred tax assets, due to our continued profitability and timing of tax payments, and a $0.1 million decrease in accounts receivable. Uses of cash were primarily related to a $1.9 million increase in prepaid expenses and other assets and a $1.5 million increase in inventory to ensure adequate levels of inventory to support shipments of new product introductions in the second half of the year.

Investing Activities

Our investing activities during the six months ended June 30, 2012 consisted primarily of purchases, sales and maturities of investments, and to a lesser extent capital expenditures and acquisitions. The $105.9 million of cash used in investing activities during the six months ended June 30, 2012 was primarily due to net purchases of investments of $101.5 million, purchases of property and equipment of $3.9 million, and our acquisition of IntruGuard of $0.6 million.

Our investing activities during the six months ended June 30, 2011 consisted primarily of purchases, sales and maturities of investments, and to a lesser extent capital expenditures. The $79.9 million of cash used by investing activities during the six months ended June 30, 2011 was due to net purchases of investments of $75.8 million, our acquisition of TalkSwitch for $2.6 million, and purchases of property and equipment of $1.5 million.

Financing Activities

Our financing activities during the six months ended June 30, 2012 resulted in net cash provided of $22.8 million as a result of proceeds of $12.7 million and $5.0 million, from the issuance of common stock under our stock option plans and ESPP, respectively, and an excess tax benefit from employee stock option exercises of $5.2 million.

Our financing activities during the six months ended June 30, 2011 resulted in net cash provided of $15.7 million as a result of proceeds of $11.2 million from the issuance of common stock under our stock option plans and an excess tax benefit from employee stock option exercises of $4.5 million.

Contractual Obligations

The following summarizes our contractual obligations as of June 30, 2012:

	Payments Due By Period				
	Total	Remainder of 2012	2013 - 2015	2016 - 2017	Thereafter
	($ amounts in 000's)				
Operating leases (1)	21,718	6,547	15,171	—	—
Capital leases (2)	110	11	70	29	—
Purchase commitments (3)	26,900	26,900	—	—	—
Other contracts (4)	3,054	3,054	—	—	—
Total (5)	51,782	36,512	15,241	29	—

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(1) Consists of contractual obligations from non-cancelable office space under operating leases.

(2) Consists of contractual obligations from non-cancelable equipment financed under capital leases. Includes principal and imputed interest.

(3) Consists of minimum purchase commitments with independent contract manufacturers.

(4)

Consists of an estimate of all open purchase orders and contractual obligations in the ordinary course of business, other than commitments with contract manufacturers and suppliers, for which we have not received the goods or services. Purchase obligations do not include contracts that may be cancelled without penalty. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to the delivery of goods or performance of services.

(5) No tax liabilities related to uncertain tax positions have been included in the table. As of June 30, 2012, we had $23.6 million of tax liabilities, including interest, related to uncertain tax positions. Because of the high degree of uncertainty regarding the settlement of these liabilities, we are unable to estimate the years in which future cash outflows may occur.

Off-Balance Sheet Arrangements

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As of June 30, 2012, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities, that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in our market risk during the six months ended June 30, 2012, compared to the disclosures in Part II, Item 7A of our Form 10-K.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of June 30, 2012. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. 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 benefits of possible controls and procedures relative to their costs.

Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of June 30, 2012 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 the Securities and Exchange Commission 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

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the three months ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

ITEM 1. Legal Proceedings

In August 2009, ESR, a non-practicing entity, filed a complaint against us in the United States District Court for the District of Delaware alleging infringement by us and other defendants of two patents. The plaintiffs are claiming unspecified damages and requesting an injunction against the alleged infringement. In June 2010, the Court granted our motion to stay pending the outcome of reexamination proceedings in the PTO on both asserted patents. The PTO rejected all of the claims of the patents in the suit and ESR has appealed this result to the BPAI.

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us claiming unspecified damages in the California Superior Court for the County of Los Angeles alleging violation of various California Corporations Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company. In September 2010, the Court granted our motion to transfer the case to the California Superior Court for Santa Clara County and the plaintiff has filed several amended complaints in the Superior Court to add individual defendants, among other amendments. The Superior Court will be hearing motions for summary judgment in November 2012, and has set a trial date for December 2012.

In July 2010, NPS, a non-practicing entity, filed a complaint in the United States District Court for the Eastern District of Texas alleging patent infringement by us and other defendants. NPS is claiming unspecified damages, including treble damages for willful infringement, and requests an injunction against such alleged infringement. In December 2011, the United States District Court for the Eastern District of Texas ordered the case to be transferred to the Northern District of California. In June 2012, the United States District Court for the Northern District of California dismissed the other defendants for misjoinder, and the case is proceeding with the company as the sole defendant.

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In June 2012, we received a letter from SRI International ("SRI") claiming that we infringed certain SRI patents. Subsequently, we filed a complaint in the United States District Court for the Northern District of California seeking declaratory relief and a judgment that the SRI patents were invalid, unenforceable and/or not infringed by any of our products or services. The case is currently in the very early stages, and we have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

ITEM 1A. Risk Factors

Investing in our common stock involves a high degree of risk. You should carefully consider the following risks and all other information contained in this Quarterly Report on Form 10-Q, including our condensed consolidated financial statements and the related notes, before investing in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, also may become important factors that affect us. If any of the following risks materialize, our business, financial condition and results of operations could be materially harmed. In that case, the trading price of our common stock could decline, and you may lose some or all of your investment.

Risks Related to Our Business

Our quarterly operating results are likely to vary significantly and be unpredictable.

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

- the level of demand for our products and services;
- the timing of channel partner and end-customer orders;
- the timing of shipments, which may depend on many factors such as inventory levels and logistics, our ability to ship new products on schedule and to accurately forecast inventory requirements, and potential delays in the manufacturing process;
- inventory imbalances, such as those related to new products and the end of life of existing products;
- the mix of products sold, the mix of revenue between products and services and the degree to which products and services are bundled and sold together for a package price;
- the budgeting cycles and purchasing practices of our channel partners and end-customers;
- seasonal buying patterns of our end-customers;
- the timing of revenue recognition for our sales, which may be affected by both the mix of sales by our "sell-in" versus our "sell-through" channel partners, and by the extent to which we bring on new distributors;
- the accuracy and timing of point of sale reporting by our sell-through distributors, which impacts our ability to recognize revenue;
- the level of perceived threats to network security, which may fluctuate from period to period;
- changes in end-customer, distributor or reseller requirements or market needs;

- changes in the growth rate of the network security or UTM markets;
- the timing and success of new product and service introductions by us or our competitors or any other change in the competitive landscape of our industry, including consolidation among our competitors or end-customers;
- deferral of orders from end-customers in anticipation of new products or product enhancements announced by us or our competitors;

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- increases or decreases in our expenses caused by fluctuations in foreign currency exchange rates, as a significant portion of our expenses are incurred and paid in currencies other than the U.S. dollar;
- decisions by potential end-customers to purchase network security solutions from larger, more established security vendors or from their primary network equipment vendors;
- price competition;
- changes in customer renewal rates for our services;
- changes in the length of services contracts sold;
- insolvency or credit difficulties confronting our customers, affecting their ability to purchase or pay for our products and services;
- disruptions in our channel or termination of our relationship with important channel partners;
- insolvency or credit difficulties confronting our key suppliers, which could disrupt our supply chain;
- general economic conditions, both in our domestic and foreign markets; and
- future accounting pronouncements or changes in our accounting policies.

Any one of the factors above or the cumulative effect of some of the factors referred to above may result in significant fluctuations in our quarterly financial and other operating results, including fluctuations in our key metrics. This variability and unpredictability could result in our failing to meet our internal operating plan or the expectations of securities analysts or investors for any period. If we fail to meet or exceed such expectations for these or any other reasons, the market price of our shares could fall substantially and we could face costly lawsuits, including securities class action suits. In addition, a significant percentage of our operating expenses are fixed in nature and based on forecasted revenue trends. Accordingly, in the event of revenue shortfalls, we are generally unable to mitigate the negative impact on margins in the short term.

Our billings and revenue growth may slow or may not continue.

Billings and revenue growth may slow or decline for a number of reasons, including a slowdown in demand for our products or services, an increase in competition, a decrease in the growth of our overall market, softness in demand in certain geographies, or if we fail for any reason to continue to capitalize on growth opportunities. We may not be able to sustain profitability in future periods if we fail to increase billings, revenue or deferred revenue, do not appropriately manage our cost structure, or encounter unanticipated liabilities. Any failure by us to maintain profitability and continue our billings and revenue growth could cause the price of our common stock to materially decline.

Reliance on a concentration of shipments at the end of the quarter could cause our revenue to fall below expected levels.

As a result of customer-buying patterns and the efforts of our sales force and channel partners to meet or exceed quarterly quotas, we have historically received a substantial portion of each quarter's sales orders and generated a substantial portion of each quarter's revenue during the last two weeks of the quarter. If expected revenue at the end of any quarter is delayed for any reason, including the failure of anticipated purchase orders to materialize, or our logistics partners' inability to ship products prior to quarter-end to fulfill purchase orders received near the end of the quarter, our failure to manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, or any delays in shipments based on trade compliance requirements, our revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

We rely significantly on revenue from subscription and support services which may decline, and because we recognize revenue from subscription and support services over the term of the relevant service period, downturns or upturns in sales of subscription and support services are not immediately reflected in full in our operating results.

Our services revenue has historically accounted for a significant percentage of our total revenue. Sales of new or renewal subscription and support services contracts may decline and fluctuate as a result of a number of factors, including end-customers' level of satisfaction with our products and services, the prices of our products and services, the prices of products and services offered by our competitors or reductions in our customers' spending levels. If our sales of new or renewal

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subscription and support services contracts decline, our revenue and revenue growth may decline and our business will suffer. In addition, we recognize subscription and support services revenue monthly over the term of the relevant service period, which is typically one year but has been as long as five years. As a result, much of the revenue we report each quarter is the recognition of deferred revenue from subscription and support services contracts entered into during previous quarters. Consequently, a decline in new or renewed subscription or support services contracts in any one quarter will not be fully reflected in revenue in that quarter but will negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in new or renewed sales of our subscriptions or support services is not reflected in full in our results of operations until future periods. Our subscription and support services revenue also makes it difficult for us to rapidly increase our revenue through additional service sales in any period, as revenue from new and renewal services contracts must be recognized over the applicable service period. Furthermore increases in the average term of services contracts would result in revenue for services contracts being recognized over longer periods of time.

Managing inventory of our products and product components is complex. Insufficient inventory may result in lost sales opportunities or delayed revenue, while excess inventory may harm our gross margins.

Managing our inventory is complex. Our channel partners may increase orders during periods of product shortages, cancel orders if their inventory is too high, return products or take advantage of price protection (if any is available to the particular partner), or delay orders in anticipation of new products. They also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them and in response to seasonal fluctuations in end-customer demand. Furthermore, if the time required to manufacture certain products or ship products increases for any reason, this could result in inventory shortfalls. Management of our inventory is further complicated by the significant number of different products and models that we sell.

In addition, for those channel partners that have rights of return, inventory held by such channel partners affects our results of operations. Our inventory management systems and related supply chain visibility tools may be inadequate to enable us to effectively manage inventory. Inventory management remains an area of focus as we balance the need to maintain inventory levels that are sufficient to ensure competitive lead times against the risk of inventory obsolescence because of rapidly changing technology and customer requirements. If we ultimately determine that we have excess inventory, we may have to reduce our prices and write-down inventory, which in turn could result in lower gross margins. Alternatively, insufficient inventory levels may lead to shortages that result in delayed revenue or loss of sales opportunities altogether as potential end-customers turn to competitors' products that are readily available. For example, we experienced inventory shortages in the third quarter of 2011, based largely on more demand for certain products than we had forecasted. If we are unable to effectively manage our inventory and that of our channel partners, our results of operations could be adversely affected.

We rely on third-party channel partners to generate substantially all of our revenue. If our partners fail to perform, our ability to sell our products and services will be limited, and if we fail to optimize our channel partner model going forward, our operating results will be harmed.

Substantially all of our revenue is generated through sales by our channel partners, which include distributors and resellers. We depend upon our channel partners to generate sales opportunities and manage the sales process. To the extent our channel partners are unsuccessful in selling our products, or we are unable to enter into arrangements with, and retain, a sufficient number of high quality channel partners in each of the regions in which we sell products, and keep them motivated to sell our products, our ability to sell our products and operating results will be harmed. The termination of our relationship with any significant channel partner may adversely impact our sales and operating results.

We provide sales channel partners with specific programs to assist them in selling our products, but there can be no assurance that these programs will be effective. In addition, our channel partners may be unsuccessful in marketing, selling and supporting our products and services. Our channel partners generally do not have minimum purchase requirements. They may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products. They may also have incentives to promote our competitors' products to the detriment of our own. They may cease selling our products altogether. We cannot assure you that we will retain these channel partners or that we will be able to secure additional or replacement partners or that existing channel partners will continue to perform. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results. In addition, any new sales channel partner will require extensive training and may take several months or more to achieve productivity. Our channel partner sales structure could subject us to lawsuits, potential liability and reputational harm if, for example, any of our channel partners misrepresent the functionality of our products or services to end-customers or our channel partners violate laws or our corporate policies. If we fail to optimize our channel partner model or fail to manage existing sales channels, our business will be seriously harmed.

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If we are not successful in continuing to execute our strategy to increase our sales to larger end-customers, our results of operations may suffer.

An important part of our growth strategy is to increase sales of our products to large enterprises, service providers and governmental entities. Sales to enterprises, service providers and governmental entities involve risks that may not be present (or that are present to a lesser extent) with sales to small-to-mid-sized entities. These risks include:

- increased competition from competitors, such as Cisco Systems, Inc., Check Point Software Technologies Ltd., McAfee, Inc. (acquired by Intel Corporation), Palo Alto Networks, Inc., and Juniper Networks, Inc., that traditionally target enterprises, service providers and governmental entities and that may already have purchase commitments from those end-customers;

- increased purchasing power and leverage held by large end-customers in negotiating contractual arrangements;

- more stringent requirements in our support service contracts, including stricter support response times, and increased penalties for any failure to meet support requirements; and

- longer sales cycles and the associated risk that substantial time and resources may be spent on a potential end-customer that elects not to purchase our products and services.

Large enterprises, service providers and governmental entities often undertake a significant evaluation process that results in a lengthy sales cycle, in some cases over 12 months. Although we have a channel sales model, our sales representatives typically engage in direct interaction with our distributors and resellers in connection with sales to larger end-customers. Due to the lengthy nature, the size and scope, and stringent requirements of these evaluations, we typically provide evaluation products to these customers. We may spend substantial time, effort and money in our sales efforts without being successful in producing any sales. If we are unsuccessful in converting these evaluations into sales, we may experience an increased inventory of used products and potentially increased write-offs. In addition, product purchases by enterprises, service providers and governmental entities are frequently subject to budget constraints, multiple approvals, and unplanned administrative, processing and other delays. Finally, enterprise, service providers and governmental entities typically have longer implementation cycles, require greater product functionality and scalability and a broader range of services, including design services, demand that vendors take on a larger share of risks, sometimes require acceptance provisions that can lead to a delay in revenue recognition, and expect greater payment flexibility from vendors. All these factors can add further risk to business conducted with these customers. If sales expected from a large end-customer for a particular quarter are not realized in that quarter or at all, our business, operating results and financial condition could be materially and adversely affected.

The average sales prices of our products may decrease, which may reduce our gross profits and adversely impact our financial results and the trading price of our common stock.

The average sales prices for our products may decline for a variety of reasons, including competitive pricing pressures, discounts we offer, a change in our mix of products, anticipation of the introduction of new products or promotional programs. Competition continues to increase in the market segments in which we participate, and we expect competition to further increase in the future, thereby leading to increased pricing pressures. Larger competitors with more diverse product offerings may reduce the price of products that compete with ours in order to promote the sale of other products or may bundle them with other products. Additionally, although we price our products and services worldwide in U.S. dollars, currency fluctuations in certain countries and regions may negatively impact actual prices that partners and customers are willing to pay in those countries and regions. Furthermore, we anticipate that the average sales prices and gross profits for our products will decrease over product life cycles. We cannot assure you that we will be successful in developing and introducing new offerings with enhanced functionality on a timely basis, or that our product offerings, if introduced, will enable us to maintain our prices and gross profits at levels that will allow us to maintain profitability.

Actual, possible or perceived defects or vulnerabilities in our products or services, the failure of our products or services to prevent a virus or security breach, or misuse of our products could harm our reputation and divert resources.

Because our products and services are complex, they have contained and may contain defects or errors that are not detected until after their commercial release and deployment by our customers. Defects or vulnerabilities may impede or block network traffic or cause our products or services to be vulnerable to electronic break-ins or cause them to fail to help secure networks. Because the techniques used by computer hackers to access or sabotage networks change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques. In addition, defects or errors in our FortiGuard subscription updates or our FortiGate appliances could result in a failure of our FortiGuard services to effectively update end-customers' FortiGate appliances and thereby leave customers vulnerable to attacks. Furthermore, our solutions may also fail to detect or prevent viruses, worms or similar threats due to a number of reasons such as the evolving nature of such threats and the continual emergence of new threats that we may fail to add to our FortiGuard databases in time to protect our end-customers' networks. Our FortiGuard or FortiCare data centers and networks may also experience technical failures and downtime, and may fail to distribute appropriate updates, or fail to meet the increased requirements of a growing customer base. Any such technical failure, downtime, or failures in general may temporarily or permanently expose our end-customers' networks, leaving their networks unprotected against the latest security threats.

An actual, possible or perceived security breach or infection of the network of one of our end-customers, regardless of whether the breach is attributable to the failure of our products or services to prevent the security breach, could adversely affect the market's perception of our security products and services. We may not be able to correct any security flaws or vulnerabilities promptly, or at all. Our products may also be misused by end-customers or third parties who obtain access to our products. For example, our products could be used to censor private access to certain information on the Internet. Such use of our products for censorship could result in negative press coverage and negatively affect our reputation, even if we take reasonable measures to prevent any improper shipment of our products or if our products are provided by an unauthorized third-party. Any actual, possible, or perceived defects, errors or vulnerabilities in our products, or misuse of our products, could result in:

- expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;
- loss of existing or potential end-customers or channel partners;
- delayed or lost revenue;
- delay or failure to attain market acceptance;
- negative publicity, which will harm our reputation; and
- litigation, regulatory inquiries or investigations that may be costly and harm our reputation.

Our business and operations have experienced rapid growth, and if we do not appropriately manage any future growth, or are unable to improve our systems and processes, our operating results will be negatively affected.

We have a high volume business that has grown over the last several years. We rely heavily on information technology systems to help manage critical functions such as order processing, revenue recognition, financial forecasts, inventory and supply chain management and trade compliance reviews. However, we have been slow to adopt and implement certain automated functions, like Electronic Data Interchange, which could have a negative impact on our business. For example, a large part of our order processing relies on the manual processing of emails internally and from our customers. Combined with the fact that we may receive a majority of our orders in the last few weeks of any given quarter, a significant interruption in our email service or other systems could result in delayed order fulfillment and decreased revenue for that quarter. To manage any future growth effectively, we must continue to improve and expand our information technology and financial infrastructure, operating and administrative systems and controls, and continue to manage headcount, capital and processes in an efficient manner. We may not be able to successfully implement improvements to these systems and processes in a timely or efficient manner. In addition, our systems and processes may not prevent or detect all errors, omissions or fraud. Our failure to improve our systems and processes, or their failure to operate in the intended manner, may result in our inability to manage the growth of our business and to accurately forecast our revenue, expenses and earnings, or to prevent certain losses. Our productivity and the quality of our products and services may be adversely affected if we do not integrate and train our new employees quickly and effectively. Any future growth would add complexity to our organization and require effective coordination throughout our organization. Failure to manage any future growth effectively could result in increased costs and harm our results of operations.

If our estimates or judgments relating to our critical accounting policies are based on assumptions that change or prove to be incorrect, our operating results could fall below expectations of securities analysts and investors, resulting in a decline in our stock price.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial

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statements and accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, as provided in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Form 10-Q, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price. Significant assumptions and estimates used in preparing our condensed consolidated financial statements include those related to revenue recognition, stock-based compensation, valuation of inventory, warranty liabilities, and accounting for income taxes.

We offer retroactive price protection to certain of our major distributors, and if we fail to balance their inventory with end-customer demand for our products, our allowance for price protection may be inadequate, which could adversely affect our results of operations.

We provide certain of our major distributors with price protection rights for inventories of our products held by them. If we reduce the list price of our products, certain distributors receive refunds or credits from us that reduce the price of such products held in their inventory based upon the new list price. Future credits for price protection will depend on the percentage of our price reductions for the products in inventory and our ability to manage the levels of our major distributors' inventories. If future price protection adjustments are higher than expected, our future results of operations could be materially and adversely affected.

If we are unable to hire, retain and motivate qualified personnel, our business will suffer.

Our future success depends, in part, on our ability to continue to attract and retain highly skilled personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel, or delays in hiring required personnel, particularly in engineering and sales, may seriously harm our business, financial condition and results of operations. From time to time, we have experienced turnover in our management-level personnel. None of our key employees has an employment agreement for a specific term, and any of our employees may terminate their employment at any time. Our ability to continue to attract and retain highly skilled personnel will be critical to our future success. Competition for highly skilled personnel is frequently intense, especially in the locations where we have a substantial presence and need for highly-skilled personnel: the San Francisco Bay Area, Vancouver, Canada and Beijing, China. A large portion of our employee base is substantially vested in significant stock option grants, and the ability to exercise those options and sell their stock may result in a larger than normal turnover rate. We may not be successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs. Also, to the extent we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited or divulged proprietary or other confidential information.

We are dependent on the continued services and performance of our senior management, the loss of any of whom could adversely affect our business, operating results and financial condition.

Our future performance depends on the continued services and continuing contributions of our senior management to execute on our business plan, and to identify and pursue new opportunities and product innovations. The loss of services of senior management, particularly Ken Xie, our Co-founder, President and Chief Executive Officer, Michael Xie, our Co-founder, Vice President of Engineering and Chief Technology Officer, Ken Goldman, our Vice President and Chief Financial Officer, and any of our senior sales leaders, could significantly delay or prevent the achievement of our development and strategic objectives. In addition, key personnel may be distracted by activities unrelated to our business. The loss of the services, or distraction, of our senior management for any reason could adversely affect our business, financial condition and results of operations.

Adverse economic conditions or reduced information technology spending may adversely impact our business.

Our business depends on the overall demand for information technology and on the economic health of our current and prospective customers. In addition, the purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. Weak global economic conditions, weak economic conditions in certain geographies, or a reduction in information technology spending regardless of macro-economic conditions, could adversely impact our business, financial condition and results of operations in a number of ways, including longer sales cycles, lower prices for our products and services, higher default rates among our distributors, reduced unit sales and lower or no growth.

Because we depend on several third-party manufacturers to build our products, we are susceptible to manufacturing delays that could prevent us from shipping customer orders on time, if at all, and may result in the loss of sales and customers, and third-party manufacturing cost increases could result in lower gross margins.

We outsource the manufacturing of our security appliance products to a variety of contract manufacturing partners and original design manufacturing partners.

Our reliance on our third-party manufacturers reduces our control over the manufacturing process, exposing us to risks, including reduced control over quality assurance, product costs and product supply and timing. Any manufacturing disruption by our third-party manufacturers could impair our ability to fulfill orders. If we are unable to manage our relationships with these third-party manufacturers effectively, or if these third-party manufacturers experience delays, increased manufacturing lead-times, disruptions, capacity constraints or quality control problems in their manufacturing operations, or fail to meet our future requirements for timely delivery, our ability to ship products to our customers could be impaired and our business would be seriously harmed.

These manufacturers fulfill our supply requirements on the basis of individual purchase orders. We have no long-term contracts or arrangements with certain of our third-party manufacturers that guarantee capacity, the continuation of particular payment terms or the extension of credit limits. Accordingly, they are not obligated to continue to fulfill our supply requirements, and the prices we are charged for manufacturing services could be increased on short notice. If we are required to change third-party manufacturers, our ability to meet our scheduled product deliveries to our customers would be adversely affected, which could cause the loss of sales and existing or potential customers, delayed revenue or an increase in our costs which could adversely affect our gross margins. Our individual product lines are generally manufactured by only one manufacturing partner. Any production interruptions for any reason, such as a natural disaster, epidemic, capacity shortages, or quality problems, at one of our manufacturing partners would severely affect sales of our product lines manufactured by that manufacturing partner. Furthermore manufacturing cost increases for any reason could result in lower gross margins.

Our proprietary FortiASIC, which is the key to the performance of our appliances, is fabricated by contract manufacturers in foundries operated by United Microelectronics Corporation and Taiwan Semiconductor Manufacturing Company Limited (“TSMC”). Faraday Technology Corporation (using UMC's foundry), Kawasaki Microelectronics America, Inc. (“K-Micro”) (using TSMC's foundry) and Renesas Electronics Corporation (using UMC's foundry) manufacture our ASICs on a purchase order basis, and these foundries do not guarantee any capacity and could reject orders from Faraday, K-Micro or Renesas or try to increase pricing. Accordingly, the foundries are not obligated to continue to fulfill our supply requirements, and due to the long lead time that a new foundry would require, we could suffer temporary or long term inventory shortages of our FortiASIC as well as increased costs. Our suppliers may also prioritize orders by other companies that order higher volumes of products. If any of these suppliers materially delays its supply of ASICs or specific product models to us, or requires us to find an alternate supplier and we are not able to do so on a timely and reasonable basis, or if these foundries materially increase their prices for fabrication of our ASICs or specific product models, our business would be harmed.

In addition, our reliance on third-party manufacturers and foundries limits our control over environmental regulatory requirements such as the hazardous substance content of our products and therefore our ability to ensure compliance with the European Union's (“EU”) Restriction of Hazardous Substances Directive (“RoHS”) and other similar laws.

Because some of the key components in our products come from limited sources of supply, we are susceptible to supply shortages, long lead times for components, and supply changes, each of which could disrupt or delay our scheduled product deliveries to our customers, result in inventory shortage, and may result in the loss of sales and customers, and increased component costs may result in lower gross margins.

We and our contract manufacturers currently purchase several key parts and components used in the manufacture of our products from limited sources of supply. We are therefore subject to the risk of shortages and long lead times in the supply of these components and the risk that component suppliers discontinue or modify components used in our products. We have in the past experienced, and are currently experiencing, shortages and long lead times for certain components. Certain of our limited source components for particular appliances and suppliers of those components include: specific types of central processing units from Intel Corporation, Advanced Micro Devices, Inc., RMI/Netlogic Corporation and VIA Technologies, Inc., network chips from Broadcom Corporation, Marvell Technology Group Ltd. and Intel, and hard drives from Western Digital Technologies, Inc. The introduction by component suppliers of new versions of their products, particularly if not anticipated by us or our contract manufacturers, could require us to expend significant resources to incorporate these new components into our products. In addition, if these suppliers were to discontinue production of a necessary part or component, we would be required to expend significant resources and time in locating and integrating replacement parts or components from another vendor. Qualifying additional suppliers for limited source parts or components can be time-consuming and expensive.

Our manufacturing partners have experienced long lead times for the purchase of components incorporated into our products. Lead times for components may be adversely impacted by factors outside of our control, such as natural disasters and other factors. Our reliance on a limited number of suppliers involves several additional risks, including:

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- a potential inability to obtain an adequate supply of required parts or components when required;
- financial or other difficulties faced by our suppliers;
- infringement or misappropriation of our intellectual property;
- price increases;
- failure of a component to meet environmental or other regulatory requirements;
- failure to meet delivery obligations in a timely fashion; and
- failure in component quality.

The occurrence of any of these would be disruptive to us and could seriously harm our business. Any interruption or delay in the supply of any of these parts or components, or the inability to obtain these parts or components from alternate sources at acceptable prices and within a reasonable amount of time, would harm our ability to meet our scheduled product deliveries to our distributors, resellers and end-customers. This could harm our relationships with our channel partners and end-customers and could cause delays in shipment of our products and adversely affect our results of operations. In addition, increased component costs could result in lower gross margins.

We are exposed to fluctuations in currency exchange rates, which could negatively affect our financial condition and results of operations.

A majority of our operating expenses is incurred outside the United States. These expenses are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro and Canadian dollar. For example, during the second and third quarters of 2011, we were affected by the weakening of the dollar against the Canadian dollar and the Euro, which caused our operating expenses to increase. Although we have been hedging currency exposures relating to certain balance sheet accounts and have periodically entered into cash flow hedges relating to certain operating expenses incurred outside of the United States, if we stop hedging against any of these risks or if our attempts to hedge against these currency exposures are not successful, our financial condition and results of operations could be adversely affected. In addition, our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency risk. However, a strengthening of the U.S. dollar could increase the real cost of our products to our customers outside of the United States, which could also adversely affect our financial condition and results of operations.

We generate a majority of revenue from sales to distributors, resellers and end-customers outside of the United States, and we are therefore subject to a number of risks associated with international sales and operations.

We market and sell our products throughout the world and have established sales offices in many parts of the world. Therefore, we are subject to risks associated with having worldwide operations. We are also subject to a number of risks typically associated with international sales and operations, including:

- economic or political instability in foreign markets;
- greater difficulty in enforcing contracts, accounts receivable collection and longer collection periods;

- changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;
- the uncertainty of protection for intellectual property rights in some countries;
- costs of compliance with foreign policies, laws and regulations and the risks and costs of non-compliance with such policies, laws and regulations;
- costs of complying with U.S. laws and regulations for foreign operations, including the Foreign Corrupt Practices Act, import and export control laws, tariffs, trade barriers, and economic sanctions;

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- other regulatory or contractual limitations on our ability to sell our products in certain foreign markets, and the risks and costs of non-compliance;

- heightened risks of unfair or corrupt business practices in certain geographies and of improper or fraudulent sales arrangements that may impact financial results and result in restatements of financial statements and irregularities in financial statements;

- the potential for political unrest, terrorism, hostilities or war;

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

- multiple and possibly overlapping tax structures.

Product and service sales may be subject to foreign governmental regulations, which vary substantially from country to country. Further, we may be unable to keep up-to-date with changes in government requirements as they change from time to time. Failure to comply with these regulations could result in adverse effects to our business. In many foreign countries it is common for others to engage in business practices that are prohibited by our internal policies and procedures or U.S. regulations applicable to us. Although we implemented policies and procedures designed to ensure compliance with these laws and policies, there can be no assurance that all of our employees, contractors, channel partners and agents will comply with these laws and policies. Violations of laws or key control policies by our employees, contractors, channel partners or agents could result in delays in revenue recognition, financial reporting misstatements, fines, penalties, or the prohibition of the importation or exportation of our products and services and could have a material adverse effect on our business and results of operations.

We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets.

Because we incorporate encryption technology into our products, certain of our products are subject to U.S. export controls and may be exported outside the U.S. only with the required export license or through an export license exception. If we were to fail to comply with U.S. export licensing, U.S. Customs regulations and import regulations, U.S. economic sanctions and other countries' import and export laws, we could be subject to substantial civil and criminal penalties, including fines for the company and incarceration for responsible employees and managers, and the possible loss of export or import privileges. In addition, if our channel partners fail to obtain appropriate import, export or re-export licenses or permits, we may also be adversely affected through reputational harm and penalties. Obtaining the necessary export license for a particular sale may be time-consuming and may result in the delay or loss of sales opportunities.

Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of certain products to U.S. embargoed or sanctioned countries, governments and persons. Even though we take precautions to prevent our product from being shipped to U.S. sanctions targets, our products could be shipped to those targets by our channel partners, despite such precautions. Any such shipment could have negative consequences including government investigations and penalties and reputational harm. In addition, various countries regulate the import of certain encryption technology, including import permitting/licensing requirements, and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products globally or, in some cases, prevent the export or import of our products to certain countries, governments or persons altogether. Any change in export or import regulations, economic sanctions or related legislation, shift in the enforcement or scope of existing regulations, or change in the countries, governments, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, financial condition and results of operations.

If we fail to comply with environmental requirements, our business, financial condition, operating results and reputation could be adversely affected.

We are subject to various environmental laws and regulations including laws governing the hazardous material content of our products and laws relating to the recycling of electrical and electronic equipment. The laws and regulations to which we

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are subject include the EU, RoHS and the EU Waste Electrical and Electronic Equipment (WEEE) Directive as well as the implementing legislation of the EU member states. Similar laws and regulations have been passed or are pending in China, South Korea, Norway and Japan and may be enacted in other regions, including in the United States, and we are, or may in the future be, subject to these laws and regulations.

The EU RoHS and the similar laws of other jurisdictions ban the use of certain hazardous materials such as lead, mercury and cadmium in the manufacture of electrical equipment, including our products. We have incurred costs to comply with these laws, including research and development costs, costs associated with assuring the supply of compliant components and costs associated with writing off noncompliant inventory. We expect to incur more of these costs in the future. With respect to the EU RoHS, we and our competitors rely on an exemption for lead in network infrastructure equipment. It is possible this exemption will be revoked in the near future. If this exemption is revoked, if there are other changes to these laws (or their interpretation) or if new similar laws are passed in other jurisdictions, we may be required to reengineer our products to use components compatible with these regulations. This reengineering and component substitution could result in additional costs to us or disrupt our operations or logistics.

The EU has also adopted the WEEE Directive, which requires electronic goods producers to be responsible for the collection, recycling and treatment of such products. Although currently our EU international channel partners are responsible for the requirements of this directive as the importer of record in most of the European countries in which we sell our products, changes in interpretation of the regulations may cause us to incur costs or have additional regulatory requirements in the future to meet in order to comply with this directive, or with any similar laws adopted in other jurisdictions.

Our failure to comply with these and future environmental rules and regulations could result in reduced sales of our products, increased costs, substantial product inventory write-offs, reputational damage, penalties and other sanctions.

A portion of our revenue is generated by sales to governmental entities, which are subject to a number of challenges and risks.

Sales to U.S. and foreign federal, state and local governmental agency end-customers have accounted for a portion of our revenue in past periods, and we may in the future increase sales to governmental entities. Sales to governmental entities are subject to a number of risks. Selling to governmental entities can be highly competitive, expensive and time consuming, often requiring significant upfront time and expense without any assurance that we will win a sale. Government demand, sales, and payment for our products and services may be negatively impacted by numerous factors and requirements unique to selling to government agencies, such as public sector budgetary cycles, funding authorizations and requirements unique to government agencies, with funding or purchasing reductions or delays adversely affecting public sector demand for our products, geopolitical matters, and rules and regulations applicable to certain government sales. To date we have had limited traction in sales to U.S. federal government agencies, and any future sales to governmental entities is uncertain. All of our sales to governmental entities have been made indirectly through our distribution channel. Governmental entities may have contractual or other legal rights to terminate contracts with our distributors and resellers for convenience or due to a default, and any such termination may adversely impact our future results of operations. For example, if the distributor receives a significant portion of its revenue from sales to such governmental entity, the financial health of the distributor could be substantially harmed, which could negatively affect our future sales to such distributor. Governments routinely investigate and audit government contractors' administrative processes, and any unfavorable audit could result in the government refusing to continue buying our products and services, a reduction of revenue or fines or civil or criminal liability if the audit uncovers improper or illegal activities. Any such penalties could adversely impact our results of operations in a material way. Finally, purchases by the U.S. government may require certain products to be manufactured in the

United States and other high cost manufacturing locations, and we may not manufacture all products in locations that meet the requirements of the U.S. government.

False detection of viruses or security breaches or false identification of spam or spyware could adversely affect our business.

Our antivirus and our intrusion prevention services may falsely detect viruses or other threats that do not actually exist. This risk is heightened by the inclusion of a “heuristics” feature in our products, which attempts to identify viruses and other threats not based on any known signatures but based on characteristics or anomalies that may indicate that a particular item is a threat. When our end-customers enable the heuristics feature in our products, the risk of falsely identifying viruses and other threats significantly increases. These false positives, while typical in the industry, may impair the perceived reliability of our products and may therefore adversely impact market acceptance of our products. Also, our antispam and antispyware services may falsely identify emails or programs as unwanted spam or potentially unwanted programs, or alternatively fail to properly identify unwanted emails or programs, particularly as spam emails or spyware are often designed to circumvent antispam or spyware products. Parties whose emails or programs are blocked by our products may seek redress against us for labeling them as spammers or spyware, or for interfering with their business. In addition, false identification of emails or

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programs as unwanted spam or potentially unwanted programs may reduce the adoption of our products. If our system restricts important files or applications based on falsely identifying them as malware or some other item that should be restricted, this could adversely affect end-customers' systems and cause material system failures. Any such false identification of important files or applications could result in negative publicity, loss of end-customers and sales, increased costs to remedy any problem, and costly litigation.

If our internal network system is compromised by computer hackers, public perception of our products and services will be harmed.

We will not succeed unless the marketplace is confident that we provide effective network security protection. Because we provide network security products, we may be a more attractive target for attacks by computer hackers. Although we have not experienced significant damages from unauthorized access by a third-party of our internal network, if an actual or perceived breach of network security occurs in our internal systems it could adversely affect the market perception of our products and services. In addition, such a security breach could impair our ability to operate our business, including our ability to provide subscription and support services to our end-customers. If this happens, our revenue could decline and our business could suffer.

Our ability to sell our products is dependent on the quality of our technical support services, and our failure to offer high quality technical support services would have a material adverse effect on our sales and results of operations.

Once our products are deployed within our end-customers' networks, our end-customers depend on our technical support services, as well as the support of our channel partners, to resolve any issues relating to our products. If we or our channel partners do not effectively assist our customers in deploying our products, succeed in helping our customers quickly resolve post-deployment issues, and provide effective ongoing support, our ability to sell additional products and services to existing customers would be adversely affected and our reputation with potential customers could be damaged. Many enterprise, service provider and governmental entity end-customers require higher levels of support than smaller end-customers. If we fail to meet the requirements of the larger end-customers, it may be more difficult to execute on our strategy to increase our penetration with larger end-customers.

As a result, our failure to maintain high quality support services would have a material adverse effect on our business, financial condition and results of operations.

Changes in our provision for income taxes or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.

Our provision for income taxes is subject to volatility and could be adversely affected by several factors, many of which are outside of our control, including:

- earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates;
- changes in the valuation of our deferred tax assets and liabilities;
- expiration of, or lapses in the research and development tax credit laws;
- transfer pricing adjustments including the effect of acquisitions on our intercompany research and development and legal structure;

- an increase in non-deductible expenses for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development, and impairment of goodwill;
- a decrease in the stock option exercises by our employees in some of our foreign subsidiaries that can cause an adverse transfer pricing adjustment;
- tax costs related to intercompany realignments;
- tax assessments resulting from income tax audits or any related tax interest or penalties that could significantly affect our income tax provision for the period in which the settlement takes place;

- a change in our decision to indefinitely reinvest foreign earnings;
- changes in accounting principles; or
- changes in tax laws and regulations including possible changes in the United States to the taxation of earnings of our foreign subsidiaries, and the deductibility of expenses attributable to foreign income, or the foreign tax credit rules, or changes to the U.S. income tax rate, which would necessitate a revaluation of our deferred tax assets and liabilities.

Significant judgment is required to determine the recognition and measurement attribute prescribed in the FASB standard. In addition, the standard applies to all income tax positions, including the potential recovery of previously paid taxes, which if settled unfavorably could adversely impact our provision for income taxes or additional paid-in capital. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain foreign countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our results of operations.

Although we released our entire valuation allowance in fiscal 2009, we may in the future be required to establish a new valuation allowance. We will continue to assess the need for a valuation allowance on the deferred tax asset by evaluating both positive and negative evidence that may exist.

Forecasting our estimated annual effective tax rate is complex and subject to uncertainty, and there may be material differences between our forecasted and actual tax rates.

Forecasts of our income tax position and effective tax rate are complex and subject to uncertainty because our income tax position for each year combines the effects of a mix of profits earned and losses incurred by us in various tax jurisdictions with a broad range of income tax rates, as well as changes in the valuation of deferred tax assets and liabilities, the impact of various accounting rules and changes to these rules and tax laws, the results of examinations by various tax authorities, and the impact of any acquisition, business combination or other reorganization or financing transaction. To forecast our global tax rate, we estimate our pre-tax profits and losses by jurisdiction and forecast our tax expense by jurisdiction. If the mix of profits and losses, our ability to use tax credits, or effective tax rates by jurisdiction is different than those estimated, our actual tax rate could be materially different than forecasted, which could have a material impact on our results of business, financial condition and results of operations.

As a multinational corporation, we conduct our business in many countries and are subject to taxation in many jurisdictions. The taxation of our business is subject to the application of multiple and sometimes conflicting tax laws and regulations as well as multinational tax conventions. Our effective tax rate is highly dependent upon the geographic distribution of our worldwide earnings or losses, the tax regulations and tax holidays in each geographic region, the availability of tax credits and carryforwards, and the effectiveness of our tax planning strategies. The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws themselves are subject to change as a result of changes in fiscal policy, changes in legislation, and the evolution of regulations and court rulings. Consequently, taxing authorities may impose tax assessments or judgments against us that could materially impact our tax liability and/or our effective income tax rate.

In addition, we may be subject to examination of our income tax returns by the Internal Revenue Service and other tax authorities. If tax authorities challenge the relative mix of U.S. and international income, our future effective income tax rates could be adversely affected. While we regularly assess the likelihood of adverse outcomes from such examinations and the adequacy of our provision for income taxes, there can be no assurance that such provision is sufficient and that a determination by a tax authority will not have an adverse effect on our business, financial condition and results of operations.

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

In order to remain competitive, we may seek to acquire additional businesses, products, or technologies and intellectual property, such as patents. If we identify an appropriate acquisition candidate, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product, technology or intellectual property into our existing business and operations. We may have difficulty incorporating acquired technologies, intellectual property or products with our existing product lines and maintaining uniform standards, controls, procedures and policies. Our due diligence may fail to identify all of the problems, liabilities or other shortcomings or challenges of an acquired business, product or technology, including issues with intellectual property, product quality or product architecture, regulatory compliance practices, revenue recognition or other accounting practices or employee or customer issues. In addition, any acquisitions we are able to complete may not be accretive to earnings and may not result in any synergies or other benefits we had expected to achieve, which could result in write-offs that could be substantial. Further, completing a potential acquisition and integrating acquired businesses, products, technologies or intellectual property will significantly divert management time and resources.

Our business is subject to the risks of warranty claims, product returns, product liability and product defects.

Our products are very complex and, despite testing prior to their release, have contained and may contain undetected defects or errors, especially when first introduced or when new versions are released. Product errors have affected the performance of our products and could delay the development or release of new products or new versions of products, adversely affect our reputation and our end-customers' willingness to buy products from us, and adversely affect market acceptance or perception of our products. Any such errors or delays in releasing new products or new versions of products or allegations of unsatisfactory performance could cause us to lose revenue or market share, increase our service costs, cause us to incur substantial costs in redesigning the products, cause us to lose significant end-customers, subject us to liability for damages and divert our resources from other tasks, any one of which could materially and adversely affect our business, results of operations and financial condition. Our products must successfully interoperate with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the sources of these problems. The occurrence of hardware and software errors, whether or not caused by our products, could delay or reduce market acceptance of our products, and have an adverse effect on our business and financial performance, and any necessary revisions may cause us to incur significant expenses. The occurrence of any such problems could harm our business, financial condition and results of operations.

Although we have limitation of liability provisions in our standard terms and conditions of sale, they may not fully or effectively protect us from claims as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The sale and support of our products also entail the risk of product liability claims. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management's time and other resources.

Our business is subject to the risks of earthquakes, fire, power outages, floods and other catastrophic events, and to interruption by manmade problems such as civil unrest and terrorism.

A significant natural disaster, such as an earthquake, fire, a flood, or significant power outage could have a material adverse impact on our business, operating results and financial condition. Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity. In addition, natural disasters could affect our manufacturing vendors, suppliers or logistics providers' ability to perform services such as obtaining product components and manufacturing products on a timely basis and assisting with shipments on a timely basis. In the event our or our service providers' information technology systems or manufacturing or logistics abilities are hindered by any of the events discussed above, shipments could be delayed, resulting in missing financial targets, such as revenue and shipment targets, for a particular quarter. In addition, regional instability, acts of terrorism and other geo-political unrest could cause disruptions in our business or the business of our manufacturers, logistics providers, partners, or end-customers or the economy as a whole. Given our typical concentration of sales at each quarter end, any disruption in the business of our manufacturers, logistics providers, partners or end-customers that impacts sales at the end of our quarter could have a significant adverse impact on our quarterly results. All of the aforementioned risks may be augmented if the disaster recovery plans for us and our suppliers prove to be inadequate. To the extent that any of the above results in delays or cancellations of customer orders, or the delay in the manufacture, deployment or shipment of our products, our business, financial condition and results of operations would be adversely affected.

Risks Related to Our Industry

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

The network security market is expected to continue to evolve rapidly. Moreover, many of our end-customers operate

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in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated techniques to gain access to and attack systems and networks. The technology in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, while minimizing the impact on network performance. Additionally, some of our new products and enhancements may require us to develop new hardware architectures and ASICs that involve complex, expensive and time consuming research and development processes. Although the market expects rapid introduction of new products or product enhancements to respond to new threats, the development of these products is difficult and the timetable for commercial release and availability is uncertain and there can be long time periods between releases and availability of new products. We have in the past and may in the future experience unanticipated delays in the availability of new products and services and fail to meet previously announced timetables for such availability. If we do not quickly respond to the rapidly changing and rigorous needs of our end-customers by developing and releasing and making available on a timely basis new products and services or enhancements that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

Our URL database for our Web filtering service may fail to keep pace with the rapid growth of URLs and may not categorize websites in accordance with our end-customers' expectations.

The success of our Web filtering service depends on the breadth and accuracy of our URL database. Although our URL database currently catalogs millions of unique URLs, it contains only a portion of the URLs for all of the websites that are available on the Internet. In addition, the total number of URLs and software applications is growing rapidly, and we expect this rapid growth to continue in the future. Accordingly, we must identify and categorize content for our security risk categories at an extremely rapid rate. Our database and technologies may not be able to keep pace with the growth in the number of websites, especially the growing amount of content utilizing foreign languages and the increasing sophistication of malicious code and the delivery mechanisms associated with spyware, phishing and other hazards associated with the Internet. Further, the ongoing evolution of the Internet and computing environments will require us to continually improve the functionality, features and reliability of our Web filtering function. Any failure of our databases to keep pace with the rapid growth and technological change of the Internet will impair the market acceptance of our products, which in turn will harm our business, financial condition and results of operations.

In addition, our Web filtering service may not be successful in accurately categorizing Internet and application content to meet our end-customers' expectations. We rely upon a combination of automated filtering technology and human review to categorize websites and software applications in our proprietary databases. Our end-customers may not agree with our determinations that particular URLs should be included or not included in specific categories of our databases. In addition, it is possible that our filtering processes may place material that is objectionable or that presents a security risk in categories that are generally unrestricted by our users' Internet and computer access policies, which could result in such material not being blocked from the network. Conversely, we may miscategorize websites such that access is denied to websites containing information that is important or valuable to our customers. Any miscategorization could result in customer dissatisfaction and harm our reputation. Any failure to effectively categorize and filter websites according to our end-customers' and channel partners' expectations will impair the growth of our business.

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

We spend substantial amounts of time and money to research and develop new products and enhanced versions of our existing products to incorporate additional features, improved functionality or other enhancements in order to meet our customers' rapidly evolving demands for network security in our highly competitive industry. When we develop a new product or an enhanced version of an existing product, we typically incur expenses and expend resources upfront to market, promote and sell the new offering. Therefore, when we develop and introduce new or enhanced products, they must achieve high levels of market acceptance in order to justify the amount of our investment in developing and bringing them to market.

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

- delays in releasing our new products or enhancements to the market;
- failure to accurately predict market demand in terms of product functionality and to supply products that meet this demand in a timely fashion;

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- failure of our sales force and partners to focus on selling new products;
- inability to interoperate effectively with the networks or applications of our prospective end-customers;
- inability to protect against new types of attacks or techniques used by hackers;
- defects, vulnerabilities, errors or failures or any perceived possible defects, vulnerabilities, errors or failures;
- negative publicity about their performance or effectiveness;
- introduction or anticipated introduction of competing products by our competitors;
- poor business conditions for our end-customers, causing them to delay IT purchases;
- easing of regulatory requirements around security; and
- reluctance of customers to purchase products incorporating open source software.

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

Unless we continue to develop better market awareness of our company and our products, our revenue may not continue to grow.

Increased market awareness of our capabilities and products is essential to our continued growth and our success in all of our markets, particularly for the large enterprise, service provider and governmental entities markets. We have historically had relatively low spending on certain marketing activities, and, if our marketing programs are not successful in creating market awareness of our company and products, our business, financial condition and results of operations will be adversely affected, and we will not be able to achieve sustained growth.

Demand for UTM products may be limited by market perception that UTM products are inferior to network security solutions from multiple vendors.

Sales of most of our products depend on increased demand for UTM products. If the UTM market fails to grow as we anticipate, our business will be seriously harmed. Target customers may view UTM “all-in-one” solutions as inferior to security solutions from multiple vendors because of, among other things, their perception that UTM products provide security functions from only a single vendor and do not allow users to choose “best-of-breed” defenses from among the wide range of dedicated security applications available. Target customers might also perceive that, by combining multiple security functions into a single platform, UTM solutions create a “single point of failure” in their networks, which means that an error, vulnerability or failure of the UTM product may place the entire network at risk. In addition, the market perception that UTM solutions may be suitable only for small and medium sized businesses because UTM lacks the performance capabilities and functionality of other solutions may harm our sales to large enterprise, service provider, and governmental entity end-customers. If the foregoing concerns and perceptions become prevalent, even if there is no factual basis for these concerns and perceptions, or if other issues arise with the UTM market in general, demand for UTM products could be severely limited, which would limit our growth and harm our business, financial condition and results of operations. Further a successful and publicized targeted attack against us or another well known UTM vendor exposing a “single point of failure” could significantly increase these concerns and perceptions and may harm our business and results of operations.

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

The market for network security products is intensely competitive, and we expect competition to intensify in the future. Our competitors include networking companies such as Cisco Systems, Inc., Juniper Networks, Inc., and security vendors such as Check Point Software Technologies Ltd., McAfee, Inc. (acquired by Intel Corporation), SonicWALL, Inc. (acquired by Dell, Inc.), Palo Alto Networks, Inc., and other point solution security vendors.

Many of our existing and potential competitors enjoy substantial competitive advantages such as:

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- greater name recognition and longer operating histories;
- larger sales and marketing budgets and resources;
- broader distribution and established relationships with distribution partners and end-customers;
- access to larger customer bases;
- greater customer support resources;
- greater resources to make acquisitions;
- lower labor and development costs; and
- substantially greater financial, technical and other resources.

In addition, some of our larger competitors have substantially broader product offerings and leverage their relationships based on other products or incorporate functionality into existing products in a manner that discourages users from purchasing our products. These larger competitors often have broader product lines and market focus and are in a better position to withstand any significant reduction in capital spending by end-customers in these markets. Therefore, these competitors will not be as susceptible to downturns in a particular market. Also, many of our smaller competitors that specialize in providing protection from a single type of network security threat are often able to deliver these specialized network security products to the market more quickly than we can. Some of our smaller competitors are using third-party chips designed to accelerate performance. Conditions in our markets could change rapidly and significantly as a result of technological advancements or continuing market consolidation. Our current and potential competitors may also establish cooperative relationships among themselves or with third parties that may further enhance their resources. In addition, current or potential competitors may be acquired by third parties with greater available resources, such as Juniper's acquisition of NetScreen Technologies, Intel's acquisition of McAfee, Check Point's acquisition of Nokia's security appliance business and Dell's acquisition of SonicWALL. As a result of such acquisitions, our current or potential competitors might be able to adapt more quickly to new technologies and customer needs, devote greater resources to the promotion or sale of their products and services, initiate or withstand substantial price competition, take advantage of acquisition or other opportunities more readily or develop and expand their product and service offerings more quickly than we do. In addition, our competitors may bundle products and services competitive with ours with other products and services. Customers may accept these bundled products and services rather than separately purchasing our products and services. Due to budget constraints or economic downturns, organizations may be more willing to incrementally add solutions to their existing network security infrastructure from competitors than to replace it with our solutions. These competitive pressures in our market or our failure to compete effectively may result in price reductions, fewer customer orders, reduced revenue and gross margins and loss of market share.

If functionality similar to that offered by our products is incorporated into existing network infrastructure products, organizations may decide against adding our appliances to their network, which would have an adverse effect on our business.

Large, well-established providers of networking equipment such as Cisco Systems, Inc. and Juniper Networks, Inc. offer, and may continue to introduce, network security features that compete with our products, either in stand-alone security products or as additional features in their network infrastructure products. The inclusion of, or the announcement of an intent to include, functionality perceived to be similar to that offered by our security solutions in networking products that are already generally accepted as necessary components of network architecture may have an adverse effect on our ability to market and sell our products. Furthermore, even if the functionality offered by network infrastructure providers is more limited than our products, a significant number of customers may elect to accept such limited functionality in lieu of adding appliances from an additional vendor such as us. Many organizations have invested substantial personnel and financial resources to design and operate their networks and have established deep relationships with other providers of networking products, which may make them reluctant to add new components to their networks, particularly from other vendors such as us. In addition, an organization's existing vendors or new vendors with a broad product offering may be able to offer concessions that we are not able to match because we currently offer only network security products and have fewer resources than many of our competitors. If organizations are reluctant to add additional network infrastructure from new vendors or otherwise decide to work with their existing vendors, our business, financial condition and results of operations will be adversely affected.

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Risks Related to Intellectual Property

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

We rely primarily on patent, trademark, copyright and trade secrets laws, confidentiality procedures and contractual provisions to protect our technology. Valid patents may not issue from our pending applications, and the claims eventually allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate defensive protection or competitive advantages to us. Patent applications in the United States are typically not published until at least 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 pending patent applications or that we were the first to file for patent protection. 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. In addition, recent changes to the patent laws in the United States may bring into question the validity of certain software patents. As a result, we may not be able to obtain adequate patent protection or effectively enforce our issued patents.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary. We generally enter into confidentiality or license agreements with our employees, consultants, vendors and customers, and generally limit access to and distribution of our proprietary information. However, we cannot assure you that the steps taken by us will prevent misappropriation of our technology. Policing unauthorized use of our technology or products is difficult. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as the laws of the United States, and many foreign countries do not enforce these laws as diligently as government agencies and private parties in the United States. From time-to-time, legal action by us may be necessary to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, operating results and financial condition. If we are unable to protect our proprietary rights (including aspects of our software and products protected other than by patent rights), we may find ourselves at a competitive disadvantage to others who need not incur the additional expense, time and effort required to create the innovative products that have enabled us to be successful to date.

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

Our products contain software modules licensed to us by third-party authors under “open source” licenses, including the GNU Public License, the GNU Lesser Public License (LGPL), the BSD License, the Apache License and others. From time-to-time, there have been claims against companies that distribute or use open source software in their products and services, asserting that open source software infringes the claimants' intellectual property rights. We could be subject to suits by parties claiming infringement of intellectual property rights in what we believe to be licensed open source software. Use and distribution of open source software may entail greater risks than use of third-party commercial software, as open source licensors generally do not provide warranties or other contractual protections regarding infringement claims or the quality of the code. Some open source licenses contain requirements that we make available source code for modifications or derivative works we create based upon the type of open source software we use. If we combine our proprietary software with open source software in a certain manner, we could, under certain open source licenses, be required to release the source code of our proprietary software to the public. This would allow our competitors to create similar products with lower development effort and time and ultimately could result in a loss of product sales for us.

Although we monitor our use of open source software to avoid subjecting our products to conditions we do not intend, the terms of many open source licenses have not been interpreted by United States courts, and there is a risk that these licenses could be construed in a way that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In this event, we could be required to seek licenses from third parties to continue offering our products, to make generally available, in source code form, our proprietary code, to re-engineer our products, or to discontinue the sale of our products if re-engineering could not be accomplished on a timely basis, any of which could adversely affect our business, operating results and financial condition.

Claims by others that we infringe their proprietary technology or other litigation matters could harm our business.

Patent and other intellectual property disputes are common in the network security industry. Third parties have

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asserted and may in the future assert claims of infringement of intellectual property rights against us. They may also assert such claims against our end-customers or channel partners whom we typically indemnify against claims that our products infringe the intellectual property rights of third parties. As the number of products and competitors in our market increases and overlaps occur, infringement claims may increase. Any claim of infringement by a third-party, even those without merit, could cause us to incur substantial costs defending against the claim and could distract our management from our business. In addition, litigation may involve patent holding companies or other adverse patent owners who have no relevant product revenue and against whom our own patents may therefore provide little or no deterrence or protection.

Although third parties may offer a license to their technology, the terms of any offered license may not be acceptable, and the failure to obtain a license or the costs associated with any license could cause our business, financial condition and results of operations to be materially and adversely affected. In addition, some licenses may be non-exclusive, and therefore our competitors may have access to the same technology licensed to us.

Alternatively, we may be required to develop non-infringing technology, which could require significant time, effort and expense and may ultimately not be successful. Furthermore, a successful claimant could secure a judgment or we may agree to a settlement that prevents us from distributing certain products or performing certain services or that requires us to pay substantial damages (including treble damages if we are found to have willfully infringed such claimant's patents or copyrights), royalties or other fees. Any of these events could seriously harm our business, financial condition and results of operations.

From time to time we are subject to lawsuits claiming patent infringement, and there are lawsuits claiming patent infringement currently pending, as discussed in “Item 1-Legal Proceedings.” We are also subject to other litigation in addition to patent infringement claims, such as employment-related litigation and disputes, general commercial litigation, and other forms of litigation and disputes. If we are unsuccessful in defending any such claims, our operating results and financial condition and results may be materially and adversely affected. For example, we may be required to pay substantial damages and could be prevented from selling certain of our products. Litigation, with or without merit, could negatively impact our business, reputation, and sales in a material fashion. In addition to the lawsuits described in "Legal Proceedings," several other non-practicing patent holding companies have sent us letters proposing that we license certain of their patents, and given this and the proliferation of lawsuits in our industry and other similar industries by both non-practicing entities and operating entities, we expect that we will be sued for patent infringement in the future, regardless of the merits of any such lawsuits. The cost to defend such lawsuits and any adverse result in such lawsuits could have a material adverse effect on our results of operations and financial condition.

We rely on the availability of third-party licenses.

Many of our products include software or other intellectual property licensed from third parties. It may be necessary in the future to renew licenses relating to various aspects of these products or to seek new licenses for existing or new products. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could result in delays in product releases until equivalent technology can be identified, licensed or developed, if at all, and integrated into our products and may have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other intellectual property licensed from third parties on a nonexclusive basis could limit our ability to differentiate our products from those of our competitors.

Risks Related to Ownership of our Common Stock

As a public company, we are subject to compliance initiatives that will require substantial time from our management and result in significantly increased costs that may adversely affect our operating results and financial condition.

The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as well as other rules implemented by the SEC and The NASDAQ Stock Market, impose various requirements on public companies, including requiring changes in corporate governance practices. These and proposed corporate governance laws and regulations under consideration may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management's attention from other business concerns, it could have a material adverse effect on our business, financial condition and results of operations. The Sarbanes-Oxley Act requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually and disclosure controls and procedures quarterly. We are in the early stages of completing our evaluation of our internal controls over financial reporting for fiscal 2012 as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing and evaluation resulted in our conclusion that

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as of December 31, 2011, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in 2012 or future periods. If our internal controls or disclosure controls are ineffective in future periods, our business and reputation could be harmed. We may incur additional expenses and commitment of management's time in connection with further evaluations, both of which could materially increase our operating expenses and accordingly reduce our operating results.

Changes in financial accounting standards may cause adverse unexpected fluctuations and affect our reported results of operations.

A change in accounting standards or practices and varying interpretations of existing accounting pronouncements, such as changes to standards related to the increased use of fair value measure, financial instruments, and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards ("IFRS"), could have a significant effect on our reported financial results or the way we conduct our business. If we do not ensure that our systems and processes are aligned with the new standards, we could encounter difficulties generating quarterly and annual financial statements in a timely manner, which would have an adverse effect on our business and our ability to meet our reporting obligations.

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

The trading market for our common stock will depend in part on the research and reports that securities or industry analysts publish about us or our business. If we do not maintain adequate research coverage or if one or more of the analysts who covers us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price and trading volume to decline.

The trading price of our common stock is likely to be volatile.

The market price of our common stock is subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, and other factors such as rumors or fluctuations in the valuation of companies perceived by investors to be comparable to us. For example, in the three months ended June 30, 2012, the price of our common stock ranged from $20.41 to $28.44.

Furthermore, the stock markets have experienced price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political, and market conditions, such as recessions, interest rate changes or international currency fluctuations, may negatively affect the market price of our common stock.

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

Our failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in new products could reduce our ability to compete and could harm our business.

We expect that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. If we need to raise additional funds in the future, we may not be able to obtain additional debt or equity financing on favorable terms, if at all. If we raise additional equity financing, our stockholders may experience significant dilution of their ownership interests and the per-share value of our common stock could decline. Furthermore, if we engage in debt financing, the holders of debt would have priority over the holders of common stock and we may be required to accept terms that restrict our ability to incur additional indebtedness. We may also be required to take other actions that would otherwise be in the interests of the stockholders and force us to maintain specified liquidity or other ratios, any of which could harm our business, operating results and financial condition. If we need additional capital and cannot raise it on acceptable terms, we may not be able to, among other things:

- develop or enhance our products and services;

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- continue to expand our sales and marketing and research and development organizations;
- acquire complementary technologies, products or businesses;
- expand operations, in the United States or internationally;
- hire, train and retain employees; or
- respond to competitive pressures or unanticipated working capital requirements.

Our failure to do any of these things could seriously harm our business, financial condition and results of operations.

Concentration of ownership among our existing executive officers, directors and their affiliates may prevent new investors from influencing significant corporate decisions.

As of July 31, 2012, our executive officers, directors and their affiliates beneficially owned, in the aggregate, approximately 18% of our outstanding common stock. As a result, these stockholders are able to exercise a significant level of control over all matters requiring stockholder approval, including the election of directors, amendment of our certificate of incorporation and approval of significant corporate transactions. This control could have the effect of delaying or preventing a change of control of our company or changes in management and will make the approval of certain transactions difficult or impossible without the support of these stockholders.

Anti-takeover provisions contained in our certificate of incorporation and bylaws, as well as provisions of Delaware law, could impair a takeover attempt.

Our certificate of incorporation, bylaws and Delaware law contain provisions that could have the effect of rendering more difficult, delaying or preventing an acquisition deemed undesirable by our board of directors. Our corporate governance documents include provisions:

- providing for a classified board of directors whose members serve staggered three-year terms;
- authorizing “blank check” preferred stock, which could be issued by the board without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;
- limiting the liability of, and providing indemnification to, our directors and officers;
- limiting the ability of our stockholders to call and bring business before special meetings;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;
- controlling the procedures for the conduct and scheduling of board and stockholder meetings; and
- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

These provisions, alone or together, could delay or prevent hostile takeovers and changes in control or changes in our management.

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation law, which prevents some stockholders holding more than 15.0% of our outstanding common stock from engaging in certain business combinations without approval of the holders of a substantial majority of all of our outstanding common stock.

Any provision of our certificate of incorporation or bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock.

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

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Not applicable.

ITEM 3. Defaults upon Senior Securities

Not applicable.

ITEM 4. Mine Safety Disclosures

Not applicable.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

The exhibits listed in the accompanying Exhibit Index are filed or incorporated by reference as part of this Quarterly Report on Form 10-Q.

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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.

Date: August 7, 2012

FORTINET, INC.

By: /s/ KEN GOLDMAN
Ken Goldman
Vice President and Chief Financial Officer

Ken Goldman
Vice President and Chief Financial Officer

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EXHIBIT INDEX

Exhibit Number	Description	Incorporated By Reference Herein	
		Form	Date
31.1*	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		
31.2*	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002		
101.SCH**	XBRL Taxonomy Extension Schema Document		
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document		
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document		
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document		
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document		
101.INS**	XBRL Instance Document		

*Filed herewith.
** XBRL information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, and is not subject to liability under those sections, is not part of any registration statement or prospectus to which it relates and is not incorporated or deemed to be incorporated by reference into any registration statement, prospectus or other document.