FORTINET INC
Form 10-Q
November 05, 2013
Table of Contents

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

FORM 10-Q
(Mark One)

T QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2013
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 001-34511

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	94086
(Address of principal executive offices)	(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 o

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

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

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

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

As of October 29, 2013, there were 163,460,178 shares of the registrant's common stock outstanding.

FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended September 30, 2013
Table of Contents

		Page
	Part I	
Item 1.	Financial Statements	3
	Condensed Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012	3
	Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2013 and 2012	4
	Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2013 and 2012	5
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 and 2012	6
	Notes to Condensed Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	26
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	43
Item 4.	Controls and Procedures	43
	Part II	
Item 1.	Legal Proceedings	44
Item 1A.	Risk Factors	44
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	66
Item 3.	Defaults Upon Senior Securities	66
Item 4.	Mine Safety Disclosures	66
Item 5.	Other Information	66
Item 6.	Exhibits	66
	Signatures	67

Table of Contents

Part I

ITEM 1. Financial Statements

FORTINET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands, except per share amounts)

	September 30, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$144,546	$122,975
Short-term investments	368,472	290,719
Accounts receivable—Net	107,802	107,642
Inventory	46,876	21,060
Prepaid expenses and other current assets	38,271	26,878
Total current assets	705,967	569,274
PROPERTY AND EQUIPMENT—Net	28,380	25,638
LONG-TERM INVESTMENTS	327,987	325,892
GOODWILL AND OTHER INTANGIBLE ASSETS—Net	10,612	2,117
DEFERRED TAX ASSETS—Non-current	51,996	48,525
OTHER ASSETS	3,200	4,051
TOTAL ASSETS	$1,128,142	$975,497
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$33,257	$20,816
Accrued liabilities	32,317	22,263
Accrued payroll and compensation	30,450	28,957
Deferred revenue	271,302	247,268
Total current liabilities	367,326	319,304
DEFERRED REVENUE—Non-current	128,871	115,917
INCOME TAXES PAYABLE—Non-current	30,568	28,778
OTHER LIABILITIES	1,424	564
Total liabilities	528,189	464,563
COMMITMENTS AND CONTINGENCIES (Note 8)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value — 300,000 shares authorized; 163,329 and 161,757 shares issued and 163,329 and 160,348 shares outstanding as of September 30, 2013 and December 31, 2012, respectively	163	162
Additional paid-in capital	455,279	400,075
Treasury stock	—	(2,995)
Accumulated other comprehensive income	1,653	3,091
Retained earnings	142,858	110,601
Total stockholders' equity	599,953	510,934
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,128,142	$975,497

See notes to condensed consolidated financial statements.

3

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
REVENUE:				
Product	$69,687	$63,027	$194,162	$177,923
Services	83,883	69,782	239,447	197,332
Ratable and other revenue	1,129	3,459	4,338	7,222
Total revenue	154,699	136,268	437,947	382,477
COST OF REVENUE:				
Product	27,126	23,995	77,032	66,997
Services	16,374	13,166	48,207	36,846
Ratable and other revenue	430	647	1,527	2,135
Total cost of revenue	43,930	37,808	126,766	105,978
GROSS PROFIT:				
Product	42,561	39,032	117,130	110,926
Services	67,509	56,616	191,240	160,486
Ratable and other revenue	699	2,812	2,811	5,087
Total gross profit	110,769	98,460	311,181	276,499
OPERATING EXPENSES:				
Research and development	26,421	20,498	74,913	60,553
Sales and marketing	56,687	44,743	162,660	131,038
General and administrative	9,382	7,449	26,161	19,473
Total operating expenses	92,490	72,690	263,734	211,064
OPERATING INCOME	18,279	25,770	47,447	65,435
INTEREST INCOME	1,282	1,318	3,988	3,606
OTHER EXPENSE—Net	(1,151)	(317)	(1,036)	(315)
INCOME BEFORE INCOME TAXES	18,410	26,771	50,399	68,726
PROVISION FOR INCOME TAXES	7,381	9,565	18,142	23,397
NET INCOME	$11,029	$17,206	$32,257	$45,329
Net income per share:				
Basic	$0.07	$0.11	$0.20	$0.29
Diluted	$0.07	$0.10	$0.19	$0.27
Weighted-average shares outstanding:				
Basic	162,906	158,751	162,150	157,416
Diluted	168,666	166,791	168,054	166,127

See notes to condensed consolidated financial statements.

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Net income	$11,029	$17,206	$32,257	$45,329
Other comprehensive income (loss), net of reclassification adjustments:				
Foreign currency translation gains (losses)	912	1,092	(901)	867
Unrealized gains (losses) on investments	600	1,968	(826)	3,441
Unrealized losses on cash flow hedges	—	(19)	—	—
Tax (provision) benefit related to items of other comprehensive income or loss	(209)	(618)	289	(1,133)
Other comprehensive income (loss), net of tax	1,303	2,423	(1,438)	3,175
Comprehensive income	$12,332	$19,629	$30,819	$48,504

See notes to condensed consolidated financial statements.

Table of Contents

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

	Nine Months Ended	
	September 30, 2013	September 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$32,257	$45,329
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,511	8,076
Amortization of investment premiums	8,900	10,002
Stock-based compensation expense	31,784	23,928
Excess tax benefit from employee stock option plans	(2,504)	(9,611)
Other non-cash items, net	520	893
Changes in operating assets and liabilities:		
Accounts receivable—Net	589	5,680
Inventory	(31,344)	(14,977)
Prepaid expenses and other current assets	219	(71)
Other assets	(13,928)	(2,630)
Accounts payable	11,054	3,049
Accrued payroll and compensation	1,400	1,563
Accrued and other liabilities	2,631	1,301
Deferred revenue	36,425	45,192
Income taxes payable	11,202	15,849
Net cash provided by operating activities	100,716	133,573
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(419,124)	(523,389)
Sales of investments	25,488	25,768
Maturities of investments	303,852	343,174
Purchases of property and equipment	(6,729)	(20,283)
Payments made in connection with acquisitions, net of cash acquired	(7,635)	(749)
Net cash used in investing activities	(104,148)	(175,479)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	24,470	36,006
Taxes paid related to net share settlement of equity awards	(966)	—
Excess tax benefit from employee stock option plans	2,504	9,611
Net cash provided by financing activities	26,008	45,617
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(1,005)	(235)
NET INCREASE IN CASH AND CASH EQUIVALENTS	21,571	3,476
CASH AND CASH EQUIVALENTS—Beginning of period	122,975	71,990
CASH AND CASH EQUIVALENTS—End of period	$144,546	$75,466
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	$19,721	$10,335
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Purchase of property and equipment not yet paid	$1,349	$722
Liability incurred in connection with business acquisition	$100	$201

See notes to condensed consolidated financial statements.

6

Table of Contents

FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation

The unaudited condensed consolidated financial statements of Fortinet, Inc. and its wholly owned subsidiaries (collectively, "we," "us," or "our") have been prepared in accordance with U.S. generally accepted accounting principles ("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 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, 2012, contained in our Annual Report on Form 10-K ("Form 10-K") filed with the SEC on February 27, 2013. In the opinion of management, all adjustments, which only includes normal recurring adjustments, considered necessary for a fair presentation have been included. All intercompany balances, transactions and cash flows have been eliminated. The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the operating results for any subsequent quarter, for the full year or for any future periods. The condensed consolidated balance sheets as of December 31, 2012 are derived from the audited consolidated financial statements for the year ended December 31, 2012.

The preparation of financial statements in accordance with 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.

During the three and nine months ended September 30, 2013, we recorded a non-recurring out-of-period adjustment of $3.0 million to correct the presentation on our condensed consolidated balance sheets relating to our repurchase of 1,409,264 shares during the fiscal year ended December 31, 2009. This reclassification adjustment resulted in a decrease to the outstanding treasury stock balance and a corresponding decrease to additional paid-in capital. We believe the impact of the adjustment is not material to the current or prior fiscal periods. The shares that we repurchased in 2009 were retired immediately after repurchase. There was no outstanding treasury stock balance at September 30, 2013.

There have been no material changes in our significant accounting policies as of and for the three and nine months ended September 30, 2013, as compared to the significant accounting policies described in the Form 10-K, except for the inclusion of policies related to goodwill and other indefinite-lived assets, long-term investments, and stock-based compensation expense pertaining to performance stock units ("PSUs").

Goodwill and other indefinite-lived intangible assets

Goodwill represents the excess of purchase consideration over the estimated fair value of net assets of businesses acquired in a business combination. Goodwill and other indefinite-lived intangible assets such as in-process research and development acquired in a business combination are not amortized, but instead tested for impairment at least annually during the fourth quarter. We perform our annual goodwill impairment analysis at the reporting unit level. As of September 30, 2013, we had one reporting unit.
In reviewing goodwill for impairment we have the option to (i) assess qualitative factors to determine whether it is more-likely-than-not that the fair value of the reporting unit is less than its carrying amount or (ii) bypass the qualitative assessment and proceed directly to a quantitative assessment. If we opt to perform a qualitative assessment,

the factors we may review include, but are not limited to (a) macroeconomic conditions; (b) industry and market considerations; (c) cost factors; (d) overall financial performance; (e) other relevant entity-specific events such as changes in management, strategy, customers, or litigation; (f) events affecting the reporting unit; or (g) or sustained decrease in share price. If we believe, as a result of the qualitative assessment, that it is more-likely-than-not that the fair value of the reporting unit is less than its carrying amount, the quantitative impairment test will be required. Otherwise, no further testing will be required. A quantitative assessment utilizes a two-step process. In the first step, the fair value of the reporting unit is determined, and is compared against its carrying amount, including goodwill. We consider a combination of an income-based approach using projected discounted cash flows and a market-based approach using multiples of comparable companies to determine the fair value. The fair value of the reporting unit is estimated using significant judgment based on a combination of the income and the market approaches. Under the income approach, we estimate fair value of the reporting unit based on the present value of forecasted future cash flows that

the reporting unit is expected to generate over its remaining life. Under the market approach, we estimate fair value of our reporting unit based on an analysis that compares the value of the reporting unit to values of other companies in similar lines of business. If the fair value of the reporting unit does not exceed its carrying value, then we perform the second step to measure the amount of impairment loss. The amount of impairment is determined by comparing the implied fair value of reporting unit goodwill to the carrying value of the goodwill. When the carrying value of the reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference. Determining the fair value of the reporting unit requires us to make judgments and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, operating trends, risk-adjusted discount rates, future economic and market conditions and determination of appropriate market comparables. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. We may also test goodwill and other intangible assets for impairment between annual tests in the presence of impairment indicators. Acquired in-process research and development assets are classified as indefinite-lived intangible assets until the successful completion or abandonment of the associated research and development efforts. Upon successful completion of the associated research and development efforts, the useful life of the asset is determined and the asset is amortized over its useful life. If the associated research and development efforts are abandoned, an impairment loss is recognized for the carrying value of the related asset.

Long-term investments

Investments in privately held companies where we own less than 20% of the voting stock and have no indicators of significant influence over operating and financial policies of those companies are included in Long-term investments in the consolidated balance sheets and are accounted for under the cost method. For these non-quoted investments, we regularly review the assumptions underlying the operating performance and cash flow forecasts based on information provided by these privately held companies. If it is determined that an other-than-temporary decline exists in an equity security, we write down the investment to its fair value and record the related impairment as an investment loss in our consolidated statements of operations. As of September 30, 2013, we only have one investment of $2.0 million in a privately-held company accounted for under the cost method.

Stock-Based Compensation Expense - Performance Stock Units

PSUs are restricted stock units (“RSUs”) that contain both service-based and market-based vesting conditions. PSUs vest over a specified service period upon the satisfaction of certain market-based vesting conditions, and settle into shares of our common stock upon vesting over a two- or three-year period. The fair value of a PSU is calculated using the Monte Carlo simulation model on the grant date and is based on the market price of our common stock on the grant date modified to reflect the impact of the market-based vesting condition, including the estimated payout level based on that condition. We do not adjust compensation cost for subsequent changes in the expected outcome of the market-based vesting conditions.

Certain prior period amounts have been combined on the condensed consolidated balance sheets and statements of cash flows to conform to the current period presentation.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220)—Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (“ASU 2013-02”). ASU 2013-02 requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the

amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. We adopted ASU 2013-02 on January 1, 2013, and presented the effects within Note 16, Accumulated Other Comprehensive Income.

In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740)-Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists ("ASU 2013-11"). ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. This new standard requires the netting of unrecognized tax benefits ("UTBs") against a deferred tax asset for a loss or other carryforward that would apply in settlement of the uncertain

tax positions. UTBs will be netted against all available same-jurisdiction loss or other tax carryforwards that would be utilized, rather than only against carryforwards that are created by the UTBs. ASU 2013-11 will be effective for us beginning in the first quarter of fiscal 2014. Early adoption is permitted. Since ASU 2013-11 only impacts financial statement disclosure requirements for unrecognized tax benefits, we do not expect its adoption to have an impact on our financial position or results of operations.

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2. INVESTMENT IN PRIVATELY-HELD COMPANY

In August 2013, we invested $2.0 million in equity securities in HyTrust, a privately-held company. This investment is accounted for as a cost-basis investment, as we own less than 20% of the voting securities and do not have the ability to exercise significant influence over operating and financial policies of the entity. As of September 30, 2013, no events have occurred that would adversely affect the carrying value of this investment. We did not record any impairment charges for this investment during the three and nine months ended September 30, 2013.

3. FINANCIAL INSTRUMENTS AND FAIR VALUE

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

	September 30, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government and agency securities	2,000	—	—	2,000
Corporate debt securities	566,962	1,336	(441)	567,857
Commercial paper	81,955	13	(6)	81,962
Municipal bonds	34,554	44	(14)	34,584
Certificates of deposit and term deposits	8,053	3	—	8,056
Total available-for-sale securities	693,524	1,396	(461)	694,459

	December 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	529,738	1,814	(161)	531,391
Commercial paper	39,229	22	(6)	39,245
Municipal bonds	36,787	83	—	36,870
Certificates of deposit and term deposits	9,099	6	—	9,105
Total available-for-sale securities	614,853	1,925	(167)	616,611

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, as of September 30, 2013 ($ 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	232,721	(434)	5,309	(7)	238,030	(441)
Commercial paper	20,076	(6)	—	—	20,076	(6)
Municipal bonds	12,941	(14)	—	—	12,941	(14)
Total available-for-sale securities	265,738	(454)	5,309	(7)	271,047	(461)

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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, as of December 31, 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	133,006	(156)	5,010	(5)	138,016	(161)
Commercial paper	8,464	(6)	—	—	8,464	(6)
Total available-for-sale securities	141,470	(162)	5,010	(5)	146,480	(167)

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

	September 30, 2013	December 31, 2012
Due within one year	368,472	290,719
Due within one to three years	325,987	325,892
Total available-for-sale securities	694,459	616,611

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 September 30, 2013 and December 31, 2012 ($ amounts in 000's):

	September 30, 2013			December 31, 2012		
	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)
U.S. government and agency securities	2,000	—	2,000	—	—	—
Corporate debt securities	574,578	—	574,578	531,391	—	531,391
Commercial paper	83,262	—	83,262	41,994	—	41,994
Municipal bonds	34,584	—	34,584	36,870	—	36,870
Certificates of deposit and term deposits	8,056	—	8,056	9,105	—	9,105
Money market funds	45,897	45,897	—	39,871	39,871	—
	748,377	45,897	702,480	659,231	39,871	619,360
Reported as:						
Cash equivalents	53,918			42,620		
Short-term investments	368,472			290,719		
Long-term investments	325,987			325,892		
Total	748,377			659,231		

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the three and nine months ended September 30, 2013.

Table of Contents

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

4. INVENTORY

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

	September 30, 2013	December 31, 2012
Raw materials	7,765	4,958
Finished goods	39,111	16,102
Inventory	46,876	21,060

5. PROPERTY AND EQUIPMENT—Net

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

	September 30, 2013	December 31, 2012
Land	13,895	13,895
Building and building improvements	610	610
Evaluation units	21,986	18,322
Computer equipment and software	22,785	17,176
Furniture and fixtures	1,709	1,501
Construction-in-process	1,295	—
Leasehold improvements and tooling	5,532	5,354
Total property and equipment	67,812	56,858
Less: accumulated depreciation	(39,432)	(31,220)
Property and equipment—net	28,380	25,638

Depreciation expense was $3.8 million and $2.7 million for the three months ended September 30, 2013 and September 30, 2012, respectively. Depreciation expense was $10.4 million and $7.2 million for the nine months ended September 30, 2013 and September 30, 2012, respectively.

6. NET INCOME PER SHARE

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

12

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Numerator:				
Net income	11,029	17,206	32,257	45,329
Denominator:				
Basic shares:				
Weighted-average common stock outstanding-basic	162,906	158,751	162,150	157,416
Diluted shares:				
Weighted-average common stock outstanding-basic	162,906	158,751	162,150	157,416
Effect of potentially dilutive securities:				
Stock options	5,525	8,019	5,844	8,694
RSUs	213	—	50	—
ESPP	22	21	10	17
Weighted-average shares used to compute diluted net income per share	168,666	166,791	168,054	166,127
Net income per share:				
Basic	0.07	0.11	0.20	0.29
Diluted	0.07	0.10	0.19	0.27

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		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Stock options	6,640	5,686	7,364	6,847
RSUs	1,416	388	2,383	130
ESPP	407	303	399	300
	8,463	6,377	10,146	7,277

7. DEFERRED REVENUE

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

	September 30, 2013	December 31, 2012
Product	5,114	5,411
Services	389,571	348,548
Ratable and other revenue	5,488	9,226
Total deferred revenue	400,173	363,185
Reported As:		
Current	271,302	247,268
Non-current	128,871	115,917
Total deferred revenue	400,173	363,185

8. COMMITMENTS AND CONTINGENCIES

Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2020. Rent expense was $2.4 million and $2.1 million for the three months ended September 30, 2013 and September 30, 2012, respectively. Rent expense was $7.1 million and $6.5 million for the nine months ended September 30, 2013 and September 30, 2012, respectively. Rent expense is recognized using the straight-line method over the term of the lease. The aggregate future non-cancelable minimum rental payments on operating leases as of September 30, 2013 are as follows ($ amounts in 000's):

	Rental Payment
Fiscal Years:	
2013 (remainder)	2,675
2014	7,715
2015	5,342
2016	4,279
2017	3,738
Thereafter	7,779
Total	31,528

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 issue non-cancelable purchase orders to some of our independent contract manufacturers. As of September 30, 2013, we had $46.6 million of open purchase orders with our independent contract manufacturers that may not be cancelable.

In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations in the ordinary course of business for which we have not received goods or services. As of September 30, 2013, we had $10.2 million in other purchase commitments.

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Warranties—We generally provide a 1-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 Nine Months Ended	
	September 30, 2013	September 30, 2012
Accrued warranty balance—beginning of the period	2,309	2,582
Warranty costs incurred	(2,670)	(1,843)
Provision for warranty, including warranty assumed from Xtera	3,134	1,604
Changes in prior period estimates	274	(307)
Accrued warranty balance—end of the period	3,047	2,036

Litigation—We are involved in disputes, litigation, and other legal actions, including, but not limited to, the matters described below. We are defending these litigation matters, and while there can be no assurances and the outcome of these matters is currently not determinable, we currently believe that there are no existing claims or proceedings that are likely to have a material adverse effect on our financial position. There are many uncertainties associated with any litigation and these actions or other third-party claims against us may cause us to incur costly litigation or substantial settlement charges. In addition, the resolution of any intellectual property litigation may require us to make royalty payments, which could adversely affect our gross margins in future periods. If any of those events were to occur, our business, financial condition, results of operations, and cash flows could be adversely affected. The actual liability in any such matters may be materially different from our estimates, if any, which could result in the need to adjust the liability and record additional expenses. Unless otherwise noted below, during the period presented, we have not: recorded any material accrual for loss contingencies associated with such legal proceedings; determined that an unfavorable outcome is probable or reasonably possible; or determined that the amount or range of any possible loss is reasonably estimable.

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. 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 thereafter proceeded with Fortinet as the sole defendant. Between June and August 2013, we filed a number of pretrial motions with the Court. As a result of those motions, the Court found that NPS had engaged in litigation misconduct. The Court also granted our motion to strike NPS's expert report on the issue of damages. Shortly thereafter, in September 2013, NPS agreed to abandon the case and we did not make any payments related to this case. NPS and its principals furthermore agreed not to sue us on related patents. The litigation related to NPS is no longer material to us.

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 not infringed by any of our products or services. The case is proceeding in the United States District Court for the Northern District of California. The case is currently in the early stages, and we have determined that, as of this time, there is not a reasonable possibility that a material 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.

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9. STOCKHOLDERS' EQUITY

Our 2009 Equity Incentive Plan (the "Plan") permits us to grant awards of stock options, stock appreciation rights, restricted stock, restricted stock units, and performance units or performance shares.

Employee Stock Options

In August 2012, we began to primarily grant RSUs instead of stock options to employees, non-employees and members of the board of directors.

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

	Three Months Ended	Nine Months Ended	
	September 30, 2013	September 30, 2013	September 30, 2012
Expected term in years	4.6	4.6	4.6
Volatility (%)	47.8	47.8	46.4 - 51.9
Risk-free interest rate (%)	1.2	1.2	0.7 - 0.9
Dividend rate (%)	—	—	—

There were no stock options granted during the three months ended September 30, 2012.

The following table summarizes the stock option activity and related information for the periods presented below (in 000's, except per share amounts, exercise prices and contractual life):

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price ($)	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value ($)
Balance—December 31, 2012	18,571	12.40		
Granted	209	21.11		
Forfeited	(631)	21.82		
Exercised	(2,210)	5.33		
Balance—September 30, 2013	15,939	13.12	3.5	134,415
Options vested and expected to vest—September 30, 2013	15,914	13.11	3.5	134,407
Options exercisable—September 30, 2013	11,781	9.98	3.1	129,937

The aggregate intrinsic value represents the pre-tax difference between the exercise price of stock options and the quoted market price of our common stock on September 30, 2013, for all in-the-money options. As of September 30, 2013, total compensation expense related to unvested stock options granted to employees but not yet recognized was $46.0 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 2.0 years.

16

Additional information related to our stock options is summarized below ($ amounts in 000's, except per share amounts):

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Weighted-average fair value per share granted	8.61	—	8.61	11.13
Intrinsic value of options exercised	7,880	32,623	36,997	83,313
Fair value of options vested	5,063	6,823	21,553	19,897

Restricted Stock Units

The following table summarizes the activity and related information for RSUs for the period presented below (in 000's, except per share amounts):

	Restricted Stock Units Outstanding	
	Number of Shares	Weighted-Average Grant-Date Fair Value per Share ($)
Balance—December 31, 2012	830	23.73
Granted	3,871	21.86
Forfeited	(251)	22.97
Vested	(144)	24.86
Balance—September 30, 2013	4,306	21.98
RSUs expected to vest—September 30, 2013	3,988	22.01

As of September 30, 2013, total compensation expense related to unvested RSUs that were granted to employees and non-employees, but not yet recognized, was $86.3 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 3.4 years.

RSUs settle into shares of common stock upon vesting. RSUs that were previously granted began vesting in August 2013. Upon the vesting of the RSUs, we net-settled the RSUs and withheld a portion of the shares to satisfy minimum statutory employee withholding taxes. Total payment for the employees' tax obligations to the taxing authorities is reflected as a financing activity within the condensed consolidated statements of cash flows. These net settlements had the effect of share repurchases by us as they reduced and retired the number of shares that would have otherwise been issued as a result of the vesting and did not represent an expense to us.

The following summarizes the number and value of the shares withheld for employee taxes for the three and nine months ended September 30, 2013 ($ amount in 000's, except share amount):

Shares withheld for taxes	45
Amount withheld for taxes	966

Performance Stock Units

During the three and nine months ended September 30, 2013, we granted PSUs under the Plan to certain of our executive officers. Based on the achievement of the market-based vesting conditions during the performance period, the final settlement of the PSUs will range between 0% and 150% of the target shares underlying the PSUs based on a specified objective formula approved by our Compensation Committee. The PSUs entitle our executive officers to receive a number of shares of our common stock based on the performance of our stock price over a two- or three-year period as compared to the NASDAQ Composite index for the same periods.

The following table summarizes the weighted-average assumptions relating to our PSUs for the three and nine months ended September 30, 2013:

Expected term in years	2.97
Volatility (%)	50.11
Risk-free interest rate (%)	0.67
Dividend rate (%)	—

The target number of shares underlying the PSUs that were granted to certain of our executive officers during the three months ended September 30, 2013, totaled 180,000 shares that had a grant date fair value of $22.06 per share.

As of September 30, 2013, total compensation expense related to unvested PSUs that were granted to certain of our executive officers, but not yet recognized, was $3.8 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.8 years.

Employee Stock Purchase Plan

In determining the fair value of the shares subject to our ESPP, we use the Black-Scholes option pricing model that employs the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Expected term in years	0.5	0.5	0.5	0.5
Volatility (%)	35.1	43.1	44.0	53.7
Risk-free interest rate (%)	0.1	0.2	0.1	0.1
Dividend rate (%)	—	—	—	—

Additional information related to our ESPP is provided below (in 000’s, except per share amounts):

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Weighted-average fair value per share granted ($)	5.04	6.63	6.11	7.06
Shares issued under the ESPP	343,761	288,884	672,397	576,833
Weighted-average price per share issued ($)	17.90	20.29	18.88	18.90

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock-based Compensation Expense

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

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Cost of product revenue	91	85	277	237
Cost of services revenue	1,297	1,018	3,543	2,704
Research and development	3,548	2,525	9,605	6,774
Sales and marketing	5,215	3,879	13,927	10,797
General and administrative	1,627	1,323	4,432	3,416
Total stock-based compensation expense	11,778	8,830	31,784	23,928

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

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Stock options	5,180	6,985	15,801	19,982
RSUs	5,408	576	12,439	576
ESPP	1,190	1,269	3,544	3,370
Total stock-based compensation expense	11,778	8,830	31,784	23,928

Total income tax benefit from employee stock option plans that is recognized in the consolidated statements of operations is as follows ($ amounts in 000's):

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Income tax benefit from employee stock option plans	3,176	6,685	9,557	17,073

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

10. INCOME TAXES

The effective tax rate was 40% for the three months ended September 30, 2013, compared to an effective tax rate of 36% for the three months ended September 30, 2012. The effective tax rate was 36% for the nine months ended September 30, 2013, compared to an effective tax rate of 34% for the nine months ended September 30, 2012. The provision for income taxes for the periods presented is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax.

As of September 30, 2013 and December 31, 2012, unrecognized tax benefits were $28.7 million and $27.8 million, respectively. The total amount of $28.3 million in 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 September 30, 2013, we had accrued approximately $2.3 million for estimated interest related to uncertain tax provisions.

The State of California has been conducting an audit of our state income tax returns for fiscal 2010 and fiscal 2011. We do not expect this audit to have a significant detrimental effect on our income tax liability nor have a material impact on our results of operations.

11. 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 annual contribution limit specified by the Internal Revenue Service (“IRS”). In Canada, we have a Group Registered Retirement Savings Plan program (the “RRSP”) which permits participants to make tax deductible contributions up to the maximum contribution limits under the Income Tax Act. Our matching contributions to the 401(k) Plan and RRSP were $0.6 million and $0.4 million for the three months ended September 30, 2013 and September 30, 2012, respectively. Our matching contributions to the 401(k) Plan and RRSP were $1.6 million and $1.4 million for the nine months ended September 30, 2013 and September 30, 2012, respectively.

12. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

The following tables set forth revenue and property and equipment by geographic region ($ amounts in 000’s):

Revenue	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Americas:				
United States	40,654	38,674	114,257	103,983
Other Americas	24,794	18,543	63,844	51,587
Total Americas	65,448	57,217	178,101	155,570
Europe, Middle East and Africa (“EMEA”)	51,373	45,566	149,500	130,116
Asia Pacific and Japan (“APAC”)	37,878	33,485	110,346	96,791
Total revenue	154,699	136,268	437,947	382,477

During each of the three and nine months ended September 30, 2013, Exclusive Networks Group accounted for 11% of total revenue. During the three and nine months ended September 30, 2012, Exclusive Networks Group accounted for 10% and 11% of total revenue, respectively. No other customers accounted for more than 10% of our total revenue during the three and nine months ended September 30, 2013 and 2012.

Table of Contents

Property and Equipment —Net	September 30, 2013	December 31, 2012
Americas:		
United States	21,288	18,764
Canada	3,924	4,376
Other Americas	61	87
Total Americas	25,273	23,227
EMEA	1,459	1,213
APAC	1,648	1,198
Total property and equipment—net	28,380	25,638

13. FOREIGN CURRENCY DERIVATIVES

The notional amounts of forward exchange contracts to hedge balance sheet accounts as of September 30, 2013 and December 31, 2012 were ($ amounts in 000's):

	Buy/Sell	Notional
Balance Sheet Contracts:		
Currency - As of September 30, 2013		
Canadian dollar	Buy	25,367
Currency - As of December 31, 2012		
Canadian dollar	Buy	17,968

14. BUSINESS COMBINATIONS

Xtera

On September 13, 2013, we acquired certain assets of Xtera Communications, Inc. ("Xtera"), including certain load balancing products and certain patents, for a total consideration of $1.8 million, of which $1.7 million was paid in cash on the acquisition date and $0.1 million payment in cash is contingent upon attainment of revenue milestones. This acquisition will enable us to enhance our load balancing solutions in our product portfolio.

We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price was allocated to the identifiable tangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. The fair value assigned to the intangible assets acquired was determined using the income approach which discounts expected cash flows to present value using our estimates and assumptions.

In connection with this acquisition, we acquired net tangible assets of $0.2 million, intangible assets of $1.5 million, and recognized an estimated contingent obligation of $0.1 million payable upon attainment of revenue milestones.

21

The following table summarizes the fair value of assets acquired and liabilities assumed as of the acquisition date ($ amounts in 000's):

Current assets	459
Finite-lived intangible assets	1,525
Total assets acquired	1,984
Current liabilities	234
Total liabilities assumed	234
Total purchase price	1,750

Identified finite-lived intangible assets consist of developed technology that will be amortized as cost of revenue, ratably on a straight-line basis over an estimated useful life of 3 years. Pro-forma results of operations have not been presented because the acquisitions, individually and collectively, were not material to our results of operations.

Coyote Point Systems

On March 21, 2013, we acquired all of the outstanding equity securities of Coyote Point Systems, Inc. ("Coyote"), a provider of application delivery, load balancing and acceleration solutions, for $6.0 million in cash. The acquisition also includes a contingent obligation for up to $5.5 million in future earn-out payments to former stockholders of Coyote, if specified future operational objectives, service conditions and financial results are met within two years of the acquisition date. Of the maximum $5.5 million in contingent earn-out payments, up to $3.5 million will be payable after eighteen months from the acquisition date, and up to $2.0 million will be payable after two years from the acquisition date. As the future earn-out payments are also contingent upon one of Coyote's former stockholder's employment during the earn-out period, these contingent obligations are being recorded as compensation expense ratably over the earn-out periods.

We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price was allocated to Coyote's identifiable tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. The fair value assigned to the intangible assets acquired was determined using the income approach which discounts expected cash flows to present value using our estimates and assumptions.

The following table summarizes the fair value of assets acquired and liabilities assumed as of the acquisition date ($ amounts in 000's):

Cash and cash equivalents	206
Other current assets	501
Finite-lived intangible assets	2,800
Indefinite-lived intangible assets	2,600
Goodwill	2,766
Other assets	88
Total assets acquired	8,961
Current liabilities	1,078
Long-term liabilities	1,898
Total liabilities assumed	2,976
Total purchase price	5,985

Of the total acquired identified intangible assets, we allocated $2.3 million to developed technology, $0.5 million to customer relationships, and $2.6 million to in-process research and development ("IPR&D") as of the acquisition date.

Identified finite-lived intangible assets consist of developed technology and customer relationships that are being amortized as cost of revenue and sales and marketing expense, respectively, ratably on a straight-line basis, each over an estimated useful life of 6 years. Identified indefinite-lived intangible assets consisted of acquired IPR&D relating to existing research and development projects at the time of acquisition. The goodwill of $2.8 million represents the premium we paid over the fair value of the net tangible liabilities assumed and identified intangible assets acquired. We paid this premium for a number of

reasons, primarily for acquiring developed and in-process technology. None of the goodwill recognized as a result of the acquisition is deductible for income tax purposes. The financial results of this acquisition were considered immaterial for purposes of pro-forma financial disclosures. During the three months ended September 30, 2013, we completed the development of technology associated with the IPR&D projects, and started amortizing this developed technology as cost of revenue ratably on a straight-line basis over an estimated useful life of 6 years.

XDN

On December 7, 2012, we completed the acquisition of XDN, Inc., a provider of cloud-based content delivery solutions, for a total consideration of $0.5 million. We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price was allocated to identifiable intangible assets acquired based on their estimated fair market value as of the acquisition date. The purchase price allocation resulted in purchased identifiable intangible assets of $0.5 million. Identifiable intangible assets consist of developed technology. The fair value assigned to identifiable intangible assets acquired was determined using the market approach, which compares the value of the purchased assets to similar assets in similar lines of business. These purchased identifiable intangible assets are being amortized as cost of revenue ratably over three years. The financial results of this acquisition were considered immaterial for purposes of pro forma financial disclosures.

IntruGuard

On March 8, 2012, we completed the acquisition of IntruGuard Devices, Inc. (“IntruGuard”), a supplier of Distributed Denial of Services ("DDoS"), prevention products, for a total consideration of $1.0 million. Of the total consideration, $0.4 million was withheld in 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 was 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 $0.9 million. 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 amortized as cost of revenue ratably over three years. Of the $0.4 million previously withheld in escrow, $0.2 million and $0.2 million were released to the selling stockholders during the three months ended September 30, 2012 and the three months ended March 31, 2013, respectively. The financial results of this acquisition were considered immaterial for purposes of pro forma financial disclosures.

15. GOODWILL AND OTHER INTANGIBLE ASSETS—NET

Goodwill

We recorded $2.8 million of goodwill based on the purchase price allocation of the acquisition of Coyote during the nine months ended September 30, 2013. There were no impairments to goodwill during the three and nine months ended September 30, 2013.

Other Intangible Assets—Net

The following tables present other intangible assets ($ amounts in 000's):

23

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	September 30, 2013		
	Gross	Accumulated Amortization	Net
Finite-lived other intangible assets:			
Developed technology [1]	9,909	2,520	7,389
Customer relationships	500	43	457
Total other intangible assets	10,409	2,563	7,846

[1] This amount includes the completed IPR&D acquired from Coyote of $2.6 million. During the three months ended September 30, 2013, we completed the associated IPR&D projects and transferred the IPR&D to developed technology. We started amortizing this developed technology as cost of revenue ratably on a straight-line basis over an estimated useful life of 6 years.

	December 31, 2012		
	Gross	Accumulated Amortization	Net
Finite-lived other intangible assets:			
Developed technology	3,541	1,424	2,117
Total other intangible assets	3,541	1,424	2,117

Amortization expense was $0.4 million and $0.3 million for the three months ended September 30, 2013 and September 30, 2012, respectively. Amortization expense was $1.1 million and $0.7 million for the nine months ended September 30, 2013 and September 30, 2012, respectively. The following table summarizes estimated future amortization expense of other intangible assets with finite lives for future fiscal years ($ amounts in 000’s):

	Amount
Fiscal Years:	
2013 (remainder)	615
2014	2,095
2015	1,679
2016	1,287
2017	900
Thereafter	1,270
Total	7,846

Table of Contents
FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

16. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the changes in accumulated balances of other comprehensive income for the nine months ended September 30, 2013 ($ amounts in 000's):

	Foreign Currency Translation Gains and Losses	Unrealized Gains and Losses on Investments	Tax benefit or provision related to items of other comprehensive income or loss	Total
Beginning balance	1,948	1,758	(615)	3,091
Other comprehensive income before reclassifications	(901)	(819)	287	(1,433)
Amounts reclassified from accumulated other comprehensive income	—	(8)	3	(5)
Net current-period other comprehensive income	(901)	(827)	290	(1,438)
Ending balance	1,047	931	(325)	1,653

The following table provides details about the reclassification out of accumulated other comprehensive income for the nine months ended September 30, 2013 ($ amounts in 000s):

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains on investments	(8)	Other expense, net
Tax provision related to items of other comprehensive income or loss	3	Provision for income taxes
Total reclassification for the period	(5)	

Table of Contents

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, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended ("Exchange Act"). 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;
- the expected impact of certain acquisitions, asset purchases and strategic investments;
- expected impact of sales of certain products;
- the significance of stock-based compensation as an expense;
- the proportion of our revenue that consists of our product and service revenues, and the mix of billings between products and services;
- the impact of our product innovation strategy;
- expanding our reach into new high growth verticals and emerging markets and continuing to sell to large enterprises and service providers;
- our ability to meet increasing customer expectations about the quality and functionality of our products;
- 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, and expectations regarding these expenses as a percentage of revenue;
- continued investments in research and development to strengthen our technology leadership position and in sales and marketing;
- expectations regarding uncertain tax benefits and our effective tax rate;
- the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next 12 months; and
- 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 in Part II, Item 1A. Risk Factors and elsewhere in this Quarterly Report on Form 10-Q and in our other SEC filings, including the 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. From inception through September 30, 2013, we shipped over 1,300,000 appliances via more than 19,000 channel partners to more than 170,000 end-customers worldwide, including a majority of the 2012 Fortune Global 100.

Our core Unified Threat Management ("UTM")/Next Generation Firewall ("NGFW") and Data Center Firewall ("DCFW") product line of FortiGate physical and virtual appliances ships with a set of security and networking capabilities,

Table of Contents

including firewall, VPN, application control, anti-malware, intrusion prevention, Web filtering, anti-spam 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. Our UTM/NGFW/DCFW solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to intrusion prevention, application control, anti-malware, Web filtering, vulnerability management and anti-spam 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, protection against DDoS, endpoint security for employee computers and mobile devices, wireless access points and application delivery controllers. Although sales of these complementary products have grown in recent quarters, these products still represent less than 10% of our total revenue.

On September 13, 2013, we acquired certain assets of Xtera Communications, Inc. (“Xtera”) in order to add products to enhance our load balancing solutions and to add patents to our patent portfolio .

In August 2013, we invested in and entered into a strategic go-to-market alliance agreement with HyTrust, a privately-held company, that specializes in cloud security automation in order to strengthen our commitment to virtualization and data center security.

Financial Highlights

- We recorded total revenue of $154.7 million and $437.9 million during the three and nine months ended September 30, 2013, respectively. This represents an increase of 14% and 15% during the three and nine months ended September 30, 2013, respectively, compared to the same periods last year. Product revenue was $69.7 million and $194.2 million during the three and nine months ended September 30, 2013, respectively, an increase of 11% and 9%, respectively, compared to the same periods last year. Services revenue was $83.9 million and $239.4 million during the three and nine months ended September 30, 2013, respectively, an increase of 20% and 21%, respectively, compared to the same periods last year.

- We generated cash flows from operating activities of $100.7 million during the nine months ended September 30, 2013, a decrease of 25% compared to the same period last year.

- Cash, cash equivalents and investments were $841.0 million as of September 30, 2013, an increase of $101.4 million from December 31, 2012.

- Deferred revenue was $400.2 million as of September 30, 2013, an increase of $37.0 million from December 31, 2012.

During the three and nine months ended September 30, 2013, revenue grew as a result of a slightly better business environment, along with our focus on improving sales execution and productivity of our sales force. We also continued to gain traction with several recently introduced products, including new FortiGate entry-level appliances such as the FG-60D and FG-90D with its WIFI counterparts; the FG-200D and FG-800C mid-range appliance; and the FG-3600C and FG-5001C for large enterprises and service providers.

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. During the three and nine months ended September 30, 2013, we experienced higher sales volume in our FortiGate product family, particularly entry-level products, wireless security and access point products, which contributed to the largest portion of the growth during this period. During the three and nine months ended September 30, 2013, we experienced an increase in the number of deals involving sales greater than $100,000 when compared to the same periods last year as the number of deals involving sales greater than $100,000 was 187 and 547 in the three and nine months ended September 30, 2013, respectively, compared to 168 and 489 in the three and nine months ended September 30, 2012, respectively. The number of deals involving sales greater than $250,000 was 61 and 174 in the three and nine months ended September 30, 2013, respectively, compared to 61 and 163 in the three and nine months ended September 30, 2012, respectively. Additionally, the number of deals involving sales greater than $500,000 was 19 and 52 in the three and nine months ended September 30, 2013,

Table of Contents

respectively, compared to 16 and 54 in the three and nine months ended September 30, 2012, respectively. We expect some variability in this metric, and remain focused on investing in our sales and marketing and research and development resources in order to expand our reach into new high-growth verticals and emerging markets. Moreover, we expect such investments to help us to meet increasing customer expectations about the quality and functionality of our products, as we continue to sell to large enterprises and service providers. While we have experienced some success selling to large enterprises, across key verticals, including service provider, government, retail, financial services and education, we experienced increased pressure from the macro-economic environment in APAC during the three and nine months ended September 30, 2013, and there can be no assurance we will be successful selling into these vertical customer segments.

During the three and nine months ended September 30, 2013, operating expenses increased by 27% and 25% compared to the same periods last year. The increase was primarily driven by additional headcount as we continued to invest in the development of new products and expand our sales coverage. Headcount increased to 2,238 as of September 30, 2013 from 1,854 as of September 30, 2012. Our accelerated pace of hiring continued during the three and nine months ended September 30, 2013, particularly in sales and marketing, research and development, and technical support.

Key Metrics

We monitor the key financial metrics set forth below 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 $10.5 million from $389.7 million as of June 30, 2013 to $400.2 million as of September 30, 2013. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period less any deferred revenue balances acquired from business combinations 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 revenue that we recognize in a typical quarter. As of September 30, 2013, we had $841.0 million in cash, cash equivalents and investments and have had positive cash flow from operations every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under "—Results of Operations," 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.

	Three Months Ended Or As Of			
	September 30, 2013		September 30, 2012	
	($ amounts in 000's)			
Revenue	154,699		136,268	
Gross margin	72	%	72	%
Operating income [1]	18,279		25,770	
Operating margin	12	%	19	%
Total deferred revenue	400,173		340,078	
Increase in total deferred revenue	10,491		8,710	
Cash, cash equivalents and investments	841,005		690,303	
Cash provided by operating activities	25,384		40,770	
Free cash flow (Non-GAAP)[2]	22,224		24,342	

(1) Includes:		
Stock-based compensation expense	11,778	8,830
Patent settlement income	478	478

(2) See "—Cash flow from operations" below for a definition of free cash flow.

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. We define billings as revenue recognized during a period plus the change in deferred revenue from the beginning to the end of the period less any deferred revenue balances acquired from business combination(s) during the period. The following table reflects the reconciliation of billings to revenue. For a discussion of the limitations of non-GAAP financial measures, see "—Other Non-GAAP Financial Measures" below.

Table of Contents

	Three Months Ended	
	September 30, 2013	September 30, 2012
	($ amounts in 000's)	
Billings:		
Revenue	154,699	136,268
Add increase in deferred revenue	10,491	8,710
Total billings (Non-GAAP)	165,190	144,978

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 our billings growth, profitability, and our ability to successfully manage our working capital. 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. The following table provides a reconciliation of free cash flow to cash provided by operating activities. For a discussion of the limitations of non-GAAP financial measures, see "—Other Non-GAAP Financial Measures" below.

	Three Months Ended	
	September 30, 2013	September 30, 2012
	($ amounts in 000's)	
Free Cash Flow:		
Net cash provided by operating activities	25,384	40,770
Less purchases of property and equipment	(3,160)	(16,428)
Free cash flow (Non-GAAP)	22,224	24,342

Other Non-GAAP Financial Measures

To supplement our consolidated financial statements presented in accordance with 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 operating income, 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, offset by patent settlement income. Effective second quarter of fiscal 2013, our non-GAAP financial measures exclude amortization expense of certain intangible assets. Prior period amounts have been adjusted to conform to current period presentation. Stock-based compensation expense 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

Table of Contents

operations. We compensate for these limitations by providing the nearest GAAP equivalents of these non-GAAP financial measures and describing these GAAP equivalents in the section entitled "—Results of Operations" below. Non-GAAP gross margin represents gross margin as reported in our consolidated statements of operations, excluding the impact of stock-based compensation expense and amortization expense of certain intangible assets, both of which are non-cash charges. Non-GAAP operating income is operating income, as reported in our consolidated statements of operations, excluding the impact of stock-based compensation expense, amortization expense of certain intangible assets, and the income we receive from a patent settlement. Non-GAAP operating margin is non-GAAP operating income divided by revenue. The following table reconciles GAAP gross profit, GAAP gross margin, GAAP operating income, and GAAP operating margin to non-GAAP gross profit, non-GAAP gross margin, non-GAAP operating income, and non-GAAP operating margin for the three months ended September 30, 2013 and September 30, 2012.

	Three Months Ended			
	September 30, 2013		September 30, 2012	
	Amount ($)	% of Revenue	Amount ($)	% of Revenue
	($ amounts in 000's)			
Total revenue	154,699		136,268	
GAAP gross profit and margin	110,769	72	98,460	72
Stock-based compensation expense	1,388	1	1,103	1
Amortization expense of certain intangible assets [1]	423	—	226	—
Non-GAAP gross profit and margin	112,580	73	99,789	73
GAAP operating income and margin	18,279	12	25,770	19
Stock-based compensation expense:				
Cost of revenue	1,388	1	1,103	1
Research and development	3,548	2	2,525	1
Sales and marketing	5,215	3	3,879	3
General and administrative	1,627	1	1,323	1
Total stock-based compensation expense	11,778	7	8,830	6
Amortization expense of certain intangible assets [1]	423	—	226	—
Patent settlement income	(478)	—	(478)	—
Non-GAAP operating income and margin	30,002	19	34,348	25

(1) Effective second quarter of fiscal 2013, amortization expense of certain intangible assets is excluded from GAAP gross profit and margin, and GAAP operating income and margin to reconcile to non-GAAP financial metrics. Prior period amounts have been adjusted to conform to current period presentation.

Table of Contents

Non-GAAP operating expenses represent operating expenses, as reported in our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense and the income from a patent settlement. The following table reconciles GAAP operating expenses to non-GAAP operating expenses for the three months ended September 30, 2013 and September 30, 2012.

	Three Months Ended September 30, 2013		September 30, 2012	
	Amount ($)	% of Revenue	Amount ($)	% of Revenue
	($ amounts in 000's)			
Operating Expenses:				
Research and development expenses:				
GAAP research and development expenses	26,421	17	20,498	15
Stock-based compensation expense	(3,548)	(2)	(2,525)	(1)
Non-GAAP research and development expenses	22,873	15	17,973	14
Sales and marketing expenses:				
GAAP sales and marketing expenses	56,687	37	44,743	33
Stock-based compensation expense	(5,215)	(3)	(3,879)	(3)
Non-GAAP sales and marketing expenses	51,472	34	40,864	30
General and administrative expenses:				
GAAP general and administrative expenses	9,382	6	7,449	5
Stock-based compensation expense	(1,627)	(1)	(1,323)	(1)
Patent settlement income	478	—	478	—
Non-GAAP general and administrative expenses	8,233	5	6,604	4
Total operating expenses:				
GAAP operating expenses	92,490	60	72,690	53
Stock-based compensation expense	(10,390)	(6)	(7,727)	(5)
Patent settlement income	478	—	478	—
Non-GAAP operating expenses	82,578	54	65,441	48

Table of Contents

Non-GAAP net income represents net income, as reported in our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense, amortization expense of certain intangible assets, and income from a patent settlement. The following table reconciles GAAP net income to non-GAAP net income for the three months ended September 30, 2013 and September 30, 2012.

	Three Months Ended	
	September 30, 2013	September 30, 2012
	($ and share amounts in 000's, except per share amounts)	
Net Income:		
GAAP net income	11,029	17,206
Stock-based compensation expense [1]	11,778	8,830
Amortization expense of certain intangible assets [2]	423	226
Patent settlement income [3]	(478)	(478)
Provision for income taxes [4]	7,381	9,565
Non-GAAP income before provision for income taxes	30,133	35,349
Non-GAAP provision for income taxes [5]	(9,944)	(12,019)
Non-GAAP net income	20,189	23,330
Non-GAAP net income per share—diluted	0.12	0.14
Shares used in per share calculation—diluted	168,666	166,791

(1) Stock-based compensation expense is excluded from GAAP net income to reconcile to non-GAAP income before provision for income taxes.

(2) Effective second quarter of fiscal 2013, amortization expense of certain intangible assets is excluded from GAAP net income to reconcile to non-GAAP income before provision for income taxes. Prior period amounts have been adjusted to conform to current period presentation.

(3) The patent settlement income is excluded from GAAP net income to reconcile to non-GAAP income before provision for income taxes.

(4) Provision for income taxes is our GAAP tax provision that is included in GAAP net income to reconcile to non-GAAP income before provision for income taxes.

(5) We used non-GAAP effective tax rates of 33% and 34%, which could differ from the GAAP tax rates, to calculate non-GAAP net income for the three months ended September 30, 2013 and September 30, 2012, respectively.

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 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 expense, 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.

During the three and nine months ended September 30, 2013, we recorded a non-recurring out-of-period adjustment of $3.0 million to correct the presentation on our condensed consolidated balance sheets relating to our repurchase of 1,409,264 shares during the fiscal year ended December 31, 2009. This reclassification adjustment resulted in a decrease to the outstanding treasury stock balance and a corresponding decrease to additional paid-in capital. We believe the impact of the adjustment is not material to the current or prior fiscal periods. The shares that we

repurchased in 2009 were retired immediately after repurchase. There was no outstanding treasury stock balance at September 30, 2013.

There have been no material changes in our significant accounting policies since the fiscal year ended December 31, 2012, except for the inclusion of policies related to goodwill and other indefinite-lived intangible assets, long-term investments, and stock-based compensation expense pertaining to PSUs.

Goodwill and other indefinite-lived intangible assets

Goodwill represents the excess of purchase consideration over the estimated fair value of net assets of businesses acquired in a business combination. Goodwill and other indefinite-lived intangible assets such as in-process research and development acquired in a business combination are not amortized, but instead tested for impairment at least annually during

Table of Contents

the fourth quarter. We perform our annual goodwill impairment analysis at the reporting unit level. As of September 30, 2013, we had one reporting unit.

In reviewing goodwill for impairment we have the option to (i) assess qualitative factors to determine whether it is more-likely-than-not that the fair value of the reporting unit is less than its carrying amount or (ii) bypass the qualitative assessment and proceed directly to a quantitative assessment. If we opt to perform a qualitative assessment, the factors we may review include, but are not limited to (a) macroeconomic conditions; (b) industry and market considerations; (c) cost factors; (d) overall financial performance; (e) other relevant entity-specific events such as changes in management, strategy, customers, or litigation; (f) events affecting the reporting unit; or (g) or sustained decrease in share price. If we believe, as a result of the qualitative assessment, that it is more-likely-than-not that the fair value of the reporting unit is less than its carrying amount, the quantitative impairment test will be required. Otherwise, no further testing will be required. A quantitative assessment utilizes a two-step process. In the first step, the fair value of the reporting unit is determined, and is compared against its carrying amount, including goodwill. We consider a combination of an income-based approach using projected discounted cash flows and a market-based approach using multiples of comparable companies to determine the fair value. The fair value of the reporting unit is estimated using significant judgment based on a combination of the income and the market approaches. Under the income approach, we estimate fair value of the reporting unit based on the present value of forecasted future cash flows that the reporting unit is expected to generate over its remaining life. Under the market approach, we estimate fair value of our reporting unit based on an analysis that compares the value of the reporting unit to values of other companies in similar lines of business. If the fair value of the reporting unit does not exceed its carrying value, then we perform the second step to measure the amount of impairment loss. The amount of impairment is determined by comparing the implied fair value of reporting unit goodwill to the carrying value of the goodwill. When the carrying value of the reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference.

Determining the fair value of the reporting unit requires us to make judgments and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, operating trends, risk-adjusted discount rates, future economic and market conditions and determination of appropriate market comparables. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. We may also test goodwill and other intangible assets for impairment between annual tests in the presence of impairment indicators. Acquired in-process research and development assets are classified as indefinite-lived intangible assets until the successful completion or abandonment of the associated research and development efforts. Upon successful completion of the associated research and development efforts, the useful life of the asset is determined and the asset is amortized over its useful life. If the associated research and development efforts are abandoned, an impairment loss is recognized for the carrying value of the related asset.

Long-term investments

Investments in privately held companies where we own less than 20% of the voting stock and have no indicators of significant influence over operating and financial policies of those companies are included in Long-term investments in the consolidated balance sheets and are accounted for under the cost method. For these non-quoted investments, we regularly review the assumptions underlying the operating performance and cash flow forecasts based on information provided by these privately held companies. If it is determined that an other-than-temporary decline exists in an equity security, we write down the investment to its fair value and record the related impairment as an investment loss in our consolidated statements of operations. As of September 30, 2013, we only have one investment of $2.0 million in a privately-held company accounted for under the cost method.

Performance Stock Units

PSUs are RSUs that contain both service-based and market-based vesting conditions. PSUs vest over a specified service period upon the satisfaction of certain market-based vesting conditions, and settle into shares of our common stock upon vesting over a two- or three-year period. The fair value of a PSU is calculated using the Monte Carlo simulation model on the grant date and is based on the market price of our common stock on the grant date modified to reflect the impact of the market-based vesting condition, including the estimated payout level based on that condition. We do not adjust compensation cost for subsequent changes in the expected outcome of the market-based vesting conditions.

Table of Contents

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-02, Comprehensive Income (Topic 220)-Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (“ASU 2013-02”). ASU 2013-02 requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. We adopted ASU 2013-02 on January 1, 2013, and presented the effects within Note 16, Accumulated Other Comprehensive Income, of the notes to our condensed consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740)-Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (“ASU 2013-11”). ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. This new standard requires the netting of unrecognized tax benefits (“UTBs”) against a deferred tax asset for a loss or other carryforward that would apply in settlement of the uncertain tax positions. UTBs will be netted against all available same-jurisdiction loss or other tax carryforwards that would be utilized, rather than only against carryforwards that are created by the UTBs. ASU 2013-11 will be effective for us beginning in the first quarter of fiscal 2014. Early adoption is permitted. Since ASU 2013-11 only impacts financial statement disclosure requirements for unrecognized tax benefits, we do not expect its adoption to have an impact on our financial position or results of operations.

Results of Operations

Three months ended September 30, 2013 and September 30, 2012

Revenue

	Three Months Ended September 30, 2013		September 30, 2012			
	Amount ($)	% of Total Revenue	Amount ($)	% of Total Revenue	Change	% Change
	($ amounts in 000’s)					
Revenue:						
Product	69,687	45	63,027	46	6,660	11
Services	83,883	54	69,782	51	14,101	20
Ratable and other revenue	1,129	1	3,459	3	(2,330)	(67)
Total revenue	154,699	100	136,268	100	18,431	14
Revenue by geography:						
Americas	65,448	42	57,217	42	8,231	14
Europe, Middle East and Africa (“EMEA”)	51,373	33	45,566	33	5,807	13
Asia Pacific and Japan (“APAC”)	37,878	25	33,485	25	4,393	13
Total revenue	154,699	100	136,268	100	18,431	14

Total revenue increased by $18.4 million, or 14%, during the three months ended September 30, 2013 compared to the same period last year. All three regions experienced similar revenue growth compared to the same period last year. Product revenue increased by $6.7 million, or 11%, compared to the same period last year. The increase in product

revenue was primarily driven by greater sales volume in our FortiGate product family, particularly with our low-end and high-end enterprise (such as the FortiGate-3600C) and service provider products, which contributed the largest portion of the growth. Services revenue increased by $14.1 million, or 20%, in the three months ended September 30, 2013 compared to the same period last year due to the recognition of revenue from our growing deferred revenue balance consisting of subscription and support

Table of Contents

contracts sold to a larger customer base, as well as growth in our professional services revenues from existing large enterprise customers.

Cost of revenue and gross margin

	Three Months Ended September 30, 2013	September 30, 2012	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	27,126	23,995	3,131	13
Services	16,374	13,166	3,208	24
Ratable and other revenue	430	647	(217)	(34)
Total cost of revenue	43,930	37,808	6,122	16
Gross margin (%):				
Product	61.1	61.9	(0.8)	
Services	80.5	81.1	(0.6)	
Ratable and other revenue	61.9	81.3	(19.4)	
Total gross margin	71.6	72.3	(0.7)	

Total gross margin decreased by 0.7 percentage points in the three months ended September 30, 2013 compared to the same period last year, as both product and services gross margins declined slightly. Product gross margin decreased by 0.8 percentage points in the three months ended September 30, 2013 compared to the same period last year primarily as a result of higher overhead costs which were partially offset by improved direct product margins due to a greater mix of high-end products sold. Services gross margin decreased by 0.6 percentage points during the three months ended September 30, 2013 primarily due to our continued investments in our technical support organization to accommodate our expanding customer base and higher service level expectations from our enterprise customers. In addition, we experienced growth in our professional consulting services which have lower gross margins than our support and subscription businesses. Cost of services revenue increased by $3.2 million primarily due to a $2.0 million increase in cash-based personnel costs related to an increase in headcount, a $0.3 million increase in stock-based compensation expense, a $0.4 million increase in warranty-related costs and a $0.5 million increase in depreciation and other expenses.

Operating expenses

	Three Months Ended September 30, 2013		September 30, 2012		Change	% Change
	Amount ($)	% of Total Revenue	Amount ($)	% of Total Revenue		
	($ amounts in 000's)					
Operating expenses:						
Research and development	26,421	17	20,498	15	5,923	29
Sales and marketing	56,687	37	44,743	33	11,944	27
General and administrative	9,382	6	7,449	5	1,933	26
Total operating expenses	92,490	60	72,690	53	19,800	27

Table of Contents

Research and development expense

Research and development expense increased by $5.9 million, or 29%, in the three months ended September 30, 2013 compared to the same period last year, primarily due to an increase of $2.7 million in cash-based personnel costs and $1.0 million in stock-based compensation expense as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Product development expenses consisting of prototypes and third-party testing and certification costs increased by $0.9 million. Other costs, including earn-out payment obligations to former stockholders of Coyote, also increased by $1.3 million. We intend to continue to invest in our research and development organization, but we currently expect research and development expense as a percentage of total revenue to remain at approximately comparable levels during the remainder of fiscal 2013.

Sales and marketing expense

Sales and marketing expense increased by $11.9 million, or 27%, in the three months ended September 30, 2013 compared to the same period last year, primarily due to an increase of $7.4 million in cash-based personnel costs and stock-based compensation expense of $1.3 million as we continued to increase our sales headcount in order to expand our global footprint. In addition, we incurred increases in trade show and promotional expenses of $1.4 million, travel expenses of $0.8 million and depreciation expenses of $0.7 million. As a percentage of total revenue, sales and marketing expenses increased as we continued to invest in our sales force 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 we currently expect sales and marketing expense as a percentage of total revenue to remain at approximately comparable levels during the remainder of fiscal 2013.

General and administrative expense

General and administrative expense increased by $1.9 million, or 26%, in the three months ended September 30, 2013 compared to the same period last year. Cash-based personnel costs increased by $0.7 million and stock-based compensation expense increased by $0.3 million due to increased headcount. In addition, we incurred $1.8 million of higher costs for professional services primarily related to patent litigation matters, compared to a $1.0 million accrual related to litigation settlement in the same period last year. We currently expect general and administrative expense as a percentage of total revenue to remain at approximately comparable levels during the remainder of fiscal 2013.

Interest income and other expense, net

	Three Months Ended			
	September 30, 2013	September 30, 2012	Change	% Change
	($ amounts in 000’s)			
Interest income	1,282	1,318	(36)	(3)
Other expense, net	(1,151)	(317)	(834)	263

The slight decrease in interest income in the three months ended September 30, 2013 compared to the same period last year was primarily due to lower interest earned on invested balances of cash, cash equivalents and investments. The change in other expense, net, for the three months ended September 30, 2013 was primarily the result of higher foreign exchange losses as the U.S. dollar weakened against other major currencies.

Provision for income taxes

	Three Months Ended			
			Change	% Change

	September 30, 2013	September 30, 2012		
	($ amounts in 000's)			
Provision for income taxes	7,381	9,565	(2,184)	(23)
Effective tax rate (%)	40	36	4	

Our effective tax rate was 40% in the three months ended September 30, 2013, compared to an effective tax rate of 36% in the same period last year. The provision for income taxes for the periods presented is comprised of foreign income

Table of Contents

taxes, U.S. federal and state taxes, and withholding tax. The increase in the effective tax rate was primarily due to a reduction in tax benefits from stock options related to our foreign subsidiaries, an increase in non-deductible stock-based compensation expense, and limitations on the utilization of foreign tax credits.

As of September 30, 2013 and December 31, 2012, unrecognized tax benefits were $28.7 million and $27.8 million, respectively. The total amount of $28.3 million in 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 September 30, 2013, we had accrued approximately $2.3 million for estimated interest related to uncertain tax provisions.

The State of California has been conducting an audit of our state income tax returns for fiscal 2010 and fiscal 2011. We do not expect this audit to have a significant detrimental effect on our income tax liability nor have a material impact on our results of operations.

Within the next twelve months, we do not believe there will be a decrease in uncertain tax benefits that could impact our future effective tax rate.

Nine months ended September 30, 2013 and September 30, 2012

Revenue

	Nine Months Ended September 30, 2013		September 30, 2012			
	Amount ($)	% of Total Revenue	Amount ($)	% of Total Revenue	Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	194,162	44	177,923	47	16,239	9
Services	239,447	55	197,332	52	42,115	21
Ratable and other revenue	4,338	1	7,222	1	(2,884)	(40)
Total revenue	437,947	100	382,477	100	55,470	15
Revenue by geography:						
Americas	178,101	41	155,570	41	22,531	14
EMEA	149,500	34	130,116	34	19,384	15
APAC	110,346	25	96,791	25	13,555	14
Total revenue	437,947	100	382,477	100	55,470	15

Total revenue increased by $55.5 million, or 15%, during the nine months ended September 30, 2013 compared to the same period last year. All three regions contributed comparable growth on a percentage basis. Product revenue increased by $16.2 million, or 9%, compared to the same period last year. The increase in product revenue was primarily driven by greater sales volume in our FortiGate product family, particularly entry-level products, wireless security and access point products, and continued traction for our high-end enterprise products including newly introduced products such as the FortiGate-3600C. Services revenue increased by $42.1 million, or 21%, in the nine months ended September 30, 2013 compared to the same period last year due to the recognition of revenue from our

growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base.

Table of Contents

Cost of revenue and gross margin

	Nine Months Ended September 30, 2013	September 30, 2012	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	77,032	66,997	10,035	15
Services	48,207	36,846	11,361	31
Ratable and other revenue	1,527	2,135	(608)	(28)
Total cost of revenue	126,766	105,978	20,788	20
Gross margin (%):				
Product	60.3	62.3	(2.0)	
Services	79.9	81.3	(1.4)	
Ratable and other revenue	64.8	70.4	(5.6)	
Total gross margin	71.1	72.3	(1.2)	

Total gross margin decreased by 1.2 percentage points in the nine months ended September 30, 2013 compared to the same period last year, as both product and services gross margins declined. Product gross margin decreased by 2.0 percentage points in the nine months ended September 30, 2013 compared to the same period last year primarily as a result of the higher mix of entry-level products and higher overhead costs. Services gross margin decreased by 1.4 percentage points during the nine months ended September 30, 2013 primarily due to our continued investments in our technical support organization to accommodate our expanding customer base and higher service level expectations from our enterprise customers. In addition, we experienced growth in our professional consulting services which have lower gross margins than our support and subscription businesses. Cost of services revenue increased by $11.4 million primarily due to a $7.9 million increase in cash-based personnel costs related to an increase in headcount, a $0.8 million increase in stock-based compensation expense, a $1.1 million increase in warranty-related costs and freight, and a $1.5 million increase in travel, depreciation and other expenses.

Operating expenses

	Nine Months Ended September 30, 2013		September 30, 2012		Change	% Change
	Amount ($)	% of Total Revenue	Amount ($)	% of Total Revenue		
	($ amounts in 000's)					
Operating expenses:						
Research and development	74,913	17	60,553	16	14,360	24
Sales and marketing	162,660	37	131,038	34	31,622	24
General and administrative	26,161	6	19,473	5	6,688	34
Total operating expenses	263,734	60	211,064	55	52,670	25

Research and development expense

Research and development expense increased by $14.4 million, or 24%, in the nine months ended September 30, 2013 compared to the same period last year, primarily due to an increase of $8.7 million in cash-based personnel costs and

$2.8 million in stock-based compensation expense as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, product development expenses consisting of prototypes and third-party testing and certification costs increased by $0.5 million, depreciation expense increased by $0.5 million and other expenses including expected earn-out payment obligations to former stockholders of Coyote increased by $2.3 million.

Sales and marketing expense

Sales and marketing expense increased by $31.6 million, or 24%, in the nine months ended September 30, 2013 compared to the same period last year, primarily due to an increase of $18.4 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 increases in travel expenses of $3.2 million, stock-based compensation expense of $3.1 million, trade shows and promotional expenses of $3.0 million and depreciation expenses of $1.9 million. Other expenses, including occupancy-related costs, also increased by $2.0 million. As a percentage of total revenue, sales and marketing expenses increased as we accelerated the investment in our sales force to support future growth.

General and administrative expense

General and administrative expense increased by $6.7 million, or 34%, in the nine months ended September 30, 2013 compared to the same period last year. Cash-based personnel costs increased by $2.4 million and stock-based compensation expense increased by $1.0 million. In addition, we incurred $3.3 million of higher legal fees due to litigation and increased accounting fees.

Interest income and other expense, net

	Nine Months Ended			
	September 30, 2013	September 30, 2012	Change	% Change
	($ amounts in 000's)			
Interest income	3,988	3,606	382	11
Other expense, net	(1,036)	(315)	(721)	229

The $0.4 million increase in interest income in the nine months ended September 30, 2013 compared to the same period last year, was primarily due to interest earned on higher invested balances of cash, cash equivalents and investments. The change in other expense, net, for the nine months ended September 30, 2013 was the result of higher foreign exchange losses compared to the same period last year.

Provision for income taxes

	Nine Months Ended			
	September 30, 2013	September 30, 2012	Change	% Change
	($ amounts in 000's)			
Provision for income taxes	18,142	23,397	(5,255)	(22)
Effective tax rate (%)	36	34	2	

Our effective tax rate was 36% in the nine months ended September 30, 2013, compared to an effective tax rate of 34% in the same period last year. The provision for income taxes for the periods presented is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The increase in the effective tax rate was primarily due to a reduction in tax benefits from the stock options related to our foreign subsidiaries, an increase in non-deductible stock based compensation expense and limitations on the utilization of foreign tax credits. Further, in January 2013, the American Taxpayer Relief Act of 2012 reinstated the U.S. Federal Research and Development Tax Credit retroactive to January 1, 2012. As a result, the U.S. Federal Research and Development Tax Credit benefit was recorded in the nine months ended September 30, 2013.

Table of Contents

Liquidity and Capital Resources

	September 30, 2013	December 31, 2012
	($ amounts in 000's)	
Cash and cash equivalents	144,546	122,975
Investments	696,459	616,611
Total cash, cash equivalents and investments	841,005	739,586
Working capital	338,641	249,970

The following table presents a summary of our cash flows:

	Nine Months Ended	
	September 30, 2013	September 30, 2012
	($ amounts in 000's)	
Cash provided by operating activities	100,716	133,573
Cash used in investing activities	(104,148)	(175,479)
Cash provided by financing activities	26,008	45,617
Effect of exchange rates on cash and cash equivalents	(1,005)	(235)
Net increase in cash and cash equivalents	21,571	3,476

As of September 30, 2013, our cash, cash equivalents, and investments of $841.0 million were held for working-capital purposes and were invested primarily in money market funds, commercial paper, corporate debt securities, U.S. government and agency securities, municipal bonds and certificates of deposit and term deposits. As of September 30, 2013, $69.9 million of our cash and investments was held by certain international subsidiaries and is not immediately available to fund domestic operations unless the cash is repatriated. While we do not intend to do so, should this amount be repatriated, it would be subject to U.S. federal income tax which would be partially offset by foreign tax credits. We do not enter into investments for trading or speculative purposes. We believe that our existing cash, cash equivalents and investments 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 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 access to adequate manufacturing capacity and the continuing market acceptance of our products. Historically, we have required capital principally to fund our working capital needs, capital expenditures, and acquisition activities. 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 are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

Table of Contents

The following table presents our cash flows from operating activities:

	Nine Months Ended	
	September 30, 2013	September 30, 2012
	($ amounts in 000's)	
Net income	32,257	45,329
Adjustments for non-cash charges [(1)]	50,211	33,288
Net income before non-cash charges	82,468	78,617
Increase in deferred revenue	36,425	45,192
Increase in accounts payable and accrued liabilities, net [(2)]	13,685	4,350
Increase in income taxes payable [(2)]	11,202	15,849
Increase in accrued payroll and compensation	1,400	1,563
Decrease in accounts receivable—net	589	5,680
Decrease (increase) in prepaid expenses and other current assets [(2)]	219	(71)
Increase in inventory	(31,344)	(14,977)
Increase in other assets [(2)]	(13,928)	(2,630)
Net cash provided by operating activities	100,716	133,573

(1) Non-cash charges consist of stock-based compensation expense, depreciation and amortization, amortization of investment premiums, an excess tax benefit from our employee stock option plans, and other non-cash items, net.
(2) Certain prior period amounts have been combined to conform to current period presentation.

Operating Activities

Cash generated by operating activities is our primary source of liquidity. Our operating activities during the nine months ended September 30, 2013, provided $100.7 million in cash as a result of our billings growth, profitability, and our ability to successfully manage our working capital. Net income was $32.3 million, increased by adjustments for non-cash charges of $50.2 million and sources of cash of $63.5 million, partially offset by uses of cash of $45.3 million from changes in operating assets and liabilities. Adjustments for non-cash charges consisted of stock-based compensation expense of $31.8 million, amortization of investment premiums of $8.9 million, depreciation and amortization of $11.5 million, and other non-cash items, net, of $0.5 million, partially offset by an excess tax benefit from stock option exercises of $2.5 million. Sources of cash were related to a $36.4 million increase in deferred revenue which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized in income, a $13.7 million increase in accounts payable and accrued liabilities related to timing of payments, a $11.2 million increase in income taxes payable due to our continued profitability and timing of tax payments, a $1.4 million increase in accrued payroll and compensation primarily related to increased headcount and employer taxes related to the exercise of stock options, a $0.6 million decrease in accounts receivable due to higher collections, and a $0.2 million decrease in prepaid expenses and other current assets. Uses of cash were related to a $31.3 million increase in inventory to ensure an adequate level of inventory to support high-turnover channel driven products to reduce the risk of product stockouts, and a $13.9 million increase in other assets, primarily related to an increase in deferred tax assets.

Our operating activities during the nine months ended September 30, 2012 provided $133.6 million in cash as a result of net income of $45.3 million, increased by adjustments for non-cash charges of $33.3 million and sources of cash of $72.6 million partially offset by uses of cash of $17.7 million. Adjustments for non-cash charges consisted of stock-based compensation of $23.9 million, amortization of investment premiums of $10.0 million, depreciation and amortization of $8.1 million, and other non-cash items, net, of $0.9 million, offset partially by an excess tax benefit from stock option exercises of $9.6 million. Sources of cash were related to a $45.2 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 $4.4 million increase in accounts payable and accrued liabilities, net, related to timing of payments, a $15.8 million increase in income taxes payable due to our continued profitability and timing of tax payments, a $1.6 million increase in accrued payroll and compensation primarily related to increased headcount and employer taxes related to the exercise of stock options, and a $5.7 million decrease in accounts receivable, net, due to higher collection. Uses of cash were primarily related to a $0.1 million increase in prepaid expenses and other current assets, a $15.0 million increase in inventory to ensure an adequate level of inventory to support high-turnover channel driven products to reduce the risk of product stockouts, and a $2.6 million increase in other assets.

Table of Contents

Investing Activities

Our investing activities during the nine months ended September 30, 2013 consisted primarily of purchases and sales of investments, and to a much lesser extent, acquisitions and capital expenditures. The $104.1 million of cash used in investing activities was due to net purchases of investments of $89.8 million, payments made in connection with acquisitions of Coyote and Xtera of $7.6 million and purchases of property and equipment of $6.7 million.

Our investing activities during the nine months ended September 30, 2012 consisted primarily of purchases, sales and maturities of investments, and to a lesser extent capital expenditures and acquisitions. The $175.5 million of cash used in investing activities during the nine months ended September 30, 2012 was primarily due to net purchases of investments of $154.4 million, purchases of property and equipment of $20.3 million including $14.5 million to purchase land and building to support the growth in our business operations, and our acquisition of IntruGuard for $0.7 million.

Financing Activities

Our financing activities during the nine months ended September 30, 2013 resulted in net cash provided of $26.0 million as a result of receiving proceeds of $11.8 million and $12.7 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 $2.5 million. This was partially offset by $1.0 million related to taxes paid for the net-share settlement of equity awards.

Our financing activities during the nine months ended September 30, 2012 resulted in net cash provided of $45.6 million as a result of proceeds of $25.1 million and $10.9 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 $9.6 million.

Contractual Obligations and Commitments

There have been no material changes during the nine months ended September 30, 2013, to the contractual obligations and commitments disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II, Item 7, of the Form 10-K, other than the following which summarizes the specified contractual obligations as of September 30, 2013:

	Payments Due by Period				
	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
	($ amounts in 000's)				
Operating leases [1]	31,528	9,191	14,528	5,499	2,310
Purchase commitments [2]	46,621	46,621	—	—	—
Total [3]	78,149	55,812	14,528	5,499	2,310

(1) Consists of contractual obligations from non-cancelable office space under operating leases. In March 2013, we extended the operating lease for one of our existing facilities in Canada through 2020. The total incremental lease payments are $14.3 million.

(2) Consists of minimum purchase commitments with independent contract manufacturers. As of September 30, 2013, we had $46.6 million of open purchase orders with our independent contract manufacturers that may not be cancelable compared to $30.0 million as of December 31, 2012. The increase was required to replenish current inventory and to ensure adequate future inventory related to new product releases and product lead-times for certain products.

(3)

No tax liabilities related to uncertain tax positions have been included in the table. As of September 30, 2013, we had $31.0 million of long-term 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

As of September 30, 2013, 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.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in our market risk during the nine months ended September 30, 2013, compared to the disclosures in Part II, Item 7A of the 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 Rule 13a-15(e) or 15d-15(e) under the Exchange Act) as of September 30, 2013. 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 September 30, 2013, to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

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 September 30, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

Part II

ITEM 1. Legal Proceedings

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. 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 thereafter proceeded with Fortinet as the sole defendant. Between June and August 2013, we filed a number of pretrial motions with the Court. As a result of those motions, the Court found that NPS had engaged in litigation misconduct. The Court also granted our motion to strike NPS's expert report on the issue of damages. Shortly thereafter, in September 2013, NPS agreed to abandon the case and we did not make any payments related to this case. NPS and its principals furthermore agreed not to sue us on related patents. The litigation related to NPS is no longer material to us.

In June 2012, we received a letter from 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 not infringed by any of our products or services. The case is proceeding in the United States District Court for the Northern District of California.

We do not currently believe that any of the foregoing litigation matters will have a material adverse effect on our business.

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 and our reliance on a concentration of shipments at the end of the quarter;
- 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;

Table of Contents

- 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 and buying practices and patterns;
- 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;
- 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, and increased competitiveness in general in our market;
- changes in customer renewal rates for our services;
- changes in the payment terms of services contracts or the length of services contracts sold;
- increased expenses, unforeseen liabilities or write-downs and any impact on results of operations from any acquisition consummated;
- 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.

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

Table of Contents

prices for our products and services, higher default rates among our channel partners, reduced unit sales and lower or no growth.

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

Billings and revenue growth may slow, or we may experience a decrease in billings and revenue, 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. For example, we experienced lower than expected billings during the first quarter of 2013 due to a number of factors, including decreased sales in the service provider market and slower sales in Latin America and EMEA. Our expenses as a percentage of total revenue may be higher than expected if our revenue is lower than expectations, and 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.

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 subscription and support 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 subscription and support services contracts decline, our revenue and revenue growth may decline and our business will suffer. In addition, in the event significant customers require payment terms for subscription or support services in arrears or for shorter periods of time than annually, such as monthly or quarterly, this may negatively impact subscription and support revenue. Furthermore, 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 subscription and support services 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 statements 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.

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;

Table of Contents

- 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 or sales-related arrangements that may result in disruption in the sales team through terminations of employment or otherwise, and may adversely impact financial results as compared to those already reported or the forecasted results and result in restatements of financial statements and irregularities in financial statements;

- our ability to effectively implement adequate internal controls to properly manage our international sales and operations;

- 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.

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. (“Cisco”), Sourcefire, Inc. (“Sourcefire”) (acquired by Cisco), Check Point Software Technologies Ltd. (“Check Point”), McAfee, Inc. (“McAfee”) (acquired by Intel Corporation (“Intel”)), Blue Coat Systems, Inc. ("Blue Coat"), Palo Alto Networks, Inc. (“Palo Alto Networks”), SonicWALL, Inc. (“SonicWALL”) (acquired by Dell Inc. (“Dell”)), Juniper Networks, Inc. (“Juniper”), and Stonesoft Corporation (“Stonesoft”) (acquired by McAfee) 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;

- unanticipated changes in the capital resources of or purchasing behavior of large end-customers, including changes in the volume and frequency of their purchases;

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more stringent support requirements in our support service contracts, including stricter support response times, more complex customer requirements, 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.

Table of Contents

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, enterprises, 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.

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 first quarter of 2013 due to 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 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 members of senior management, particularly Ken Xie, our Co-founder, President and Chief Executive Officer and Michael Xie, our Co-founder, Vice President of Engineering and Chief Technology Officer, and any of our senior sales leaders or functional area leaders, could significantly delay or prevent the achievement of our development and strategic objectives. We hired a new Chief Financial Officer and Chief Operating Officer in April 2013, and it will take time for this executive officer to become fully integrated in his role. 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.

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. 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.

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.

Reliance on a concentration of shipments at the end of the quarter could cause our billings and 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 billings and revenue during the last two weeks of the quarter. For example, on average over the past eight quarters, our shipments during the last two weeks of each quarter accounted for approximately 37% of aggregate billings for each quarter. If expected orders at the end of any quarter are delayed for any reason, including the failure of anticipated purchase orders to materialize, 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 billings and 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 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.

Table of Contents

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 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.

Our business 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 requisite improvements to these systems, controls and processes, such as system access and change management controls, in a timely or efficient manner.We are in the planning stages for an upgrade to our enterprise resource planning system and such change may cause disruption and additional cost. 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 consolidated financial 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 Quarterly Report on 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 consolidated financial statements include those related to revenue recognition, stock-based compensation expense, 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.

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 (“UMC”) and Taiwan Semiconductor Manufacturing Company Limited (“TSMC”). Faraday Technology Corporation (“Faraday”) (using UMC’s foundry), Kawasaki Microelectronics America, Inc. (“K-Micro”) (using TSMC’s foundry) and Renesas Electronics Corporation (“Renesas”) (using

UMC's foundry) manufacture our Application-Specific Integrated Circuits ("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. It also exposes us to the risk that certain minerals and metals that originated in the Democratic Republic of Congo or an adjoining country, known as "conflict minerals," are contained within our products. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC adopted new disclosure requirements for public companies using conflict minerals in their products. Under these rules, we are required to perform due diligence, disclose and report our efforts to prevent the sourcing of such conflict minerals. As a result of these new rules, we expect to incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the conflict minerals that may be used in our products. Moreover, the implementation of these new requirements could adversely affect the sourcing, availability, and pricing of materials used in the manufacture of our products to the extent that there may be only a limited number of suppliers offering "conflict free" minerals that can be used in our products. There can be no assurance that we will be able to obtain such minerals in sufficient quantities or at competitive prices. We may also encounter customers who require that all of the components of our products be certified as conflict free. If we are not able to meet customer requirements, such customers may choose to not purchase our products, which could impact our sales and the value of portions of our inventory.

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, Advanced Micro Devices, Inc., and RMI/Netlogic Corporation, 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:

- 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

Table of Contents

•failure in component quality.

The occurrence of any of these events 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. 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 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, for orders placed by partners as stocking orders for example, 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 are subject include the EU, RoHS and the EU Waste Electrical and Electronic Equipment Directive (“WEEE Directive”) as well as the implementing legislation of the EU member states. Similar laws and regulations have been passed or are pending in

Table of Contents

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.

The rules and regulations applicable to government sales may also negatively impact sales to non-governmental entities. 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.

Table of Contents

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 anti-spam and anti-malware 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 anti-spam 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 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 large end-customers, service provider and governmental entity end-customers require higher levels of support than smaller end-customers because of their more complex deployments. If we fail to meet the requirements of our larger end-customers, it may be more difficult to execute on our strategy to increase our penetration with enterprises, service providers and governmental entities.

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 examination of our income tax returns by the IRS and other tax authorities. For example, the California Franchise Tax Board is examining our tax returns for 2010 and 2011. 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 currently do not have a valuation allowance, we may in the future be required to establish one. 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

Table of Contents

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 IRS 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, and we may not accurately forecast the financial impact of an acquisition. In addition, any acquisitions we are able to complete may be dilutive to revenue growth and 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. Acquisitions during a quarter may result in increased operating expenses and adversely affect our results of operations for that period or future periods compared to the results that we have previously forecasted or achieved. Further, completing a potential acquisition and integrating acquired businesses, products, technologies or intellectual property could 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

Table of Contents

technology systems or manufacturing or logistics abilities are hindered by any of the events discussed above, shipments could be delayed, resulting in us 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 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 could impair the market acceptance of our products, which in turn could 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 customers' 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 could impair the growth of our business.

Table of Contents

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;
- 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;
- actual or perceived 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

Table of Contents

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 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 and Juniper, security vendors such as Check Point, McAfee (acquired by Intel), Sourcefire (acquired by Cisco), Stonesoft (acquired by McAfee), SonicWALL (acquired by Dell), Blue Coat, and Palo Alto Networks, and other point solution security vendors.

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

- greater name recognition and longer operating histories;
- larger sales and marketing budgets and resources;
- 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 Inc., Intel's acquisition of McAfee,

McAfee's acquisition of Stonesoft, Check Point's acquisition of Nokia Corporations' 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.

Table of Contents

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 and Juniper 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.

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 and may make it more difficult and costly to prosecute patent applications. 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 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 the section entitled "Legal Proceedings" in Part II, Item 1 of this Quarterly Report on Form 10-Q. We are also subject to other litigation in addition to patent infringement claims, such as employment-related litigation and disputes, general commercial litigation, and could become subject to other forms of litigation and disputes, including stockholder litigation. 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. Although our most recent assessment, testing and evaluation resulted in our conclusion that as of December 31, 2012, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in 2013 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 revenue recognition, 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, 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 nine months ended September 30, 2013, the closing price of our common stock ranged from $16.53 to $25.00.

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

Table of Contents

could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

Table of Contents

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% 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.

Table of Contents

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

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.

Table of Contents

SIGNATURES

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

Date: November 5, 2013

FORTINET, INC.

By: /s/ AHMED RUBAIE
Ahmed Rubaie
Chief Financial Officer and Chief Operating Officer
(Principal Financial and Accounting Officer) (Duly Authorized Officer)

Ken Goldman
Vice President and Chief Financial Officer

Table of Contents

EXHIBIT INDEX

Exhibit Number	Description	Incorporated by reference herein		
		Form	Date	Exhibit Number
10.1†*	Fortinet, Inc. Cash and Equity Incentive Plan			
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			

† Indicates management compensatory plan, contract or arrangement.
* Filed herewith.