FORTINET INC
Form 10-Q
May 01, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended March 31, 2015
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<br>(State or other jurisdiction of<br>incorporation or organization) | 77-0560389<br>(I.R.S. Employer<br>Identification No.) |
| 899 Kifer Road<br>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 ("Exchange Act") 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 Act). Yes o No x

As of April 24, 2015, there were 169,563,012 shares of the registrant’s common stock outstanding.

FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended March 31, 2015
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Part I

Item 1. Financial Statements
FORTINET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited, in thousands, except per share amounts)

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $386,352 | $283,254 |
| Short-term investments | 417,605 | 436,766 |
| Accounts receivable—Net of sales returns reserve and allowance for doubtful accounts of $4,882 and $6,204 as of March 31, 2015 and December 31, 2014, respectively | 161,854 | 184,741 |
| Inventory | 72,060 | 69,477 |
| Deferred tax assets | 41,175 | 41,484 |
| Prepaid expenses and other current assets | 32,757 | 31,143 |
| Total current assets | 1,111,803 | 1,046,865 |
| LONG-TERM INVESTMENTS | 268,608 | 271,724 |
| PROPERTY AND EQUIPMENT—Net | 63,487 | 58,919 |
| DEFERRED TAX ASSETS | 38,998 | 31,080 |
| GOODWILL | 2,824 | 2,824 |
| OTHER INTANGIBLE ASSETS—Net | 2,559 | 2,832 |
| OTHER ASSETS | 10,024 | 10,530 |
| TOTAL ASSETS | $1,498,303 | $1,424,774 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | $40,164 | $49,947 |
| Accrued liabilities | 25,873 | 29,016 |
| Accrued payroll and compensation | 42,727 | 45,875 |
| Income taxes payable | 3,343 | 2,689 |
| Deferred revenue | 406,526 | 368,929 |
| Total current liabilities | 518,633 | 496,456 |
| DEFERRED REVENUE | 193,645 | 189,828 |
| INCOME TAXES PAYABLE | 50,280 | 45,139 |
| OTHER LIABILITIES | 15,998 | 17,385 |
| Total liabilities | 778,556 | 748,808 |
| COMMITMENTS AND CONTINGENCIES (Note 8) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock, $0.001 par value — 300,000 shares authorized; 169,247 and 166,443 shares issued and outstanding as of March 31, 2015 and December 31, 2014, respectively | 169 | 166 |
| Additional paid-in capital | 604,147 | 562,504 |
| Accumulated other comprehensive income (loss) | 226 | (349 ) |
| Retained earnings | 115,205 | 113,645 |
| Total stockholders' equity | 719,747 | 675,966 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $1,498,303 | $1,424,774 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| REVENUE: | | |
| Product | $97,509 | $76,765 |
| Service | 115,377 | 92,184 |
| Total revenue | 212,886 | 168,949 |
| COST OF REVENUE: | | |
| Product | 41,368 | 32,139 |
| Service | 22,234 | 18,604 |
| Total cost of revenue | 63,602 | 50,743 |
| GROSS PROFIT: | | |
| Product | 56,141 | 44,626 |
| Service | 93,143 | 73,580 |
| Total gross profit | 149,284 | 118,206 |
| OPERATING EXPENSES: | | |
| Research and development | 35,816 | 29,055 |
| Sales and marketing | 100,609 | 67,326 |
| General and administrative | 11,961 | 9,010 |
| Total operating expenses | 148,386 | 105,391 |
| OPERATING INCOME | 898 | 12,815 |
| INTEREST INCOME | 1,422 | 1,333 |
| OTHER EXPENSE—Net | (677) | (389) |
| INCOME BEFORE INCOME TAXES | 1,643 | 13,759 |
| PROVISION FOR INCOME TAXES | 83 | 5,366 |
| NET INCOME | $1,560 | $8,393 |
| Net income per share (Note 6): | | |
| Basic | $0.01 | $0.05 |
| Diluted | $0.01 | $0.05 |
| Weighted-average shares outstanding: | | |
| Basic | 168,077 | 162,391 |
| Diluted | 173,720 | 168,114 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Net income | $1,560 | $8,393 |
| Other comprehensive income (loss)—net of taxes: | | |
| Foreign currency translation losses | — | (1,017) |
| Unrealized gains on investments | 885 | 2 |
| Tax provision related to items of other comprehensive income | (310) | — |
| Other comprehensive income (loss)—net of taxes | 575 | (1,015) |
| Comprehensive income | $2,135 | $7,378 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $1,560 | $8,393 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,353 | 4,422 |
| Amortization of investment premiums | 1,938 | 2,513 |
| Stock-based compensation | 18,880 | 12,930 |
| Excess tax benefit from stock-based compensation | — | (579) |
| Other non-cash items—net | 159 | (67) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable—net | 23,621 | 19,119 |
| Inventory | (6,296) | 3,326 |
| Deferred tax assets | (7,918) | 24 |
| Prepaid expenses and other current assets | (1,203) | (287) |
| Other assets | 507 | 45 |
| Accounts payable | (11,305) | (6,042) |
| Accrued liabilities | (3,450) | (170) |
| Accrued payroll and compensation | (3,149) | 1,071 |
| Other liabilities | (1,569) | 16,155 |
| Deferred revenue | 40,696 | 18,469 |
| Income taxes payable | 5,795 | (18,420) |
| Net cash provided by operating activities | 64,619 | 60,902 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of investments | (120,991) | (120,590) |
| Sales of investments | 6,679 | 10,920 |
| Maturities of investments | 135,363 | 118,641 |
| Purchases of property and equipment | (4,927) | (11,318) |
| Payments made in connection with business acquisitions—net of cash acquired | — | (17) |
| Net cash provided by (used in) investing activities | 16,124 | (2,364) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock | 28,955 | 14,471 |
| Taxes paid related to net share settlement of equity awards | (6,600) | (3,633) |
| Excess tax benefit from stock-based compensation | — | 579 |
| Repurchase and retirement of common stock | — | (12,305) |
| Net cash provided by (used in) financing activities | 22,355 | (888) |
| EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS | — | (555) |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 103,098 | 57,095 |
| CASH AND CASH EQUIVALENTS—Beginning of period | 283,254 | 115,873 |
| CASH AND CASH EQUIVALENTS—End of period | $386,352 | $172,968 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid for income taxes—net | $6,498 | $22,136 |
| NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Transfers of evaluation units from inventory to property and equipment | $3,869 | $2,307 |
| Liability for purchase of property and equipment and asset retirement obligations | $2,140 | $5,844 |

| | | |
|---|---|---|
| Liability incurred for repurchase of common stock | $— | $657 |

See notes to condensed consolidated financial statements.

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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 generally accepted accounting principles in the United States (“GAAP”) for interim financial information as well as the instructions to Form 10-Q pursuant to 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 year ended December 31, 2014, contained in our Annual Report on Form 10-K (“Form 10-K”) filed with the SEC on March 2, 2015. In the opinion of management, all adjustments, which 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 months ended March 31, 2015 are not necessarily indicative of the results for the full year or for any future periods. The condensed consolidated balance sheet as of December 31, 2014 is derived from the audited consolidated financial statements for the year ended December 31, 2014.

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.

There have been no material changes to our significant accounting policies as of and for the three months ended March 31, 2015.

In the third quarter of 2014, we reevaluated the selected functional currency of our international subsidiaries due to the nature of our business operations and recorded the cumulative impact of the reevaluation of the functional currency in the consolidated statement of operations. Subsequently, the remeasurement of the assets and liabilities of all international subsidiaries has been recorded in the consolidated statement of operations prospectively. The impact of this reevaluation is not material for our fiscal 2014 or any of our previously issued financial statements.

Recent Accounting Pronouncement

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09—Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”) to create a single, joint revenue standard that is consistent across all industries and markets for companies that prepare their financial statements in accordance with GAAP. Under ASU 2014-09, an entity is required to recognize revenue upon the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to receive in exchange for those goods or services. ASU 2014-09 is effective for us beginning on January 1, 2017. We are currently evaluating the impact of ASU 2014-09 on our consolidated financial statements.

## 2. FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

The following table summarizes our investments as of March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Corporate debt securities | $568,456 | $593 | $(243) | $568,806 |
| Commercial paper | 43,758 | 1 | (9) | 43,750 |
| Municipal bonds | 49,825 | 21 | (26) | 49,820 |
| Certificates of deposit and term deposits [1] | 13,080 | — | — | 13,080 |
| U.S. government and agency securities | 10,749 | 8 | — | 10,757 |
| Total available-for-sale securities | $685,868 | $623 | $(278) | $686,213 |
| | December 31, 2014 | | | |
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Corporate debt securities | $589,526 | $365 | $(875) | $589,016 |
| Commercial paper | 51,156 | 3 | (4) | 51,155 |
| Municipal bonds | 39,745 | 15 | (39) | 39,721 |
| Certificates of deposit and term deposits [1] | 22,854 | — | — | 22,854 |
| U.S. government and agency securities | 5,749 | 1 | (6) | 5,744 |
| Total available-for-sale securities | $709,030 | $384 | $(924) | $708,490 |

[1] The majority of our certificates of deposit and term deposits are foreign deposits.

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 March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | $177,364 | $(214) | $13,142 | $(29) | $190,506 | $(243) |
| Commercial paper | 8,375 | (9) | — | — | 8,375 | (9) |
| Municipal bonds | 32,205 | (26) | — | — | 32,205 | (26) |
| Total available-for-sale securities | $217,944 | $(249) | $13,142 | $(29) | $231,086 | $(278) |

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

| | December 31, 2014 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | $317,011 | $(858) | $6,011 | $(17) | $323,022 | $(875) |
| Commercial paper | 8,185 | (4) | — | — | 8,185 | (4) |
| Municipal bonds | 26,684 | (39) | — | — | 26,684 | (39) |
| U.S. government and agency securities | 4,745 | (6) | — | — | 4,745 | (6) |
| Total available-for-sale securities | $356,625 | $(907) | $6,011 | $(17) | $362,636 | $(924) |

The contractual maturities of our investments as of March 31, 2015 and December 31, 2014 were as follows (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| Due within one year | $417,605 | $436,766 |
| Due within one to three years | 268,608 | 271,724 |
| Total | $686,213 | $708,490 |

Available-for-sale securities are reported at fair value, with unrealized gains and losses, net of tax, included as a separate component of stockholders’ equity and in total comprehensive income. Realized gains and losses on available-for-sale securities are included in Other expense—net in our condensed consolidated statements of operations. Realized gains and losses from the sale of available-for-sale securities were not significant in any period presented.

The unrealized losses on our available-for-sale securities were caused by fluctuations in market value and interest rates as a result of the economic environment. As the decline in market value is attributable to changes in market conditions and not credit quality, and because we have concluded currently that we neither intend to sell nor is it more likely than not that we will be required to sell these investments prior to a recovery of par value, we do not consider these investments to be other-than temporarily impaired as of March 31, 2015.

Fair Value Accounting—We apply the following fair value hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1—Inputs are unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2—Inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the assets or liabilities, either directly or indirectly through market corroboration, for substantially the full term of the financial instruments.

Level 3—Unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. The inputs require significant management judgment or estimation.

We measure the fair value of money market funds and certain U.S. government and agency securities using quoted prices in active markets for identical assets. The fair value of all other financial instruments was based on quoted prices for similar assets in active markets, or model driven valuations using significant inputs derived from or corroborated by observable market data.

We classify investments within Level 1 if quoted prices are available in active markets for identical securities.

We classify items within Level 2 if the investments are valued using model driven valuations using observable inputs such as quoted market prices, benchmark yields, reported trades, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. Investments are held by custodians who obtain investment prices from a third-party pricing provider that incorporates standard inputs in various asset price models.

Fair Value of Financial Instruments

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents the fair value of our financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Aggregate Fair Value | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Remaining Inputs (Level 2) | Aggregate Fair Value | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Remaining Inputs (Level 2) |
| Assets: | | | | | | |
| Corporate debt securities | $568,806 | $— | $568,806 | $589,016 | $— | $589,016 |
| Commercial paper | 43,750 | — | 43,750 | 51,155 | — | 51,155 |
| Municipal bonds | 49,820 | — | 49,820 | 39,721 | — | 39,721 |
| Certificates of deposit and term deposits | 13,080 | — | 13,080 | 22,854 | — | 22,854 |
| Money market funds | 29,154 | 29,154 | — | 13,311 | 13,311 | — |
| U.S. government and agency securities | 10,757 | 2,001 | 8,756 | 5,744 | 1,998 | 3,746 |
| Total | $715,367 | $31,155 | $684,212 | $721,801 | $15,309 | $706,492 |
| | | | | | | |
| Reported as: | | | | | | |
| Cash equivalents | $29,154 | | | $13,311 | | |
| Short-term investments | 417,605 | | | 436,766 | | |
| Long-term investments | 268,608 | | | 271,724 | | |
| Total | $715,367 | | | $721,801 | | |

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the period ended March 31, 2015.

3. INVENTORY

Inventory consisted of the following as of March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| Raw materials | $12,077 | $10,617 |

| | | |
|---|---|---|
| Finished goods | 59,983 | 58,860 |
| Inventory | $72,060 | $69,477 |

Inventory includes finished goods held by distributors where revenue is recognized on a sell-through basis of $1.0 million and $1.2 million as of March 31, 2015 and December 31, 2014, respectively. Inventory also includes materials at contract manufacturers of $4.6 million and $4.8 million as of March 31, 2015 and December 31, 2014, respectively.

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

## 4. PROPERTY AND EQUIPMENT—Net

Property and equipment—net consisted of the following as of March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| Land | $13,895 | $13,895 |
| Building and building improvements | 20,224 | 20,166 |
| Evaluation units | 34,053 | 31,474 |
| Computer equipment and software | 38,306 | 31,821 |
| Furniture and fixtures | 5,469 | 5,096 |
| Construction-in-progress | 3,157 | 3,902 |
| Leasehold improvements | 8,711 | 7,998 |
| Total property and equipment | 123,815 | 114,352 |
| Less: accumulated depreciation | (60,328) | (55,433) |
| Property and equipment—net | $63,487 | $58,919 |

Depreciation expense was $6.0 million and $3.9 million during the three months ended March 31, 2015 and March 31, 2014, respectively.

## 5. INVESTMENTS IN PRIVATELY-HELD COMPANIES

As of March 31, 2015, we have invested a total of $6.4 million in the equity securities of three privately-held companies. Each of these investments are accounted for as cost-basis investments, 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 respective entities. These investments are carried at historical cost and are recorded as Other assets on our condensed consolidated balance sheets and would be measured at fair value if indicators of impairment exist.

During the three months ended March 31, 2015, no events have occurred that would adversely affect the carrying value of these investments.

## 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, restricted stock units (“RSUs”) including performance stock units (“PSUs”), and the employee stock purchase plan (“ESPP”). Dilutive shares of common stock are determined by applying the treasury stock method.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Numerator: | | |
| Net income | $1,560 | $8,393 |
| Denominator: | | |
| Basic shares: | | |
| Weighted-average common stock outstanding—basic | 168,077 | 162,391 |
| Diluted shares: | | |
| Weighted-average common stock outstanding—basic | 168,077 | 162,391 |
| Effect of potentially dilutive securities: | | |
| Stock options | 3,837 | 5,196 |
| RSUs (including PSUs) | 1,741 | 484 |
| ESPP | 65 | 43 |
| Weighted-average shares used to compute diluted net income per share | 173,720 | 168,114 |
| Net income per share: | | |
| Basic | $0.01 | $0.05 |
| Diluted | $0.01 | $0.05 |

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 anti-dilutive (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Stock options | 249 | 5,079 |
| RSUs (including PSUs) | 1,333 | 1,348 |
| ESPP | 169 | 358 |
| | 1,751 | 6,785 |

7. DEFERRED REVENUE

Deferred revenue consisted of the following as of March 31, 2015 and December 31, 2014 (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|---|---|
| Product | $4,255 | $4,642 |
| Service | 595,916 | 554,115 |
| Total deferred revenue | $600,171 | $558,757 |
| Reported As: | | |
| Current | $406,526 | $368,929 |

| | | |
|---|---|---|
| Non-current | 193,645 | 189,828 |
| Total deferred revenue | $600,171 | $558,757 |

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## 8. COMMITMENTS AND CONTINGENCIES

The following table summarizes our future principal contractual obligations as of March 31, 2015 (in thousands):

| | Total | 2015 (remainder) | 2016 | 2017 | 2018 | 2019 | Thereafter |
|---|---|---|---|---|---|---|---|
| Operating lease commitments | $40,130 | $9,560 | $9,453 | $7,252 | $6,506 | $4,567 | $2,792 |
| Less: Sublease rental income | 224 | 224 | — | — | — | — | — |
| Operating lease commitments—net | 39,906 | 9,336 | 9,453 | 7,252 | 6,506 | 4,567 | 2,792 |
| Inventory purchase commitments | 67,715 | 67,715 | — | — | — | — | — |
| Other contractual commitments and open purchase orders | 28,108 | 26,020 | 1,518 | 570 | — | — | — |
| Total | $135,729 | $103,071 | $10,971 | $7,822 | $6,506 | $4,567 | $2,792 |

Operating Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2024. In addition to the amounts above, certain leases require us to pay variable costs such as taxes, maintenance, insurance, and asset retirement obligations. The terms of certain operating leases also provide for renewal options and escalation clauses. Rent expense was $3.1 million and $2.7 million during the three months ended March 31, 2015 and 2014, respectively. Rent expense is recognized using the straight-line method over the term of the lease.

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 analysis, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of March 31, 2015, we had $67.7 million of open purchase orders with our independent contract manufacturers.

In addition to commitments with contract manufacturers, we have other contractual commitments and open purchase orders in the ordinary course of business for which we have not received goods or services. As of March 31, 2015, we had $28.1 million in other contractual commitments and open purchase orders.

Warranties—Accrued warranty activities are summarized as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Accrued warranty balance—beginning of the period | $4,269 | $3,037 |
| Warranty costs incurred | (1,095) | (756) |
| Provision for warranty for the period | 945 | 837 |
| Adjustment related to pre-existing warranties | 222 | (313) |

| | | |
|---|---|---|
| Accrued warranty balance—end of the period | $4,341 | $2,805 |

Litigation—We are involved in disputes, litigation, and other legal actions. For lawsuits where we are the defendant, we are in the process of 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. We have not recorded any significant 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.

Indemnification—Under the indemnification provisions of our standard sales contracts, we agree to defend our customers against third-party claims asserting various allegations such as damage resulting from product defects and 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 certain defined limits, such as the total amount paid by our customer under the agreement. However, certain agreements include covenants and indemnification provisions including and beyond indemnification for third-party claims of intellectual property infringement and that could potentially expose us to losses in excess of the amount received under the agreement and, in some instances, to potential liability that is not contractually limited. To date, there have been no awards under such indemnification provisions.

## 9. STOCKHOLDERS' EQUITY

### Stock-Based Compensation Plans

We have stock-based compensation plans pursuant to which we have granted stock options and RSUs, including PSUs. The Company also has an ESPP for all eligible employees. As of March 31, 2015, there were a total of 44,040,580 shares of common stock available for grant under our stock-based compensation plans.

### Employee Stock Options

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

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2015 | | March 31, 2014 | |
| Expected term in years | 4.3 | | 4.9 | |
| Volatility | 40 | % | 45 | % |
| Risk-free interest rate | 1.5 | % | 1.7 | % |
| Dividend rate | — | % | — | % |

The following table summarizes the stock option activity and related information for the periods presented below (in thousands, except 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, 2014 | 10,702 | $14.98 | | |

| | | | | |
|---|---|---|---|---|
| Granted | 269 | 32.79 | | |
| Forfeited | (73 ) | 24.59 | | |
| Exercised | (1,931 ) | 10.49 | | |
| Balance—March 31, 2015 | 8,967 | $16.41 | | |
| Options vested and expected to vest—March 31, 2015 | 8,924 | $16.35 | 2.8 | $165,975 |
| Options exercisable—March 31, 2015 | 7,589 | $14.71 | 2.4 | $153,634 |

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 March 31, 2015, for all in-the-money options. As of March 31, 2015, total compensation expense related to unvested stock options granted to employees but not yet recognized was $15.6 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 1.8 years.

Additional information related to our stock options is summarized below (in thousands, except per share amounts):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Weighted-average fair value per share granted | $11.17 | $8.65 |
| Intrinsic value of options exercised | 41,003 | 15,321 |
| Fair value of options vested | 3,792 | 4,562 |

Restricted Stock Units

The following table summarizes the activity and related information for RSUs for the periods presented below (in thousands, except per share amounts):

| | Restricted Stock Units Outstanding | |
|---|---|---|
| | Number of Shares | Weighted-Average Grant-Date-Fair Value per Share |
| Balance—December 31, 2014 | 6,291 | $22.93 |
| Granted | 2,492 | 32.96 |
| Forfeited | (198) | 26.36 |
| Vested | (670) | 22.01 |
| Balance—March 31, 2015 | 7,915 | $26.18 |
| RSUs expected to vest—March 31, 2015 | 7,450 | $26.02 |

As of March 31, 2015, total compensation expense related to unvested RSUs that were granted to employees and non-employees, but not yet recognized, was $197.8 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 3.1 years.

RSUs settle into shares of common stock upon vesting. Upon the vesting of the RSUs, we net-settle the RSUs and withhold 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.

The following summarizes the number and value of the shares withheld for employee taxes (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Shares withheld for taxes | 221 | 171 |
| Amount withheld for taxes | $6,600 | $3,633 |

Performance Stock Units

We have granted PSUs to certain of our executive officers and employees. PSUs granted to executive officers are 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. PSUs granted to certain employees are based on the achievement of personal- and company-based performance vesting conditions during the performance period. The final settlement of these PSUs will range between 50% to 150% of the target shares underlying the PSUs based on specified objective formula approved by our Compensation Committee. The PSUs entitle the employees to receive a number of shares of our common stock based on a one year performance period, and vest equally in the second and third years.

The following table summarizes the weighted-average assumptions relating to our PSUs granted to our executive officers:

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2015 | | March 31, 2014 | |
| Expected term in years | 3.0 | | 3.0 | |
| Volatility | 38 | % | 48 | % |
| Risk-free interest rate | 1.1 | % | 0.7 | % |
| Dividend rate | — | % | — | % |

The following table summarizes the activity and related information for PSUs for the periods presented below (in thousands, except per share amounts):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Shares granted to executive officers and employees | 206 | 25 |
| Weighted-average fair value per share granted | $34.86 | $22.44 |

As of March 31, 2015, total compensation expense related to unvested PSUs that were granted to certain of our executive officers and employees, but not yet recognized, was $9.5 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.5 years.

Employee Stock Purchase Plan

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

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2015 | | March 31, 2014 | |
| Expected term in years | 0.5 | | 0.5 | |
| Volatility | 28 | % | 37 | % |
| Risk-free interest rate | 0.1 | % | 0.1 | % |

| | | |
|---|---|---|
| Dividend rate | — % | — % |

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Additional information related to the ESPP is provided below (in thousands, except per share amounts):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Weighted-average fair value per share granted | $7.56 | $5.76 |
| Shares issued under the ESPP | 427 | 424 |
| Weighted-average price per share issued | $21.34 | $17.18 |

Stock-based Compensation Expense

Stock-based compensation expense is included in costs and expenses as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Cost of product revenue | $140 | $113 |
| Cost of service revenue | 1,632 | 1,329 |
| Research and development | 5,157 | 3,882 |
| Sales and marketing | 9,307 | 5,746 |
| General and administrative | 2,686 | 1,860 |
| Total stock-based compensation expense | $18,922 | $12,930 |

The following table summarizes stock-based compensation expense by award type (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Stock options | $3,455 | $4,692 |
| RSUs (including PSUs) | 14,292 | 7,363 |
| ESPP | 1,175 | 875 |
| Total stock-based compensation expense | $18,922 | $12,930 |

Total income tax benefit associated with stock-based compensation that is recognized in the condensed consolidated statements of operations is as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| Income tax benefit associated with stock-based compensation | $3,377 | $3,349 |

Share Repurchase Program

In December 2013, our Board of Directors (“Board”) authorized a Share Repurchase Program (“Program”) to repurchase up to $200.0 million of our outstanding common stock through December 31, 2014. Under the Program, share repurchases may be made by us from time to time in privately negotiated transactions or in open market transactions.

The Program does not require us to purchase a minimum number of shares, and may be suspended, modified or discontinued at any time without prior notice. In October 2014, our Board extended the share repurchase authorization under the Program through December 31, 2015. During the three months ended March 31, 2015, there were no shares repurchased under the Program. As of March 31, 2015, $122.5 million remains available for future share repurchases under the Program.

## 10. INCOME TAXES

The effective tax rate was 5% for the three months ended March 31, 2015, compared to an effective tax rate of 39% for the same period last year. The provision for income taxes for the periods presented is comprised of U.S. federal and state taxes, Singapore and other foreign income taxes, withholding tax, and transfer pricing allocations which impact jurisdictional income taxed at various tax rates. During the three months ended March 31, 2015, discrete items included a higher tax benefit from stock-based compensation expense and foreign exchange impact relating to uncertain tax benefit for developments in international tax that impacted the quarterly effective tax rate.

As of March 31, 2015 and December 31, 2014, unrecognized tax benefits were $46.6 million and $44.2 million, respectively. The total amount of $46.6 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 March 31, 2015, we had accrued approximately $4.5 million for estimated interest related to uncertain tax positions.

We file income tax returns in the U.S. federal jurisdiction, and various U.S. state and foreign jurisdictions. The statute of limitations is open for years that generated state net operating loss carryforwards and after 2009 for state jurisdictions. Additionally, we have foreign net operating losses that have an indefinite life. Generally, we are no longer subject to non-U.S. income tax examinations by tax authorities for tax years prior to 2008. We are no longer subject to examination by U.S federal income tax authorities for tax years prior to 2010.

## 11. DEFINED CONTRIBUTION PLANS

Our tax-deferred savings plan under our 401(k) Plan, permits participating employees to defer a portion of their pre-tax earnings. In Canada, we have a Group Registered Retirement Savings Plan program (the "RRSP") which permits participants to make tax deductible contributions. Our Board approved 50% matching contributions on employee contributions up to 4% of each employee's eligible earnings. Our matching contributions to the 401(k) Plans and RRSP during the three months ended March 31, 2015 and March 31, 2014 were $0.8 million and $0.6 million, respectively.

## 12. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. We have one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, we have determined that we have one operating segment, and therefore, one reportable segment.

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Revenue by geographic region is based on the billing address of the customer. The following table sets forth revenue (in thousands):

| Revenue | Three Months Ended March 31, 2015 | March 31, 2014 |
|---|---|---|
| Americas: | | |
| United States | $58,501 | $44,793 |
| Other Americas | 33,059 | 27,639 |
| Total Americas | 91,560 | 72,432 |
| Europe, Middle East, and Africa (“EMEA”) | 75,664 | 56,643 |
| Asia Pacific and Japan (“APAC”) | 45,662 | 39,874 |
| Total revenue | $212,886 | $168,949 |

The following table sets forth property and equipment by geographic region as of March 31, 2015 and December 31, 2014 (in thousands):

| Property and Equipment—net | March 31, 2015 | December 31, 2014 |
|---|---|---|
| Americas: | | |
| United States | $49,471 | $46,116 |
| Canada | 6,356 | 6,054 |
| Other Americas | 924 | 875 |
| Total Americas | 56,751 | 53,045 |
| EMEA | 3,723 | 3,256 |
| APAC | 3,013 | 2,618 |
| Total property and equipment—net | $63,487 | $58,919 |

The following customers, each of which is a distributor, accounted for 10% or more of our revenue:

| | Three Months Ended March 31, 2015 | | March 31, 2014 | |
|---|---|---|---|---|
| Exclusive Networks Group | 17 | % | 14 | % |
| Ingram Micro | — | % | 10 | % |

The following customers, each of which is a distributor, accounted for 10% or more of net accounts receivable:

| | March 31, 2015 | | December 31, 2014 | |
|---|---|---|---|---|
| Exclusive Networks Group | 19 | % | 18 | % |
| Fine Tec Computer | 12 | % | — | % |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

## 13. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes the changes in accumulated balances of other comprehensive income (loss) (in thousands):

| | Unrealized Gains (Losses) on Investments | Tax benefit (provision) related to items of other comprehensive income (loss) | Total |
|---|---|---|---|
| Beginning balance as of December 31, 2014 | $(540) | $191 | $(349) |
| Other comprehensive income before reclassifications | 889 | (311) | 578 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (4) | 1 | (3) |
| Net current-period other comprehensive income | 885 | (310) | 575 |
| Ending balance as of March 31, 2015 | $345 | $(119) | $226 |

The following table provides details about the reclassification out of accumulated other comprehensive income (loss) (in thousands):

Three Months Ended March 31, 2015

| 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 | $(4) | Other expense—net |
| Tax provision related to items of other comprehensive income | 1 | Provision for income taxes |
| Total reclassification for the period | $(3) | |

## 14. FOREIGN CURRENCY DERIVATIVES

Our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency translation risk. However, a substantial portion of our operating expenses incurred outside the U.S. are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Canadian dollar (“CAD”) and the Euro (“EUR”). To help protect against significant fluctuations in value and the volatility of future cash flows caused by changes in currency exchange rates, we engage in foreign currency risk management activities, including forward contracts, to hedge balance sheet items denominated in CAD. We do not use these contracts for speculative or trading purposes. All of the derivative instruments are with high quality financial institutions and we monitor the creditworthiness of these parties. These contracts typically have maturities of one month. We record changes in the fair value of forward exchange contracts related to balance sheet accounts as Other expense—net in the condensed consolidated statement of operations.

Additionally, independent of any hedging activities, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in Other expense—net in our condensed consolidated statements of operations.

Our hedging activities are intended to reduce, but not eliminate, the impact of currency exchange rate movements. As our hedging activities are relatively short-term in nature and are focused on CAD, long-term material changes in the value of the U.S. dollar against other foreign currencies, such as the GBP and EUR could adversely impact our operating expenses in the future.

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

The notional amount of forward exchange contracts to hedge balance sheet accounts were (in thousands):

| | Buy/Sell | Notional |
|---|---|---|
| Currency—As of March 31, 2015 | | |
| CAD | Sell | $9,093 |
| Currency—As of December 31, 2014 | | |
| CAD | Buy | $6,879 |

## 15. RELATED PARTY TRANSACTIONS

The son of one member of our Board is a partner of an outside law firm that we utilize for certain complex litigation matters. Expenses for legal services provided by the law firm related to matters that arose subsequent to the member joining our Board were $1.9 million and $0.3 million for the three months ended March 31, 2015 and March 31, 2014, respectively. Amounts due and payable to the law firm were $1.7 million and $1.3 million as of March 31, 2015 and December 31, 2014, respectively.

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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 and Section 21E of the Exchange Act. These statements include, among other things, statements concerning our expectations regarding:

- continued growth and market share gains;
- variability in sales in certain product categories from year to year and between quarters;
- expected impact of sales of certain products;
- the proportion of our revenue that consists of our product and service revenue, and the mix of billings between products and services;
- the impact of our product innovation strategy;
- growing our sales to large enterprises, service providers, and government organizations;
- trends in revenue, costs of revenue, and gross margin;
- trends in our operating expenses, including research and development expenses, sales and marketing expenses and general and administrative expenses, and expectations regarding these expenses as a percentage of revenue;
- continued investments in research and development;
- continued investments in sales and marketing and the impact of those investments;
- expectations regarding uncertain tax benefits and our effective tax rate;
- expectations regarding spending related to capital expenditures;
- competition in our markets;
- our intentions regarding repatriation of cash, cash equivalents and investments held by our international subsidiaries and the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next 12 months; and
- 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” in Part II, Item 1A of 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 high performance cyber security solutions to some of the largest enterprise, service providers and government organizations across the globe, including a majority of the 2014 Fortune 100. Our cyber security solutions are fast and secure and designed to provide broad, high-performance protection against dynamic security threats while simplifying the information technology (“IT”) infrastructure of our end-customers worldwide.

Our flagship integrated network security solution consists of our FortiGate physical and virtual appliance products that provide a broad array of integrated security and networking functions to protect data, applications, and users from network- and

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content-level security threats. These functions, which can be integrated in a variety of ways, include firewall, intrusion prevention, anti-malware, application control, virtual private network, web-filtering, vulnerability management, anti-spam, wireless controller, and wide area network acceleration. Our FortiGate appliances may be deployed as Next Generation Firewalls, Data Center Firewalls, Unified Threat Management systems, Internal Network Firewall, Virtual Machine Firewalls or Cloud Firewalls. Our FortiGate appliances range from the FortiGate-20 series for small businesses and branch offices to the FortiGate-5000 series for large enterprises and service providers, and are based on our proprietary technology platform. This platform includes our FortiASICs, which are specifically designed for accelerated processing of security and networking functions, and our FortiOS operating system, which provides the foundation for all FortiGate security functions. Our FortiGuard security subscription services provide end-customers with access to dynamic updates to our application control, anti-malware, intrusion prevention, web filtering, and anti-spam functionality. Our security services are based on intelligence gathered by our FortiGuard Labs team, which is comprised of a large team of threat researchers who detect threats and help protect our customers. By combining multiple proprietary security and networking functions with our purpose-built FortiASIC and FortiOS, our FortiGate solution delivers broad protection against dynamic security threats while reducing the operational burden and costs associated with managing multiple point products.

We complement our FortiGate product line with the FortiManager product family, which enables end-customers to manage the system configuration and security functions of multiple FortiGate devices from a centralized console, as well as the FortiAnalyzer product family, which enables collection, analysis and archiving of content and log data generated by our products.

We offer virtual appliances for the FortiGate, FortiManager, FortiAnalyzer, FortiWeb, FortiMail, FortiCache, and FortiADC product lines that can be used in conjunction with traditional Fortinet physical appliances, such as FortiGate, FortiManager, and FortiAnalyzer, to help ensure the visibility, management, and protection of physical and virtual environments. We also offer on-demand cloud-based versions of FortiGate and FortiWeb.

Financial Highlights

- We recorded total revenue of $212.9 million for the three months ended March 31, 2015, an increase of 26% compared to the same period last year. Product revenue was $97.5 million during the three months ended March 31, 2015, an increase of 27% compared to the same period last year. Service revenue was $115.4 million for the three months ended March 31, 2015, an increase of 25% compared to the same period last year.

- Cash, cash equivalents and investments were $1.07 billion as of March 31, 2015, an increase of $80.8 million, or 8%, from December 31, 2014.

- Deferred revenue was $600.2 million as of March 31, 2015, an increase of $41.4 million, or 7%, from December 31, 2014.

- We generated cash flows from operating activities of $64.6 million during the three months ended March 31, 2015, an increase of $3.7 million, or 6%, compared to the same period last year.

Revenue grew as a result of our focus on growth and our strategy to increase sales capacity and invest in our marketing activities. We continue to grow and strengthen our enterprise sales force. Our marketing investments are also beginning to yield returns, with improvement in lead quality and conversion rates. Our strategy is enabling us to gain market share, win new customers, and expand within existing customer accounts, especially in the enterprise market. We continue to grow the number of large deals with enterprises and service providers, which is key to our long-term growth strategy as these high-end customers tend to provide higher lifetime value and are beneficial to our business model over time.

During the three months ended March 31, 2015, our revenue growth was primarily driven by greater sales volume in our FortiGate product family due to increased demand across all product categories. Our high-end FortiGate products (FortiGate-1000 to -5000 series) accounted for 37% of billings primarily driven by continued enterprise adoption of our high-end appliances such as the FortiGate-1500D and 3700D series appliances. Our mid-range products (FortiGate-200 to -800 series) accounted for 26% of billings, and our entry-level products (FortiGate-20 to -100 series) accounted for 37% of billings.

During the three months ended March 31, 2015, while our operating expenses benefited from favorable foreign exchange rates, operating expenses increased compared to the same period last year. The increase was primarily driven by our accelerated pace of hiring and marketing investments to support our growth as we continued to invest in expanding our sales coverage, marketing capabilities, developing new products and scaling our customer support organization to meet the needs of

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our customer base. Headcount, including full time equivalent employees, increased to 3,076 as of March 31, 2015 from 2,389 as of March 31, 2014.

Key Financial 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. The following table summarizes revenue, deferred revenue, billings (non-GAAP), cash, cash equivalents and investments, net cash provided by operating activities, and free cash flow (non-GAAP). We discuss revenue below under "—Results of Operations," and we discuss our cash, cash equivalents, and investments, and net cash provided by operating activities below under "—Liquidity and Capital Resources." Deferred revenue, billings (non-GAAP), and free cash flow (non-GAAP) are discussed immediately below the following table.

| | Three Months Ended Or As Of | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| | (in thousands) | |
| Revenue | $212,886 | $168,949 |
| Deferred revenue | $600,171 | $451,303 |
| Increase in deferred revenue | $41,414 | $18,675 |
| Billings (non-GAAP) | $254,300 | $187,624 |
| Cash, cash equivalents and investments | $1,072,565 | $888,314 |
| Net cash provided by operating activities | $64,619 | $60,902 |
| Free cash flow (non-GAAP) | $59,692 | $49,584 |

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 FortiGuard security subscription and FortiCare support service contracts. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods.

Billings (Non-GAAP).We define billings as 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 combination(s) during the period, if any. We consider billings to be a useful metric for management and investors because billings drives deferred revenue, which is an important indicator of the health and viability of our business, and historically the recognition of previously deferred revenue represented a majority of the quarterly revenue that we recognize. There are a number of limitations related to the use of billings versus revenue calculated in accordance with GAAP. First, billings include amounts that have not yet been recognized as revenue. Second, we may calculate billings in a manner that is different from peer companies that report similar financial measures. Management compensates for these limitations by providing specific information regarding GAAP revenue and evaluating billings together with revenue calculated in accordance with GAAP. A reconciliation of billings to revenue, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| | (in thousands) | |
| Billings: | | |
| Revenue | $212,886 | $168,949 |
| Increase in deferred revenue | 41,414 | 18,675 |

| | | |
|---|---|---|
| Total billings (Non-GAAP) | $254,300 | $187,624 |

Free cash flow (Non-GAAP). We define free cash flow as net cash provided by operating activities minus capital expenditures. We consider free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after the acquisition of property and equipment, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, repurchasing outstanding common stock, and strengthening the balance sheet. Analysis of free cash flow facilitates management's comparisons of our operating results to competitors' operating results. A limitation of using free cash flow versus the GAAP measure of net cash

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provided by operating activities as a means for evaluating liquidity is that free cash flow does not represent the total increase or decrease in the cash, cash equivalents and investments balance for the period because free cash flow excludes cash used for capital expenditures and also excludes cash provided by or used for other investing and financing activities. Management compensates for this limitation by providing information about our capital expenditures and other investing and financing activities on the face of the cash flow statement and under "—Liquidity and Capital Resources." A reconciliation of free cash flow to net cash provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

| | Three Months Ended | |
|---|---|---|
| | March 31, 2015 | March 31, 2014 |
| | (in thousands) | |
| Free Cash Flow: | | |
| Net cash provided by operating activities | $64,619 | $60,902 |
| Less purchases of property and equipment | (4,927) | (11,318) |
| Free cash flow (Non-GAAP) | $59,692 | $49,584 |

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, cost of revenue, expenses, and related disclosures. Our estimates include those related to revenue recognition, stock-based compensation expense, valuation of inventory, warranty liabilities, investments, goodwill and other long-lived assets 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. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

There have been no material changes to our critical accounting policies and estimates as of and for the three months ended March 31, 2015, as compared to the critical accounting policies and estimates described in the Form 10-K.

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Results of Operations

Revenue

| | Three Months Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | March 31, 2015 | | | March 31, 2014 | | | | | | |
| | Amount | % of Revenue | | Amount | % of Revenue | | Change | % Change | |
| | (in thousands, except percentages) | | | | | | | | |
| Revenue: | | | | | | | | | |
| Product | $97,509 | 46 | % | $76,765 | 45 | % | $20,744 | 27 | % |
| Service | 115,377 | 54 | | 92,184 | 55 | | 23,193 | 25 | |
| Total revenue | $212,886 | 100 | % | $168,949 | 100 | % | $43,937 | 26 | % |
| Revenue by geography: | | | | | | | | | |
| Americas | $91,560 | 43 | % | $72,432 | 43 | % | $19,128 | 26 | % |
| EMEA | 75,664 | 36 | | 56,643 | 33 | | 19,021 | 34 | |
| APAC | 45,662 | 21 | | 39,874 | 24 | | 5,788 | 15 | |
| Total revenue | $212,886 | 100 | % | $168,949 | 100 | % | $43,937 | 26 | % |

Total revenue increased by $43.9 million, or 26%, during the three months ended March 31, 2015 compared to the same period last year. The EMEA region grew by 34% due to strong sales performance across the region. The Americas region grew by 26% as we saw continued strength in the U.S. enterprise market driven by increased sales to large enterprises. The APAC region grew by 15% as we saw continued growth in certain parts of the region. Product revenue increased by $20.7 million, or 27%, during the three months ended March 31, 2015 compared to the same period last year. The increase in product revenue was primarily driven by greater sales volume in our FortiGate product family due to increased demand across all product categories for our entry-level products for smaller enterprises, our mid-range products for mid-to-large enterprises and branch deployments, and our high-end products for large enterprise and service provider customers.

Service revenue increased by $23.2 million, or 25%, during the three months ended March 31, 2015 compared to the same period last year due to the recognition of revenue from our deferred revenue balance consisting of FortiGuard security subscription and FortiCare technical support contracts sold to a larger customer base as well as the renewals of similar contracts sold in earlier periods.

Cost of revenue and gross margin

| | Three Months Ended | | | | | | |
|---|---|---|---|---|---|---|---|
| | March 31, 2015 | | March 31, 2014 | | Change | % Change | |
| | (in thousands, except percentages) | | | | | | |
| Cost of revenue: | | | | | | | |
| Product | $41,368 | | $32,139 | | $9,229 | 29 | % |
| Service | 22,234 | | 18,604 | | 3,630 | 20 | |
| Total cost of revenue | $63,602 | | $50,743 | | $12,859 | 25 | % |
| Gross margin (%): | | | | | | | |
| Product | 57.6 | % | 58.1 | % | (0.5 | )% | |
| Service | 80.7 | | 79.8 | | 0.9 | | |
| Total gross margin | 70.1 | % | 70.0 | % | 0.1 | % | |

Total gross margin remained relatively consistent during the three months ended March 31, 2015 compared to the same period last year. Product gross margin decreased by 0.5 percentage points during the three months ended March 31, 2015 compared to the same period last year primarily due to an increase in freight costs of $1.3 million and warranty costs of $1.0 million.

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Service gross margin increased by 0.9 percentage points during the three months ended March 31, 2015 as compared to the same period last year. Cost of service revenue increased by $3.6 million primarily due to a $2.9 million increase in personnel costs, including stock-based compensation, related to headcount increases, and a $0.7 million increase in depreciation and other costs.

Operating expenses

| | Three Months Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | March 31, 2015 | | | March 31, 2014 | | | Change | % Change | |
| | Amount | % of Revenue | | Amount | % of Revenue | | | | |
| | (in thousands, except percentages) | | | | | | | | |
| Operating expenses: | | | | | | | | | |
| Research and development | $35,816 | 17 | % | $29,055 | 17 | % | $6,761 | 23 | % |
| Sales and marketing | 100,609 | 47 | | 67,326 | 40 | | 33,283 | 49 | |
| General and administrative | 11,961 | 6 | | 9,010 | 5 | | 2,951 | 33 | |
| Total operating expenses | $148,386 | 70 | % | $105,391 | 62 | % | $42,995 | 41 | % |

Research and development

Research and development expense increased by $6.8 million, or 23%, during the three months ended March 31, 2015 compared to the same period last year primarily due to an increase of $3.2 million in personnel costs and $1.3 million in stock-based compensation as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Occupancy-related and other costs increased by $0.7 million and depreciation expense increased by $0.5 million. During the three months ended March 31, 2014, expenses were also lower by $1.1 million due to the reversal of a previously recorded liability for estimated contingent consideration. We intend to continue to invest in our research and development organization but expect research and development expense as a percentage of total revenue to remain at comparable levels during the remainder of 2015.

Sales and marketing

Sales and marketing expense increased by $33.3 million, or 49%, during the three months ended March 31, 2015 compared to the same period last year, primarily due to an increase of $19.9 million in personnel costs as we continued to increase our sales headcount in order to drive continued market share gains globally. Marketing-related expenses increased by $3.6 million as we invested significantly in marketing to capture market share, particularly in the enterprise market, including costs related to trade-shows and lead generation campaigns. In addition, stock-based compensation expense increased by $3.6 million, depreciation and other expenses increased by $2.8 million, travel expenses increased by $1.7 million, and supplies increased by $1.6 million. As a percentage of total revenue, sales and marketing expenses increased as we accelerated the investment in our sales force and marketing campaigns to drive future growth. We intend to continue to make investments in our sales resources and infrastructure and marketing, which are critical to support growth, and expect sales and marketing expense as a percentage of total revenue to decrease during the remainder of 2015.

General and administrative

General and administrative expense increased by $3.0 million, or 33%, during the three months ended March 31, 2015 compared to the same period last year. Personnel costs, including stock-based compensation, increased by $2.6 million, as we continued to increase our headcount in order to support our expanding business. In addition, depreciation and other expenses increased by $0.3 million. We expect general and administrative expense to increase as a percentage of total revenue during the remainder of 2015.

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Interest income and other expense—net

| | Three Months Ended March 31, 2015 | March 31, 2014 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Interest income | $1,422 | $1,333 | $89 | 7 % |
| Other expense—net | (677 ) | (389 ) | (288 ) | 74 |

Interest income increased in the three months ended March 31, 2015 compared to the same period last year due to interest earned on higher invested balances of cash, cash equivalents and investments. The increase in other expense—net for the three months ended March 31, 2015 when compared to the same period last year, was the result of higher foreign exchange losses.

Provision for income taxes

| | Three Months Ended March 31, 2015 | March 31, 2014 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Provision for income taxes | $83 | $5,366 | $(5,283 ) | (98 )% |
| Effective tax rate (%) | 5 % | 39 % | (34 )% | — |

Our effective tax rate was 5% for the three months ended March 31, 2015, compared with an effective tax rate of 39% for the same period last year. The provision for income taxes for the three months ended March 31, 2015 was comprised primarily of U.S. federal and state taxes, other foreign income taxes, foreign withholding taxes, and transfer pricing allocations which impact jurisdictional income taxed at various tax rates. During the three months ended March 31, 2015, discrete items included a higher tax benefit from stock-based compensation expense and foreign exchange impact relating to uncertain tax benefit for developments in international tax that impacted the quarterly 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 March 31, 2015, we had accrued $4.5 million for estimated interest related to uncertain tax provisions.

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

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Liquidity and Capital Resources

| | As of March 31, 2015 | December 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Cash and cash equivalents | $386,352 | $283,254 |
| Investments | 686,213 | 708,490 |
| Total cash, cash equivalents and investments | $1,072,565 | $991,744 |
| | | |
| Working capital | $593,170 | $550,409 |

| | Three Months Ended March 31, 2015 | March 31, 2014 |
|---|---|---|
| | (in thousands) | |
| Cash provided by operating activities | $64,619 | $60,902 |
| Cash provided by (used) in investing activities | 16,124 | (2,364) |
| Cash provided by (used in) financing activities | 22,355 | (888) |
| Effect of exchange rates on cash and cash equivalents | — | (555) |
| Net increase in cash and cash equivalents | $103,098 | $57,095 |

Liquidity and capital resources may be impacted by our operating activities, as well as acquisitions, capital expenditures, stock repurchases, proceeds associated with stock option exercises and issuances of common stock under the ESPP, payment of taxes in connection with the net settlement of RSUs, and investments in strategic relationships that we have made or may make in the future. As of March 31, 2015, $122.5 million remains available for future share repurchases under our stock repurchase program ("Program"), which will be financed through our available working capital. In recent years, we have received significant capital resources as a result of exercises of stock options and purchases under our ESPP. We expect proceeds in future years to be impacted by our share price and the changing mix of stock options and RSUs granted. We expect to spend approximately $30.0 million to $35.0 million primarily related to expansion of our offices to support worldwide growth, as well as the implementation of our enterprise resource planning system.

As of March 31, 2015, our cash, cash equivalents, and investments of $1.07 billion were invested primarily in corporate debt securities, commercial paper, municipal bonds, certificates of deposit and term deposits, money market funds, and U.S. government and agency debt securities. It is our investment policy to invest excess cash in a manner that preserves capital, provides liquidity and maximizes return without significantly increasing risk.

As of March 31, 2015, $326.2 million of our cash and investments were held by our international subsidiaries and are therefore 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 and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending 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, share repurchases, 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.

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Operating Activities

Cash generated by operating activities is our primary source of liquidity. It is primarily comprised of net income, adjusted for non-cash items, and changes in operating assets and liabilities. Non-cash adjustments consisted primarily of stock-based compensation, depreciation of property and equipment, amortization of intangible assets, excess tax benefit from stock-based compensation, and amortization of investment premiums.

Our operating activities during the three months ended March 31, 2015 provided $64.6 million in cash as a result of profitability, timing of billings and collections, and the ability to successfully manage our working capital. The primary sources of cash from operating activities during the three months ended March 31, 2015 consisted of net income of $1.6 million increased by non-cash adjustments of $27.3 million and changes in operating assets and liabilities of $35.7 million. Changes in operating assets and liabilities primarily included an increase in payments received from customers, partially offset by an increase in payments to vendors for inventory-related purchases and prepayment of certain expenses.

Our operating activities during the three months ended March 31, 2014, provided $60.9 million in cash as a result of our growth in billings, profitability, and the ability to successfully manage our working capital. The primary sources of cash from operating activities during the three months ended March 31, 2014 consisted of net income of $8.4 million increased by non-cash adjustments of $19.2 million and changes in operating assets and liabilities of $33.3 million. During the three months ended March 31, 2014, we received $20.0 million pursuant to a six year mutual covenant-not-to-sue and release agreement with Palo Alto Networks, Inc. Changes in operating assets and liabilities primarily included an increase in payments received from customers and a receipt of cash related to the mutual covenant-not-to-sue and release agreement, partially offset by payment of income taxes during the period.

Investing Activities

The changes in cash flows from investing activities primarily relate to timing of purchases, maturities, and sales of investments, purchases of property and equipment, and payments made in connection with acquisitions.

During the three months ended March 31, 2015, cash provided by investing activities was a result of positive cash flow due to maturities, net of purchases, from our investments of $21.1 million, partially offset by capital expenditures of $4.9 million.

During the three months ended March 31, 2014, cash used by investing activities was primarily due to capital expenditures of $11.3 million, partially offset by positive cash flow due to maturities, net of purchases, from our investments of $9.0 million.

Financing Activities

The changes in cash flows from financing activities primarily relate to proceeds from the issuance of common stock under our equity incentive plan and ESPP, taxes paid related to net share settlement of equity awards, excess tax benefit from stock-based compensation, and repurchase and retirement of common stock.

During the three months ended March 31, 2015, cash provided by financing activities was $22.4 million as a result of proceeds of $29.0 million from the issuance of common stock under our stock plans. This cash inflow was partially offset by $6.6 million of tax payments related to withholding upon the issuance of RSUs.

During the three months ended March 31, 2014, we used $12.3 million to repurchase and retire our common stock and $3.6 million to pay taxes related to withholding upon issuance of RSUs. These cash outflows were partially offset by proceeds of $14.5 million from the issuance of common stock under our stock plans, as well as excess tax benefit from employee stock-based compensation of $0.6 million.

Contractual Obligations and Commitments

There have been no material changes outside the ordinary course of business during the three months ended March 31, 2015 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. See Note 8 to the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Form 10-Q for additional information regarding contractual obligations and commitments.

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## Off-Balance Sheet Arrangements

As of March 31, 2015, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

## ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in our market risk during the three months ended March 31, 2015 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 ("CEO") and chief financial officer ("CFO"), 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 March 31, 2015. 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 CEO and CFO concluded that our disclosure controls and procedures were effective as of March 31, 2015 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 CEO and CFO, 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 March 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II

ITEM 1. Legal Proceedings

We are subject to various claims, complaints and legal actions that arise from time to time in the normal course of business. We believe that the possibility that any of these claims, complaints or legal proceedings will result in a material loss is remote. There can be no assurance that existing or future legal proceedings arising in the ordinary course of business or otherwise will not have a material adverse effect on our business, consolidated financial position, results of operations or cash flows.

ITEM 1A. Risk Factors

Investing in our common stock involves a high degree of risk. Investors 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 investors may lose some or all of their 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, which may render forecasts inaccurate;
- the timing of channel partner and end-customer orders and our reliance on a concentration of shipments at the end of each quarter;
- the timing of shipments, which may depend on many factors such as inventory levels, logistics, shipping delays at ports or otherwise, 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;
- timing and level of our investments in sales and marketing;
- 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 the accuracy and timing of point of sale reporting by our “sell-through” channel

partners, 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 markets;

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- 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, partners, 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, and fluctuations may impact the actual prices that partners and customers are willing to pay for our products and services;
- decisions by potential end-customers to purchase network security solutions from newer technology providers, 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;
- changes in our estimated annual effective tax rates;
- changes in circumstances and challenges in business conditions, including decreased demand, which may negatively impact our channel partners’ ability to sell the current inventory they hold and negatively impact their future purchases of products from us;
- increased expenses, unforeseen liabilities or write-downs and any impact on results of operations from any acquisition consummated;
- our channel partners may have insufficient financial resources and may not be able to withstand changes and challenges in business conditions;
- disruptions in our channel or termination of our relationship with important channel partners;
- insolvency, credit, or other difficulties confronting our key suppliers or channel partners, affecting their ability to purchase or pay for our products and services, which could disrupt our supply or distribution 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. 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 prices for our products and services, higher default rates among our channel partners, reduced unit sales and slower or declining 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, increased competition, a decrease in the growth of our overall market, softness in demand in certain geographies or industry verticals, such as the service provider industry, if we fail for any reason to continue to capitalize on growth opportunities, and due to other risks identified in the risk factors. Our expenses as a percentage of total revenue may be higher than expected if our revenue is lower than expected and if our investments in sales and marketing and other functional areas do not result in expected billings and revenue growth, 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 FortiGuard security subscription and FortiCare technical support services which may decline, and because we recognize revenue from FortiGuard security subscription and FortiCare technical support services over the term of the relevant service period, downturns or upturns in sales of FortiGuard security subscription and FortiCare technical support services are not immediately reflected in full in our operating results.

Our FortiGuard security subscription and FortiCare technical support services revenue has historically accounted for a significant percentage of our total revenue. Sales of new, or renewals of existing, FortiGuard security subscription and FortiCare technical support services contracts may decline and fluctuate as a result of a number of factors, including fluctuations in purchases of FortiGate appliances, 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 renewals of existing FortiGuard security subscription and FortiCare technical 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 FortiGuard security subscription or FortiCare technical support services in arrears or for shorter periods of time than annually, such as monthly or quarterly, this may negatively impact our billings and revenue. Furthermore, we recognize FortiGuard security subscription and FortiCare technical support services revenue monthly over the term of the relevant service period, which is typically from one to three years, but in some instances has been as long as five years. As a result, much of the FortiGuard security subscription and FortiCare technical support services revenue we report each quarter is the recognition of deferred revenue from FortiGuard security subscription and FortiCare technical support services contracts entered into during previous quarters. Consequently, a decline in new or renewed FortiGuard security subscription or FortiCare technical 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 sales of new, or renewals of existing, FortiGuard security subscriptions or FortiCare technical support services is not reflected in full in our statements of operations until future periods. Our FortiGuard security subscription and FortiCare technical 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 support 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;

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- protectionist policies and penalties, and local laws, requirements, policies and perceptions that may adversely impact U.S. headquartered business's sales in certain countries outside of the United States;

- costs of complying with U.S. or other foreign laws and regulations for foreign operations, including the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act 2010, import and export control laws, tariffs, trade barriers, and economic sanctions;

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

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

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

- 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 over 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 litigation, regulatory action, costs of investigation, delays in revenue recognition, delays in financial reporting, financial reporting misstatements, fines, penalties, or the prohibition of the importation or exportation of our products and services, any of which 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 government organizations. While we have increased sales to service providers and enterprises in recent periods, we have experienced less traction selling to certain government organizations and there can be no assurance that we will be successful selling to these customers. Sales to enterprises, service providers and government organizations 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 that traditionally target enterprises, service providers and government organizations 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;
- more stringent support requirements in our support service contracts, including stricter support response times, more complex 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.