

FORTINET INC
Form 10-Q
August 06, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2013

or

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

For the transition period from _____ to _____
Commission file number: 001-34511

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

Delaware	77-0560389
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1090 Kifer Road	94086
Sunnyvale, California	(Zip Code)
(Address of principal executive offices)	
(408) 235-7700	
(Registrant's telephone number, including area code)	

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

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

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

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>
(Do not check if smaller reporting company)			

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

As of July 31, 2013, there were 162,586,517 shares of the registrant's common stock outstanding.

FORTINET, INC.
 QUARTERLY REPORT ON FORM 10-Q
 For the Quarter Ended June 30, 2013
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Part I

ITEM 1. Financial Statements

FORTINET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share amounts)

	June 30, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$123,468	\$122,975
Short-term investments	379,229	290,719
Accounts receivable—Net	108,907	107,642
Inventory	33,317	21,060
Prepaid expenses and other current assets	27,479	26,878
Total current assets	672,400	569,274
PROPERTY AND EQUIPMENT—Net	27,047	25,638
LONG-TERM INVESTMENTS	311,713	325,892
GOODWILL AND OTHER INTANGIBLE ASSETS—Net	9,539	2,117
DEFERRED TAX ASSETS—Non-current	61,764	48,525
OTHER ASSETS	3,283	4,051
TOTAL ASSETS	\$1,085,746	\$975,497
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$35,964	\$20,816
Accrued liabilities	28,091	22,263
Accrued payroll and compensation	30,787	28,957
Deferred revenue	265,639	247,268
Total current liabilities	360,481	319,304
DEFERRED REVENUE—Non-current	124,043	115,917
INCOME TAXES PAYABLE—Non-current	32,628	28,778
OTHER LIABILITIES	1,409	564
Total liabilities	518,561	464,563
COMMITMENTS AND CONTINGENCIES (Note 7)		
STOCKHOLDERS' EQUITY:		
Common stock, \$0.001 par value — 300,000 shares authorized; 163,773 and 161,757 shares issued and 162,364 and 160,348 shares outstanding as of June 30, 2013 and December 31, 2012, respectively	164	162
Additional paid-in capital	437,837	400,075
Treasury stock	(2,995	) (2,995
Accumulated other comprehensive income	350	3,091
Retained earnings	131,829	110,601
Total stockholders' equity	567,185	510,934
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$1,085,746	\$975,497
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		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
REVENUE:				
Product	\$66,525	\$61,692	\$124,475	\$114,896
Services	79,668	65,412	155,564	127,550
Ratable and other revenue	1,235	1,858	3,209	3,763
Total revenue	147,428	128,962	283,248	246,209
COST OF REVENUE:				
Product	26,948	23,935	49,906	43,003
Services	16,259	12,467	31,833	23,680
Ratable and other revenue	501	725	1,097	1,487
Total cost of revenue	43,708	37,127	82,836	68,170
GROSS PROFIT:				
Product	39,577	37,757	74,569	71,893
Services	63,409	52,945	123,731	103,870
Ratable and other revenue	734	1,133	2,112	2,276
Total gross profit	103,720	91,835	200,412	178,039
OPERATING EXPENSES:				
Research and development	25,158	20,388	48,492	40,055
Sales and marketing	55,997	44,259	105,973	86,295
General and administrative	8,788	6,238	16,779	12,023
Total operating expenses	89,943	70,885	171,244	138,373
OPERATING INCOME	13,777	20,950	29,168	39,666
INTEREST INCOME	1,337	1,203	2,706	2,287
OTHER (EXPENSE) INCOME—Net	(100	) 73	115	3
INCOME BEFORE INCOME TAXES	15,014	22,226	31,989	41,956
PROVISION FOR INCOME TAXES	6,035	8,276	10,761	13,833
NET INCOME	\$8,979	\$13,950	\$21,228	\$28,123
Net income per share:				
Basic	\$0.06	\$0.09	\$0.13	\$0.18
Diluted	\$0.05	\$0.08	\$0.13	\$0.17
Weighted-average shares outstanding:				
Basic	162,247	157,474	161,767	156,742
Diluted	168,042	166,061	168,033	165,808

See notes to condensed consolidated financial statements.

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FORTINET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited, in thousands)

	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2013	2012	2013	2012
Net income	\$8,979	\$13,950	\$21,228	\$28,123
Other comprehensive (loss) income, net of reclassification adjustments:				
Foreign currency translation losses	(861)	(783)	(1,813)	(225)
Unrealized (losses) gains on investments	(1,468)	(326)	(1,426)	1,473
Unrealized gains on cash flow hedges	—	19	—	19
Tax benefit (provision) related to items of other comprehensive income or loss	513	114	498	(515)
Other comprehensive (loss) income, net of tax	(1,816)	(976)	(2,741)	752
Comprehensive income	\$7,163	\$12,974	\$18,487	\$28,875

See notes to condensed consolidated financial statements.

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

	Six Months Ended	
	June 30, 2013	June 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$21,228	\$28,123
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,322	5,077
Amortization of investment premiums	5,889	6,528
Stock-based compensation expense	20,006	15,098
Excess tax benefit from employee stock option plans	(1,894	) (5,158
Other non-cash items, net	(925	) 31
Changes in operating assets and liabilities:		
Accounts receivable—Net	(801	) 171
Inventory	(16,375	) (7,952
Prepaid expenses and other current assets	(243	) (152
Other assets	(12,442	) 1,461
Accounts payable	14,255	4,337
Accrued payroll and compensation	2,287	3,119
Accrued and other liabilities	(257	) (115
Deferred revenue	25,943	36,492
Income taxes payable	11,339	5,743
Net cash provided by operating activities	75,332	92,803
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(275,029	) (355,025
Sales of investments	16,691	44,255
Maturities of investments	176,378	209,242
Purchases of property and equipment	(3,569	) (3,855
Payments made in connection with acquisitions, net of cash acquired	(5,985	) (550
Net cash used in investing activities	(91,514	) (105,933
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	15,590	17,650
Excess tax benefit from employee stock option plans	1,894	5,158
Net cash provided by financing activities	17,484	22,808
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(809	) (442
NET INCREASE IN CASH AND CASH EQUIVALENTS	493	9,236
CASH AND CASH EQUIVALENTS—Beginning of period	122,975	71,990
CASH AND CASH EQUIVALENTS—End of period	\$123,468	\$81,226
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	\$11,640	\$6,380
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Purchase of property and equipment not yet paid	\$1,056	\$580
Liability incurred in connection with business acquisition	\$—	\$400
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 U.S. generally accepted accounting principles (“GAAP”) for interim financial information as well as the instructions to Form 10-Q and the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the fiscal year ended December 31, 2012, contained in our Annual Report on Form 10-K (“Form 10-K”) filed with the SEC on February 27, 2013. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. All intercompany balances, transactions and cash flows have been eliminated. The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the operating results for any subsequent quarter, for the full year or for any future periods. The condensed consolidated balance sheets as of December 31, 2012 are derived from the audited consolidated financial statements for the year ended December 31, 2012.

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

There have been no material changes in our significant accounting policies as of and for the three and six months ended June 30, 2013, as compared to the significant accounting policies described in the Form 10-K, except for the inclusion of policies related to goodwill and other indefinite-lived assets.

Goodwill and other indefinite-lived intangible assets

Goodwill represents the excess of purchase consideration over the estimated fair value of net assets of businesses acquired in a business combination. Goodwill and other indefinite-lived intangible assets such as in-process research and development acquired in a business combination are not amortized, but instead tested for impairment at least annually during the fourth quarter. We perform our annual goodwill impairment analysis at the reporting unit level. As of June 30, 2013, we had one reporting unit.

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

flows that the reporting unit is expected to generate over its remaining life. Under the market approach, we estimate fair value of our reporting unit based on an analysis that compares the value of the reporting unit to values of other companies in similar lines of business. If the fair value of the reporting unit does not exceed its carrying value, then we perform the second step to measure the amount of impairment loss. The amount of impairment is determined by comparing the implied fair value of reporting unit goodwill to the carrying value of the goodwill. When the carrying value of the reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference.

Determining the fair value of the reporting unit is highly judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220)—Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (“ASU 2013-02”). ASU 2013-02 requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. We adopted ASU 2013-02 on January 1, 2013, and presented the effects within Note 15, Accumulated Other Comprehensive Income.

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

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2. FINANCIAL INSTRUMENTS AND FAIR VALUE

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

	June 30, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	576,447	1,188	(919)	) 576,716
Commercial paper	71,844	15	(7)	) 71,852
Municipal bonds	34,387	63	(12)	) 34,438
Certificates of deposit and term deposits	7,933	4	(1)	) 7,936
Total available-for-sale securities	690,611	1,270	(939)	) 690,942
	December 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	529,738	1,814	(161)	) 531,391
Commercial paper	39,229	22	(6)	) 39,245
Municipal bonds	36,787	83	—	) 36,870
Certificates of deposit and term deposits	9,099	6	—	) 9,105
Total available-for-sale securities	614,853	1,925	(167)	) 616,611

The following table shows the gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position, as of June 30, 2013 (\$ amounts in 000's):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	262,379	(919)	) —	—	262,379	(919)
Commercial paper	18,372	(7)	) —	—	18,372	(7)
Municipal bonds	10,370	(12)	) —	—	10,370	(12)
Certificate of deposit	1,000	(1)	) —	—	1,000	(1)
Total available-for-sale securities	292,121	(939)	) —	—	292,121	(939)

The following table shows the gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position, as of December 31, 2012 (\$ amounts in 000's):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	133,006	(156)	) 5,010	(5)	) 138,016	(161)
Commercial paper	8,464	(6)) —	—	8,464	(6)
Total available-for-sale securities	141,470	(162)) 5,010	(5)) 146,480	(167)

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

	June 30, 2013	December 31, 2012
Due within one year	379,229	290,719
Due within one to three years	311,713	325,892
Total	690,942	616,611

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

The following table presents the fair value of our financial assets measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012 (\$ amounts in 000's):

	June 30, 2013			December 31, 2012		
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)
Assets:						
Corporate debt securities	576,716	—	576,716	531,391	—	531,391
Commercial paper	75,977	—	75,977	41,994	—	41,994
Municipal bonds	34,438	—	34,438	36,870	—	36,870
Certificates of deposit and term deposits	7,936	—	7,936	9,105	—	9,105
Money market funds	6,674	6,674	—	39,871	39,871	—
Total	701,741	6,674	695,067	659,231	39,871	619,360
Reported as:						
Cash equivalents	10,799			42,620		
Short-term investments	379,229			290,719		
Long-term investments	311,713			325,892		
Total	701,741			659,231		

We did not hold financial assets or liabilities which were recorded at fair value using inputs in the Level 3 category as of June 30, 2013 or December 31, 2012. There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the three and six months ended June 30, 2013.

3. INVENTORY

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

June 30, 2013	December 31, 2012
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Raw materials	6,625	4,958
Finished goods	26,692	16,102
Inventory	33,317	21,060

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

4. PROPERTY AND EQUIPMENT—Net

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

	June 30, 2013	December 31, 2012
Land	13,895	13,895
Building and building improvements	610	610
Evaluation units	21,154	18,322
Computer equipment and software	20,478	17,176
Furniture and fixtures	1,666	1,501
Leasehold improvements and tooling	5,368	5,354
Total property and equipment	63,171	56,858
Less: accumulated depreciation	(36,124	) (31,220
Property and equipment—net	27,047	25,638

Depreciation expense was \$3.4 million and \$2.4 million for the three months ended June 30, 2013 and June 30, 2012, respectively. Depreciation expense was \$6.6 million and \$4.5 million for the six months ended June 30, 2013 and June 30, 2012, respectively.

5. 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”), and the employee stock purchase plan (“ESPP”). Potentially dilutive shares of common stock are determined by applying the treasury stock method.

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Numerator:				
Net income	8,979	13,950	21,228	28,123
Denominator:				
Basic shares:				
Weighted-average common stock outstanding-basic	162,247	157,474	161,767	156,742
Diluted shares:				
Weighted-average common stock outstanding-basic	162,247	157,474	161,767	156,742
Effect of potentially dilutive securities:				
Stock options	5,734	8,576	6,152	9,043
RSUs	32	—	46	—
ESPP	29	11	68	23
Weighted-average shares used to compute diluted net income per share	168,042	166,061	168,033	165,808
Net income per share:				
Basic	0.06	0.09	0.13	0.18
Diluted	0.05	0.08	0.13	0.17

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Stock options	7,472	7,475	7,483	6,767
RSUs	2,554	—	1,804	—
ESPP	434	311	395	298
	10,460	7,786	9,682	7,065

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6. DEFERRED REVENUE

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

	June 30, 2013	December 31, 2012
Product	4,611	5,411
Services	378,453	348,548
Ratable and other revenue	6,618	9,226
Total deferred revenue	389,682	363,185
Reported As:		
Short-term	265,639	247,268
Long-term	124,043	115,917
Total deferred revenue	389,682	363,185

7. COMMITMENTS AND CONTINGENCIES

Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2020. Rent expense was \$2.4 million and \$2.2 million for the three months ended June 30, 2013 and June 30, 2012, respectively. Rent expense was \$4.7 million and \$4.4 million for the six months ended June 30, 2013 and June 30, 2012, respectively. Rent expense is recognized using the straight-line method over the term of the lease. The aggregate future non-cancelable minimum rental payments on operating leases as of June 30, 2013 are as follows (\$ amounts in 000's):

	Rental Payment
Fiscal Years:	
2013 (remainder)	4,325
2014	5,974
2015	4,384
2016	3,968
2017	3,632
Thereafter	7,544
Total	29,827

Contract Manufacturer and Other Commitments—Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we issue non-cancelable purchase orders to some of our independent contract manufacturers. As of June 30, 2013, we had \$39.8 million of open purchase orders with our independent contract manufacturers that may not be cancelable.

In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations in the ordinary course of business for which we have not received goods or services. As of June 30, 2013, we had \$9.1 million in other purchase commitments.

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Warranties—We generally provide a 1-year warranty on hardware products and a 90-day warranty on software.

Accrued warranty activities are summarized as follows (\$ amounts in 000's):

	For The Six Months Ended	
	June 30, 2013	June 30, 2012
Accrued warranty balance—beginning of the period	2,309	2,582
Warranty costs incurred	(1,744	) (1,141
Provision for warranty	2,204	764
Changes in prior period estimates	208	(265
Accrued warranty balance—end of the period	2,977	1,940

Litigation—In August 2009, Enhanced Security Research, LLC and Security Research Holdings LLC (collectively “ESR”), a non-practicing entity, filed a complaint against us in the United States District Court for the District of Delaware alleging infringement by us and other defendants of two patents. The plaintiffs are claiming unspecified damages and requesting an injunction against the alleged infringement. In June 2010, the Court granted our motion to stay pending the outcome of reexamination proceedings in the U.S. Patent and Trademark Office (“PTO”) on both asserted patents. The PTO rejected all of the claims of the patents in the suit and ESR appealed this result to the Board of Patent Appeals and Interferences (“BPAI”). In August 2012, the BPAI completed its review of both reexamination proceedings, and, after the BPAI’s review, all claims of the asserted ESR patents remain rejected. In October 2012, ESR filed an additional appeal of the BPAI decision with the United States Court of Appeal for the Federal Circuit. That appeal is still pending. We have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred. The litigation related to ESR is no longer material to us, and we will no longer report on this case.

In July 2010, Network Protection Sciences, LLC (“NPS”), a non-practicing entity, filed a complaint in the United States District Court for the Eastern District of Texas alleging patent infringement by us and other defendants. NPS is claiming unspecified damages, including treble damages for willful infringement, and requests an injunction against such alleged infringement. In December 2011, the United States District Court for the Eastern District of Texas ordered the case to be transferred to the Northern District of California. In June 2012, the United States District Court for the Northern District of California dismissed the other defendants for misjoinder, and the case is proceeding with Fortinet as the sole defendant. We have filed a motion to dismiss the case and a separate motion for summary judgment, both of which are pending. This case is currently scheduled for a jury trial starting in September 2013. We have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

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

Indemnification—Under the indemnification provisions of our standard sales contracts, we agree to defend our customers against third-party claims asserting infringement of certain intellectual property rights, which may include

patents, copyrights, trademarks, or trade secrets, and to pay judgments entered on such claims. Our exposure under these indemnification provisions is generally limited by the terms of our contracts to the total amount paid by our customer under the agreement. However, certain agreements include indemnification provisions that could potentially expose us to losses in excess of the amount received under the agreement. To date, there have been no claims under such indemnification provisions.

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

8. STOCKHOLDERS' EQUITY

Employee Stock Options

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

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
Expected term in years	4.6	4.6
Volatility (%)	46.4	46.4 - 51.9
Risk-free interest rate (%)	0.9	0.7 - 0.9
Dividend rate (%)	—	—

There were no stock options granted during the three and six months ended June 30, 2013.

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

	Options Outstanding		Weighted- Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (\$)
	Number of Shares	Weighted- Average Exercise Price (\$)		
Balance—December 31, 2012	18,571	12.40		
Forfeited	(464	) 21.54		
Exercised	(1,687	) 5.36		
Balance—June 30, 2013	16,420	12.86		117,043
Options vested and expected to vest—June 30, 2013	16,405	12.86	3.7	117,034
Options exercisable—June 30, 2013	11,657	9.30	3.2	112,038

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 June 30, 2013, for all in-the-money options. As of June 30, 2013, total compensation expense related to unvested stock options granted to employees but not yet recognized was \$51.2 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 2.1 years.

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Weighted-average fair value per share granted	—	9.62	—	10.94

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Intrinsic value of options exercised	3,058	12,588	29,117	50,690
Fair value of options vested	5,486	4,881	16,489	13,074

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Restricted Stock Units

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

	Restricted Stock Units Outstanding	
	Number of Shares	Weighted-Average Grant-Date Fair Value per Share (\$)
Balance—December 31, 2012	830	23.73
Granted	2,711	22.12
Forfeited	(170)	) 23.36
Balance—June 30, 2013	3,371	22.35
RSUs expected to vest—June 30, 2013	3,097	22.36

As of June 30, 2013, total compensation expense related to unvested RSUs that were granted to employees and non-employees, but not yet recognized, was \$71.2 million, net of estimated forfeitures. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 3.5 years.

Employee Stock Purchase Plan

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

	Six Months Ended	
	June 30, 2013	June 30, 2012
Expected term in years	0.5	0.5
Volatility (%)	48	58
Risk-free interest rate (%)	0.1	0.2
Dividend rate (%)	—	—

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

	Six Months Ended	
	June 30, 2013	June 30, 2012
Weighted-average fair value per share granted (\$)	7.02	8.08
Shares issued under the ESPP	329	288
Weighted-average price per share issued (\$)	19.91	17.51

There were no ESPP shares granted or issued during the three months ended June 30, 2013 and June 30, 2012.

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock-based Compensation Expense

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Cost of product revenue	96	88	186	152
Cost of services revenue	1,226	941	2,246	1,686
Research and development	3,291	2,292	6,057	4,249
Sales and marketing	4,594	3,475	8,712	6,918
General and administrative	1,500	1,056	2,805	2,093
Total stock-based compensation expense	10,707	7,852	20,006	15,098

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Stock options	1,215	6,681	6,701	12,997
RSUs	4,357	—	5,496	—
ESPP	5,135	1,171	7,809	2,101
Total stock-based compensation expense	10,707	7,852	20,006	15,098

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

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Income tax benefit from employee stock option plans	2,794	3,713	6,381	10,387

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9. INCOME TAXES

The effective tax rate was 40% for the three months ended June 30, 2013, compared to an effective tax rate of 37% for the three months ended June 30, 2012. The effective tax rate was 34% for the six months ended June 30, 2013, compared to an effective tax rate of 33% for the six months ended June 30, 2012. The provision for income taxes for the periods presented is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax.

As of June 30, 2013 and December 31, 2012, unrecognized tax benefits were \$31.2 million and \$27.8 million, respectively. The total amount of \$30.8 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 June 30, 2013, we had accrued approximately \$2.2 million for estimated interest related to uncertain tax provisions.

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

10. EMPLOYEE BENEFIT PLAN

The 401(k) tax-deferred savings plan (the “401(k) Plan”) permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code of 1986, as amended. Under the 401(k) Plan, participating employees may defer a portion of their pre-tax earnings, up to the annual contribution limit specified by the Internal Revenue Service (“IRS”). In Canada, we have a Group Registered Retirement Savings Plan program (the “RRSP”) which permits participants to make tax deductible contributions up to the maximum contribution limits under the Income Tax Act. Our matching contributions to the 401(k) Plan and RRSP were \$0.5 million for each of the three months ended June 30, 2013 and June 30, 2012. Our matching contributions to the 401(k) Plan and RRSP were \$1.1 million and \$0.9 million for the six months ended June 30, 2013 and June 30, 2012, respectively.

11. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

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

Revenue	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Americas:				
United States	38,815	34,190	73,603	65,309
Other Americas	21,211	17,732	39,050	33,044
Total Americas	60,026	51,922	112,653	98,353
Europe, Middle East and Africa (“EMEA”)	50,801	43,664	98,127	84,550
Asia Pacific and Japan (“APAC”)	36,601	33,376	72,468	63,306
Total revenue	147,428	128,962	283,248	246,209

During the three and six months ended June 30, 2013, one distributor, Exclusive Networks Group, accounted for 11% and 12% of revenue, respectively. During the three and six months ended June 30, 2012, one distributor, Exclusive Networks Group, accounted for 11% and 12% of total revenue, respectively.

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	June 30, 2013	December 31, 2012
Property and Equipment		
Americas:		
United States	19,704	18,764
Canada	4,268	4,376
Other Americas	61	87
Total Americas	24,033	23,227
EMEA	1,402	1,213
APAC	1,612	1,198
Total property and equipment—net	27,047	25,638

12. FOREIGN CURRENCY DERIVATIVES

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

	Buy/Sell	Notional
Balance Sheet Contracts:		
Currency - As of June 30, 2013		
CAD	Buy	23,025
Currency - As of December 31, 2012		
CAD	Buy	17,968

13. BUSINESS COMBINATIONS

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

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

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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

Of the total acquired identified intangible assets, we allocated \$2.3 million to developed technology, \$0.5 million to customer relationships, and \$2.6 million to in-process research and development. Identified finite-lived intangible assets consist of developed technology and customer relationships that will be amortized as cost of revenue and sales and marketing expense, respectively, ratably on a straight-line basis, each over an estimated useful life of 6 years. Identified indefinite-lived intangible assets consist of in-process research and development. The goodwill of \$2.8 million represents the premium we paid over the fair value of the net tangible liabilities assumed and identified intangible assets acquired. We paid this premium for a number of reasons, primarily for acquiring developed and in-process technology. None of the goodwill recognized as a result of the acquisition is deductible for income tax purposes. The financial results of this acquisition were considered immaterial for purposes of pro-forma financial disclosures.

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

On March 8, 2012, we completed the acquisition of IntruGuard Devices, Inc. ("IntruGuard"), a supplier of Distributed Denial of Services ("DDoS"), prevention products, for a total consideration of \$1.0 million. Of the total consideration, \$0.4 million was withheld in escrow as security for IntruGuard's indemnification obligations. We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price was allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair market values as of the acquisition date. The purchase price allocation resulted in purchased tangible assets of \$53,000 and liabilities of \$43,000, and purchased identifiable intangible assets of \$0.9 million. Identifiable intangible assets consist of purchased technology. The fair value assigned to identifiable intangible assets acquired was determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by us. Purchased identifiable intangible assets are being amortized as cost of revenue ratably over three years. Of the \$0.4 million previously withheld in escrow, \$0.2 million and \$0.2 million were released to the selling

stockholders during the three months ended September 30, 2012 and the three months ended March 31, 2013, respectively. The financial results of this acquisition were considered immaterial for purposes of pro forma financial disclosures.

14. GOODWILL AND OTHER INTANGIBLE ASSETS—NET

We acquired \$2.8 million of goodwill during the six months ended June 30, 2013, which approximated the carrying value as of June 30, 2013.

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

We acquired \$2.3 million of developed technology, \$0.5 million of customer relationships, and \$2.6 million of in-process research and development during the six months ended June 30, 2013. The following tables present other intangible assets (\$ amounts in 000's):

	June 30, 2013		
	Gross	Accumulated Amortization	Net
Finite-lived other intangible assets:			
Developed technology	5,784	2,090	3,694
Customer relationships	500	21	479
	6,284	2,111	4,173
Indefinite-lived other intangible assets:			
In-process research and development	2,600	—	2,600
Total other intangible assets	8,884	2,111	6,773
	December 31, 2012		
	Gross	Accumulated Amortization	Net
Finite-lived other intangible assets:			
Developed technology	3,541	1,424	2,117
Total other intangible assets	3,541	1,424	2,117

Amortization expense was \$0.4 million and \$0.3 million for the three months ended June 30, 2013 and June 30, 2012, respectively. Amortization expense was \$0.7 million and \$0.6 million for the six months ended June 30, 2013 and June 30, 2012, respectively. The following table summarizes estimated future amortization expense of other intangible assets with finite lives for future fiscal years (\$ amounts in 000's):

	Amount
Fiscal Years:	
2013 (remainder)	758
2014	1,154
2015	738
2016	472
2017	467
Thereafter	584
Total	4,173

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FORTINET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

15. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Foreign Currency Translation Gains and Losses	Unrealized Gains and Losses on Investments	Tax benefit or provision related to items of other comprehensive income or loss	Total
Beginning balance	1,948	1,758	(615)	3,091
Other comprehensive income before reclassifications	(1,813)	(1,421)	496)	(2,738)
Amounts reclassified from accumulated other comprehensive income	—	(5)	2)	(3)
Net current-period other comprehensive income	(1,813)	(1,426)	498)	(2,741)
Ending balance	135	332	(117)	350

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

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains on investments	(5)	Other (expense) income, net
Tax provision related to items of other comprehensive income or loss	2	Provision for income taxes
Total reclassification for the period	(3)	

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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 of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended ("Exchange Act"). These statements include, among other things, statements concerning our expectations regarding:

- variability in sales in certain product categories from year to year and between quarters;
- expected impact of sales of certain products;
- continued sales into large enterprises and service providers;
- the significance of stock-based compensation as an expense;
- the proportion of our revenue that consists of our product and service revenues, and the mix of billings between products and services;
- the impact of our product innovation strategy;
- trends in revenue, costs of revenue, and gross margin;
- trends in our operating expenses, including personnel costs, research and development expense, sales and marketing expense and general and administrative expense, and expectations regarding these expenses as a percentage of revenue;
- our effective tax rate;
- the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next 12 months; and
- as well as other statements regarding our future operations, financial condition and prospects and business strategies.

These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and, in particular, the risks discussed under the heading "Risk Factors" included in Part II, Item 1A. Risk Factors and elsewhere in this Quarterly Report on Form 10-Q and in our other SEC filings, including the Form 10-K. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Business Overview

We provide network security solutions, which enable broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and governmental entities worldwide. From inception through June 30, 2013, we shipped over 1,250,000 appliances via more than 15,000 channel partners to more than 160,000 end-customers worldwide, including a majority of the 2012 Fortune Global 100.

Our core Unified Threat Management (“UTM”)/Next Generation Firewall (“NGFW”) product line of FortiGate physical and virtual appliances ships with a set of security and networking capabilities, including firewall, VPN, application control, anti-malware, intrusion prevention, Web filtering, anti-spam and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-20, designed for small businesses, to the FortiGate-5000 series for large enterprises, telecommunications carriers, and service providers. Our UTM/NGFW solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to intrusion prevention, application control, anti-malware, Web filtering, vulnerability management and anti-spam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. End-customers also often use FortiManager and FortiAnalyzer products in conjunction with a FortiGate deployment to provide centralized management, analysis and reporting capabilities.

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We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web application firewalls, databases, protection against DDoS, endpoint security for employee computers and mobile devices and wireless access point. Although sales of these complementary products have grown in recent quarters, these products still represent less than 10% of our total revenue.

Financial Highlights

We recorded total revenue of \$147.4 million and \$283.2 million during the three and six months ended June 30, 2013, respectively. This represents an increase of 14% and 15% during the three and six months ended June 30, 2013, respectively, compared to the same periods last year. Product revenue was \$66.5 million and \$124.5 million during the three and six months ended June 30, 2013, respectively, an increase of 8% during each of the periods, compared to the same periods last year. Services revenue was \$79.7 million and \$155.6 million during the three and six months ended June 30, 2013, respectively, an increase of 22% during each of the periods, compared to the same periods last year.

We generated cash flows from operating activities of \$75.3 million during the six months ended June 30, 2013, a decrease of 19% compared to the same period last year.

Cash, cash equivalents and investments were \$814.4 million as of June 30, 2013, an increase of \$74.8 million from December 31, 2012.

Deferred revenue was \$389.7 million as of June 30, 2013, an increase of \$26.5 million from December 31, 2012.

During the three and six months ended June 30, 2013, revenue grew as a result of our sales efforts and product offerings. We also continued to gain traction with several recently introduced products, including new FortiGate entry-level appliances such as the FG-60D with its WIFI counterparts; the FG-800C mid-range appliance; and the FG-3600C and FG-5001C for large enterprises and service providers.

We continue to invest in research and development to strengthen our technology leadership position, as well as sales and marketing to expand brand awareness, strengthen our value proposition, and expand our global sales team and distribution channels. During the three and six months ended June 30, 2013, we experienced higher sales volume in our FortiGate product family, particularly entry-level products, wireless security and access point products, which contributed to the largest portion of the growth during this period. Although we experienced a decline in deals valued at greater than \$500,000 during the six months ended June 30, 2013 when compared to the same period last year, during the three and six months ended June 30, 2013, we experienced an increase in the number of deals involving sales greater than \$250,000 and deals greater than \$100,000 when compared to the same periods last year. Specifically, the number of deals involving sales greater than \$500,000 was 20 and 33 in the three and six months ended June 30, 2013, respectively, compared to 19 and 38 in the three and six months ended June 30, 2012, respectively. The number of deals involving sales greater than \$250,000 was 58 and 113 in the three and six months ended June 30, 2013, respectively, compared to 55 and 102 in the three and six months ended June 30, 2012, respectively. The number of deals involving sales greater than \$100,000 was 190 and 360 in the three and six months ended June 30, 2013, respectively, compared to 168 and 321 in the three and six months ended June 30, 2012, respectively. We expect some variability in this metric, and remain focused on investing in our sales and marketing and research and development resources in order to expand our reach into new high-growth verticals and emerging markets. Moreover, such investments will allow us to meet increasing customer expectations about the quality and functionality of our products, as we continue to sell to large enterprises and service providers. While we have experienced some success selling to large enterprises, across key verticals, including service provider, government,

retail, financial services and education, we experienced slower sales in the U.S. service provider sector during the three and six months ended June 30, 2013, and there can be no assurance we will be successful selling into these vertical customer segments.

During the three and six months ended June 30, 2013, operating expenses increased by 27% and 24% compared to the same periods last year. The increase was primarily driven by additional headcount as we continued to invest in the development of new products and expand our sales coverage. Headcount increased to 2,182 as of June 30, 2013 from 1,762 as of June 30, 2012. Our accelerated pace of hiring continued during the three and six months ended June 30, 2013, particularly in sales and marketing, research and development, and technical support.

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Key Metrics

We monitor the key financial metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts, and assess operational efficiencies. Our total deferred revenue increased by \$13.3 million from \$376.4 million as of March 31, 2013 to \$389.7 million as of June 30, 2013. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period less any deferred revenue balances acquired from business combination(s) is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the revenue that we recognize in a typical quarter. As of June 30, 2013, we had \$814.4 million in cash, cash equivalents and investments and have had positive cash flow from operations every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under “—Results of Operations,” and we discuss our cash, cash equivalents, and investments under “—Liquidity and Capital Resources.” Deferred revenue and cash flow from operations are discussed immediately below the following table.

	Three Months Ended Or As Of		
	June 30,	June 30,	
	2013	2012	
	(\$ amounts in 000's)		
Revenue	147,428	128,962	
Gross margin	70	% 71	%
Operating income ⁽¹⁾	13,777	20,950	
Operating margin	9	% 16	%
Total deferred revenue	389,682	331,368	
Increase in total deferred revenue	13,268	16,796	
Cash, cash equivalents and investments	814,410	644,398	
Cash provided by operating activities	37,221	44,285	
Free cash flow (Non-GAAP) ⁽²⁾	35,186	42,054	
<hr/>			
(1) Includes:			
Stock-based compensation expense	10,707	7,852	
Patent settlement income	478	478	

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

Deferred revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. The majority of our deferred revenue balance consists of the unamortized portion of services revenue from subscription and support service contracts. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods. We define billings as revenue recognized during a period plus the change in deferred revenue from the beginning to the end of the period less any deferred revenue balances acquired from business combination(s) during the period. The following table reflects the reconciliation of billings to revenue. For a discussion of the limitations of non-GAAP financial measures, see “—Other Non-GAAP Financial Measures” below.

	Three Months Ended	
	June 30,	June 30,
	2013	2012
	(\$ amounts in 000's)	
Billings:		
Revenue	147,428	128,962

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Add increase in deferred revenue	13,268	16,796
Total billings (Non-GAAP)	160,696	145,758

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Cash flow from operations. We monitor cash flow from operations as a measure of our overall business performance. Our cash flow from operations is driven in large part by our billings growth, profitability, and our ability to successfully manage our working capital. Monitoring cash flow from operations and free cash flow enables us to analyze our financial performance excluding the non-cash effects of certain items such as depreciation, amortization and stock-based compensation expenses, thereby allowing us to better understand and manage the cash needs of our business. Free cash flow, an alternative non-GAAP financial measure of liquidity, is defined as net cash provided by operating activities less capital expenditures. The following table provides a reconciliation of free cash flow to cash provided by operating activities. For a discussion of the limitations of non-GAAP financial measures, see “—Other Non-GAAP Financial Measures” below.

	Three Months Ended	
	June 30, 2013	June 30, 2012
	(\$ amounts in 000's)	
Free Cash Flow:		
Net cash provided by operating activities	37,221	44,285
Less purchases of property and equipment	(2,035	) (2,231
Free cash flow (Non-GAAP)	35,186	42,054

Other Non-GAAP Financial Measures

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

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

These non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information prepared in accordance with GAAP. There are a number of limitations related to the use of these non-GAAP financial measures versus the nearest GAAP equivalent of these financial measures. First, these non-GAAP financial measures exclude certain recurring, non-cash charges such as stock-based compensation expense, offset by patent settlement income. Effective second quarter of fiscal 2013, our non-GAAP financial measures will include amortization expense of certain intangible assets. Prior period amounts have been adjusted to conform to current period presentation. Stock-based compensation expense has been, and will continue to be, for the foreseeable future, a significant recurring expense in our business and is an important part of our employees' overall compensation. Second, the expenses that we exclude in our calculation of these non-GAAP financial measures may differ from the expenses, if any, that our peer companies may exclude when they report their results of operations. We compensate for these limitations by providing the nearest GAAP equivalents of these non-GAAP financial measures and describing these GAAP equivalents in the section entitled “—Results of Operations” below.

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Non-GAAP gross margin represents gross margin as reported in our consolidated statements of operations, excluding the impact of stock-based compensation expense and amortization expense of certain intangible assets, both of which are non-cash charges. Non-GAAP operating income is operating income, as reported on our consolidated statements of operations, excluding the impact of stock-based compensation expense, amortization expense of certain intangible assets, and the income we received from a patent settlement. Non-GAAP operating margin is non-GAAP operating income divided by revenue. The following table reconciles GAAP gross profit, GAAP gross margin, GAAP operating income, and GAAP operating margin to non-GAAP gross margin, non-GAAP operating income, and non-GAAP operating margin for the three months ended June 30, 2013 and June 30, 2012.

	Three Months Ended		June 30,	
	June 30, 2013	% of Revenue	June 30, 2012	% of Revenue
	Amount (\$)		Amount (\$)	
	(\$ amounts in 000's)			
Total revenue	147,428		128,962	
GAAP gross profit and margin	103,720	70	91,835	71
Stock-based compensation expense	1,322	1	1,029	1
Amortization expense of certain intangible assets ⁽¹⁾	354	—	226	—
Non-GAAP gross profit and margin	105,396	71	93,090	72
GAAP operating income and margin	13,777	9	20,950	16
Stock-based compensation expense:				
Cost of revenue	1,322	1	1,029	1
Research and development	3,291	2	2,292	2
Sales and marketing	4,594	3	3,475	2
General and administrative	1,500	1	1,056	1
Total stock-based compensation expense	10,707	7	7,852	6
Amortization expense of certain intangible assets ⁽¹⁾	354	—	226	—
Patent settlement income	(478)	) —	(478)) —
Non-GAAP operating income and margin	24,360	16	28,550	22

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

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

	Three Months Ended		June 30,	
	June 30, 2013		2012	
	Amount (\$)	% of Revenue	Amount (\$)	% of Revenue
	(\$ amounts in 000's)			
Operating Expenses:				
Research and development expenses:				
GAAP research and development expenses	25,158	17	20,388	16
Stock-based compensation expense	(3,291)	(2)	(2,292)	(2)
Non-GAAP research and development expenses	21,867	15	18,096	14
Sales and marketing expenses:				
GAAP sales and marketing expenses	55,997	38	44,259	34
Stock-based compensation expense	(4,594)	(3)	(3,475)	(2)
Non-GAAP sales and marketing expenses	51,403	35	40,784	32
General and administrative expenses:				
GAAP general and administrative expenses	8,788	6	6,238	5
Stock-based compensation expense	(1,500)	(1)	(1,056)	(1)
Patent settlement income	478	—	478	—
Non-GAAP general and administrative expenses	7,766	5	5,660	4
Total operating expenses:				
GAAP operating expenses	89,943	61	70,885	55
Stock-based compensation expense	(9,385)	(6)	(6,823)	(5)
Patent settlement income	478	—	478	—
Non-GAAP operating expenses	81,036	55	64,540	50

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

	Three Months Ended	
	June 30, 2013	June 30, 2012
	(\$ and share amounts in 000's, except per share amounts)	
Net Income:		
GAAP net income	8,979	13,950
Stock-based compensation expense ⁽¹⁾	10,707	7,852
Amortization expense of certain intangible assets ⁽²⁾	354	226
Patent settlement income ⁽³⁾	(478)	(478)
Provision for income taxes ⁽⁴⁾	6,035	8,276
Non-GAAP income before provision for income taxes	25,597	29,826
Non-GAAP provision for income taxes ⁽⁵⁾	(8,447)	(10,141)
Non-GAAP net income	17,150	19,685
Non-GAAP net income per share—diluted	0.10	0.12
Shares used in per share calculation—diluted	168,042	166,061

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

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

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

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

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

Critical Accounting Policies and Estimates

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

There have been no material changes in our significant accounting policies since the fiscal year ended December 31, 2012, except for the inclusion of policies related to goodwill and other indefinite-lived intangible assets.

Goodwill and other indefinite-lived intangible assets

Goodwill represents the excess of purchase consideration over the estimated fair value of net assets of businesses acquired in a business combination. Goodwill and other indefinite-lived intangible assets such as in-process research and development acquired in a business combination are not amortized, but instead tested for impairment at least annually during the fourth quarter. We perform our annual goodwill impairment analysis at the reporting unit level. As of June 30, 2013, we had one reporting unit.

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

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

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-02, Comprehensive Income (Topic 220)-Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (“ASU 2013-02”). ASU 2013-02 requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. We adopted ASU 2013-02 on January 1, 2013, and presented the effects within Note 15, Accumulated Other Comprehensive Income, of the notes to our condensed consolidated financial statements.

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

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

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Results of Operations

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

Revenue

	Three Months Ended June 30, 2013		June 30, 2012		Change	% Change
	Amount (\$)	% of Total Revenue (\$ amounts in 000's)	Amount (\$)	% of Total Revenue		
Revenue:						
Product	66,525	45	61,692	48	4,833	8
Services	79,668	54	65,412	51	14,256	22
Ratable and other revenue	1,235	1	1,858	1	(623)	(34)
Total revenue	147,428	100	128,962	100	18,466	14