FORTINET INC
Form 10-Q
October 30, 2012

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

FORM 10-Q

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

For the quarterly period ended September 30, 2012
or

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

For the transition period from to

Commission File Number: 001-34511

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

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

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

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

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

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

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

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

As of October 23, 2012, there were 159,938,847 shares of the registrant's common stock outstanding.

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

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

	September 30, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$75,466	$71,990
Short-term investments	299,180	318,283
Accounts receivable, net of allowance for doubtful accounts of $234 and $336 at September 30, 2012 and December 31, 2011, respectively	89,843	95,522
Inventory	26,182	16,249
Deferred tax assets	7,088	7,578
Prepaid expenses and other current assets	16,893	13,948
Total current assets	514,652	523,570
PROPERTY AND EQUIPMENT—Net	26,020	7,966
DEFERRED TAX ASSETS—Non-current	50,393	46,523
LONG-TERM INVESTMENTS	315,657	148,414
OTHER ASSETS	6,546	8,274
TOTAL ASSETS	$913,268	$734,747
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$23,160	$19,768
Accrued liabilities	19,032	15,971
Accrued payroll and compensation	25,940	24,197
Deferred revenue	230,562	206,928
Total current liabilities	298,694	266,864
DEFERRED REVENUE—Non-current	109,516	87,905
OTHER LIABILITIES	26,589	21,624
Total liabilities	434,799	376,393
COMMITMENTS AND CONTINGENCIES (Note 7)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value - 300,000 shares authorized; 161,217 and 156,401 shares issued and 159,808 and 154,992 shares outstanding at September 30, 2012 and December 31, 2011, respectively	161	156
Additional paid-in-capital	388,632	317,026
Treasury stock	(2,995)	(2,995)
Accumulated other comprehensive income	3,577	402
Retained earnings	89,094	43,765
Total stockholders' equity	478,469	358,354
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$913,268	$734,747

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
REVENUE:				
Product	$63,027	$53,093	$177,923	$139,945
Services	69,782	57,835	197,332	159,192
Ratable and other revenue	3,459	5,498	7,222	13,578
Total revenue	136,268	116,426	382,477	312,715
COST OF REVENUE:				
Product	23,995	20,606	66,997	51,272
Services	13,166	9,438	36,846	25,815
Ratable and other revenue	647	1,095	2,135	4,026
Total cost of revenue	37,808	31,139	105,978	81,113
GROSS PROFIT:				
Product	39,032	32,487	110,926	88,673
Services	56,616	48,397	160,486	133,377
Ratable and other revenue	2,812	4,403	5,087	9,552
Total gross profit	98,460	85,287	276,499	231,602
OPERATING EXPENSES:				
Research and development	20,498	16,834	60,553	47,197
Sales and marketing	44,743	36,934	131,038	105,548
General and administrative	7,449	5,359	19,473	16,473
Total operating expenses	72,690	59,127	211,064	169,218
OPERATING INCOME	25,770	26,160	65,435	62,384
INTEREST INCOME	1,318	904	3,606	2,560
OTHER (EXPENSE) INCOME—Net	(317)	60	(315)	(242)
INCOME BEFORE INCOME TAXES	26,771	27,124	68,726	64,702
PROVISION FOR INCOME TAXES	9,565	9,207	23,397	18,704
NET INCOME	$17,206	$17,917	$45,329	$45,998
Net income per share:				
Basic	$0.11	$0.12	$0.29	$0.30
Diluted	$0.10	$0.11	$0.27	$0.28
Weighted-average shares outstanding:				
Basic	158,751	153,265	157,416	151,958
Diluted	166,791	163,869	166,127	163,554

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Net income	$17,206	$17,917	$45,329	$45,998
Other comprehensive income:				
Foreign currency translation gains (losses)	1,092	(1,722)	867	(797)
Unrealized gains (losses) on investments	1,968	(1,347)	3,441	(1,194)
Unrealized losses on cash flow hedges	(19)	(119)	—	(194)
Tax provision related to items of other comprehensive income	(618)	—	(1,133)	—
Net change in accumulated other comprehensive income	2,423	(3,188)	3,175	(2,185)
Comprehensive income	$19,629	$14,729	$48,504	$43,813

See notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	September 30, 2012	September 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$45,329	$45,998
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,076	5,114
Amortization of investment premiums	10,002	9,508
Stock-based compensation	23,928	12,674
Excess tax benefit from employee stock option plan	(9,611)	(9,264)
Other non-cash items, net	893	22
Changes in operating assets and liabilities:		
Accounts receivable—net	5,680	(3,559)
Inventory	(14,977)	(1,478)
Deferred tax assets	(4,515)	(5,546)
Prepaid expenses and other current assets	(71)	(1,009)
Other assets	1,885	312
Accounts payable	3,049	2,514
Accrued liabilities	2,662	4,867
Accrued payroll and compensation	1,563	1,582
Other liabilities	(1,361)	2,664
Deferred revenue	45,192	22,471
Income taxes payable	15,849	23,413
Net cash provided by operating activities	133,573	110,283
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(523,389)	(407,110)
Sales of investments	25,768	75,582
Maturities of investments	343,174	204,099
Purchases of property and equipment	(20,283)	(2,785)
Payment made in connection with business acquisition	(749)	(2,623)
Net cash used in investing activities	(175,479)	(132,837)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	36,006	14,018
Excess tax benefit from employee stock option plan	9,611	9,264
Net cash provided by financing activities	45,617	23,282
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(235)	(957)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,476	(229)
CASH AND CASH EQUIVALENTS—Beginning of period	71,990	66,859
CASH AND CASH EQUIVALENTS—End of period	$75,466	$66,630
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (refunded) for income taxes	$10,335	$(689)
NON-CASH INVESTING ACTIVITIES:		
Purchases of property and equipment not yet paid	$722	$301
Liability incurred in connection with business acquisition	$201	$—

See notes to condensed consolidated financial statements.

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

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

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

Recently Adopted Accounting Pronouncements

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

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

2. INVESTMENTS AND FAIR VALUE MEASUREMENTS

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

	September 30, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	7,600	1	—	7,601
Corporate debt securities	521,502	1,856	(102)	523,256
Commercial paper	33,814	15	—	33,829
Municipal bonds	40,210	94	(4)	40,300
Certificates of deposit and term deposits	9,844	7	—	9,851
Total available-for-sale securities	612,970	1,973	(106)	614,837

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

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

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	84,190	(98)	2,001	(4)	86,191	(102)
Municipal bonds	5,382	(4)	—	—	5,382	(4)
Total available-for-sale securities	89,572	(102)	2,001	(4)	91,573	(106)

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

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses

U.S. government and agency securities	10,996	(2)	—	—	10,996	(2)
Corporate debt securities	258,159	(1,832)	—	—	258,159	(1,832)
Commercial paper	9,279	(5)	—	—	9,279	(5)
Municipal bonds	8,067	(5)	—	—	8,067	(5)
Certificates of deposit and term deposits	7,499	(2)	—	—	7,499	(2)
Total available-for-sale securities	294,000	(1,846)	—	—	294,000	(1,846)

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

	September 30, 2012	December 31, 2011
Due within one year	299,180	318,283
Due within one to three years	315,657	148,414
Total	614,837	466,697

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

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

	September 30, 2012			December 31, 2011		
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)
Assets:						
U.S. government and agency securities	7,601	—	7,601	38,908	—	38,908
Corporate debt securities	523,256	—	523,256	337,497	—	337,497
Commercial paper	44,428	—	44,428	64,890	—	64,890
Municipal bonds	40,300	—	40,300	20,504	—	20,504
Certificates of deposit and term deposits	9,851	—	9,851	18,761	—	18,761
Money market funds	33,000	33,000	—	31,438	31,438	—
Total	658,436	33,000	625,436	511,998	31,438	480,560
Reported as:						
Cash equivalents	43,599			45,301		
Short-term investments	299,180			318,283		
Long-term investments	315,657			148,414		
Total	658,436			511,998		

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

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3. INVENTORY

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

	September 30, 2012	December 31, 2011
Raw materials	4,927	3,447
Finished goods	21,255	12,802
Inventory	26,182	16,249

4. PROPERTY AND EQUIPMENT—Net

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

	September 30, 2012	December 31, 2011
Land	13,895	—
Building and building improvements	610	—
Evaluation units	17,388	13,912
Computer equipment and software	17,449	12,219
Furniture and fixtures	1,400	1,307
Leasehold improvements and tooling	5,047	4,381
Total property and equipment	55,789	31,819
Less: accumulated depreciation	(29,769)	(23,853)
Property and equipment—net	26,020	7,966

In August 2012, we purchased certain real property including land and a building in Sunnyvale, California, for cash of $14.5 million, to support the growth in our business operations. Of the total cost, we allocated $13.9 million to land and $0.6 million to building and building improvements.

Depreciation expense was $2.7 million and $1.8 million during the three months ended September 30, 2012 and September 30, 2011, respectively. Depreciation expense was $7.2 million and $5.1 million during the nine months ended September 30, 2012 and September 30, 2011, respectively.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

5. NET INCOME PER SHARE

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

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Numerator:				
Net income	17,206	17,917	45,329	45,998
Denominator:				
Basic shares:				
Weighted-average common shares outstanding - basic	158,751	153,265	157,416	151,958
Diluted shares:				
Weighted-average common shares outstanding - basic	158,751	153,265	157,416	151,958
Effect of potentially dilutive securities:				
Employee stock options, restricted stock units, and employee stock purchase plan	8,040	10,604	8,711	11,596
Weighted-average shares used to compute diluted net income per share	166,791	163,869	166,127	163,554
Net income per share:				
Basic	0.11	0.12	0.29	0.30
Diluted	0.10	0.11	0.27	0.28

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Options to purchase common stock	5,686	5,058	6,847	3,375
RSUs	388	—	130	—
ESPP	303	186	300	186
	6,377	5,244	7,277	3,561

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

6. DEFERRED REVENUE

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

	September 30, 2012	December 31, 2011
Product	6,391	5,817
Services	322,936	272,843
Ratable and other revenue	10,751	16,173
Total deferred revenue	340,078	294,833
Reported as:		
Current	230,562	206,928
Non-current	109,516	87,905
Total deferred revenue	340,078	294,833

7. COMMITMENTS AND CONTINGENCIES

Leases—We lease certain of our facilities under various non-cancelable operating leases, which expire through 2017. Rent expense was $2.1 million for each of the three-month periods ended September 30, 2012 and September 30, 2011. Rent expense was $6.5 million and $6.1 million for the nine months ended September 30, 2012 and September 30, 2011, respectively.

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

	Rental Payment
Fiscal years:	
2012 (remainder)	2,425
2013	7,799
2014	5,024
2015	2,291
Thereafter	579
Total	18,118

Contract Manufacturer and Other Commitments—Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of September 30, 2012, we had $23.8 million of open purchase orders with our independent contract manufacturers that are not cancelable.

In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations associated with our ordinary course of business for which we have not received goods or services. As of September 30, 2012, we had $3.9 million in other purchase commitments.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

	For The Nine Months Ended And As Of September 30, 2012	For The Year Ended And As Of December 31, 2011
Accrued warranty balance - beginning of the period	2,582	1,878
Warranty costs incurred	(1,843)	(1,778)
Provision for warranty	1,604	2,103
Adjustments to previous estimates	(307)	379
Accrued warranty balance - end of the period	2,036	2,582

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

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us claiming unspecified damages in the California Superior Court for the County of Los Angeles alleging violation of various California Corporations Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company. In September 2010, the Court granted our motion to transfer the case to the California Superior Court for Santa Clara County and the plaintiff has filed several amended complaints in the Superior Court to add individual defendants, among other amendments. The Superior Court set a trial date for December 2012, but subsequently we have made progress in settlement discussions for this matter. We have determined that, as of this time, it is reasonably likely that to settle this matter, Fortinet will pay approximately $1.0 million, which has been accrued as of September 30, 2012.

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 determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

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

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

8. STOCKHOLDERS' EQUITY

Restricted Stock Units

Our 2009 Equity Incentive Plan (the “2009 Plan”) permits us to grant awards of stock options, stock appreciation rights, restricted stock, restricted stock units, and performance units or performance shares. In August 2012, we began to grant RSUs instead of stock options to employees, non-employees, and members of the board of directors. RSUs are payable in shares of our common stock as the periodic vesting requirements are satisfied. RSUs will vest over a four-year period from the date of grant if the employees, non-employees, or directors, as applicable, remain with us for the duration of the vesting period. The value of RSUs is determined based on the number of shares granted and the quoted price of our common stock on the date of grant.

The following table summarizes the RSU activity and related information 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, 2011	—	—
Granted	667	24.89
Forfeited	(14)	24.89
Vested	—	—
Balance—September 30, 2012	653	24.89
RSUs expected to vest—September 30, 2012	602	24.89

As of September 30, 2012, total compensation cost related to unvested RSUs that were granted to employees and non-employees under the 2009 Plan but not yet recognized was $16.0 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average vesting period of 3.8 years.

Stock Options

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Expected term in years	—	4.6	4.6	4.6
Volatility (%)	—	46.2	46.4 - 51.9	40.4 - 46.2
Risk-free interest rate (%)	—	1.5	0.7 - 0.9	1.5 - 2.0

Dividend rate (%)	—	—	—	—
Estimated fair value ($)	—	8.07	11.13	7.85

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

	Options Outstanding			
	Number Of Shares	Weighted-Average Exercise Price ($)	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value ($)
Balance—December 31, 2011	21,389	9.10		
Granted	3,401	26.38		
Forfeited	(1,024)	19.10		
Exercised (aggregate intrinsic value of $83,313)	(4,238)	5.92		
Balance—September 30, 2012	19,528	12.32		
Options vested and expected to vest—September 30, 2012	18,876	12.07	4.36	234,005
Options vested and exercisable—September 30, 2012	10,894	6.17	3.44	195,582

As of September 30, 2012, total compensation cost related to unvested stock options granted to employees under the 2009 plan but not yet recognized was $75.5 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of 2.7 years.

Shares Available for Grant

The following table presents the equity based awards (including stock options and RSUs) available for future issuance (in 000's)

	Shares Available For Grant
Balance—December 31, 2011	17,399
Authorized	7,750
Options granted	(3,401)
Options forfeited	1,024
Options exercised	—
RSUs granted	(667)
RSUs forfeited	14
RSUs exercised	—
Balance—September 30, 2012	22,119

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Employee Stock Purchase Plan

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Expected term in years	0.5	0.5	0.5	0.5
Volatility (%)	43.1	59.9	53.7	59.9
Risk-free interest rate (%)	0.2	0.1	0.1	0.1
Dividend rate (%)	—	—	—	—
Estimated fair value ($)	6.63	6.56	7.06	6.56

Stock-based Compensation Expense

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Cost of product revenue	85	64	237	129
Cost of services revenue	1,018	564	2,704	1,124
Research and development	2,525	1,516	6,774	2,954
Sales and marketing	3,879	2,708	10,797	6,289
General and administrative	1,323	882	3,416	2,178
	8,830	5,734	23,928	12,674

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

	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Options—employee	6,825	5,193	19,507	11,877
Options—non-employee	160	6	475	262
RSUs	576	—	576	—
ESPP	1,269	535	3,370	535
	8,830	5,734	23,928	12,674

FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

9. INCOME TAXES

The effective tax rate was 36% for the three months ended September 30, 2012, compared to an effective tax rate of 34% for the three months ended September 30, 2011. The effective tax rate was 34% for the nine months ended September 30, 2012, compared to an effective tax rate of 29% for the nine months ended September 30, 2011. The provision for income taxes for the periods presented is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax.

As of September 30, 2012 and December 31, 2011, unrecognized tax benefits were $25.2 million and $19.3 million, respectively. The total amount of $25.2 million in unrecognized tax benefits, if recognized, would favorably impact the effective tax rate.

It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of September 30, 2012, we had approximately $1.5 million accrued for estimated interest related to uncertain tax positions. We do not expect any material unrecognized tax benefits to expire within the next twelve months.

10. EMPLOYEE BENEFIT PLAN

The 401(k) tax-deferred savings plan (the “401(k) Plan”) permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code of 1986, as amended. Under the 401(k) Plan, participating employees may defer a portion of their pre-tax earnings, up to the IRS annual contribution limit. In Canada, we have a Group Registered Retirement Savings Plan program (the “RRSP Plan”) which permits participants to make tax deductible contributions up to the maximum contribution limits under the Income Tax Act. Our aggregate matching contributions to the 401(k) Plan and RRSP Plan for the three and nine months ended September 30, 2012 were $0.4 million and $1.4 million, respectively. Our aggregate matching contributions to the 401(k) Plan and RRSP Plan for the three and nine months ended September 30, 2011 were $0.4 million and $1.2 million, respectively.

11. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

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

Revenue	Three Months Ended		Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Americas:				
United States	38,674	36,565	103,983	88,838
Other Americas	18,543	13,463	51,587	37,376
Total Americas	57,217	50,028	155,570	126,214
Europe, Middle East and Africa (“EMEA”)	45,566	37,942	130,116	108,216
Asia Pacific and Japan (“APAC”)	33,485	28,456	96,791	78,285

Total revenue	136,268	116,426	382,477	312,715

During the three and nine months ended September 30, 2012, one distributor, Exclusive Networks, accounted for 10% and 11% of revenue, respectively. During the three and nine months ended September 30, 2011, no single customer or distributor accounted for 10% or more of total revenue.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Property and Equipment—Net	September 30, 2012	December 31, 2011
Americas:		
United States	18,499	2,225
Canada	4,888	4,062
Other Americas	78	33
Total Americas	23,465	6,320
EMEA	1,348	805
APAC	1,207	841
Total property and equipment—net	26,020	7,966

12. FOREIGN CURRENCY DERIVATIVES

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

	Buy/Sell	Notional
Balance Sheet Contracts:		
Currency		
CAD	Buy	16,812
EUR	Buy	5,908
GBP	Buy	3,083

13. ACQUISITION

On March 8, 2012, we completed the acquisition of IntruGuard Devices (“IntruGuard”), a leading supplier of Intelligent Availability Protection Systems, for a total consideration of $950,000. Of the total consideration, $400,000 is being withheld in escrow as security for IntruGuard's indemnification obligations. We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price has been allocated to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair market values as of the acquisition date. The purchase price allocation resulted in purchased tangible assets of $53,000 and liabilities of $43,000, and purchased identifiable intangible assets of $940,000. Identifiable intangible assets consist of purchased technology. The fair value assigned to identifiable intangible assets acquired was determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by us. Purchased identifiable intangible assets are being expensed as Cost of revenue on a straight-line basis over three years. Of the $400,000 previously withheld in escrow, $199,000 was released to the selling shareholders during the three months ended September 30, 2012.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

14. INTANGIBLE ASSETS

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

	September 30, 2012			December 31, 2011		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Existing technology	3,041	1,145	1,896	1,772	394	1,378

Amortization expense was $0.3 million and $0.2 million for the three months ended September 30, 2012 and September 30, 2011, respectively, and $0.7 million and $0.3 million for the nine months ended September 30, 2012 and September 30, 2011, respectively. The following table summarizes estimated future amortization expense of intangible assets with definite lives as of September 30, 2012 ($ amounts in 000's):

	Amount
Fiscal Years:	
2012 (remainder)	279
2013	964
2014	540
2015	108
2016	5
Total	1,896

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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 and Section 21E of the Securities Exchange Act of 1934. These statements include, among other things, statements concerning our expectations regarding:

- variability in sales in certain product categories from year to year and between quarters;
- expected impact of sales of certain products;
- continued sales into large enterprises;
- mix of billings between products and services;
- mix of service sales containing multi-year support and subscription contracts;
- the significance of stock-based compensation as an expense;
- the proportion of our revenue that consists of our product and service revenues and future trends with respect to service revenue as we renew existing services contracts and expand our customer base;
- the impact of our product innovation strategy;
- trends in revenue, costs of revenue, and gross margin;
- trends in our operating expenses, including personnel costs, research and development expense, sales and marketing expense and general and administrative expense;
- our effective tax rate; and
- the sufficiency of our existing cash and investments to meet our cash needs for at least the next 12 months;

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

Business Overview

We provide network security solutions, which enable broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and governmental entities worldwide. As of September 30, 2012, we had shipped over 1,000,000 appliances to more than 10,000 channel partners and to more than 140,000 end-customers worldwide, including a majority of the Fortune Global 100.

Our core Unified Threat Management (“UTM”) product line of FortiGate physical and virtual appliances ships with a set of security and networking capabilities, including firewall, VPN, application control, antivirus, intrusion prevention, Web filtering, antispam and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-20 series, designed for small businesses, to the FortiGate-5000 series for large enterprises, telecommunications carriers, and service providers. Sales of FortiGate products are generally balanced across entry-level (FortiGate-20 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately one-third of FortiGate sales. Our UTM solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to intrusion prevention, application control, antivirus, Web filtering, vulnerability management and antispam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. End-customers also often use FortiManager and FortiAnalyzer products in conjunction with a FortiGate

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deployment to provide centralized management, analysis and reporting capabilities. We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web application firewalls, databases, protection against denial of service attacks (DDoS) and endpoint security for employee computers and mobile devices. Sales of these complementary products have grown in recent quarters, although these products still represent less than 10% of our revenue.

In October 2012, we announced our new FortiOS 5.0 operating system. FortiOS 5.0 is our fifth generation security operating system, and this release brings more than 150 new features to our FortiGate product line. In addition, we announced version 5.0 operating systems for our FortiManager, FortiAnalyzer, and FortiClient products, to address the need for increasingly sophisticated management and analysis of the network infrastructure and endpoint devices in various environments.

In October 2012, we also announced our new FortiASIC-SoC2 processor. FortiASIC-SoC2 is our second-generation processor that combines general purpose processing power with Fortinet's custom technology to provide hardware-accelerated network security performance for our FortiGate appliances. It provides more than double the general processing capacity than its predecessor.

Financial Highlights

- We recorded revenue of $136.3 million and $382.5 million during the three and nine months ended September 30, 2012, respectively. This represents an increase of 17% and 22% during the three and nine months ended September 30, 2012, respectively, compared to the same periods last year. Revenue included $1.8 million and $2.6 million from the sales of previously-acquired patents during the three months ended September 30, 2012 and September 30, 2011, respectively. Product revenue was $63.0 million and $177.9 million during the three and nine months ended September 30, 2012, respectively, an increase of 19% and 27% during the three and nine months ended September 30, 2012, respectively, compared to the same periods last year. Services revenue was $69.8 million and $197.3 million during the three and nine months ended September 30, 2012, respectively, an increase of 21% and 24% during the three and nine months ended September 30, 2012, respectively, compared to the same periods last year.

- We generated cash flows from operating activities of $133.6 million during the nine months ended September 30, 2012, an increase of 21% compared to the same period last year.

- Cash, cash equivalents and investments were $690.3 million as of September 30, 2012, an increase of $151.6 million from December 31, 2011.

- Deferred revenue was $340.1 million as of September 30, 2012, an increase of $45.2 million from December 31, 2011.

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

We continue to invest in research and development to strengthen our technology leadership position, as well as sales and marketing to expand brand awareness, strengthen our value proposition, and expand our global sales team and distribution channels. We experienced healthy deal volumes driven by traction in enterprise data center deployments, large enterprise deals, with particular strength in the retail, financial and telecommunications sectors. The number of deals involving sales greater than $100,000 was 168 in the three months ended September 30, 2012, compared to 130 in the three months ended September 30, 2011. The number of deals involving sales greater than $250,000 was 61 in the three months ended September 30, 2012, compared to 39 in the three months ended September 30, 2011. The number of deals involving sales greater than $500,000 was 16 in the three months ended September 30, 2012, compared to 13 in the three months ended September 30, 2011. We expect some variability in this metric, and remain focused on investing in our sales and research and development resources in order to expand our reach into new high-growth verticals and emerging markets, and meet increasing customer expectations about the quality and functionality of our products, as we continue to sell to large customers, such as enterprise and service providers. While we have experienced some success selling into certain vertical customer segments, such as service providers and enterprise, we have experienced less traction selling into other verticals such as the U.S. federal government and there can be

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no assurance we will be successful selling into certain vertical customer segments.

During the three months ended September 30, 2012, operating expenses increased by 23% compared to the same period last year. The increase was primarily driven by additional headcount to support our growth as we continued to invest in the development of new products and expand our sales coverage. We also incurred $1.3 million of litigation settlement expense in the three months ended September 30, 2012. These increases were partially offset by favorable foreign currency exchange rates compared to the same period last year. Headcount increased to 1,854 at September 30, 2012 from 1,527 at September 30, 2011. Our accelerated pace of hiring continued this quarter, particularly in support, sales and marketing and research and development as we increased headcount by 92 from June 30, 2012.

Key Metrics

We monitor the key financial metrics set forth below on a quarterly basis to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. Our total deferred revenue increased by $8.7 million from $331.4 million at June 30, 2012 to $340.1 million at September 30, 2012. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the quarterly revenue that we recognize. We also ended the three months ended September 30, 2012 with $690.3 million in cash, cash equivalents and investments and have had positive cash flow from operations for every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin 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.

	For The Three Months Ended Or As Of			
	September 30, 2012		September 30, 2011	
	($ amounts in 000's)			
Revenue	136,268		116,426	
Gross margin	72	%	73	%
Operating income[(1)]	25,770		26,160	
Operating margin	19	%	22	%
Total deferred revenue	340,078		275,126	
Increase in total deferred revenue over prior quarter	8,710		1,927	
Cash, cash equivalents and investments	690,303		502,967	
Cash flows from operating activities	40,770		36,039	
Free cash flow[(2)]	24,342		34,704	

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(1) Includes:				
Stock-based compensation expense	8,830		5,734	
Patent settlement income	478		478	

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

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

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	Three Months Ended September 30, 2012	September 30, 2011
	($ amounts in 000's)	
Billings:		
Revenue	136,268	116,426
Increase in deferred revenue	8,710	1,927
Total billings (Non-GAAP)	144,978	118,353

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

	Three Months Ended September 30, 2012	September 30, 2011
	($ amounts in 000's)	
Free Cash Flow:		
Net cash provided by operating activities	40,770	36,039
Less purchases of property and equipment	(16,428)	(1,335)
Free cash flow (Non-GAAP)	24,342	34,704

Other Non-GAAP Financial Measures

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

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

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

Non-GAAP gross margin is gross margin as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense, which is a non-cash charge. Non-GAAP income from operations is operating

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

	Three Months Ended			
	September 30, 2012		September 30, 2011	
	Amount	% of Revenue	Amount	% of Revenue
	($ amounts in 000's)			
Total revenue	136,268		116,426	
GAAP gross profit and margin	98,460	72	85,287	73
Stock-based compensation expense	1,103	1	628	1
Non-GAAP gross profit and margin	99,563	73	85,915	74
GAAP income from operations and margin	25,770	19	26,160	22
Stock-based compensation expense:				
Cost of revenue	1,103	1	628	1
Research and development	2,525	1	1,516	1
Sales and marketing	3,879	3	2,708	2
General and administrative	1,323	1	882	1
Total stock-based compensation	8,830	6	5,734	5
Patent settlement	(478)	—	(478)	—
Non-GAAP income from operations and margin	34,122	25	31,416	27

Non-GAAP operating expenses exclude the impact of stock-based compensation expense and the income from a patent settlement. The following tables reconcile GAAP operating expenses to non-GAAP operating expenses for the three months ended September 30, 2012 and September 30, 2011.

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	Three Months Ended September 30, 2012		September 30, 2011	
	Amount	% of Revenue	Amount	% of Revenue
	($ amounts in 000's)			
Operating Expenses:				
Research and development expenses:				
GAAP research and development expenses	20,498	15	16,834	14
Stock-based compensation	(2,525)	(1)	(1,516)	(1)
Non-GAAP research and development expenses	17,973	14	15,318	13
Sales and marketing expenses:				
GAAP sales and marketing expenses	44,743	33	36,934	32
Stock-based compensation	(3,879)	(3)	(2,708)	(2)
Non-GAAP sales and marketing expenses	40,864	30	34,226	30
General and administrative expenses:				
GAAP general and administrative expenses	7,449	5	5,359	5
Stock-based compensation	(1,323)	(1)	(882)	(1)
Patent settlement	478	—	478	—
Non-GAAP general and administrative expenses	6,604	4	4,955	4
Total operating expenses:				
GAAP operating expenses	72,690	53	59,127	51
Stock-based compensation	(7,727)	(5)	(5,106)	(4)
Patent settlement	478	—	478	—
Non-GAAP operating expenses	65,441	48	54,499	47

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

	Three Months Ended September 30, 2012	September 30, 2011
	($ amounts in 000's)	
Net Income:		
GAAP net income	17,206	17,917
Stock-based compensation expense(1)	8,830	5,734
Patent settlement(2)	(478)	(478)
Provision for income taxes(3)	9,565	9,207
Non-GAAP income before provision for income taxes	35,123	32,380
Tax effects related to non-GAAP adjustments(4)	(11,942)	(10,685)
Non-GAAP net income	23,181	21,695
Non-GAAP net income per share - diluted	0.14	0.13

Shares used in per share calculation - diluted	166,791	163,869

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

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

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

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income before taxes.

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

Critical Accounting Policies and Estimates

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recently Adopted Accounting Pronouncements

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

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Results of Operations

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

Revenue

	Three Months Ended September 30, 2012		September 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	63,027	46	53,093	46	9,934	19
Services	69,782	51	57,835	50	11,947	21
Ratable and other revenue	3,459	3	5,498	4	(2,039)	(37)
Total revenue	136,268	100	116,426	100	19,842	17
Revenue by Geography:						
Americas	57,217	42	50,028	43	7,189	14
EMEA	45,566	33	37,942	33	7,624	20
APAC	33,485	25	28,456	24	5,029	18
Total revenue	136,268	100	116,426	100	19,842	17

Total revenue increased by $19.8 million, or 17%, during the three months ended September 30, 2012 compared to the three months ended September 30, 2011. All three regions delivered growth compared to the prior year. Product revenue increased by $9.9 million, or 19%, compared to the three months ended September 30, 2011, as we experienced higher sales volumes and increased demand for our entry-level and high-end products. Strong demand for the FortiGate-40C, FortiGate-60C and Fortigate-100D entry-level models and the FortiGate-1000C, -3240C and 5000-series high-end appliance products all contributed to the growth. Overall, the average selling price for products was slightly lower due to a greater mix of entry-level products, while unit volume increased to drive the growth, compared to the three months ended September 30, 2011. Services revenue increased by $11.9 million, or 21%, during the three months ended September 30, 2012 compared to the three months ended September 30, 2011 due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable and other revenue was due to the continuing decline in amortization of ratable revenue. Ratable and other revenue for the three months ended September 30, 2012 included a $1.8 million sale of previously-acquired patents, which was a decrease from a $2.6 million sale of previously-acquired patents in the three months ended September 30, 2011. Excluding the decline in ratable and other revenue, product and services revenue combined together increased by 20% compared to the three months ended September 30, 2011.

Cost of revenue and gross margin

	Three Months Ended September 30, 2012	September 30, 2011	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	23,995	20,606	3,389	16
Services	13,166	9,438	3,728	39
Ratable and other revenue	647	1,095	(448)	(41)

Total cost of revenue	37,808	31,139	6,669	21
Gross margin (%):				
Product	61.9	61.2	0.7	
Services	81.1	83.7	(2.6)	
Ratable and other revenue	81.3	80.1	1.2	
Total gross margin	72.3	73.3	(1.0)	

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Total gross margin decreased by 1.0 percentage point during the three months ended September 30, 2012 driven by a decline in services gross margins. Product gross margin increased by 0.7 of a percentage point during the three months ended September 30, 2012 compared to the three months ended September 30, 2011, primarily related to lower overhead and indirect product costs as a percentage of product revenue. This was partially offset by higher direct product costs as a percentage of product revenue due to a greater mix of entry-level product sales. We also continued to experience the impact from cost increases related to higher material costs incurred to support higher density storage requirements for our recent release of FortiOS 5.0, our next generation operating system. We expect these product cost increases to be temporary as we begin to bring costs down in the future. From time to time, we have experienced sales of previously reserved inventory. During the three months ended September 30, 2012, we experienced a positive impact to gross margin of 0.2 of a percentage point due to the sale of fully reserved inventory compared to a positive impact to gross margin of 0.5 of a percentage point during the three months ended September 30, 2011. The 2.6 percentage points' decrease in services gross margin was primarily due to our continued investment in our technical support team to accommodate our expanding customer base and higher demands from large enterprise customers. In addition, we experienced growth in our professional consulting services which have lower gross margins than our support and subscription services. The $3.7 million increase in services costs consisted primarily of a $2.2 million increase in cash-based personnel costs related to headcount growth, a $0.5 million increase in warranty costs, and a $0.5 million increase in other expenses. Higher stock-based compensation expense of $0.5 million also reduced services gross margin by 0.6 of a percentage point compared to the three months ended September 30, 2011.

Operating expenses

	Three Months Ended					
	September 30, 2012		September 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Operating expenses:						
Research and development	20,498	15	16,834	14.4	3,664	22
Sales and marketing	44,743	33	36,934	31.7	7,809	21
General and administrative	7,449	5	5,359	4.6	2,090	39
Total operating expenses	72,690	53	59,127	50.7	13,563	23

Research and development expense

Research and development expense increased by $3.7 million, or 22%, during the three months ended September 30, 2012 compared to the three months ended September 30, 2011, primarily due to an increase in personnel costs. Cash-based personnel costs increased by $2.2 million primarily due to increased headcount to support the development of new products and continued enhancements of our existing products. In addition, stock-compensation expense increased by $1.0 million and other expenses increased by $0.5 million. The increase in research and development expense was partially offset by a 4% year-over-year increase in the US dollar exchange rate against the Canadian dollar, as a majority of our research and development personnel are located in Canada. We intend to continue to invest in our research and development organization but expect research and development expense as a percentage of revenue to remain comparable or decline for the remainder of fiscal 2012.

Sales and marketing expense

Sales and marketing expense increased by $7.8 million, or 21%, in the three months ended September 30, 2012 compared to the three months ended September 30, 2011, primarily due to increased personnel costs. Cash-based personnel costs increased by $4.0 million due to higher salaries, commissions, and benefits resulting from increased headcount in order to expand our sales infrastructure. We also incurred a $1.2 million increase in stock-based compensation expense, a $0.9 million increase in marketing related activities, a $0.4 million increase in depreciation expense, a $0.3 million increase in litigation settlement expense, a $0.2 million increase in occupancy-related costs, and a $0.7 million increase other expenses. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth but expect sales and marketing expense as a percentage of revenue to remain at comparable levels for the remainder of fiscal 2012.

General and administrative expense

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General and administrative expense increased by $2.1 million, or 39% in the three months ended September 30, 2012, compared to the three months ended September 30, 2011. Cash-based personnel costs increased by $0.4 million, stock-based compensation expense increased by $0.4 million, supplies expense increased by $0.2 million, and professional services expenses increased by $0.1 million. In addition, we recorded an accrual of $1.0 million for litigation settlement expense. We expect general and administrative expense as a percentage of revenue to remain comparable or decline during the remainder of fiscal 2012.

Interest income and other (expense) income, net

	Three Months Ended			
	September 30, 2012	September 30, 2011	Change	% Change
	($ amounts in 000's)			
Interest income	1,318	904	414	46
Other (expense) income, net	(317)	60	(377)	*

* not meaningful

The $0.4 million increase in interest income in the three months ended September 30, 2012 compared to the three months ended September 30, 2011 was due to interest earned on higher invested balances. The $0.4 million change in other (expense) income, net was primarily due to higher foreign exchange losses for the three months ended September 30, 2012.

Provision for income taxes

	Three Months Ended			
	September 30, 2012	September 30, 2011	Change	% Change
	($ amounts in 000's)			
Provision for income taxes	9,565	9,207	358	4
Effective tax rate (%)	36	34	2	—

Our effective tax rate was 36% for the three months ended September 30, 2012, compared to an effective tax rate of 34% for the three months ended September 30, 2011.

The provision for income taxes for the three months ended September 30, 2012 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax, and includes the benefit from adjustments in our intercompany transfer pricing associated with the benefit from stock options exercised by employees in various foreign subsidiaries. During the three months ended September 30, 2012, we paid $4.0 million for income taxes. During the three months ended September 30, 2011, we paid $0.3 million for income taxes.

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

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Nine months ended September 30, 2012 and September 30, 2011

Revenue

	Nine Months Ended September 30, 2012		September 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	177,923	47	139,945	45	37,978	27
Services	197,332	52	159,192	51	38,140	24
Ratable and other revenue	7,222	1	13,578	4	(6,356)	(47)
Total revenue	382,477	100	312,715	100	69,762	22
Revenue by Geography:						
Americas	155,570	41	126,214	40	29,356	23
EMEA	130,116	34	108,216	35	21,900	20
APAC	96,791	25	78,285	25	18,506	24
Total revenue	382,477	100	312,715	100	69,762	22

Total revenue increased by $69.8 million, or 22%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, with all three regions growing over the prior year. Product revenue increased by $38.0 million, or 27%, compared to the nine months ended September 30, 2011. The increase in product revenue was primarily driven by strong growth in the entry-level and mid-range product lines, driven by increased sales to large enterprise customers. Overall, the average selling price for products was slightly lower due to a greater mix of entry-level and mid-range products, while unit volume increased to drive the growth, compared to the nine months ended September 30, 2011. Services revenue increased by $38.1 million, or 24%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable and other revenue was primarily due to the decline in amortization of ratable revenue. Ratable and other revenue for the nine months ended September 30, 2012 included a $1.8 million sale of previously-acquired patents, which was a decrease from a $2.6 million sale of previously-acquired patents in the nine months ended September 30, 2011. Excluding the decline in ratable and other revenue, product and services revenue combined together increased by 25% compared to the nine months ended September 30, 2011.

Cost of revenue and gross margin

	Nine Months Ended September 30, 2012	September 30, 2011	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	66,997	51,272	15,725	31
Services	36,846	25,815	11,031	43
Ratable and other revenue	2,135	4,026	(1,891)	(47)
Total cost of revenue	105,978	81,113	24,865	31

Gross margin (%):

Product	62.3	63.4	(1.1)
Services	81.3	83.8	(2.5)
Ratable and other revenue	70.4	70.3	0.1
Total gross margin	72.3	74.1	(1.8)

Total gross margin decreased by 1.8 percentage points during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, as both product and services gross margins declined. Product gross margin

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decreased 1.1 percentage points during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily related to a higher quantity of mid-range products purchased by a large retail customer with lower than average gross margins. We also experienced the impact from cost increases related to higher material costs incurred to support higher density storage requirements for our recent release of FortiOS 5.0, our next generation operating system. We expect these product cost increases to be temporary as we begin to bring costs down in the future. From time to time, we have experienced sales of previously reserved inventory. During the nine months ended September 30, 2012, we experienced a positive impact to gross margin of 0.2 of a percentage point due to the sale of fully reserved inventory compared to a positive impact to gross margin of 0.4 of a percentage point in the same period of the prior year. Services gross margin decreased by 2.5 percentage points during the nine months ended September 30, 2012 primarily due to our continued investment in our technical support organization to accommodate our expanding customer base and higher demands from enterprise customers. In addition, we experienced growth in our professional consulting services which has lower gross margins than our support and subscription businesses. Cost of services revenue increased by $11.0 million primarily due to a $6.1 million increase in cash-based personnel costs, a $1.6 million increase in stock-based compensation, a $1.4 million increase in warranty costs, a $0.5 million increase in professional services expenses, a $0.4 million increase in travel expenses, a $0.4 million increase in occupancy-related costs, and a $0.6 million increase in depreciation and other expenses.

Operating expenses

	Nine Months Ended September 30, 2012		September 30, 2011			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	($ amounts in 000's)					
Operating expenses:						
Research and development	60,553	16	47,197	15	13,356	28
Sales and marketing	131,038	34	105,548	34	25,490	24
General and administrative	19,473	5	16,473	5	3,000	18
Total operating expenses	211,064	55	169,218	54	41,846	25

Research and development expense

Research and development expense increased by $13.4 million, or 28%, in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily due to an increase of $6.5 million in cash-based personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, we incurred higher stock-based compensation expense of $3.8 million, product development expenses of $1.3 million, depreciation expense of $0.7 million, supplies expense of $0.6 million, occupancy-related costs of $0.3 million, and other expenses of $0.2 million. The increase in research and development expense was partially offset by a 3% year-over-year increase in the US dollar exchange rate against the Canadian dollar, as a majority of our research and development personnel are located in Canada. We intend to continue to invest in our research and development organization but expect expense as a percentage of revenue to remain at comparable levels for the remainder of fiscal 2012.

Sales and marketing expense

Sales and marketing expense increased by $25.5 million, or 24%, in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily due to an increase of $15.6 million in cash-based personnel costs as we continued to increase our sales headcount in order to expand our global footprint. In addition, we incurred higher stock-based compensation expense of $4.5 million, marketing-related expenses of $2.4 million, depreciation expenses of $0.9 million, occupancy-related costs of $0.5 million, travel expenses of $0.4 million, product development expenses of $0.2 million, supplies expense of $0.2 million, and other expenses of $0.7 million. As a percentage of revenue, sales and marketing expenses remained flat as we accelerated the investment in our sales force during the past year to support future growth. The increase in sales and marketing expense was partially offset by a 10% year-over-year increase in the US dollar exchange rate against the Euro. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth but expect sales and marketing expense as a percentage of revenue to remain at comparable levels for the remainder of fiscal 2012.

General and administrative expense

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General and administrative expense increased by $3.0 million, or 18%, in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. The increase was primarily due to a $1.2 million increase in stock-based compensation expense. Cash-based personnel costs increased $0.3 million, supplies expense increased by $0.3 million and other expenses increased by $0.1 million. In addition, we recorded an accrual of $1.0 million for litigation settlement expense. We expect general and administrative expense as a percentage of revenue to remain comparable or decline slightly during the remainder of fiscal 2012.

Interest income and other (expense) income, net

	Nine Months Ended			
	September 30, 2012	September 30, 2011	Change	% Change
	($ amounts in 000's)			
Interest income	3,606	2,560	1,046	41
Other (expense) income, net	(315)	(242)	(73)	*

* not meaningful

The $1.0 million increase in interest income in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 was due to interest earned on higher invested balances. The $0.1 million change in other (expense) income, net for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 was due to slightly higher foreign exchange losses.

Provision for income taxes

	Nine Months Ended			
	September 30, 2012	September 30, 2011	Change	% Change
	($ amounts in 000's)			
Provision for income taxes	23,397	18,704	4,693	25
Effective tax rate (%)	34	29	5	—

Our effective tax rate was 34% for the nine months ended September 30, 2012, compared with an effective tax rate of 29% for the nine months ended September 30, 2011. The provision for income taxes for the periods presented was comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The increase in the effective tax rate for the nine months ended September 30, 2012 was primarily due to the expiration of the U.S. federal research tax credit and a decrease in benefit from adjustments in our intercompany transfer pricing associated with stock options exercised by employees of various foreign subsidiaries. During the nine months ended September 30, 2012, we paid $10.3 million for income taxes. During the nine months ended September 30, 2011, we received a net refund of $0.7 million for income taxes.

Liquidity and Capital Resources

	September 30, 2012	December 31, 2011
	($ amounts in 000's)	
Cash and cash equivalents	75,466	71,990
Investments	614,837	466,697
Total cash, cash equivalents and investments	690,303	538,687

Working capital	215,958	256,706

As of September 30, 2012, our cash, cash equivalents and investments of $690.3 million were invested primarily in money market funds, commercial paper, corporate debt securities, municipal bonds, certificates of deposit and term deposits, and U.S. government and agency securities. As of September 30, 2012, $19.9 million of our cash was held by our international subsidiaries and is therefore not immediately available to fund domestic operations unless the cash is repatriated. We do not

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enter into investments for trading or speculative purposes. We believe that our cash from operations together with existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending necessary to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure the continuing market acceptance of our products, and any capital for acquisitions. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we were unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

Summary of Cash Flows

	Nine Months Ended	
	September 30, 2012	September 30, 2011
	($ amounts in 000's)	