FORTINET INC
Form 10-Q
August 05, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 001-34511

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

| Delaware | 77-0560389 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 899 Kifer Road<br>Sunnyvale, California | 94086 |
| (Address of principal executive offices) | (Zip Code) |

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
As of July 29, 2016, there were 172,687,823 shares of the registrant's common stock outstanding.

FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended June 30, 2016
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Part I

ITEM 1. Financial Statements

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

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $596,380 | $543,277 |
| Short-term investments | 388,388 | 348,074 |
| Accounts receivable—net of reserves for sales returns and doubtful accounts of $10,215 and $6,228 at June 30, 2016 and December 31, 2015, respectively | 254,379 | 259,563 |
| Inventory | 81,247 | 83,868 |
| Prepaid expenses and other current assets | 33,490 | 35,761 |
| Total current assets | 1,353,884 | 1,270,543 |
| LONG-TERM INVESTMENTS | 237,223 | 272,959 |
| DEFERRED TAX ASSETS | 180,782 | 119,216 |
| PROPERTY AND EQUIPMENT—net | 125,636 | 91,067 |
| OTHER INTANGIBLE ASSETS—net | 31,488 | 17,640 |
| GOODWILL | 14,235 | 4,692 |
| OTHER ASSETS | 16,930 | 14,393 |
| TOTAL ASSETS | $1,960,178 | $1,790,510 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | $56,920 | $61,500 |
| Accrued liabilities | 32,901 | 33,028 |
| Accrued payroll and compensation | 70,787 | 61,111 |
| Income taxes payable | 8,161 | 8,379 |
| Deferred revenue | 563,195 | 514,652 |
| Total current liabilities | 731,964 | 678,670 |
| DEFERRED REVENUE | 340,786 | 276,651 |
| INCOME TAX LIABILITIES | 66,304 | 60,624 |
| OTHER LIABILITIES | 16,498 | 19,188 |
| Total liabilities | 1,155,552 | 1,035,133 |
| COMMITMENTS AND CONTINGENCIES (Note 10) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock, $0.001 par value—300,000 shares authorized; 172,436 and 171,399 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively | 172 | 171 |
| Additional paid-in capital | 744,922 | 687,658 |
| Accumulated other comprehensive income (loss) | 724 | (933) |
| Retained earnings | 58,808 | 68,481 |
| Total stockholders' equity | 804,626 | 755,377 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $1,960,178 | $1,790,510 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| REVENUE: | | | | |
| Product | $136,641 | $114,777 | $261,213 | $212,286 |
| Service | 174,750 | 125,008 | 334,754 | 240,385 |
| Total revenue | 311,391 | 239,785 | 595,967 | 452,671 |
| COST OF REVENUE: | | | | |
| Product | 52,788 | 47,397 | 102,101 | 88,765 |
| Service | 31,715 | 22,101 | 60,046 | 44,335 |
| Total cost of revenue | 84,503 | 69,498 | 162,147 | 133,100 |
| GROSS PROFIT: | | | | |
| Product | 83,853 | 67,380 | 159,112 | 123,521 |
| Service | 143,035 | 102,907 | 274,708 | 196,050 |
| Total gross profit | 226,888 | 170,287 | 433,820 | 319,571 |
| OPERATING EXPENSES: | | | | |
| Research and development | 45,502 | 37,389 | 90,256 | 73,205 |
| Sales and marketing | 162,694 | 111,928 | 308,797 | 212,537 |
| General and administrative | 22,184 | 18,018 | 41,623 | 29,979 |
| Restructuring charges | 553 | — | 881 | — |
| Total operating expenses | 230,933 | 167,335 | 441,557 | 315,721 |
| OPERATING INCOME (LOSS) | (4,045) | 2,952 | (7,737) | 3,850 |
| INTEREST INCOME | 1,705 | 1,364 | 3,451 | 2,786 |
| OTHER EXPENSE—net | (1,350) | (830) | (2,662) | (1,507) |
| INCOME (LOSS) BEFORE INCOME TAXES | (3,690) | 3,486 | (6,948) | 5,129 |
| PROVISION FOR (BENEFIT FROM) INCOME TAXES | (2,302) | 2,694 | (7,678) | 2,777 |
| NET INCOME (LOSS) | $(1,388) | $792 | $730 | $2,352 |
| Net income (loss) per share (Note 8): | | | | |
| Basic | $(0.01) | $— | $— | $0.01 |
| Diluted | $(0.01) | $— | $— | $0.01 |
| Weighted-average shares outstanding: | | | | |
| Basic | 172,075 | 169,930 | 171,910 | 169,009 |
| Diluted | 172,075 | 176,234 | 175,360 | 174,983 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Net income (loss) | $(1,388) | $ 792 | $730 | $ 2,352 |
| Other comprehensive income (loss): | | | | |
| Unrealized gains (losses) on investments | 662 | (822) | 2,549 | 63 |
| Tax provision (benefit) | 232 | (287) | 892 | 23 |
| Other comprehensive income (loss)—net of taxes | 430 | (535) | 1,657 | 40 |
| Comprehensive income (loss) | $(958) | $ 257 | $2,387 | $ 2,392 |

See notes to condensed consolidated financial statements.

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

| | Six Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $730 | $2,352 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 21,841 | 13,382 |
| Amortization of investment premiums | 2,794 | 3,881 |
| Stock-based compensation | 59,249 | 40,525 |
| Other non-cash items—net | 1,192 | 1,891 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable—net | 2,022 | 9,523 |
| Inventory | (8,019) | (7,917) |
| Deferred tax assets | (27,120) | (13,072) |
| Prepaid expenses and other current assets | 2,442 | (3,492) |
| Other assets | (2,409) | (513) |
| Accounts payable | (130) | (8,383) |
| Accrued liabilities | (6,426) | (228) |
| Accrued payroll and compensation | 8,679 | 5,670 |
| Other liabilities | (2,858) | (1,884) |
| Deferred revenue | 111,082 | 97,156 |
| Income taxes payable | 5,463 | 10,033 |
| Net cash provided by operating activities | 168,532 | 148,924 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of investments | (230,855) | (229,479) |
| Sales of investments | 7,366 | 22,472 |
| Maturities of investments | 219,131 | 240,625 |
| Purchases of property and equipment | (44,399) | (15,688) |
| Payments made in connection with business acquisition, net of cash acquired | (20,660) | — |
| Net cash provided by (used in) investing activities | (69,417) | 17,930 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock | 22,972 | 42,647 |
| Taxes paid related to net share settlement of equity awards | (17,358) | (11,362) |
| Repurchase and retirement of common stock | (50,000) | — |
| Payments of debt assumed in connection with business acquisition | (1,626) | — |
| Net cash provided by (used in) financing activities | (46,012) | 31,285 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 53,103 | 198,139 |
| CASH AND CASH EQUIVALENTS—Beginning of period | 543,277 | 283,254 |
| CASH AND CASH EQUIVALENTS—End of period | $596,380 | $481,393 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid for income taxes—net | $13,673 | $10,077 |
| NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Transfers of evaluation units from inventory to property and equipment | $11,449 | $8,923 |
| Liability for purchase of property and equipment and asset retirement obligations | $7,617 | $1,359 |
| Liability incurred in connection with business acquisition | $1,513 | $— |

See notes to condensed consolidated financial statements.

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FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation—The unaudited condensed consolidated financial statements of Fortinet, Inc. and its wholly-owned subsidiaries (collectively, "we," "us" or "our") have been prepared in accordance with generally accepted accounting principles in the United States ("GAAP") for interim financial information, as well as the instructions to Form 10-Q pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2015, contained in our Annual Report on Form 10-K (the "Form 10-K") filed with the SEC on February 26, 2016. In the opinion of management, all adjustments, which includes normal recurring adjustments, considered necessary for a fair presentation have been included. All intercompany balances, transactions and cash flows have been eliminated. The results of operations for the three and six months ended June 30, 2016 are not necessarily indicative of the results for the full year or for any future periods. The condensed consolidated balance sheet as of December 31, 2015 is derived from the audited consolidated financial statements for the year ended December 31, 2015.

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

There have been no material changes to our significant accounting policies as of and for the three and six months ended June 30, 2016, except for changes to our policy related to stock-based compensation expense. For more information, refer to the "Recently Adopted Accounting Standards."

Recently Adopted Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09—Compensation—Stock Compensation—Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). The new guidance changes the accounting for certain aspects of stock-based payments to employees and requires excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity apart from other income tax cash flows. The standard also allows us to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made on an employee's behalf for withheld shares should be presented as a financing activity on our cash flows statement, and provides an accounting policy election to account for forfeitures as they occur. The new standard is effective for us beginning January 1, 2017, with early adoption permitted.

We elected to early adopt the new guidance in the second quarter of 2016. The primary impact of the adoption was the recognition of excess tax benefits in our provision for income taxes rather than paid-in capital, as well as the adjustment in stock-based compensation expense as a result of our change in forfeiture policy. The new guidance eliminates the requirement to delay the recognition of excess tax benefits until it reduces current taxes payable. We adopted this change on a modified retrospective basis, and recorded unrecognized excess tax benefits amounting to $32.4 million as a cumulative-effect adjustment, which increased retained earnings on January 1, 2016. The new guidance also requires us to record, subsequent to the adoption, excess tax benefits and tax deficiencies in the period these arise. As a result, our provision for income taxes decreased by $3.6 million during the first quarter of 2016 and $2.6 million during the second quarter of 2016.

Under the new guidance, we have elected to change our policy and have started to recognize forfeitures of awards as they occur. The change in forfeiture policy was adopted using a modified retrospective transition method. We recorded a cumulative-effect adjustment to decrease retained earnings by $0.8 million upon transition on January 1, 2016 and a retrospective decrease of stock-based compensation of $2.0 million during the first quarter of 2016.

The amendment to the minimum statutory withholding tax requirements was adopted on a modified retrospective basis. The adoption had no impact on the January 1, 2016 retained earnings. In addition, we adopted the presentation of taxes paid related to net share settlement of equity awards as a financing activity on the statement of cash flows on a retrospective basis. Our adoption had no impact to any of the periods presented in our consolidated cash flows statements since such cash flows have historically been presented as a financing activity.

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

The adoption of ASU 2016-09 impacted our previously reported quarterly results for 2016, as well as our weighted average shares outstanding—diluted, as follows (in thousands, except for earnings per share):

| | Three Months Ended March 31, 2016 | |
|---|---|---|
| | As Reported | As Adjusted |
| Statements of Operations: | | |
| Stock-based compensation expense | $30,881 | $28,901 |
| Benefit from income taxes | $(1,809) | $(5,376) |
| Net income (loss) | $(3,429) | $2,118 |
| Net income (loss) per share—Basic | $(0.02) | $0.01 |
| Net income (loss) per share—Diluted | $(0.02) | $0.01 |
| Weighted-average shares outstanding—Diluted | 171,745 | 174,421 |

| | March 31, 2016 | |
|---|---|---|
| | As Reported | As Adjusted |
| Balance Sheets: | | |
| Deferred tax assets | $131,696 | $167,625 |
| Additional paid-in capital | $718,849 | $717,671 |
| Retained earnings | $23,089 | $60,196 |

In September 2015, the FASB issued ASU 2015-16—Business Combinations—Simplifying the Accounting for Measurement-Period Adjustments, which eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. Instead, acquirers must recognize measurement-period adjustments during the period in which they determine the amounts, including the effect on earnings of any amounts they would have recorded in previous periods if the accounting had been completed at the acquisition date. We adopted ASU 2015-16 on January 1, 2016. The adoption of ASU 2015-16 did not have any impact on our consolidated financial statements.

Recent Accounting Standards Not Yet Effective

In February 2016, the FASB issued ASU 2016-02—Leases, which amends lease accounting requirements to begin recording assets and liabilities arising from leases on the balance sheet. The new guidance will also require significant additional disclosures about the amount, timing and uncertainty of cash flows from leases. This new guidance will be effective for us beginning on January 1, 2019 using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. We expect our assets and liabilities to increase as a result of the adoption of this standard. We are currently evaluating the full impact ASU 2016-02 will have on our consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01—Financial Instruments—Overall—Recognition and Measurement of Financial Assets and Financial Liabilities, which modifies how entities measure equity investments and present changes in the fair value of financial liabilities. Under the new guidance, entities will have to measure equity

investments that do not result in consolidation and are not accounted under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicality exception. The practicality exception will apply to those equity investments that do not have a readily determinable fair value and do not qualify for the practical expedient to estimate fair value, and as such these investments may be measured at cost. ASU 2016-01 will be effective for us beginning on January 1, 2018. We do not expect the impact of ASU 2016-01 on our consolidated financial statements to be significant.

In July 2015, the FASB issued ASU 2015-11—Inventory—Simplifying the Measurement of Inventory, which changes the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. ASU 2015-11 applies to entities that measure inventory using a method other than last-in, first-out or the retail inventory method

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

(e.g., first-in, first-out or average cost). ASU 2015-11 will be effective for us beginning on January 1, 2017. We do not expect the impact of ASU 2015-11 on our consolidated financial statements to be significant.

In May 2014, the FASB issued ASU 2014-09—Revenue from Contracts with Customers, which creates a single, joint revenue standard that is consistent across all industries and markets for companies that prepare their financial statements in accordance with GAAP. Under ASU 2014-09, an entity is required to recognize revenue upon the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to receive in exchange for those goods or services. In July 2015, the FASB decided to delay the effective date of the new revenue standard by one year. In March 2016, the FASB issued ASU 2016-08, which clarifies the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, which clarifies the implementation guidance on identifying performance obligations and licensing. In May 2016, the FASB issued ASU 2016-12—Revenue from Contracts with Customers—Narrow-scope Improvements and Practical Expedients, which amends the guidance on collectability, noncash consideration, presentation of sales tax and transition. These standards will be effective for us beginning on January 1, 2018, with the option to adopt earlier on January 1, 2017. We are currently evaluating the impact of these new standards on our consolidated financial statements.

2. FINANCIAL INSTRUMENTS AND FAIR VALUE

Our investments as of June 30, 2016 and December 31, 2015 were (in thousands):

| | June 30, 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Corporate debt securities | $415,008 | $ 948 | $ (78) | $415,878 |
| Commercial paper | 68,406 | 5 | (3) | 68,408 |
| Municipal bonds | 52,531 | 81 | (1) | 52,611 |
| Certificates of deposit and term deposits [1] | 19,823 | — | — | 19,823 |
| U.S. government and agency securities | 68,731 | 160 | — | 68,891 |
| Total available-for-sale securities | $624,499 | $ 1,194 | $ (82) | $625,611 |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Corporate debt securities | $438,533 | $ 30 | $ (1,369) | $437,194 |
| Commercial paper | 66,263 | 3 | (34) | 66,232 |
| Municipal bonds | 61,050 | 12 | (40) | 61,022 |
| Certificates of deposit and term deposits [1] | 14,897 | — | — | 14,897 |
| U.S. government and agency securities | 41,727 | 3 | (42) | 41,688 |
| Total available-for-sale securities | $622,470 | $ 48 | $ (1,485) | $621,033 |

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

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

The gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position as of June 30, 2016 and December 31, 2015 were (in thousands):

| | June 30, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | $77,153 | $ (36) | $40,207 | $ (42) | $117,360 | $ (78) |
| Commercial paper | 6,964 | (3) | — | — | 6,964 | (3) |
| Municipal bonds | 4,548 | (1) | — | — | 4,548 | (1) |
| Total available-for-sale securities | $88,665 | $ (40) | $40,207 | $ (42) | $128,872 | $ (82) |

| | December 31, 2015 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | $348,534 | $ (1,187) | $42,033 | $ (182) | $390,567 | $ (1,369) |
| Commercial paper | 31,977 | (34) | — | — | 31,977 | (34) |
| Municipal bonds | 41,677 | (36) | 1,008 | (4) | 42,685 | (40) |
| U.S. government and agency securities | 34,703 | (42) | — | — | 34,703 | (42) |
| Total available-for-sale securities | $456,891 | $ (1,299) | $43,041 | $ (186) | $499,932 | $ (1,485) |

The contractual maturities of our investments as of June 30, 2016 and December 31, 2015 were (in thousands):

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Due within one year | $388,388 | $ 348,074 |
| Due within one to three years | 237,223 | 272,959 |
| Total | $625,611 | $ 621,033 |

Available-for-sale securities are reported at fair value, with unrealized gains and losses, net of tax, included as a separate component of stockholders' equity and in total comprehensive income. Realized gains and losses on available-for-sale securities are insignificant in the periods presented and are included in Other expense—net in our condensed consolidated statements of operations. We use the specific identification method to determine the cost basis of investments sold.

The unrealized losses on our available-for-sale securities were caused by fluctuations in market value and interest rates as a result of the economic environment. As the decline in market value are attributable to changes in market conditions and not credit quality, and because we have concluded currently that we neither intend to sell nor is it more likely than not that we will be required to sell these investments prior to a recovery of par value, we do not consider these investments to be other-than temporarily impaired as of June 30, 2016.

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

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

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

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

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

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

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

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

Fair Value of Financial Instruments

Assets Measured at Fair Value on a Recurring Basis

The fair values of our financial assets measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015 were (in thousands):

| | June 30, 2016 | | | | December 31, 2015 | | | |
|---|---|---|---|---|---|---|---|---|
| | Aggregate Fair Value | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Remaining Inputs (Level 2) | Significant Other Unobservable Remaining Inputs (Level 3) | Aggregate Fair Value | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Remaining Inputs (Level 2) | Significant Other Unobservable Remaining Inputs (Level 3) |
| Assets: | | | | | | | | |
| Corporate debt securities | $415,878 | $— | $415,878 | $— | $437,194 | $— | $437,194 | $— |
| Commercial paper | 78,406 | — | 78,406 | — | 69,231 | — | 69,231 | — |
| Municipal bonds | 52,611 | — | 52,611 | — | 61,022 | — | 61,022 | — |
| Certificates of deposit and term deposits | 19,823 | — | 19,823 | — | 14,897 | — | 14,897 | — |
| Money market funds | 49,231 | 49,231 | — | — | 50,030 | 50,030 | — | — |
| U.S. government and agency securities | 68,891 | 58,869 | 10,022 | — | 41,688 | 25,693 | 15,995 | — |
| Total | $684,840 | $108,100 | $576,740 | $— | $674,062 | $75,723 | $598,339 | $— |
| | | | | | | | | |
| Reported as: | | | | | | | | |
| Cash equivalents | $59,229 | | | | $53,029 | | | |
| Short-term investments | 388,388 | | | | 348,074 | | | |

| | | |
|---|---|---|
| Long-term investments | 237,223 | 272,959 |
| Total | $684,840 | $674,062 |

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the six months ended June 30, 2016.

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

3. INVENTORY

Our inventory as of June 30, 2016 and December 31, 2015 consisted of (in thousands):

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Raw materials | $17,042 | $ 15,425 |
| Finished goods | 64,205 | 68,443 |
| Inventory | $81,247 | $ 83,868 |

Inventory includes finished goods held by distributors where revenue is recognized on a sell-through basis of $1.7 million and $1.1 million as of June 30, 2016 and December 31, 2015, respectively. Inventory also includes materials at contract manufacturers of $5.5 million and $4.9 million as of June 30, 2016 and December 31, 2015, respectively.

4. PROPERTY AND EQUIPMENT—net
Our property and equipment—net as of June 30, 2016 and December 31, 2015 consisted of (in thousands):

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Land | $31,251 | $ 21,683 |
| Building and building improvements | 42,060 | 28,841 |
| Evaluation units | 18,299 | 15,784 |
| Computer equipment and software | 52,907 | 45,632 |
| Furniture and fixtures | 10,893 | 8,901 |
| Construction-in-progress | 13,681 | 8,106 |
| Leasehold improvements | 15,554 | 11,179 |
| Total property and equipment | 184,645 | 140,126 |
| Less: accumulated depreciation | (59,009) | (49,059) |
| Property and equipment—net | $125,636 | $ 91,067 |

Depreciation expense was $9.0 million and $6.8 million during the three months ended June 30, 2016 and June 30, 2015, respectively. Depreciation expense was $18.4 million and $12.8 million during the six months ended June 30, 2016 and June 30, 2015, respectively.

5. INVESTMENTS IN PRIVATELY-HELD COMPANIES

Our investments in the equity securities of three privately-held companies totaled $10.3 million as of June 30, 2016 and December 31, 2015. Each of these investments are accounted for as cost-basis investments, as we own less than 20% of the voting securities and do not have the ability to exercise significant influence over operating and financial policies of the respective entities. These investments are carried at historical cost and are recorded as Other assets on our condensed consolidated balance sheet and would be measured at fair value if indicators of impairment exist. As of June 30, 2016, no events have occurred that would adversely affect the carrying value of these investments.

We determined that we had a variable interest in these privately-held companies. However, we determined that we were not the primary beneficiary as we did not have the power to direct their activities that most significantly affect

their economic performance. The variable interest entities were not required to be consolidated in our condensed consolidated financial statements.

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

6. BUSINESS COMBINATIONS

AccelOps, Inc.

On June 7, 2016, we completed our acquisition of AccelOps, Inc., ("AccelOps"), a provider of network security monitoring and analytics solutions for total cash consideration of $22.3 million, of which $20.7 million was paid as of June 30, 2016 and the remaining balance was recorded as a current liability in the consolidated balance sheet as of June 30, 2016. We believe this acquisition will extend the Fortinet Security Fabric (as defined below) by enhancing our network security visibility, security data analytics, and threat intelligence across multi-vendor solutions.

The acquisition of AccelOps is accounted as a business combination in accordance with the Accounting Standards Codification Topic 805 "Business Combinations" ("ASC 805") issued by the FASB. We use our best estimates and assumptions to assign fair value to the tangible and intangible assets acquired and liabilities assumed at the acquisition date. We included acquisition-related costs of $0.3 million in general and administrative expenses. The total purchase price was allocated to AccelOps' identifiable tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. The total purchase price was allocated using the information currently available. As a result, we may continue to adjust the estimated purchase price allocation as and when additional information is available. The acquisition also included a contingent obligation for up to $4.0 million in future earn out payments to certain stockholders of AccelOps, if specified future financial targets are met for the three and six months period ended June 30, 2016 and December 31, 2016. The financial target for the three months period ended June 30, 2016 was not met. As of June 30, 2016, no fair value was assigned to the contingent consideration based on the estimated probability of attainment of the remaining target. We will remeasure the contingent consideration periodically during the six-month contingency period for the remaining target, with changes in fair value to be recorded in our consolidated statements of operations.

Total preliminary allocation of the purchase price was (in thousands):

| | |
|---|---|
| Cash and cash equivalents | $171 |
| Accounts receivable | 1,126 |
| Prepaid expenses and other assets | 430 |
| Property and equipment | 203 |
| Deferred tax assets | 2,977 |
| Finite-lived intangible assets | 15,800 |
| Indefinite-lived intangible assets in process research and development | 1,500 |
| Goodwill | 9,543 |
| Total assets acquired | 31,750 |
| Deferred revenue | 4,400 |
| Accounts payable and accrued liabilities | 3,311 |
| Other liabilities | 1,694 |
| Total liabilities assumed | 9,405 |
| Total purchase price allocation | $22,345 |

Finite-lived intangible assets consist of developed technology, customer relationships, and other. AccelOps' technology provides a software solution to manage security, performance and compliance from a single platform. The acquired developed technologies include software patents, know-how, process and designs. The value of customer

relationships is attributable to the generation of a consistent income source and the avoidance of costs associated with creating new customer relationships.

Indefinite-lived intangible assets consist of in-process research and development, which will begin to be amortized upon completion of development.

The estimated useful life and fair values of the acquired finite-lived intangible assets were as follows (in thousands, except for estimated useful life):

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

| | Estimated Useful Life (in years) | Fair Values |
|---|---|---|
| Developed technologies | 4 | $11,600 |
| Customer relationships | 3 | 4,000 |
| Other | 2 | 200 |
| Total | | $15,800 |

The developed technologies and other are amortized on a straight-line basis. The amortization expense of developed technologies and other are recorded in cost of product revenue. The amortization expense of customer relationships is amortized on an accelerated basis and is recorded in sales and marketing expenses.

The goodwill of $9.5 million represents the amount of the purchase price in excess of the fair value of the net tangible liabilities assumed and intangible assets acquired, including AccelOps' assembled workforce. The goodwill recorded as part of the AccelOps acquisition is not deductible for U.S. federal income tax purposes. The financial results of this acquisition are considered immaterial for purposes of pro forma financial disclosures.

Meru Networks, Inc.

On July 8, 2015, we completed our acquisition of Meru Networks, Inc. ("Meru"), a provider of Wi-Fi networking products and services.

In connection with the acquisition, we paid $41.8 million, comprised of cash consideration of $40.9 million, withholding tax liability of $0.4 million and $0.5 million in estimated fair value associated with restricted stock units ("RSUs") of Meru that were converted for 53,401 shares of our common stock.

We accounted for this transaction as a business combination. In 2015, we included acquisition-related costs of $1.7 million in general and administrative expenses. The total purchase price was allocated to Meru's identifiable tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date.

Total allocation of the purchase price was as follows (in thousands):

| | |
|---|---|
| Cash and cash equivalents | $ 3,268 |
| Accounts receivable | 8,191 |
| Inventory | 11,610 |
| Prepaid expenses and other assets | 2,409 |
| Property and equipment | 920 |
| Deferred tax assets | 18,585 |
| Finite-lived intangible assets | 19,600 |
| Goodwill | 1,868 |
| | 66,451 |

| | | |
|---|---|---|
| Total assets acquired | | |
| Deferred revenue | 9,800 | |
| Accounts payable and accrued liabilities | 14,887 | |
| Total liabilities assumed | 24,687 | |
| Total purchase price allocation | $ | 41,764 |

The goodwill of $1.9 million represents the premium we paid over the fair value of the net tangible liabilities assumed and identified intangible assets acquired, due primarily to Meru's assembled workforce. The goodwill recorded as part of the Meru acquisition is not deductible for U.S. federal income tax purposes.

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

Intangible assets consist primarily of customer relationships and developed technologies. Customer relationships represent Meru's installed base and the ability to sell existing, in-process and future versions of our products and services to its existing customers. Developed technologies represent the virtualized wireless local area network solutions offering centralized coordination and control of various access points on the network. This includes patented and unpatented technology, know-how, processes, designs and computer software. The estimated useful life and fair values of the acquired identifiable intangible assets were as follows (in thousands, except for estimated useful life):

| | Estimated Useful Life (in years) | Fair Values |
|---|---|---|
| Customer relationships | 5 | $12,200 |
| Developed technologies | 4 | 7,200 |
| Trade name | 0.5 | 200 |
| Total | | $19,600 |

Customer relationships and trade name are amortized and the amortization expense is recorded in sales and marketing expenses in the condensed consolidated statement of operations. Developed technologies is amortized and the amortization expense is recorded in cost of product revenue in the condensed consolidated statement of operations.

7. GOODWILL AND OTHER INTANGIBLE ASSETS—net

Goodwill

Changes in the carrying amount of goodwill were (in thousands):

| | Amount |
|---|---|
| Balance—December 31, 2015 | $4,692 |
| Addition due to business acquisition | 9,543 |
| Balance—June 30, 2016 | $14,235 |

There were no impairments to goodwill during the three and six months ended June 30, 2016.

Other Intangible Assets—net

Other intangible assets—net as of June 30, 2016 and December 31, 2015 were (in thousands):

| | June 30, 2016 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Life (in Years) | Gross | Accumulated Amortization | Net |
| Other intangible assets—net: | | | | |
| Finite-lived intangible assets: | | | | |
| Customer relationships | 4.5 | $16,200 | $ 3,257 | $12,943 |
| Developed technologies and other | 3.8 | 23,184 | 6,139 | 17,045 |
| | | 39,384 | 9,396 | 29,988 |
| Indefinite-lived intangible assets: | | | | |
| In-process research and development | | 1,500 | — | 1,500 |

| | | | |
|---|---|---|---|
| Total other intangible assets—net | $40,884 | $ 9,396 | $31,488 |

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

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Life (in Years) | Gross | Accumulated Amortization | Net |
| Other intangible assets—net: | | | | |
| Customer relationships | 5.0 | $12,200 | $ 1,220 | $10,980 |
| Developed technologies and other | 3.6 | 11,384 | 4,724 | 6,660 |
| Total other intangible assets—net | | $23,584 | $ 5,944 | $17,640 |

Amortization expense was $2.3 million and $0.3 million during the three months ended June 30, 2016 and June 30, 2015, respectively. Amortization expense was $3.5 million and $0.5 million during the six months ended June 30, 2016 and June 30, 2015, respectively. The following table summarizes estimated future amortization expense of Other intangible assets—net with finite lives (in thousands):

| | Amount |
|---|---|
| Years: | |
| 2016 (remainder) | $6,032 |
| 2017 | 8,878 |
| 2018 | 7,281 |
| 2019 | 5,517 |
| 2020 | 2,280 |
| Total | $29,988 |

8. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted-average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted-average number of shares of common stock outstanding, plus the dilutive effects of stock options, RSUs including performance stock units (“PSUs”), and our employee stock purchase plan (“ESPP”). Dilutive shares of common stock are determined by applying the treasury stock method.

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Numerator: | | | | |
| Net income (loss) | $(1,388) | $ 792 | $730 | $ 2,352 |
| Denominator: | | | | |
| Basic shares: | | | | |
| Weighted-average common stock outstanding-basic | 172,075 | 169,930 | 171,910 | 169,009 |
| Diluted shares: | | | | |
| Weighted-average common stock outstanding-basic | 172,075 | 169,930 | 171,910 | 169,009 |
| Effect of potentially dilutive securities: | | | | |
| Stock options | — | 3,720 | 1,796 | 3,779 |
| RSUs (including PSUs) | — | 2,521 | 1,580 | 2,131 |
| ESPP | — | 63 | 74 | 64 |
| Weighted-average shares used to compute diluted net income per share | 172,075 | 176,234 | 175,360 | 174,983 |
| Net income (loss) per share: | | | | |
| Basic | $(0.01) | $ — | $— | $ 0.01 |
| Diluted | $(0.01) | $ — | $— | $ 0.01 |

The following potentially dilutive shares of common stock were excluded from the computation of diluted net income (loss) per share for the periods presented, as their effect would have been antidilutive (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Stock options | 7,058 | 299 | 1,182 | 274 |
| RSUs (including PSUs) | 10,577 | 414 | 4,715 | 873 |
| ESPP | 554 | — | 141 | 84 |
| | 18,189 | 713 | 6,038 | 1,231 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

9. RESTRUCTURING CHARGES

The following table provides a summary of restructuring activity as of June 30, 2016 (in thousands):

| | Employee Severance and Other Benefits | Contract Terminations and Other Charges | Total |
|---|---|---|---|
| Balance as of December 31, 2015 | $ 3,689 | $ 229 | $3,918 |
| Costs incurred | 837 | 44 | 881 |
| Less cash payments | (2,757) | (171) | (2,928) |
| Less non-cash charges | (89) | — | (89) |
| Balance as of June 30, 2016 | $ 1,680 | $ 102 | $1,782 |

2015 Meru Restructuring

In connection with the acquisition of Meru, we initiated planned cost reduction and restructuring activities to improve our cost structure and operational efficiencies starting in the third quarter of 2015. We estimate that we will incur approximately $8.0 million of restructuring charges, consisting of severance and other benefits, contract terminations and other charges. We did not incur any material restructuring charges during the three and six months ended June 30, 2016. To date, we have incurred $7.8 million of charges related to this restructuring. These charges are primarily related to severance payments to be paid in cash and are included in operating expense in the condensed consolidated statements of operations of the period when incurred.

Cash payments for the restructuring activities are expected to be paid through 2017, primarily relating to severance payments. The remaining restructuring reserve balance of $1.5 million is included in accrued liabilities on the condensed consolidated balance sheet as of June 30, 2016.

2016 AccelOps Restructuring

In connection with the acquisition of AccelOps, we initiated alignment activities in the second quarter of 2016. We estimate that we will incur approximately $0.7 million of restructuring charges, primarily consisting of severance and other benefits, all of which were incurred during the three and six months ended June 30, 2016, which are included in operating expense in the condensed consolidated statements of operations.

Cash payments for the restructuring activities are expected to be made in 2016, primarily relating to severance payments. The remaining restructuring reserve accrual of $0.2 million is included in accrued liabilities on the condensed consolidated balance sheet as of June 30, 2016.

10. COMMITMENTS AND CONTINGENCIES

Our future principal contractual obligations as of June 30, 2016 were (in thousands):

| | Total | 2016 (remainder) | 2017 | 2018 | 2019 | 2020 | Thereafter |
|---|---|---|---|---|---|---|---|

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Operating lease commitments | $75,975 | $ 10,984 | $17,146 | $15,004 | $12,595 | $9,598 | $ 10,648 |
| Inventory purchase commitments | 86,448 | 86,448 | — | — | — | — | — |
| Other contractual commitments and open purchase orders | 52,085 | 44,522 | 3,509 | 1,273 | 927 | 927 | 927 |
| Total | $214,508 | $ 141,954 | $20,655 | $16,277 | $13,522 | $10,525 | $ 11,575 |

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Operating Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2026. Certain leases require us to pay variable costs such as taxes, maintenance, and insurance. The terms of certain operating leases also provide for renewal options and escalation clauses. Rent expense was $4.6 million and $2.9 million during the three months ended June 30, 2016 and June 30, 2015, respectively. Rent expense was $8.5 million and $6.0 million during the six months ended June 30, 2016 and June 30, 2015, respectively. Rent expense is recognized using the straight-line method over the term of the lease.

Inventory Purchase Commitments—Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of June 30, 2016, we had $86.4 million of open purchase orders with our independent contract manufacturers that may not be cancelable.

Other Contractual Commitments and Open Purchase Orders—In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations in the ordinary course of business for which we have not received goods or services. As of June 30, 2016, we had $52.1 million in other contractual commitments that may not be cancelable.

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

| | Six Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| Accrued warranty balance—beginning of the period | $3,144 | $4,269 |
| Warranty costs incurred | (1,481) | (2,059) |
| Provision for warranty for the period | 718 | 2,294 |
| Adjustment related to pre-existing warranties | (225) | 171 |
| Accrued warranty balance—end of the period | $2,156 | $4,675 |

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

Indemnification—Under the indemnification provisions of our standard sales contracts, we agree to defend our customers against third-party claims asserting various allegations such as product defects and infringement of certain intellectual property rights, which may include patents, copyrights, trademarks or trade secrets, and to pay judgments entered on such claims. In some contracts, our exposure under these indemnification provisions is limited by the terms of the contracts to certain defined limits, such as the total amount paid by our customer under the agreement. However, certain agreements include covenants, penalties and indemnification provisions including and beyond indemnification for third-party claims of intellectual property infringement and that could potentially expose us to losses in excess of the amount received under the agreement, and in some instances to potential liability that is not contractually limited. To date, there have been no awards under such indemnification provisions.

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11. STOCKHOLDERS' EQUITY

Stock-Based Compensation Plans

We have stock-based compensation plans pursuant to which we have granted stock options and RSUs and PSUs. We also have an ESPP for all eligible employees. As of June 30, 2016, there were a total of 45,162,348 shares of common stock available for grant under our stock-based compensation plans.

Restricted Stock Units

The activity and related information for RSUs, including PSUs, was (in thousands, except per share amounts):

| | Restricted Stock Units Outstanding | |
|---|---|---|
| | Number of Shares | Weighted-Average Grant Date Fair Value per Share |
| Balance—December 31, 2015 | 9,257 | $ 32.97 |
| Granted | 3,698 | 25.92 |
| Forfeited | (707) | 32.24 |
| Vested | (1,752) | 27.87 |
| Balance—June 30, 2016 | 10,496 | $ 31.22 |

As of June 30, 2016, total compensation expense related to unvested RSUs, including PSUs, that were granted to employees and non-employees, but not yet recognized, was $279.3 million. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.94 years. We did not grant any PSUs during the three and six months ended June 30, 2016. The stock-based compensation expense related to PSU awards is not material.

RSUs settle into shares of common stock upon vesting. Upon the vesting of the RSUs, we net-settle the RSUs and withhold a portion of the shares to satisfy minimum statutory employee withholding taxes. Total payment for the employees' tax obligations to the taxing authorities is reflected as a financing activity within the condensed consolidated statements of cash flows.

The number of shares and amount withheld for employee taxes were (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Shares withheld for taxes | 247 | 124 | 590 | 345 |
| Amount withheld for taxes | $8,051 | $4,762 | $17,358 | $11,362 |

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Employee Stock Options

The weighted-average assumptions relating to our employee stock options were:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Expected term in years | 4.3 | 4.3 | 4.3 | 4.3 |
| Volatility | 39 % | 38 % | 39% - 43% | 38% - 40% |
| Risk-free interest rate | 1.2% | 1.5 % | 1.0% - 1.2% | 1.5 % |
| Dividend rate | — % | — % | — % | — % |

The stock option activity and related information was (in thousands, except exercise prices and contractual life):

| | Options Outstanding | | | |
|---|---|---|---|---|
| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value |
| Balance—December 31, 2015 | 6,968 | $ 20.03 | | |
| Granted | 1,298 | $ 24.77 | | |
| Forfeited | (102 ) | $ 37.49 | | |
| Exercised | (1,263) | $ 8.18 | | |
| Balance—June 30, 2016 | 6,901 | $ 22.83 | 3.33 | 65,715 |
| Options exercisable—June 30, 2016 | 4,821 | $ 20.30 | 2.09 | $ 54,924 |

The aggregate intrinsic value represents the pre-tax difference between the exercise price of stock options and the quoted market price of our common stock on June 30, 2016, for all in-the-money options. As of June 30, 2016, total compensation expense related to unvested stock options granted to employees but not yet recognized was $18.0 million. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 3.2 years.

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Weighted-average fair value per share granted | $10.92 | $12.75 | $8.90 | $11.54 |
| Intrinsic value of options exercised | $6,829 | $22,034 | $26,253 | $63,038 |
| Fair value of options vested | $793 | $2,718 | $2,876 | $6,510 |

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Employee Stock Purchase Plan

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

| | Six Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| Expected term in years | 0.5 | 0.5 |
| Volatility | 48 % | 28 % |
| Risk-free interest rate | 0.4% | 0.1 % |
| Dividend rate | — % | — % |

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

| | Six Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| Weighted-average fair value per share granted | $7.19 | $7.56 |
| Shares issued under the ESPP | 614 | 427 |
| Weighted-average price per share issued | $20.49 | $21.34 |

There were no shares granted or issued under the ESPP during the three month ended June 30, 2016 and June 30, 2015.

Stock-based Compensation Expense

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Cost of product revenue | $298 | $210 | $578 | $350 |
| Cost of service revenue | 2,123 | 1,660 | 4,257 | 3,292 |
| Research and development | 7,458 | 5,541 | 14,601 | 10,698 |
| Sales and marketing | 16,990 | 11,271 | 32,805 | 20,578 |
| General and administrative | 3,478 | 3,078 | 7,008 | 5,764 |
| Total stock-based compensation expense | $30,347 | $21,760 | $59,249 | $40,682 |

The stock-based compensation expense by award type was (in thousands):

| | Three Months Ended | Six Months Ended |
|---|---|---|

| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
|---|---|---|---|---|
| RSUs | $26,799 | $17,386 | $51,902 | $31,678 |
| Stock options | 1,592 | 3,017 | 3,546 | 6,472 |
| ESPP | 1,956 | 1,357 | 3,801 | 2,532 |
| Total stock-based compensation expense | $30,347 | $21,760 | $59,249 | $40,682 |

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

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Income tax benefit associated with stock-based compensation | $7,416 | $4,266 | $14,737 | $7,643 |

Share Repurchase Program

In January 2016, our board of directors approved a new Share Repurchase Program (the "Program"), which authorizes the repurchase of up to $200.0 million of our outstanding common stock through December 31, 2017. Under the Program, share repurchases may be made by us from time to time in privately negotiated transactions or in open market transactions. The Program does not require us to purchase a minimum number of shares, and may be suspended, modified or discontinued at any time without prior notice. There were no shares repurchased under the Program during the three months ended June 30, 2016. During the six months ended June 30, 2016, we repurchased 2.0 million shares of common stock under the Program in open market transactions at an average price of $24.97 per share, for an aggregate purchase price of $50.0 million. As of June 30, 2016, $150.0 million remained available for future share repurchases under the Program.

12. INCOME TAXES

Our effective tax rate was 62% for the three months ended June 30, 2016, compared to an effective tax rate of 77% for the same period last year. The effective tax rate was 111% for the six months ended June 30, 2016, compared to an effective tax rate of 54% for the same period last year. The effective tax rate for the periods presented was comprised of U.S. federal and state taxes, foreign withholding taxes and foreign income taxes. The changes in the tax provision and effective tax rate were primarily due to the tax benefit from the adoption of the new accounting guidance relating to stock-based compensation and the tax benefit from the U.S. federal research and development credit (the "U.S. federal R&D credit"). The tax rate for the three and six months ended June 30, 2015 did not include a benefit from the U.S. federal R&D credit, as the credit had expired in December 2014. In December 2015, the U.S. federal R&D credit was made permanent and the tax benefit was reflected on the income tax provision for the three and six months ended June 30, 2016. There was a pretax loss for the three and six months ended June 30, 2016, as compared to having a pretax income for the same periods last year.

As of June 30, 2016 and December 31, 2015, unrecognized tax benefits were $63.7 million and $59.7 million, respectively. The total amount of $62.4 million in unrecognized tax benefits, if recognized, would favorably impact the effective tax rate. It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of June 30, 2016, we had accrued $7.9 million for estimated interest related to uncertain tax positions.

We file income tax returns in the U.S. federal jurisdiction, and various U.S. state and foreign jurisdictions. The statute of limitations is open for years that generated state net operating loss carryforwards and after 2009 for state jurisdictions. Additionally, we have foreign net operating losses that have an indefinite life. Generally, we are no longer subject to non-U.S. income tax examinations by tax authorities for tax years prior to 2009. We are no longer subject to examination by U.S. federal tax authorities for tax years prior to 2012. We are currently under examination

by U.S federal income tax authorities for the tax years 2012, 2013, and 2014. In addition, the tax authorities in France are examining the inter-company relationship between Fortinet Inc., Fortinet France and Fortinet Singapore. We are in the early stages of this inquiry and as of yet no official audit has been opened.

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

13. DEFINED CONTRIBUTION PLANS

Our tax-deferred savings plan under our 401(k) Plan, permits participating employees to defer a portion of their pre-tax earnings. In Canada, we have a Group Registered Retirement Savings Plan program (the "RRSP"), which permits participants to make tax deductible contributions. Our board of directors approved 50% matching contributions on employee contributions up to 4% of each employee's eligible earnings. Our matching contributions to the 401(k) Plan and RRSP for the three months ended June 30, 2016 and June 30, 2015 were $1.2 million and $0.9 million, respectively. Our matching contributions to the 401(k) Plan and RRSP during the six months ended June 30, 2016 and June 30, 2015 were $2.2 million and $1.8 million, respectively.

14. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| Revenue | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Americas: | | | | |
| United States | $80,811 | $71,224 | $156,369 | $129,725 |
| Canada | 33,782 | 26,191 | 65,087 | 46,649 |
| Other Americas | 18,053 | 11,178 | 31,236 | 23,779 |
| Total Americas | 132,646 | 108,593 | 252,692 | 200,153 |
| Europe, Middle East, and Africa ("EMEA") | 114,453 | 83,404 | 219,944 | 159,068 |
| Asia Pacific ("APAC") | 64,292 | 47,788 | 123,331 | 93,450 |
| Total revenue | $311,391 | $239,785 | $595,967 | $452,671 |

| Property and Equipment—net | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Americas: | | |
| United States | $90,457 | $ 61,064 |
| Other Americas | 10,123 | 8,972 |
| Total Americas | 100,580 | 70,036 |
| EMEA: | | |
| France | 14,841 | 13,201 |
| Other EMEA | 6,109 | 3,977 |

| | | |
|---|---|---|
| Total EMEA | 20,950 | 17,178 |
| APAC | 4,106 | 3,853 |
| Total property and equipment—net | $ 125,636 | $ 91,067 |

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

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | June 30, 2016 | June 30, 2015 |
| Exclusive Networks Group | 20% | 17% | 20% | 17% |
| Ingram Micro | 10% | * | * | * |

* Represents less than 10%

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

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Exclusive Networks Group | 24% | 23% |
| Fine Tec Computers | 11% | * |

* Represents less than 10%

15. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The changes in accumulated balances of other comprehensive income or loss were (in thousands):

| | June 30, 2016 | | |
|---|---|---|---|
| | Unrealized Gains/Losses on Investments | Tax benefit (provision) related to items of other comprehensive income or loss | Total |
| Beginning balance | $(1,437) | $ 504 | $(933) |
| Other comprehensive income (loss) before reclassifications | 2,552 | (893) | 1,659 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (3) | 1 | (2) |
| Net current-period other comprehensive income (loss) | 2,549 | (892) | 1,657 |
| Ending balance | $1,112 | $ (388) | $724 |

The details of reclassification out of accumulated other comprehensive income (loss) were (in thousands):

Six Months Ended June 30, 2016

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified from Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|

| | | | |
|---|---|---|---|
| Unrealized losses on investments | $ | (3) | Other expense—net |
| Tax benefit related to items of other comprehensive loss | | 1 | Provision for income taxes |
| Total reclassification for the period | $ | (2) | |

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

16. FOREIGN CURRENCY DERIVATIVES

Our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency translation risk. However, a substantial portion of our operating expenses incurred outside the United States is denominated in foreign currencies and is subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Canadian dollar ("CAD"), Euro ("EUR"), Great British pound ("GBP"), and Chinese yen ("CNY"). To help protect against significant fluctuations in value and the volatility of future cash flows caused by changes in currency exchange rates, we engage in foreign currency risk management activities to hedge balance sheet items denominated in CAD. We do not use these contracts for speculative or trading purposes. All of the derivative instruments are with high quality financial institutions and we monitor the creditworthiness of these parties. These contracts typically have maturities between one and three months. Changes in the fair value of forward exchange contracts related to balance sheet accounts are insignificant and are included in Other expense—net in the condensed consolidated statement of operations. As of June 30, 2016, the fair value of the forward exchange contracts was not material.

Additionally, independent of any hedging activities, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in our condensed consolidated statements of operations. Our hedging activities are intended to reduce, but not eliminate, the impact of currency exchange rate movements. As our hedging activities are relatively short-term in nature and are focused on the CAD, long-term material changes in the value of the U.S. dollar against other foreign currencies, such as the EUR, GBP and CNY could adversely impact our operating expenses in the future.

The notional amount of forward exchange contracts to hedge balance sheet accounts as of June 30, 2016 and December 31, 2015 were (in thousands):

| | Buy/Sell | Notional |
|---|---|---|
| Balance Sheet Contracts: | | |
| Currency—As of June 30, 2016 | | |
| CAD | Sell | $ 7,209 |
| | | |
| Currency—As of December 31, 2015 | | |
| CAD | Sell | $ 7,011 |

17. RELATED PARTY TRANSACTIONS

The son of one member of our board of directors is a partner of an outside law firm that we utilize for certain complex litigation matters. Expenses for legal services provided by the law firm related to matters that arose subsequent to the member joining our board of directors were $0.1 million and $0.9 million during the three months ended June 30, 2016 and June 30, 2015, respectively. No contingent fees were incurred during the three months ended June 30, 2016 and June 30, 2015. Expenses for legal services provided by the law firm related to matters that arose subsequent to the member joining our board of directors were $0.4 million and $2.8 million during the six months ended June 30, 2016 and June 30, 2015, respectively. Of such amounts, $0.2 million and $0.5 million were incurred under contingent fee arrangements during the six months ended June 30, 2016 and June 30, 2015, respectively. Amounts due and payable to the law firm were $0.3 million and $5.3 million as of June 30, 2016 and December 31, 2015, respectively.

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

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. These statements include, among other things, statements concerning our expectations regarding:

- continued growth and market share gains;
- variability in sales in certain product categories from year to year and between quarters;
- expected impact of sales of certain products and services;
- the proportion of our revenue that consists of our product and service and other revenue, and the mix of billings between products and services, and the duration of service contracts;
- the impact of our product innovation strategy;
- drivers of long-term growth and operating leverage, such as increased functionality and value in our security subscription and support service offerings;
- growing our sales to enterprise, service provider and government organizations, and the impact of sales to these organizations on our long-term growth, expansion and operating results;
- trends in revenue, costs of revenue and gross margin;
- trends in our operating expenses, including sales and marketing expense, research and development expense, general and administrative expense, and expectations regarding these expenses as a percentage of revenue;
- continued investments in research and development;
- managing our continued investments in sales and marketing, and the impact of those investments;
- expectations regarding uncertain tax benefits and our effective tax rate;
- expectations regarding spending related to capital expenditures;
- competition in our markets;
- integration of acquired companies and technologies and expectations related to acquisitions;
- success of our recently implemented enterprise resource planning ("ERP") system;
- our intentions regarding repatriation of cash, cash equivalents and investments held by our international subsidiaries and the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next 12 months; and
- other statements regarding our future operations, financial condition and prospects and business strategies.

These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and, in particular, the risks discussed under the heading “Risk Factors” in Part II, Item 1A of this Quarterly Report on Form 10-Q and those discussed in other documents we file with the SEC. 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.

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Business Overview

We provide high performance cybersecurity solutions to a wide variety of enterprises, service providers and government organizations of all sizes across the globe, including a majority of the 2015 Fortune 100. Our cybersecurity solutions are designed to provide broad, rapid protection against dynamic security threats while simplifying the IT infrastructure of our end-customers worldwide.

Our common operating system, centralized management and open application program interfaces allow many of the solutions in our portfolio to be combined to create an integrated security architecture ("Fortinet Security Fabric") designed to address sophisticated threats and next-generation environments. The Fortinet Security Fabric connects our products, services and ecosystem partner solutions to help provide seamless protection at all points in the network, from endpoint to data center to cloud, regardless of whether deployed in physical, virtual or hybrid environments. Our Security Fabric delivers integrated scalability, access, awareness, security and openness both from the cloud and for the cloud. At the core of our Security Fabric is our FortiGate physical and virtual appliances, which ship with a set of broad security services, including firewall, virtual private network, application control, intrusion prevention, web filtering and advanced threat protection. These security services are enabled by our FortiGuard Labs, which provides extensive threat research and a global cloud network to deliver protection services to each FortiGate appliance. FortiGate also has extensive networking capabilities such as switching, routing, native internet protocol version 6 and different modes of deployment. FortiManager provides central management and FortiAnalyzer provides reporting and analytics.

Enterprise customers select the form factor and deployment method that best meet their specific security requirements, such as a high-speed data center firewall at the network core, a next generation firewall at the edge or a distributed firewall solutions at branch sites. Small businesses tend to deploy unified threat management devices. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-20 to -100 series, designed for small businesses or distributed enterprises, FortiGate-200 to -900 series for mid-sized enterprises, to the FortiGate-1000 to -6000 series for large enterprises and service providers. Our network security platform also includes our FortiGuard security subscription services, to which end-customers can subscribe in order to obtain access to dynamic updates to application control, anti-virus, intrusion prevention, web filtering, and anti-spam functionality. End-customers can also choose to purchase FortiCare technical support services for our products. End-customers also often use FortiManager and FortiAnalyzer products in conjunction with a FortiGate deployment to provide centralized management and analysis and reporting capabilities.

We complement our core FortiGate product line with other appliances and software licenses that offer additional protection from security threats to other critical areas of the enterprise, such as our secure wireless and access solutions, advanced threat protection, secure email gateway, web application firewalls, application delivery controllers, database security, distributed denial of service protection, and endpoint security for employee computers and mobile devices. Sales of these complementary products have grown in recent quarters.

Financial Highlights

- We recorded total revenue of $311.4 million and $596.0 million during the three and six months ended June 30, 2016, respectively, an increase of 30% and 32%, respectively, compared to the same periods last year. Product revenue was $136.6 million and $261.2 million during the three and six months ended June 30, 2016, an increase of 19% and 23% compared to the same periods last year. Service revenue was $174.8 million and $334.8 million during the three and six months ended June 30, 2016, an increase of 40% and 39% compared to the same periods last year.

- Cash, cash equivalents and investments were $1.22 billion as of June 30, 2016, an increase of $57.7 million, or 5%, from December 31, 2015.

- Deferred revenue was $904.0 million as of June 30, 2016, an increase of $112.7 million, or 14%, from December 31, 2015.

- We generated cash flows from operating activities of $168.5 million during the six months ended June 30, 2016, an increase of $19.6 million, or 13%, compared to the same period last year.

- In June 2016, we acquired AccelOps, a provider of network security monitoring and analytics solutions, for a total cash consideration of $22.3 million.

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Revenue grew during the three and six months ended June 30, 2016 compared to the same periods last year, as our Security Fabric put us in a strong competitive position in a robust security market. Our strategy to invest in sales and marketing has enabled us to gain more enterprise customers today than we have had in the past. Large enterprises represent significant opportunity for cross-sell and upsell, as they tend to purchase more products and services over time. During the three months ended June 30, 2016, our revenue growth was driven by greater sales of our FortiGate and FortiGuard offerings, as we continued to see diversity of FortiGate product sales across all segments. Our high-end FortiGate products (FortiGate-1000 to -6000 series) accounted for 36% of billings. Our mid-range products (FortiGate-200 to -900 series) accounted for 28% of billings, and our entry-level products (FortiGate-20 to -100 series) accounted for 36% of billings. Service revenue also increased as we continue to add to and charge more for functionality and value in our FortiGuard security subscription, FortiCare technical support and other offerings.

During the three and six months ended June 30, 2016, operating expenses increased by 38% and 40%, respectively, as compared to the same period last year. The increase was primarily driven by our accelerated pace of hiring and investments made to expand our sales coverage, grow our marketing capabilities, develop new products and scale our customer support. We also continue to invest in research and development to strengthen our technology leadership position. We believe that continued product innovation has strengthened our technology and resulted in market share gains. In addition, we incurred expenses from business design and reengineering related to the implementation of an ERP system. Headcount increased by 37% to 4,562 employees and contractors as of June 30, 2016, up from 3,336 as of June 30, 2015.

Business Model

Our sales strategy is based on a distribution model whereby we primarily sell our products and services directly to distributors which sell to resellers and service providers, which, in turn, sell to our end-customers. In certain cases, we sell directly to government-focused resellers, large service providers and major systems integrators, which have significant purchasing power and unique customer deployment requirements. Typically, FortiGuard security subscription services and FortiCare technical support services are purchased along with our physical and virtual appliances, most frequently as part of a bundle offering that includes hardware and services. We invoice at the time of our sale for the total price of the products and subscription and technical support services for what has been delivered, and the invoice is generally payable within 30 to 90 days. We generally recognize product revenue up-front and defer revenue for the sale of new, and renewal of existing, FortiGuard security subscription and FortiCare technical support services contracts. We recognize the related service revenue over the service period, which is typically one to three years, although it can be as long as five years. Sales of new and renewal services are a source of recurring revenue and increase our deferred revenue balance, which contributes significantly to our increase in gross margin, as well as our positive cash flow from operations.

Key Metrics

We monitor a number of financial and operating metrics, including the key financial metrics set forth below, in order to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts, and assess operational efficiencies. The following table summarizes revenue, deferred revenue, billings, cash, cash equivalents and investments, net cash provided by operating activities, and free cash flow. We discuss revenue below under “—Results of Operations,” and we discuss our cash, cash equivalents, and investments, and net cash provided by operating activities below under “—Liquidity and Capital Resources.” Deferred revenue, billings (non-GAAP) and free cash flow (non-GAAP) are discussed immediately below the following table.

| | Three Months Ended Or As Of |
|---|---|

| | June 30, 2016 | June 30, 2015 |
|---|---|---|
| | (in thousands) | |
| Revenue | $311,391 | $239,785 |
| Deferred revenue | $903,981 | $657,561 |
| Billings (Non-GAAP) | $373,784 | $297,175 |
| Cash, cash equivalents and investments | $1,221,991 | $1,148,371 |
| Net cash provided by operating activities | $67,941 | $84,305 |
| Free cash flow (Non-GAAP) | $53,498 | $73,544 |

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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 unrecognized portion of service revenue from FortiGuard security subscription and FortiCare technical support service contracts, which is recognized as revenue ratably over the contractual service period. We monitor our deferred revenue balance and the mix of short-term and long-term deferred revenue because it represents a significant portion, and the timing, of revenue to be recognized in future periods.

Billings (Non-GAAP). We define billings as revenue recognized in accordance with GAAP plus the change in deferred revenue from the beginning to the end of the period less any deferred revenue balances acquired from business combination(s) during the period. We consider billings to be a useful metric for management and investors because billings drive future revenue, which is an important indicator of the health and viability of our business. There are a number of limitations related to the use of billings instead of GAAP revenue. First, billings include amounts that have not yet been recognized as revenue and are impacted by the term of security and support agreements. Second, we may calculate billings in a manner that is different from peer companies that report similar financial measures. Management accounts for these limitations by providing specific information regarding GAAP revenue and evaluating billings together with GAAP revenue.

A reconciliation of billings to revenue, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

| | Three Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| | (in thousands) | |
| Billings: | | |
| Revenue | $311,391 | $239,785 |
| Add increase in deferred revenue | 66,793 | 57,390 |
| Less deferred revenue balance acquired in business acquisition | (4,400) | — |
| Total billings (Non-GAAP) | $373,784 | $297,175 |

Free cash flow (Non-GAAP). We define free cash flow as net cash provided by operating activities minus capital expenditures such as purchases of real estate and other property and equipment. We consider free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after the acquisition of property and equipment, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, repurchasing outstanding common stock and strengthening the balance sheet. Analysis of free cash flow facilitates management's comparison of our operating results to those of our peer companies. A limitation of using free cash flow rather than the GAAP measure of net cash provided by operating activities as a means for evaluating liquidity is that free cash flow does not represent the total increase or decrease in the cash, cash equivalents and investments balance for the period because it excludes cash provided by or used for other investing and financing activities. Management accounts for this limitation by providing information about our capital expenditures and other investing and financing activities on the face of the cash flow statement and under "—Liquidity and Capital Resources." A reconciliation of free cash flow to net cash provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

| | Three Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |

| | (in thousands) | |
|---|---|---|
| Free Cash Flow: | | |
| Net cash provided by operating activities | $67,941 | $84,305 |
| Less purchases of property and equipment | (14,443 ) | (10,761 ) |
| Free cash flow (Non-GAAP) | $53,498 | $73,544 |

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Critical Accounting Policies and Estimates

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

Except for the change in certain policies around stock-based compensation as a result of the early adoption of ASU 2016-09, there have been no material changes to our critical accounting policies and estimates as of and for the three and six months ended June 30, 2016, as compared to the critical accounting policies and estimates described in the Form 10-K. See Note 1 to the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion relating to our change in certain accounting policies related to stock-based compensation.

Recent Accounting Pronouncements

See Note 1 to the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for information regarding recent accounting pronouncements.

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Results of Operations

Three Months Ended June 30, 2016 and 2015

Revenue

| | Three Months Ended June 30, 2016 | | | June 30, 2015 | | | | |
|---|---|---|---|---|---|---|---|---|
| | Amount | % of Revenue | | Amount | % of Revenue | | Change | % Change |
| | (in thousands, except percentages) | | | | | | | |
| Revenue: | | | | | | | | |
| Product | $136,641 | 44 | % | $114,777 | 48 | % | $21,864 | 19 % |
| Service | 174,750 | 56 | | 125,008 | 52 | | 49,742 | 40 |
| Total revenue | $311,391 | 100 | % | $239,785 | 100 | % | $71,606 | 30 % |
| Revenue by geography: | | | | | | | | |
| Americas | $132,646 | 43 | % | $108,593 | 45 | % | $24,053 | 22 % |
| EMEA | 114,453 | 36 | | 83,404 | 35 | | 31,049 | 37 |
| APAC | 64,292 | 21 | | 47,788 | 20 | | 16,504 | 35 |
| Total revenue | $311,391 | 100 | % | $239,785 | 100 | % | $71,606 | 30 % |

Total revenue increased by $71.6 million, or 30%, during the three months ended June 30, 2016 compared to the same period last year. On a geographic basis, revenue continued to be diversified globally. All three regions experienced revenue growth compared to the same period last year, with EMEA contributing to the largest portion of our revenue growth on both an absolute dollar and a percentage basis. Product revenue increased by $21.9 million, or 19%, during the three months ended June 30, 2016 compared to the same period last year. The increase in product revenue was primarily driven by greater sales of our FortiGate product family, as well as growth in other product lines. Service revenue increased by $49.7 million, or 40%, during the three months ended June 30, 2016 compared to the same period last year. The increase in service revenue was primarily due to the recognition of revenue from our growing deferred revenue balance consisting of FortiGuard security subscription and FortiCare technical support contracts sold to a larger customer base, as well as the renewals of similar contracts sold in earlier periods. Service revenue also increased as we continue to add to and charge more for functionality and value in our FortiGuard security subscription, FortiCare technical support and other offerings.

Cost of revenue and gross margin

| | Three Months Ended June 30, 2016 | June 30, 2015 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Cost of revenue: | | | | |
| Product | $52,788 | $47,397 | $5,391 | 11 % |
| Service | 31,715 | 22,101 | 9,614 | 44 |
| Total cost of revenue | $84,503 | $69,498 | $15,005 | 22 % |
| Gross margin (%): | | | | |
| Product | 61.4 % | 58.7 % | 2.7 % | |
| Service | 81.9 | 82.3 | (0.4 ) | |
| Total gross margin | 72.9 % | 71.0 % | 1.9 % | |

Total gross margin increased by 1.9 percentage points during the three months ended June 30, 2016 compared to the same period last year, primarily driven by an increase in product gross margin. Product gross margin increased by 2.7 percentage points during the three months ended June 30, 2016 compared to the same period last year. Product gross margin was positively impacted by lower warranty expense, as well as higher sales of software products such as certain of our virtualized security solutions.

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Service gross margin decreased by 0.4 percentage points during the three months ended June 30, 2016 as compared to the same period last year. Cost of service revenue increased by $9.6 million primarily due to a $5.8 million increase in personnel costs related to headcount increases. In addition, cost of service revenue increased due to an increase in product replacement costs related to our extended support service offerings.

Operating expenses

| | Three Months Ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | June 30, 2016 | | June 30, 2015 | | | Change | % Change | |
| | Amount | % of Revenue | Amount | % of Revenue | | | | |
| | (in thousands, except percentages) | | | | | | | |
| Operating expenses: | | | | | | | | |
| Research and development | $45,502 | 15 % | $37,389 | 16 % | | $8,113 | 22 % | |
| Sales and marketing | 162,694 | 52 | 111,928 | 47 | | 50,766 | 45 | |
| General and administrative | 22,184 | 7 | 18,018 | 8 | | 4,166 | 23 | |
| Restructuring charges | 553 | — | — | — | | 553 | * | |
| Total operating expenses | $230,933 | 74 % | $167,335 | 70 % | | $63,598 | 38 % | |

* not meaningful

Research and development

Research and development expense increased by $8.1 million, or 22%, during the three months ended June 30, 2016 compared to the same period last year, primarily due to an increase of $6.1 million in personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Depreciation and other occupancy-related costs increased by $1.5 million. We intend to continue to invest in our research and development organization, but expect research and development expense as a percentage of total revenue to remain at a relatively comparable level during the remainder of 2016.

Sales and marketing

Sales and marketing expense increased by $50.8 million, or 45%, during the three months ended June 30, 2016 compared to the same period last year, primarily due to an increase of $40.1 million in personnel costs as we continued to increase our sales and marketing headcount. Marketing-related expenses increased by $2.8 million as we invested in marketing to drive broader market awareness, create a global marketing engine, build broad market lead generation, nurture programs and accelerate pipeline. In addition, we incurred increases in travel and entertainment expenses of $3.1 million and depreciation expense and occupancy-related costs of $2.1 million. We intend to continue to make investments in our sales resources and infrastructure and marketing strategy, which are critical to support growth, but at a slower pace. As such, we expect sales and marketing expense as a percentage of total revenue to slightly decrease during the remainder of 2016.

General and administrative

General and administrative expense increased by $4.2 million, or 23%, during the three months ended June 30, 2016 compared to the same period last year. During the three months ended June 30, 2016, we expensed an additional $4.9 million relating to business process design and reengineering in preparation of implementing a new ERP system compared to the same period last year. In addition, personnel costs increased by $2.8 million due to increase in

headcount in order to support our expanding business. The increase in expense was partially offset by lower professional fees, such as legal fees, of $1.8 million and other costs of $1.2 million. As a percentage of total revenue, we expect general and administrative expense to remain at a relatively comparable level during the remainder of 2016.

Restructuring charges

Restructuring charges of $0.6 million during the three months ended June 30, 2016 primarily relate to our restructuring activities related to the acquisition of AccelOps. See Note 9 to the condensed consolidated financial statements for additional details, including types of expenses incurred and the timing of future expenses and cash payments. See also the

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"Liquidity and Capital Resources" section of this Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Interest income and other expense—net

| | Three Months Ended June 30, 2016 | June 30, 2015 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Interest income | $1,705 | $1,364 | $ 341 | 25 % |
| Other expense—net | (1,350) | (830) | (520) | 63 |

Interest income increased during the three months ended June 30, 2016 compared to the same period last year due to interest earned on higher invested balances of cash, cash equivalents and investments. Interest income varies depending on our average investment balances during the period, types and mix of investments, and market interest rates. The increase in Other expense—net during the three months ended June 30, 2016 as compared to the same period last year was the result of higher foreign currency exchange losses. Other expense—net consisted primarily of foreign exchange and related hedging gains and losses.

Provision for (benefit from) income taxes

| | Three Months Ended June 30, 2016 | June 30, 2015 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Provision for (benefit from) income taxes | $(2,302) | $2,694 | $(4,996) | (185)% |
| Effective tax rate (%) | 62 % | 77 % | (15)% | * |

* not meaningful

Our effective tax rate was 62% for the three months ended June 30, 2016, as compared to an effective tax rate of 77% for the same period last year. The effective tax rate for the periods presented was comprised of U.S. federal and state taxes, and foreign withholding and income taxes. The changes in the tax provision and effective tax rate were primarily due to the tax benefit from adoption of the new accounting guidance relating to stock-based compensation and the tax benefit from the U.S. federal R&D credit. The tax rate for the three months ended June 30, 2015 did not include a benefit from the U.S. federal R&D credit as the credit had expired in December 2014. In December 2015, the U.S. federal R&D credit was made permanent and the tax benefit was reflected on the income tax provision for the three months ended June 30, 2016.

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

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Six Months Ended June 30, 2016 and June 30, 2015

Revenue

| | Six Months Ended June 30, 2016 | | June 30, 2015 | | | |
|---|---|---|---|---|---|---|
| | Amount | % of Revenue | Amount | % of Revenue | Change | % Change |
| | (in thousands, except percentages) | | | | | |
| Revenue: | | | | | | |
| Product | $261,213 | 44 % | $212,286 | 47 % | $48,927 | 23 % |
| Service | 334,754 | 56 | 240,385 | 53 | 94,369 | 39 |
| Total revenue | $595,967 | 100 % | $452,671 | 100 % | $143,296 | 32 % |
| Revenue by geography: | | | | | | |
| Americas | $252,692 | 42 % | $200,153 | 44 % | $52,539 | 26 % |
| EMEA | 219,944 | 37 | 159,068 | 35 | 60,876 | 38 |
| APAC | 123,331 | 21 | 93,450 | 21 | 29,881 | 32 |
| Total revenue | $595,967 | 100 % | $452,671 | 100 % | $143,296 | 32 % |

Total revenue increased by $143.3 million, or 32%, during the six months ended June 30, 2016 compared to the same period last year. All three regions experienced revenue growth compared to the same period last year, with EMEA contributing the largest portion of our revenue growth on both an absolute dollar and a percentage basis. Product revenue increased by $48.9 million, or 23%, during the six months ended June 30, 2016 compared to the same period last year. The increase in product revenue was primarily driven by greater sales in our FortiGate product family, as well as growth in other product lines.

Service revenue increased by $94.4 million, or 39%, during the six months ended June 30, 2016 compared to the same period last year due to the recognition of revenue from our growing deferred revenue balance consisting of FortiGuard security subscription and FortiCare technical support contracts sold to a larger customer base, particularly our large enterprise customers, as well as the renewals of similar contracts sold in earlier periods. Service revenue also increased as we continue to add to and charge more for functionality and value in our FortiGuard security subscription, FortiCare technical support and other offerings.

Cost of revenue and gross margin

| | Six Months Ended June 30, 2016 | June 30, 2015 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Cost of revenue: | | | | |
| Product | $102,101 | $88,765 | $13,336 | 15 % |
| Service | 60,046 | 44,335 | 15,711 | 35 |
| Total cost of revenue | $162,147 | $133,100 | $29,047 | 22 % |
| Gross margin (%): | | | | |
| Product | 60.9 % | 58.2 % | 2.7 % | |
| Service | 82.1 | 81.6 | 0.5 | |
| Total gross margin | 72.8 % | 70.6 % | 2.2 % | |

Total gross margin increased by 2.2 percentage points during the six months ended June 30, 2016 compared to the same period last year, as both product and service gross margins increased. Product gross margin increased by 2.7 percentage points during the six months ended June 30, 2016 compared to the same period last year. Product gross margin was positively impacted by higher sales of software products such as certain of our virtualized security solutions, as well as lower warranty expense.

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Service gross margin increased by 0.5 percentage points during the six months ended June 30, 2016 as compared to the same period last year as we scaled efficiencies resulting from our ability to add to and charge more for functionality and value to our service offerings, which have translated into improved service margins. Cost of service revenue increased by $15.7 million primarily due to a $9.8 million increase in personnel costs as a result of increased headcount.

Operating expenses

| | Six Months Ended June 30, 2016 | | June 30, 2015 | | Change | % Change |
|---|---|---|---|---|---|---|
| | Amount | % of Revenue | Amount | % of Revenue | | |
| | (in thousands, except percentages) | | | | | |
| Operating expenses: | | | | | | |
| Research and development | $90,256 | 15 % | $73,205 | 16 % | $17,051 | 23 % |
| Sales and marketing | 308,797 | 52 | 212,537 | 47 | 96,260 | 45 |
| General and administrative | 41,623 | 7 | 29,979 | 7 | 11,644 | 39 |
| Restructuring charges | 881 | — | — | — | 881 | * |
| Total operating expenses | $441,557 | 74 % | $315,721 | 70 % | $125,836 | 40 % |

* not meaningful

Research and development

Research and development expense increased by $17.1 million, or 23%, during the six months ended June 30, 2016 compared to the same period last year primarily due to an increase of $10.9 million in personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Depreciation expense and other occupancy-related costs increased by $3.4 million and costs of test supplies and prototype materials used in product development increased by $1.4 million.

Sales and marketing

Sales and marketing expense increased by $96.3 million, or 45%, during the six months ended June 30, 2016 compared to the same period last year, primarily due to an increase of $73.9 million in personnel costs as we continued to increase our sales headcount in order to drive continued market share gains globally. Marketing-related expense increased by $8.0 million as we invested significantly in marketing programs to capture market share, particularly in the large enterprise market, including costs related to trade-shows and lead generation. In addition, depreciation expense and other occupancy-related expense increased by $5.6 million and travel and entertainment expense increased by $5.1 million.

General and administrative

General and administrative expense increased by $11.6 million, or 39%, during the six months ended June 30, 2016 compared to the same period last year. During the six months ended June 30, 2016, we expensed an additional $7.8 million - relating to business process design and reengineering in preparation of the ERP system implementation compared to the same period last year. In addition, personnel costs increased by $6.5 million, as we continued to increase our headcount in order to support our expanding business. The increase in expense was partially offset by lower professional fees, such as legal fees, of $2.4 million.

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Interest income and other expense—net

| | Six Months Ended | | | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | Change | % Change |
| | (in thousands, except percentages) | | | |
| Interest income | $3,451 | $2,786 | $ 665 | 24 % |
| Other expense—net | (2,662) | (1,507) | (1,155) | 77 |

Interest income increased during the six months ended June 30, 2016 compared to the same period last year due to interest earned on higher invested balances of cash, cash equivalents and investments. Interest income varies depending on our average investment balances during the period, types and mix of investments, and market interest rates. The increase in Other expense—net for the six months ended June 30, 2016 when compared to the same period last year, was the result of higher foreign currency exchange losses. Other expense—net consisted primarily of foreign exchange and related hedging gains and losses.

Provision for (benefit from) income taxes

| | Six Months Ended | | | |
|---|---|---|---|---|
| | June 30, 2016 | June 30, 2015 | Change | % Change |
| | (in thousands, except percentages) | | | |
| Provision for (benefit from) income taxes | $(7,678) | $2,777 | $(10,455) | (376)% |
| Effective tax rate (%) | 111 % | 54 % | 57 % | * |

* not meaningful

Our effective tax rate was 111% for the six months ended June 30, 2016, compared with an effective tax rate of 54% for the same period last year. The benefit from income taxes for the six months ended June 30, 2016 was comprised primarily of U.S. federal and state taxes, other foreign income taxes, foreign withholding taxes, and transfer pricing allocations which impact jurisdictional income taxed at various tax rates. The changes in the tax provision and effective tax rate were primarily due to the tax benefit from the adoption of the new accounting guidance relating to stock-based compensation and the tax benefit from the U.S. federal R&D credit. The tax rate for the six months ended June 30, 2015 did not include a benefit from the U.S. federal R&D credit as the credit had expired in December 2014. In December 2015, the U.S. federal R&D credit was made permanent and the tax benefit was reflected on the income tax provision for the six months ended June 30, 2016.

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Liquidity and Capital Resources

| | As of | |
|---|---|---|
| | June 30, 2016 | December 31, 2015 |
| | (in thousands) | |
| Cash and cash equivalents | $596,380 | $ 543,277 |
| Investments | 625,611 | 621,033 |
| Total cash, cash equivalents and investments | $1,221,991 | $ 1,164,310 |
| Working capital [(1)] | $621,920 | $ 591,873 |

| | Six Months Ended | |
|---|---|---|
| | June 30, 2016 | June 30, 2015 |
| | (in thousands) | |
| Cash provided by operating activities | $168,532 | $ 148,924 |
| Cash provided by (used in) investing activities | (69,417) | 17,930 |
| Cash provided by (used in) financing activities | (46,012) | 31,285 |
| Net increase in cash and cash equivalents | $53,103 | $ 198,139 |

[(1)] Working capital is defined as current assets less current liabilities.

Liquidity and capital resources may be impacted by our operating activities, as well as by our business acquisitions, capital expenditures, stock repurchases, proceeds associated with stock option exercises and issuances of common stock under the ESPP, payment of taxes in connection with the net settlement of equity awards, the timing of sales within an accounting period, and investments in strategic relationships that we have made or may make in the future. Our liquidity may be impacted by our customer-buying patterns and the efforts of our sales force and channel partners, which have historically resulted in our receiving a substantial portion of our billings during the last two weeks of the quarter. Billings during the last two weeks of the second quarter of 2016 were in excess of 40% compared to the historical eight-quarter average of 33%. As of June 30, 2016, $150.0 million remains available for future share repurchases under our share repurchase program, which will be financed through our available working capital. In recent years we have received significant capital as a result of the exercise of stock options and purchases under our ESPP. We expect proceeds in future years to decrease due to the increased mix of RSUs granted versus stock options and also to be impacted by our share price. During 2016, we expect to spend $80.0 million to $90.0 million in capital expenditures primarily related to expansion of our offices to support worldwide growth and the implementation of our ERP system.

As of June 30, 2016, our cash, cash equivalents, and investments of $1.2 billion were invested primarily in U.S. government and agency securities, municipal bonds, corporate debt securities, commercial paper, certificates of deposit and term deposits, and money market funds. It is our investment policy to invest excess cash in a manner that preserves capital, provides liquidity and maximizes return without significantly increasing risk.

As of June 30, 2016, $455.2 million of our cash and investments were held by our international subsidiaries and are therefore not immediately available to fund domestic operations unless the cash is repatriated. While we do not intend to do so, should this amount be repatriated, most of it would be subject to U.S. federal income tax that would be partially offset by foreign tax credits. We do not enter into investments for trading or speculative purposes. We believe that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the

introduction of new and enhanced products and services offerings, the costs to ensure access to adequate manufacturing capacity and the continuing market acceptance of our products. Historically, we have required capital principally to fund our working capital needs, capital expenditures, share repurchases and acquisition activities. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

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Operating Activities

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

Our operating activities during the six months ended June 30, 2016 provided $168.5 million in cash as a result of our continued growth in billings and our ability to successfully manage our working capital. Changes in operating assets and liabilities primarily resulted from an increase in payments received from customers, which was partially offset by an increase in payments to vendors.

Our operating activities during the six months ended June 30, 2015 provided $148.9 million in cash as a result of our continued growth in billings and the ability to successfully manage our working capital. Changes in operating assets and liabilities primarily included an increase in payments received from customers, partially offset by an increase in payments to vendors for inventory-related purchases and prepayment of certain expenses.

Investing Activities

The changes in cash flows from investing activities primarily relate to timing of purchases, maturities and sales of investments purchases of property and equipment, and payments made in connection with business acquisitions. Historically, in making a lease versus purchase decision related to our larger facilities, we have elected to purchase the facility. We expect to make similar decisions in the future.

During the six months ended June 30, 2016, cash used for investing activities was primarily due to the $44.4 million we spent on capital expenditures, including our purchase of a warehouse in Union City, California for total cash of $18.5 million, and a $20.7 million payment for the acquisition of AccelOps. Cash outflows due to purchases of investments, net of sales and maturities, amounted to $4.4 million.

During the six months ended June 30, 2015, cash provided by investing activities was a result of positive cash flow due to maturities, net of purchases, from our investments of $33.6 million, partially offset by capital expenditures of $15.7 million.

Financing Activities

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

During the six months ended June 30, 2016, cash used for financing activities was $46.0 million, primarily due to $50.0 million used to repurchase our common stock. This was partially offset by $5.6 million of proceeds from the issuance of common stock, net of taxes paid, related to withholding upon issuance of equity awards.

During the six months ended June 30, 2015, cash provided by financing activities was $31.3 million as a result of proceeds of $42.6 million from the issuance of common stock under our stock-based compensation plans. This cash inflow was partially offset by $11.4 million of withholding tax payments upon issuance of equity awards.

Contractual Obligations and Commitments

There were no material changes outside the ordinary course of business during the six months ended June 30, 2016 to the contractual obligations and commitments disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II, Item 7, of the Form 10-K. See Note 10 to the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information regarding contractual obligations and commitments.

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Off-Balance Sheet Arrangements

As of June 30, 2016, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There were no material changes in our market risk during the six months ended June 30, 2016 compared to the disclosures in Part II, Item 7A of the Form 10-K.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act) as of June 30, 2016. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of June 30, 2016 to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

In July 2015, we completed the acquisition of Meru. We have integrated Meru into our systems and controls environment as of June 30, 2016. There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the six months ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II

ITEM 1. Legal Proceedings

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

ITEM 1A. Risk Factors

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

Risks Related to Our Business

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

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

- the level of demand for our products and services, which may render forecasts inaccurate;
- the timing of channel partner and end-customer orders and our reliance on a concentration of shipments at the end of each quarter;
- the timing of shipments, which may depend on many factors such as inventory levels, logistics, shipping delays, our ability to ship new products on schedule and to accurately forecast inventory requirements, and potential delays in the manufacturing process;
- inventory management;
- the mix of products sold, the mix of revenue between products and services and the degree to which products and services are bundled and sold together for a package price;
- the purchasing practices and budgeting cycles of our channel partners and end-customers;
- seasonal buying patterns of our end-customers;
- timing and level of our investments in sales and marketing and the impact on operating expenses and operating margin;
-

the timing of revenue recognition for our sales, which may be affected by both the mix of sales by our "sell-in" versus our "sell-through" channel partners, and the accuracy and timing of point-of-sale reporting by our "sell-through" channel partners, which impacts our ability to recognize revenue;

- the level of perceived threats to network security, which may fluctuate from period to period;
- changes in the requirements, market needs or buying practices and patterns of distributors, resellers or end-customers;
- changes in the growth rate of the network security markets;

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- the timing and success of new product and service introductions by us or our competitors, or any other change in the competitive landscape of our industry, including consolidation among our competitors, partners, or end-customers;

- deferral of orders from distributors, resellers or end-customers in anticipation of new products or product enhancements announced by us or our competitors;

- increases or decreases in our billings, revenues and expenses caused by fluctuations in foreign currency exchange rates, as a significant portion of our expenses are incurred and paid in currencies other than the U.S. dollar, and fluctuations may impact the actual prices that partners and customers are willing to pay for our products and services;

- decisions by potential end-customers to purchase network security solutions from newer technology providers, from larger, more established security vendors or from their primary network equipment vendors;

- price competition and increased competitiveness in our market;

- changes in customer renewal rates for our services;

- changes in the payment terms of services contracts or the length of services contracts sold;

- changes in our estimated annual effective tax rates;

- changes in circumstances and challenges in business conditions, including decreased demand, which may negatively impact our channel partners' ability to sell the current inventory they hold and negatively impact their future purchases of products from us;

- increased expenses, unforeseen liabilities or write-downs and any impact on results of operations from any acquisition consummated;

- our channel partners may have insufficient financial resources and may not be able to withstand changes and challenges in business conditions;

- disruptions in our channel or termination of our relationship with important channel partners;

- insolvency, credit or other difficulties confronting our key suppliers and channel partners, which could affect their ability to purchase or pay for products and services and which could disrupt our supply or distribution chain;

- general economic conditions, both in our domestic and foreign markets;

- future accounting pronouncements or changes in our accounting policies; and

- legislative or regulatory changes, such as with respect to privacy, information and cyber security, exports, the environment, and accounting standards.

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

event of revenue shortfalls, we are generally unable to mitigate the negative impact on margins in the short term.

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

Our business depends on the overall demand for information technology and on the economic health of our current and prospective customers. In addition, the purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. Weak global economic conditions, weak economic conditions in certain

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geographies, or a reduction in information technology spending regardless of macro-economic conditions, could adversely impact our business, financial condition and results of operations in a number of ways, including longer sales cycles, lower prices for our products and services, higher default rates among our channel partners, reduced unit sales and slower or declining growth.

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

Billings and revenue growth may slow, or we may experience a decrease in billings and revenue, for a number of reasons, including a slowdown in demand for our products or services, increased competition, a decrease in the growth of our overall market, softness in demand in certain geographies or industry verticals, such as the service provider industry, if we fail for any reason to continue to capitalize on growth opportunities, and due to other risks identified in the “Risk Factors.” Our expenses as a percentage of total revenue may be higher than expected if our revenue is lower than expected and if our investments in sales and marketing and other functional areas do not result in expected billings and revenue growth, and we may experience margin declines in future periods if we fail to increase billings, revenue or deferred revenue, do not appropriately manage our cost structure, or encounter unanticipated liabilities. Any failure by us to maintain profitability, maintain our margins, and continue our billings and revenue growth could cause the price of our common stock to materially decline.

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

Our FortiGuard security subscription and FortiCare technical support services revenue has historically accounted for a significant percentage of our total revenue. Revenues from the sales of new, or renewals of existing, FortiGuard security subscription and FortiCare technical support services contracts may decline and fluctuate as a result of a number of factors, including fluctuations in purchases of FortiGate appliances, end-customers’ level of satisfaction with our products and services, the prices of our products and services, the prices of products and services offered by our competitors, reductions in our customers’ spending levels and the timing of revenue recognition with respect to these arrangements. If our sales of new, or renewals of existing FortiGuard security subscription and FortiCare technical support services contracts decline, our revenue and revenue growth may decline and our business could suffer. In addition, in the event significant customers require payment terms for FortiGuard security subscription or FortiCare technical support services in arrears or for shorter periods of time than annually, such as monthly or quarterly, this may negatively impact our billings and revenue. Furthermore, we recognize FortiGuard security subscription and FortiCare technical support services revenue monthly over the term of the relevant service period, which is typically from one to three years, and in some instances has been as long as five years. As a result, much of the FortiGuard security subscription and FortiCare technical support services revenue we report each quarter is the recognition of deferred revenue from FortiGuard security subscription and FortiCare technical support services contracts entered into during previous quarters or years. Consequently, a decline in new or renewed FortiGuard security subscription or FortiCare technical support services contracts in any one quarter will not be fully reflected in revenue in that quarter but will negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in sales of new, or renewals of existing, FortiGuard security subscription or FortiCare technical support services is not reflected in full in our statements of operations until future periods. Our FortiGuard security subscription and FortiCare technical support services revenue also makes it difficult for us to rapidly increase our revenue through additional service sales in any period, as revenue from new and renewal support services contracts must be recognized over the applicable service period.

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

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

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

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- difficulties and costs of staffing and managing foreign operations;
- the uncertainty of protection for intellectual property rights in some countries;
- costs of compliance with foreign policies, laws and regulations and the risks and costs of non-compliance with such policies, laws and regulations;
- protectionist policies and penalties, and local laws, requirements, policies and perceptions that may adversely impact U.S. headquartered business' sales in certain countries outside of the United States;
- costs of complying with U.S. or other foreign laws and regulations for foreign operations, including the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act 2010, import and export control laws, tariffs, trade barriers and economic sanctions;
- other regulatory or contractual limitations on our ability to sell our products in certain foreign markets, and the risks and costs of non-compliance;
- heightened risks of unfair or corrupt business practices in certain geographies and of improper or fraudulent sales or sales-related arrangements that could disrupt the sales team through terminations of employment or otherwise, and may adversely impact financial results as compared to those already reported or forecasted and result in restatements of financial statements and irregularities in financial statements;
- our ability to effectively implement and maintain adequate internal controls to properly manage our international sales and operations;
- the potential for political unrest, terrorism, hostilities, war or natural disasters;
- changes in foreign currency exchange rates;
- management communication and integration problems resulting from cultural differences and geographic dispersion; and
- changes in tax, employment and other laws

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

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

An important part of our growth strategy is to increase sales of our products to large and medium-sized enterprises, service providers and government organizations. While we have increased sales in recent periods to large enterprises and service providers, we have experienced less traction selling to certain government organizations and there can be no assurance that we will be successful selling to these customers. Sales to these organizations involve risks that may not be present (or that are present to a lesser extent) with sales to smaller entities. These risks include:

- increased competition from competitors that traditionally target large and medium-sized enterprises, service providers and government organizations and that may already have purchase commitments from those end-customers;

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- increased purchasing power and leverage held by large end-customers in negotiating contractual arrangements;
- unanticipated changes in the capital resources or purchasing behavior of large end-customers, including changes in the volume and frequency of their purchases;
- more stringent support requirements in our support service contracts, including stricter support response times, more complex requirements and increased penalties for any failure to meet support requirements; and
- longer sales cycles and the associated risk that substantial time and resources may be spent on a potential end-customer that elects not to purchase our products and services.

Large and medium-sized enterprises, service providers and government organizations often undertake a significant evaluation process that results in a lengthy sales cycle, in some cases over 12 months. Although we have a channel sales model, our sales representatives typically engage in direct interaction with end-customers, along with our distributors and resellers, in connection with sales to large and medium-sized end-customers. We may spend substantial time, effort and money in our sales efforts without being successful in producing any sales. In addition, product purchases by large and medium-sized enterprises, service providers and government organizations are frequently subject to budget constraints, multiple approvals and unplanned administrative, processing and other delays. Furthermore, service providers represent our largest industry vertical and consolidation or changes in buying behavior by larger customers within this industry could negatively impact our business. Large and medium-sized enterprises, service providers and government organizations typically have longer implementation cycles, require greater product functionality and scalability, expect a broader range of services, including design services, demand that vendors take on a larger share of risks, require acceptance provisions that can lead to a delay in revenue recognition, and expect greater payment flexibility from vendors. All these factors can add further risk to business conducted with these customers. In addition, if sales expected from a large and medium-sized end-customer for a particular quarter are not realized in that quarter or at all, our business, operating results and financial condition could be materially and adversely affected.

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

Managing our inventory is complex. Our channel partners may increase orders during periods of product shortages, cancel orders or not place orders commensurate with our expectations if their inventory is too high, return products or take advantage of price protection (if any is available to the particular partner) or delay orders in anticipation of new products. They also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them and in response to seasonal fluctuations in end-customer demand. Furthermore, if the time required to manufacture or ship certain products increases for any reason, inventory shortfalls could result. Management of our inventory is further complicated by the significant number of different products and models that we sell.

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

than we had forecasted. If we are unable to effectively manage our inventory and that of our channel partners, our results of operations could be adversely affected.

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

Our future performance depends on the continued services and continuing contributions of our senior management to execute on our business plan, and to identify and pursue new opportunities and product innovations. The loss of services of members of senior management, particularly Ken Xie, our Co-Founder, Chairman and Chief Executive Officer, and Michael Xie, our Co-Founder, President and Chief Technology Officer, and any of our senior sales leaders or functional area leaders, could significantly delay or prevent the achievement of our development and strategic objectives. The loss of the services, or distraction, of our senior management for any reason could adversely affect our business, financial condition and results of

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operations.

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

Our future success depends, in part, on our ability to continue to attract and retain highly skilled personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel, or delays in hiring required personnel, particularly in engineering and sales, may seriously harm our business, financial condition and results of operations. From time to time, we experience turnover in our management-level personnel. None of our key employees has an employment agreement for a specific term, and any of our employees may terminate their employment at any time. Our ability to continue to attract and retain highly skilled personnel will be critical to our future success. Competition for highly-skilled personnel is frequently intense, especially for qualified employees in network security and especially in the locations where we have a substantial presence and need for highly-skilled personnel, such as the San Francisco Bay Area and Vancouver, Canada. We may not be successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs. Also, to the extent we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited or divulged proprietary or other confidential information.

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

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

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

As a result of customer-buying patterns and the efforts of our sales force and channel partners to meet or exceed quarterly quotas, we have historically received a substantial portion of each quarter’s sales orders and generated a substantial portion of each quarter’s billings and revenue during the last two weeks of the quarter. For example, in the second quarter of 2016, the portion of billings during the last two weeks of the quarter was in excess of 40%, and, on average over the past eight quarters, our shipments during the last two weeks of each quarter accounted for 33% of aggregate billings for each quarter. If expected orders at the end of any quarter are delayed for any reason, including the failure of anticipated purchase orders to materialize, our logistics partners’ inability to ship products prior to quarter-end to fulfill purchase orders received near the end of the quarter, our failure to manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, any delays in shipments due to trade compliance requirements, labor disputes or logistics changes at shipping ports or otherwise, our billings and revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

Unless we continue to develop better market awareness of our company and our products, and to improve lead generation and sales enablement, our revenue may not continue to grow.

Increased market awareness of our capabilities and products and increased lead generation are essential to our continued growth and our success in all of our markets, particularly for the large enterprise, service provider and government organization market. We have historically had relatively low spending on marketing activities. While we have increased our investments in sales and marketing, it is not clear that these investments will continue to result in increased revenue. If our investments in additional sales personnel or if our marketing programs are not successful in continuing to create market awareness of our company and products and increased lead generation, or if we experience turnover and disruption in our sales and marketing teams, we will not be able to achieve sustained growth, and our business, financial condition and results of operations will be adversely affected.

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

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

We provide sales channel partners with specific programs to assist them in selling our products and incentivize them to sell our products, but there can be no assurance that these programs will be effective. In addition, our channel partners may be unsuccessful in marketing, selling and supporting our products and services and may purchase more inventory than they can sell. Our channel partners generally do not have minimum purchase requirements. Some of our channel partners may have insufficient financial resources to withstand changes and challenges in business conditions. In addition, if our channel partners' financial condition or operations weaken it could negatively impact their ability to sell our product and services. They may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products. They may also have incentives to promote our competitors' products to the detriment of our own, or they may cease selling our products altogether. We cannot ensure that we will retain these channel partners or that we will be able to secure additional or replacement partners or that existing channel partners will continue to perform. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results. During the three months ended June 30, 2016, Exclusive Networks Group and Ingram Micro, which distributed our solutions to a large group of resellers and end-customers, accounted for 20% and 10% of our total revenue, respectively. During the six months ended June 30, 2016, Exclusive Networks Group, which distributed our solutions to a large group of resellers and end-customers, accounted for 20% of our total revenue. During the three and six months ended June 30, 2015, Exclusive Networks Group, accounted for 17%, of our total revenue. In addition, any new sales channel partner will require extensive training and may take several months or more to achieve productivity. Our channel partner sales structure could subject us to lawsuits, potential liability and reputational harm if, for example, any of our channel partners misrepresent the functionality of our products or services to end-customers or our channel partners violate laws or our corporate policies. We depend on our global channel partners to comply with applicable legal and regulatory requirements. To the extent that they fail to do so, that could have a material adverse effect on our business, operating results and financial condition. If we fail to optimize our channel partner model or fail to manage existing sales channels, our business will be seriously harmed.

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

Because our products and services are complex, they have contained and may contain defects or errors that are not detected until after their commercial release and deployment by our customers. Defects or vulnerabilities may impede or block network traffic, cause our products or services to be vulnerable to electronic break-ins or cause them to fail to help secure networks. Different customers deploy and use our products in different ways, and certain deployments and usages may subject our products to adverse conditions that may negatively impact the effectiveness and useful lifetime of our products. We cannot ensure that our products will prevent all security threats. Because the techniques used by computer hackers to access or sabotage networks change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques. In addition, defects or errors in our

FortiGuard security subscription updates or our FortiGate appliances could result in a failure of our FortiGuard security subscription services to effectively update end-customers' FortiGate appliances and thereby leave customers vulnerable to attacks. Furthermore, our solutions may also fail to detect or prevent viruses, worms or similar threats due to a number of reasons such as the evolving nature of such threats and the continual emergence of new threats that we may fail to add to our FortiGuard databases in time to protect our end-customers' networks. Our FortiGuard or FortiCare data centers and networks may also experience technical failures and downtime, and may fail to distribute appropriate updates, or fail to meet the increased requirements of our customer base. Any such technical failure, downtime, or failures in general may temporarily or permanently expose our end-customers' networks, leaving their networks unprotected against the latest security threats.

An actual, possible or perceived security breach or infection of the network of one of our end-customers, regardless of whether the breach is attributable to the failure of our products or services to prevent the security breach, could adversely affect the market's perception of our security products and services and, in some instances, subject us to potential liability that is not contractually limited. We may not be able to correct any security flaws or vulnerabilities promptly, or at all. Our products may

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also be misused by end-customers or third parties who obtain access to our products. For example, our products could be used to censor private access to certain information on the Internet. Such use of our products for censorship could result in negative press coverage and negatively affect our reputation, even if we take reasonable measures to prevent any improper shipment of our products or if our products are provided by an unauthorized third-party. Any actual, possible, or perceived defects, errors or vulnerabilities in our products, or misuse of our products, could result in:

- expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;
- loss of existing or potential end-customers or channel partners;
- delayed or lost revenue;
- delay or failure to attain market acceptance;
- negative publicity, which will harm our reputation; and
- litigation, regulatory inquiries or investigations that may be costly and harm our reputation and, in some instances, subject us to potential liability that is not contractually limited.

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

Our business has grown over the last several years. We rely heavily on information technology and accounting systems to help manage critical functions such as order processing, revenue recognition, financial forecasts, inventory and supply chain management and trade compliance reviews. Certain of these systems were developed by us for our internal use and as such may have a higher risk of failure or not receive the same level of support as systems purchased from and supported by external technology companies. In addition, we have been slow to adopt and implement certain automated functions, which could have a negative impact on our business. For example, a large part of our order processing relies on the manual processing of emails internally and receipt of customer purchase orders through email and, to a lesser extent, through electronic data interchange from our customers. Combined with the fact that we may receive a majority of our orders in the last few weeks of any given quarter, a significant interruption in our email service or other systems could result in delayed order fulfillment and decreased billings and revenue for that quarter. To manage any future growth effectively, we must continue to improve and expand our information technology and financial, operating and administrative systems and controls, and continue to manage headcount, capital and processes in an efficient manner. We may not be able to successfully implement requisite improvements to these systems, controls and processes, such as system capacity, access and change management controls, in a timely or efficient manner. Our failure to improve our systems and processes, or their failure to operate in the intended manner, whether as a result of the significant growth of our business or otherwise, may result in our inability to manage the growth of our business and to accurately forecast our revenue, expenses and earnings, or to prevent certain losses. Moreover, the failure of our systems and processes could undermine our ability to provide accurate, timely and reliable reports on our financial and operating results and could impact the effectiveness of our internal control over financial reporting. In addition, our systems and processes may not prevent or detect all errors, omissions or fraud. Our productivity and the quality of our products and services may also be adversely affected if we do not integrate and train our new employees quickly and effectively. Any future growth would add complexity to our organization and require effective coordination throughout our organization. Failure to manage any future growth effectively could result in increased costs and harm our results of operations.

We may experience difficulties implementing and maintaining our new enterprise resource planning system.

We have recently implemented a new ERP system. ERP implementations are complex and time-consuming, and involve substantial expenditures on maintenance activities and software. The ERP system will be critical to our ability to provide important information to our management, obtain and deliver products, provide services and customer support, send invoices and track payments, fulfill contractual obligations, accurately maintain books and records, provide accurate, timely and reliable reports on our financial and operating results or otherwise operate our business. ERP implementations also require transformation of business and financial processes in order to reap the benefits of the ERP system; any such transformation involves risks inherent in the conversion to a new computer system, including loss of information and potential disruption to our normal operations. The implementation and maintenance of the new ERP system has required, and will continue to require, the investment of significant financial and human resources and the implementation may be subject to delays and cost overruns. In addition, we may discover deficiencies in our design or implementation or maintenance of the new ERP system that could

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adversely affect our ability to process orders, ship products, provide services and customer support, send invoices and track payments, fulfill contractual obligations, accurately maintain books and records, provide accurate, timely and reliable reports on our financial and operating results, or otherwise operate our business. Additionally, if the system does not operate as intended, the effectiveness of our internal control over financial reporting could be adversely affected or our ability to assess it adequately could be delayed.

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

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, as provided in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Quarterly Report on Form 10-Q, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price. Significant assumptions and estimates used in preparing our condensed consolidated financial statements include those related to revenue recognition and sales return reserves, stock-based compensation expense, valuation of inventory, warranty liabilities, investments, accounting for business combination, goodwill and other long-lived assets, restructuring, accounting for income taxes, and litigation and settlement costs.

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

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

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

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

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

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Our proprietary FortiASIC, which is the key to the performance of our appliances, is fabricated by contract manufacturers in foundries operated by UMC and TSMC on a purchase order basis, and UMC and TSMC do not guarantee any capacity and could reject orders or could try to increase pricing. Accordingly, the foundries are not obligated to continue to fulfill our supply requirements, and due to the long lead time that a new foundry would require, we could suffer temporary or long term inventory shortages of our FortiASIC as well as increased costs. Our suppliers may also prioritize orders by other companies that order higher volumes or more profitable products. If any of these manufacturers materially delays its supply of ASICs or specific product models to us, or requires us to find an alternate supplier and we are not able to do so on a timely and reasonable basis, or if these foundries materially increase their prices for fabrication of our ASICs, our business would be harmed.

In addition, our reliance on third-party manufacturers and foundries limits our control over environmental regulatory requirements such as the hazardous substance content of our products and therefore our ability to ensure compliance with the European Union's ("EU") Restriction of Hazardous Substances Directive ("RoHS") and other similar laws. It also exposes us to the risk that certain minerals and metals, known as "conflict minerals," that are contained in our products have originated in the Democratic Republic of the Congo or an adjoining country. As a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC adopted disclosure requirements for public companies whose products contain conflict minerals that are necessary to the functionality or production of such products. Under these rules, we are required to obtain sourcing data from suppliers, perform supply chain due diligence, and file annually with the SEC a specialized disclosure report on Form SD covering the prior calendar year. We have incurred and expect to incur additional costs to comply with the rules, including costs related to the determination of the origin, source and chain of custody of the conflict minerals used in our products and the adoption of conflict minerals-related governance policies, processes and controls. Moreover, the implementation of these compliance measures could adversely affect the sourcing, availability and pricing of materials used in the manufacture of our products to the extent that there may be only a limited number of suppliers that are able to meet our sourcing requirements. There can be no assurance that we will be able to obtain such materials in sufficient quantities or at competitive prices. We may also encounter customers who require that all of the components of our products be certified as conflict-free. If we are not able to meet customer requirements, such customers may choose to not purchase our products, which could impact our sales and the value of portions of our inventory.

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

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

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

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

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- failure to meet delivery obligations in a timely fashion; and

- failure in component quality.

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

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

A significant portion of our operating expenses are incurred outside the United States. These expenses are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro and Canadian dollar and, to a lesser extent, the British Pound. For example, the vote in the United Kingdom in June 2016 to leave the European Union resulted in significant fluctuations in the exchange rate of the British Pound. While we are not currently engaged in material hedging activities, we have been hedging currency exposures relating to certain balance sheet accounts and, if we stop hedging against any of these risks or if our attempts to hedge against these currency exposures are not successful, our financial condition and results of operations could be adversely affected. In addition, our sales contracts are primarily denominated in U.S. dollars and therefore, while substantially all of our revenue is not subject to foreign currency risk, it does not serve as a hedge to our foreign currency-denominated operating expenses. In addition, a strengthening of the U.S. dollar could increase the real cost of our products to our customers outside of the United States, which could also adversely affect our financial condition and results of operations.

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

Because we incorporate encryption technology into our products, certain of our products are subject to U.S. export controls and may be exported outside the United States only with the required export license or through an export license exception, and may be prohibited altogether from export to certain countries. If we were to fail to comply with U.S. export laws, U.S. Customs regulations and import regulations, U.S. economic sanctions and other countries' import and export laws, we could be subject to substantial civil and criminal penalties, including fines for the company and incarceration for responsible employees and managers, and the possible loss of export or import privileges. In addition, if our channel partners fail to obtain appropriate import, export or re-export licenses or permits (for example, for stocking orders placed by our partners), we may also be adversely affected through reputational harm and penalties and we may not be able to provide support related to appliances shipped pursuant to such orders. Obtaining the necessary export license for a particular sale may be time-consuming and may result in the delay or loss of sales opportunities.

Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of products to U.S. embargoed or sanctioned countries, governments and persons. Even though we take precautions to prevent our product from being shipped to U.S. sanctions targets, our products could be shipped to those targets by our channel partners, despite such precautions. Any such shipment could have negative consequences including government investigations and penalties and reputational harm. In addition, various countries regulate the import of certain encryption technology, including import permitting and licensing requirements, and have enacted laws that could limit our ability to distribute our

products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products globally or, in some cases, prevent the export or import of our products to certain countries, governments or persons altogether. Any change in export or import regulations, economic sanctions or related legislation, shift in the enforcement or scope of existing regulations, or change in the countries, governments, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, financial condition and results of operations.

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

We are subject to various environmental laws and regulations including laws governing the hazardous material content of our products, our real property, and laws relating to the recycling of electrical and electronic equipment. The laws and regulations to which we are subject include the EU RoHS and the EU Waste Electrical and Electronic Equipment Directive ("WEEE Directive"), as well as the implementing legislation of the EU member states. Similar laws and regulations have been passed or are pending in China, South Korea, Norway and Japan and may be enacted in other regions, including in the United States, and we are, or may in the future be, subject to these laws and regulations.

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

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

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

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

Sales to U.S. and foreign federal, state and local governmental agency end-customers have accounted for a portion of our revenue in past periods, and we may in the future increase sales to government organizations. Sales to government organizations are subject to a number of risks. Selling to government organizations can be highly competitive, expensive and time consuming, often requiring significant upfront time and expense, with long sales cycles and without any assurance of winning a sale.

Government demand, sales and payment for our products and services may be negatively impacted by numerous factors and requirements unique to selling to government agencies, such as:

- public sector budgetary cycles,
- funding authorizations and requirements unique to government agencies, with funding or purchasing reductions or delays adversely affecting public sector demand for our products,

- geopolitical matters, and
- rules and regulations applicable to certain government sales.

The rules and regulations applicable to sales to government organizations may also negatively impact sales to other organizations. To date, we have had limited traction in sales to U.S. federal government agencies, and any future sales to government organizations is uncertain. Government organizations may have contractual or other legal rights to terminate contracts with our distributors and resellers for convenience or due to a default, and any such termination may adversely impact our future results of operations. For example, if the distributor receives a significant portion of its revenue from sales to such government organization, the financial health of the distributor could be substantially harmed, which could negatively affect our future sales to such distributor. Governments routinely investigate and audit government contractors' administrative processes, and any unfavorable audit could result in the government refusing to continue buying our products and services, a reduction of revenue or fines or civil or criminal liability if the audit uncovers improper or illegal activities. Any such penalties

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could adversely impact our results of operations in a material way. Finally, purchases by the U.S. government may require certain products to be manufactured in the United States and other high cost manufacturing locations, and we may not manufacture all products in locations that meet the requirements of the U.S. government.

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

Our antivirus and our intrusion prevention services may falsely detect viruses or other threats that do not actually exist. This risk is heightened by the inclusion of a “heuristics” feature in our products, which attempts to identify viruses and other threats not based on any known signatures but based on characteristics or anomalies that may indicate that a particular item is a threat. When our end-customers enable the heuristics feature in our products, the risk of falsely identifying viruses and other threats significantly increases. These false positives, while typical in the industry, may impair the perceived reliability of our products and may therefore adversely impact market acceptance of our products. Also, our anti-spam and anti-malware services may falsely identify emails or programs as unwanted spam or potentially unwanted programs, or alternatively fail to properly identify unwanted emails or programs, particularly as spam emails or spyware are often designed to circumvent anti-spam or spyware products. Parties whose emails or programs are blocked by our products may seek redress against us for labeling them as spammers or spyware, or for interfering with their business. In addition, false identification of emails or programs as unwanted spam or potentially unwanted programs may reduce the adoption of our products. If our system restricts important files or applications based on falsely identifying them as malware or some other item that should be restricted, this could adversely affect end-customers’ systems and cause material system failures. In addition, our threat researchers periodically identify vulnerabilities in various third-party products, and, if these identifications are perceived to be incorrect or are in fact incorrect, this could harm our business. Any such false identification or perceived false identification of important files, applications or vulnerabilities could result in negative publicity, loss of end-customers and sales, increased costs to remedy any problem and costly litigation.

If our internal network system or our website is compromised, public perception of our products and services will be harmed, we may become subject to liability, and our business, operating results and stock price may be adversely impacted.

We will not succeed unless the marketplace is confident that we provide effective network security protection. Despite our efforts and processes to prevent breaches of our internal network system and website, we are still vulnerable to computer viruses, break-ins, phishing attacks, attempts to overload our servers with denial-of-service and other cyber-attacks and similar disruptions from unauthorized access to our internal network system or our website. Our security measures may also be breached due to employee error, malfeasance or otherwise, and third parties may attempt to fraudulently induce our employees to transfer funds or disclose information in order to gain access to our network and confidential information. We cannot assure you that the measures we have taken to protect our network and website will provide absolute security. Moreover, because we provide network security products, we may be a more attractive target for attacks by computer hackers. Although we have not yet experienced significant damages from unauthorized access by a third party of our internal network or website, an actual or perceived breach of network security occurs in our internal systems or website could adversely affect the market perception of our products and services and investor confidence in our company. Any breach of our network system or website could impair our ability to operate our business, including our ability to provide FortiGuard security subscription and FortiCare technical support services to our end-customers, lead to interruptions or system slowdowns, cause loss of critical data, or lead to the unauthorized disclosure or use of confidential, proprietary or sensitive information. We could also be subject to liability and litigation and reputational harm and our channel partners and end-customers may be harmed, lose confidence in us and decrease or cease using our products and services. Any breach of our internal network system or our website could have an adverse effect on our business, operating results and stock price.

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

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

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

We could be subject to changes in our tax rates, the adoption of new U.S. or international tax legislation, or exposure to additional tax liabilities.

We are subject to taxes in the United States and numerous foreign jurisdictions, where a number of our subsidiaries are organized. Our provision for income taxes is subject to volatility and could be adversely affected by several factors, many of which are outside of our control, including:

- earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates;
- the mix of earnings in countries with differing statutory tax rates or withholding taxes;
- changes in the valuation of our deferred tax assets and liabilities;
- transfer pricing adjustments;
- an increase in non-deductible expenses for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development, and impairment of goodwill;
- tax costs related to intercompany realignments;
- tax assessments resulting from income tax audits or any related tax interest or penalties that could significantly affect our provision for income taxes for the period in which the settlement takes place;
- a change in our decision to indefinitely reinvest foreign earnings;
- changes in accounting principles;
- court decisions, tax rulings and interpretations of tax laws, and regulations by international, federal or local governmental authorities; or
- changes in tax laws and regulations, including possible changes in the United States to the taxation of earnings of our foreign subsidiaries, the deductibility of expenses attributable to foreign income or the foreign tax credit rules, or changes to the U.S. income tax rate, which would necessitate a revaluation of our deferred tax assets and liabilities.

Significant judgment is required to determine the recognition and measurement attribute prescribed in the FASB standard. In addition, the standard applies to all income tax positions, including the potential recovery of previously paid taxes, which, if settled unfavorably, could adversely impact our provision for income taxes or additional paid-in capital. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain foreign countries is subject to reduced tax rates and, in some cases, is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the examination of our income tax returns by the Internal Revenue Service (“IRS”) and other tax authorities. The tax authorities in France are examining the inter-company relationship between Fortinet, Inc., Fortinet France and Fortinet Singapore. We are in the early stages of this inquiry and as of yet no official audit has been opened. We regularly assess the likelihood of adverse outcomes resulting from such examinations to determine the adequacy of

our provision for income taxes.

Although we currently do not have a valuation allowance, we may in the future be required to establish one. We will continue to assess the need for a valuation allowance on the deferred tax asset by evaluating both positive and negative evidence that may exist.

In addition, we hold a significant portion of our cash and investments outside of the United States. Potential legislation could result in our transferring this cash and investments back to the United States, and potentially incurring an additional tax obligation.

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

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

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

The Organisation for Economic Co-operation and Development (the “OECD”), an international association comprised of 34 countries, including the United States, has been working on a Base Erosion and Profit Sharing Project. As part of this project, the OECD has issued in 2015, and is expected to continue to issue, guidelines and proposals that may change various aspects of the existing framework under which our tax obligations are determined in many of the countries in which we do business. Due to our extensive international business activities, any changes in the taxation of such activities could increase our tax obligations in many countries and may increase our worldwide effective tax rate.

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

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

In order to remain competitive, we may seek to acquire additional businesses, products, or technologies and intellectual property, such as patents. For example, we closed our acquisitions of Meru and AccelOps in the third quarter of 2015 and the second quarter of 2016, respectively. For any past acquisition or possible future acquisition, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product, technology or intellectual property and sales force into our existing business and operations. We may have difficulty incorporating acquired technologies, intellectual property or products with our existing product lines, integrating reporting systems and procedures, and maintaining uniform standards,

controls, procedures and policies. For example, we may experience difficulties integrating an acquired company's ERP system, sales and support processes and systems, and other processes and systems with our current systems and processes. Our due diligence may fail to identify all of the problems, liabilities or other shortcomings or challenges of an acquired business, product or technology, including issues with intellectual property, product quality or product architecture, regulatory compliance practices, revenue recognition or other accounting practices or employee or customer issues, and we may not accurately forecast the financial impact of an acquisition. In addition, any acquisitions we are able to complete, such as our acquisition of AccelOps, may be dilutive to revenue growth and earnings and may not result in any synergies or other benefits we had expected to achieve, which could result in impairment charges that could be substantial. We may have to pay cash, incur debt, or issue equity securities to pay for any acquisition, each of which could affect our financial condition or the value of our capital stock and could result in dilution to our stockholders. Acquisitions during a quarter may result in increased operating expenses and adversely affect our results of operations for that period or future periods compared to the results that we have previously forecasted or achieved. Further, completing a potential acquisition and integrating acquired businesses, products, technologies or intellectual property could significantly divert management time and resources.

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

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

Although we generally have limitation of liability provisions in our standard terms and conditions of sale, they may not fully or effectively protect us from claims as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries, and in some circumstances we may be required to indemnify a customer in full, without a limitation on liability, for certain liabilities, including potential liabilities that are not contractually limited. The sale and support of our products also entail the risk of product liability claims. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not cover such claim at all or may not adequately cover any claim asserted against us, and in some instances may subject us to potential liability that is not contractually limited. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management's time and other resources.

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

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

Risks Related to Our Industry

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

The network security market is expected to continue to evolve rapidly. Moreover, many of our end-customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated techniques to gain access to and attack systems and networks. The technology in our products is

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especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, while minimizing the impact on network performance. Additionally, some of our new products and enhancements may require us to develop new hardware architectures and ASICs that involve complex, expensive and time consuming research and development processes. Although the market expects rapid introduction of new products or product enhancements to respond to new threats, the development of these products is difficult and the timetable for commercial release and availability is uncertain and there can be long time periods between releases and availability of new products. We have in the past and may in the future experience unanticipated delays in the availability of new products and services and fail to meet previously announced timetables for such availability. If we do not quickly respond to the rapidly changing and rigorous needs of our end-customers by developing and releasing and making available on a timely basis new products and services or enhancements that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

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

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

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

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

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

bringing them to market.

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

- delays in releasing our new products or enhancements to the market;
- failure to accurately predict market demand in terms of product functionality and to supply products that meet this demand in a timely fashion;
- failure of our sales force and partners to focus on selling new products;
- inability to interoperate effectively with the networks or applications of our prospective end-customers;

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- inability to protect against new types of attacks or techniques used by hackers;
- actual or perceived defects, vulnerabilities, errors or failures;
- negative publicity about their performance or effectiveness;
- introduction or anticipated introduction of competing products by our competitors;
- poor business conditions for our end-customers, causing them to delay IT purchases;
- easing of regulatory requirements around security; and
- reluctance of customers to purchase products incorporating open source software.

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

Demand for our products may be limited by market perception that individual products from one vendor that provide multiple layers of security protection in one product are inferior to point solution network security solutions from multiple vendors.

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

We face intense competition in our market and we may lack sufficient financial or other resources to maintain or improve our competitive position.

The market for network security products is intensely competitive, and we expect competition to intensify in the future. Our competitors include companies such as Check Point, Cisco, SonicWall, F5 Networks, FireEye, Intel/McAfee, Juniper, Palo Alto Networks, Sophos and Symantec.

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

- greater name recognition and longer operating histories;
- larger sales and marketing budgets and resources;
- broader distribution and established relationships with distribution partners and end-customers;
- access to larger customer bases;
- greater customer support resources;
- greater resources to make acquisitions;

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- lower labor and development costs; and

- substantially greater financial, technical and other resources.

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

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

Large, well-established providers of networking equipment such as Cisco, F5 Networks and Juniper offer, and may continue to introduce, network security features that compete with our products, either in standalone security products or as additional features in their network infrastructure products. The inclusion of, or the announcement of an intent to include, functionality perceived to be similar to that offered by our security solutions in networking products that are already generally accepted as necessary components of network architecture may have an adverse effect on our ability to market and sell our products. Furthermore, even if the functionality offered by network infrastructure providers is more limited than our products, a significant number of customers may elect to accept such limited functionality in lieu of adding appliances from an additional vendor such as us. Many organizations have invested substantial personnel and financial resources to design and operate their networks and have established deep relationships with other providers of networking products, which may make them reluctant to add new components to their networks, particularly from other vendors such as us. In addition, an organization's existing vendors or new vendors with a broad product offering may be able to offer concessions that we are not able to match because we currently offer only

network security products and have fewer resources than many of our competitors. If organizations are reluctant to add additional network infrastructure from new vendors or otherwise decide to work with their existing vendors, our business, financial condition and results of operations will be adversely affected.

Risks Related to Intellectual Property

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

We rely primarily on patent, trademark, copyright and trade secrets laws and confidentiality procedures and contractual provisions to protect our technology. Valid patents may not issue from our pending applications, and the claims eventually allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate

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defensive protection or competitive advantages to us. Patent applications in the United States are typically not published until at least 18 months after filing, or, in some cases, not at all, and publications of discoveries in industry-related literature lag behind actual discoveries. We cannot be certain that we were the first to make the inventions claimed in our pending patent applications or that we were the first to file for patent protection. Additionally, the process of obtaining patent protection is expensive and time-consuming, and we may not be able to prosecute all necessary or desirable patent applications at a reasonable cost or in a timely manner. In addition, recent changes to the patent laws in the United States may bring into question the validity of certain software patents and may make it more difficult and costly to prosecute patent applications. As a result, we may not be able to obtain adequate patent protection or effectively enforce our issued patents.

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

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

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

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

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

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

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

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

From time to time we are subject to lawsuits claiming patent infringement. We are also subject to other litigation in addition to patent infringement claims, such as employment-related litigation and disputes, as well as general commercial litigation, and could become subject to other forms of litigation and disputes, including stockholder litigation. If we are unsuccessful in defending any such claims, our operating results and financial condition and results may be materially and adversely affected. For example, we may be required to pay substantial damages and could be prevented from selling certain of our products. Litigation, with or without merit, could negatively impact our business, reputation and sales in a material fashion.

We have several on-going patent lawsuits and several non-practicing entity patent holding companies have sent us letters proposing that we license certain of their patents. Given this and the proliferation of lawsuits in our industry and other similar industries by both non-practicing entities and operating entities, we expect that we will be sued for patent infringement in the future, regardless of the merits of any such lawsuits. The cost to defend such lawsuits and any adverse result in such lawsuits could have a material adverse effect on our results of operations and financial condition.

We rely on the availability of third-party licenses.

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

Risks Related to Ownership of our Common Stock

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

The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and other rules implemented by the SEC and The NASDAQ Stock Market impose various requirements on public companies, including requiring changes in corporate governance practices. These requirements, as well as proposed corporate governance laws and regulations under consideration, may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management's attention from other

business concerns, it could have a material adverse effect on our business, financial condition and results of operations. The Sarbanes-Oxley Act requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually, and of our disclosure controls and procedures quarterly. Although our most recent assessment, testing and evaluation resulted in our conclusion that as of December 31, 2015, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in 2016 or future periods. We may incur additional expenses and commitment of management's time in connection with further evaluations, both of which could materially increase our operating expenses and accordingly reduce our operating results.

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

A change in accounting standards or practices, and varying interpretations of existing accounting pronouncements, such as changes to standards related to revenue recognition (which are effective for us beginning on January 1, 2018), the increased use of fair value measure, and financial instruments could have a significant effect on our reported financial results or

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the way we conduct our business. If we do not ensure that our systems and processes are aligned with the new standards, we could encounter difficulties generating quarterly and annual financial statements in a timely manner, which would have an adverse effect on our business and our ability to meet our reporting obligations.

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

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

The trading price of our common stock may be volatile.

The market price of our common stock may be subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, news about us and our financial results, news about our competitors and their results, and other factors such as rumors or fluctuations in the valuation of companies perceived by investors to be comparable to us, or announcements regarding any stock repurchase programs and the timing and amount of shares we purchase under such programs. For example, during the six months ended June 30, 2016, the closing price of our common stock ranged from $23.83 to $34.78.

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

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

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

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

- providing for a classified board of directors whose members serve staggered three-year terms;
- authorizing “blank check” preferred stock, which could be issued by the board without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;
- limiting the liability of, and providing indemnification to, our directors and officers;
- limiting the ability of our stockholders to call and bring business before special meetings;

- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;

- providing that certain litigation matters may only be brought against us in state or federal courts in the State of Delaware;

- controlling the procedures for the conduct and scheduling of board and stockholder meetings; and

- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation law, which prevents some stockholders holding more than 15% of our outstanding common stock from engaging in certain business combinations without approval of the holders of a substantial majority of all of our outstanding common stock.

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

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

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Share Repurchase Program

During the three months ended June 30, 2016, there were no shares repurchased under the Program. As of June 30, 2016, $150.0 million remained available for future share repurchases under the Program.

ITEM 6. Exhibits

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

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SIGNATURES

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

Date: August 5, 2016

FORTINET, INC.

By: /s/ Andrew Del Matto
Andrew Del Matto, Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)

FORTINET, INC.

By: /s/ Keith Jensen
Keith Jensen, Chief Accounting Officer
(Duly Authorized Officer and Principal Accounting Officer)

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EXHIBIT INDEX

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

* Filed herewith.