FORTINET INC
Form 10-Q
August 04, 2011

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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, 2011
Or

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

For the transition period from to

Commission file number: 001-34511

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

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

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

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

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

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

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

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

As of July 29, 2011, there were 153,102,345 shares of the registrant's common stock outstanding.

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For the Quarter Ended June 30, 2011
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Part I

ITEM 1. Financial Statements

FORTINET, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands, except per share amounts)

	June 30, 2011	December 31, 2010
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$78,019	$66,859
Short-term investments	264,001	246,651
Accounts receivable, net of allowance for doubtful accounts of $180 and $303 at June 30, 2011 and December 31, 2010, respectively	72,212	72,336
Inventory—Net	13,650	13,517
Deferred tax asset	13,704	8,158
Prepaid expenses and other current assets	10,139	8,849
Deferred cost of revenues	2,687	3,788
Total current assets	454,412	420,158
PROPERTY AND EQUIPMENT—Net	7,339	7,056
DEFERRED TAX ASSET—Non-current	37,443	37,443
DEFERRED COST OF REVENUES	4,668	5,543
LONG-TERM INVESTMENTS	126,478	73,950
OTHER ASSETS	4,895	1,272
TOTAL ASSETS	$635,235	$545,422
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$13,207	$12,761
Accrued liabilities	19,976	16,303
Accrued payroll and compensation	20,656	19,670
Deferred revenue	192,450	169,648
Total current liabilities	246,289	218,382
DEFERRED REVENUE—Non-current	80,749	82,983
OTHER NON-CURRENT LIABILITIES	20,677	11,603
Total liabilities	347,715	312,968
COMMITMENTS AND CONTINGENCIES (Note 7)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value - 300,000 shares authorized; 154,322 and 150,172 shares issued and 152,913 and 148,763 shares outstanding at June 30, 2011 and December 31, 2010, respectively	154	150
Additional paid-in-capital	277,823	251,845
Treasury stock	(2,995)	(2,995)
Accumulated other comprehensive income	3,184	2,181
Retained earnings (accumulated deficit)	9,354	(18,727)
Total stockholders' equity	287,520	232,454
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$635,235	$545,422

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
REVENUE:				
Product	$46,687	$31,037	$86,852	$58,147
Services	52,671	40,964	101,357	79,589
Ratable product and services	3,665	4,330	8,080	8,390
Total revenue	103,023	76,331	196,289	146,126
COST OF REVENUE:				
Product	16,591	11,822	30,666	23,136
Services	8,596	6,818	16,377	13,286
Ratable product and services	1,371	1,525	2,931	3,118
Total cost of revenue	26,558	20,165	49,974	39,540
GROSS PROFIT:				
Product	30,096	19,215	56,186	35,011
Services	44,075	34,146	84,980	66,303
Ratable product and services	2,294	2,805	5,149	5,272
Total gross profit	76,465	56,166	146,315	106,586
OPERATING EXPENSES:				
Research and development	15,942	12,676	30,363	24,610
Sales and marketing	35,896	27,777	68,614	54,500
General and administrative	5,848	5,933	11,114	10,992
Total operating expenses	57,686	46,386	110,091	90,102
OPERATING INCOME	18,779	9,780	36,224	16,484
INTEREST INCOME	863	399	1,656	667
OTHER INCOME (EXPENSE)—Net	(207)	87	(302)	(163)
INCOME BEFORE INCOME TAXES	19,435	10,266	37,578	16,988
PROVISION FOR INCOME TAXES	4,941	3,397	9,497	5,901
NET INCOME	$14,494	$6,869	$28,081	$11,087
Net income per share:				
Basic	$0.10	$0.05	$0.19	$0.08
Diluted	$0.09	$0.05	$0.17	$0.07
Weighted-average shares outstanding:				
Basic	152,267	136,990	151,293	135,684
Diluted	163,887	151,274	163,393	150,866

See notes to condensed consolidated financial statements.

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

	Six Months Ended	
	June 30, 2011	June 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$28,081	$11,087
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,336	2,842
Amortization of investment premiums	6,291	2,713
Stock-based compensation	6,940	4,412
Excess tax benefit from employee stock option plans	(4,491)	(3,652)
Changes in operating assets and liabilities:		
Accounts receivable—net	63	(5,255)
Inventory—net	(1,455)	(3,002)
Deferred tax assets	(5,546)	(2)
Prepaid expenses and other current assets	(2,101)	(1,534)
Deferred cost of revenues	1,976	(223)
Other assets	(1,762)	(66)
Accounts payable	355	2,352
Accrued liabilities	3,660	283
Accrued payroll and compensation	357	2,686
Deferred settlement and other liabilities	3,170	—
Deferred revenue	20,544	23,592
Income taxes payable	14,826	3,533
Net cash provided by operating activities	74,244	39,766
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investments	(287,659)	(191,806)
Maturities and sales of investments	211,845	44,176
Purchases of property and equipment	(1,450)	(2,229)
Payment made in connection with business acquisition, net	(2,623)	—
Net cash used in investing activities	(79,887)	(149,859)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	11,219	12,541
Offering costs paid in connection with Initial Public Offering	—	(872)
Excess tax benefit from employee stock option plans	4,491	3,652
Net cash provided by financing activities	15,710	15,321
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	1,093	(1,251)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	11,160	(96,023)
CASH AND CASH EQUIVALENTS—Beginning of period	66,859	212,458
CASH AND CASH EQUIVALENTS—End of period	$78,019	$116,435
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (refunded) for income taxes	$(1,017)	$1,228
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Purchases of property and equipment not yet paid	$124	$232

See notes to condensed consolidated financial statements.

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business—Fortinet, Inc. (“Fortinet”) was incorporated in Delaware in November 2000 and is a leading provider of network security appliances and Unified Threat Management (UTM) network security solutions to enterprises, service providers and government entities worldwide. Fortinet's solutions are designed to integrate multiple levels of security protection, including firewall, virtual private networking, antivirus, intrusion prevention, web filtering, antispam and WAN acceleration.

Basis of Presentation and Preparation—The condensed consolidated financial statements include the accounts of Fortinet and its wholly owned subsidiaries (collectively, the “Company,” “we,” “us,” or “our”). All intercompany transactions and balances have been eliminated in consolidation. The accompanying condensed consolidated balance sheets as of June 30, 2011, the condensed consolidated statements of operations for the three and six months ended June 30, 2011 and June 30, 2010, and the condensed consolidated statements of cash flows for the six months ended June 30, 2011 and June 30, 2010 are unaudited. The condensed consolidated balance sheet data as of December 31, 2010 was derived from the audited consolidated financial statements, which are included in our Annual Report on Form 10-K (“Form 10-K”). The accompanying statements should be read in conjunction with the audited consolidated financial statements and related notes contained in our Form 10-K.

The accompanying unaudited interim condensed consolidated financial statements for the three and six months ended June 30, 2011 and June 30, 2010 have been prepared on the same basis as the audited consolidated statements and reflect all adjustments, consisting of normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP” or “GAAP”) pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The results of operations for the three and six months ended June 30, 2011 are not necessarily indicative of the operating results for any subsequent quarter, for the full year or any future periods.

Effective June 1, 2011, we completed a two-for-one stock split of our outstanding common shares in the form of a stock dividend. In accordance with GAAP, all shares and per share information referenced throughout the condensed consolidated financial statements have been retroactively adjusted to reflect this stock split.

Use of Estimates—The preparation of condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such management estimates include implicit service periods for revenue recognition, the best estimate of selling price, litigation and settlement costs and other loss contingencies, sales returns and allowances, reserve for bad debt, inventory write-offs, reserve for warranty costs, stock-based compensation, valuation of deferred tax assets, and tangible and intangible assets. We base our estimates on historical experience and also on assumptions that we believe are reasonable. Actual results could differ from those estimates.

Certain Significant Risks and Uncertainties—We are subject to certain risks and uncertainties that could have a material adverse effect on our future financial position or results of operations, such as the following: changes in level of demand for our products and services, seasonality, the timing of new product introductions, price and sales competition and our ability to adapt to changing market conditions and dynamics, changes in the expenses caused by, for example, fluctuations in foreign currency exchange rates, management of inventory, internal control over financial reporting, market acceptance of our new products and services, demand for UTM products and services in general, failure of our channel partners to perform, the quality of our products and services, general economic conditions, challenges in doing business outside of the United States of America, changes in customer relationships, litigation, or claims against us based on intellectual property, patent, product regulatory or other factors (Note 7), product obsolescence, and our ability to attract and retain qualified employees.

We rely on sole suppliers and independent contract manufacturers for certain of our components and one third-party logistics company for distribution of some of our products. The inability of any of these parties to fulfill our supply and logistics requirements could negatively impact our future operating results.

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

Concentration of Credit Risk—Financial instruments that subject us to concentration of credit risk consist primarily of cash, cash equivalents, short-term investments, and accounts receivable. We maintain our cash and cash equivalents in fixed income securities with major financial institutions, which our management assesses to be of high credit quality, in order to limit the exposure of each investment. Deposits held with banks may exceed the amount of insurance provided on such deposits.

Credit risk with respect to accounts receivable in general is diversified due to the number of different entities comprising our customer base and their location throughout the world. We perform ongoing credit evaluations of our customers and generally do not require collateral on accounts receivable. We maintain reserves for estimated potential credit losses.

During the three and six months ended June 30, 2011 and June 30, 2010, no single customer accounted for more than 10% of total net revenue.

At June 30, 2011 and December 31, 2010, no single customer accounted for more than 10% of net accounts receivable.

Financial Instruments and Fair Value—We apply fair value accounting for all financial assets and liabilities and non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. Due to their short-term nature, the carrying amounts reported in the consolidated financial statements approximate the fair value for accounts receivable, accounts payable, accrued compensation, and other current liabilities.

Comprehensive Income—Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 220 (formerly referred to as Statement of Financial Accounting Standards (SFAS) No. 130, Reporting Comprehensive Income) establishes standards for the reporting and displaying of comprehensive income and its components. Comprehensive income includes certain changes in equity from non-owner sources that are excluded from net income. Specifically, cumulative foreign currency translation adjustments and unrealized gains and losses on available-for-sale investments are included in comprehensive income in stockholders' equity.

Foreign Currency Translation—Assets and liabilities of foreign subsidiaries are translated into U.S. dollars using the exchange rates in effect at the balance sheet dates and revenue and expenses are translated using average exchange rates during the period. The resulting foreign translation adjustments are recorded in accumulated other comprehensive income. Foreign currency transaction gains (losses) of $(0.2) million and $0.1 million, are included in other income (expense), net for the three months ended June 30, 2011 and June 30, 2010, respectively. Foreign currency transaction losses of $0.3 million and $0.2 million are included in other income (expense), net for the six months ended June 30, 2011 and June 30, 2010, respectively.

Cash, Cash Equivalents and Investments—We consider all highly liquid investments, purchased with original maturities of three months or less, to be cash equivalents. Cash and cash equivalents consist of cash on-hand, balances with banks, and highly liquid investments in money market funds, commercial paper, government securities, certificates of deposit, municipal bonds and corporate debt securities.

Our investments consist of marketable debt securities, which are classified as available-for-sale and are recognized at fair value. We include these investments on our balance sheet as either short-term or long-term investments depending on their maturity at the time of purchase. Investments with original maturities greater than three months that mature less than one year from the consolidated balance sheet date are classified as short-term investments. Investments with maturities greater than one year from the consolidated balance sheet date are classified as long-term investments.

Investments are considered to be impaired when a decline in fair value is judged to be other-than-temporary. We consult with our investment managers and consider available quantitative and qualitative evidence in evaluating potential impairment of our investments on a quarterly basis. If the cost of an individual investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established.

For debt securities in an unrealized loss position which are deemed to be other-than-temporary, the difference between the security's then-current amortized cost basis and fair value is separated into (i) the amount of the impairment related to the credit loss (i.e., the credit loss component) and (ii) the amount of the impairment related to all other factors (i.e., the non-credit loss component). The credit loss component is recognized in earnings. The non-credit loss component is recognized in accumulated other comprehensive loss.

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FORTINET, INC. AND SUBSIDIARIES
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(Unaudited)

Inventory—Inventory is recorded at the lower of cost (using the first-in, first-out method) or market, after we give appropriate consideration to obsolescence and inventory in excess of anticipated future demand. In assessing the ultimate recoverability of inventory, we are required to make estimates regarding future customer demand, the timing of new product introductions, economic trends and market conditions. If the actual product demand is significantly lower than forecasted, we could be required to record additional inventory write-downs, which could have an adverse impact on our gross margins and profitability.

Deferred Cost of Revenues—Deferred cost of revenues represents the unamortized cost of products associated with ratable products and services revenue, which is based upon the actual cost of the hardware sold and is recognized over the service periods of the arrangements. Deferred cost of revenues associated with short-term deferred revenue is classified as short-term and deferred cost of revenues associated with long-term deferred revenue is classified as long-term.

Property and Equipment—Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally one to three years. Evaluation units are transferred from inventory at cost and are amortized over one year from the date of transfer. Leasehold improvements are amortized over the shorter of the estimated useful lives of the improvements or the lease term.

Impairment of Long-Lived Assets—We evaluate events and changes in circumstances that could indicate carrying amounts of long-lived assets, including intangible assets, may not be recoverable. When such events or changes in circumstances occur, we assess the recoverability of long-lived assets by determining whether the carrying value of such assets will be recovered through undiscounted expected future cash flows. If the total of the future undiscounted cash flows is less than the carrying amount of those assets, we record an impairment charge in the period in which we make the determination. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Deferred Revenue—Deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue.

Income Taxes—We record income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in our financial statements or tax returns. In estimating future tax consequences, generally all expected future events other than enactments or changes in the tax law or rates are considered. We assess the likelihood that some portion or all of our deferred tax assets will be recovered from future taxable income within the respective jurisdictions, and to the extent we believe that recovery does not meet the “more-likely-than-not” standard, based solely on its technical merits as of the reporting date, we establish a valuation allowance. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments and which may not accurately anticipate actual outcomes.

We operate in various tax jurisdictions and are subject to audit by various tax authorities. We provide for tax contingencies whenever it is deemed more likely than not that a tax asset has been impaired or a tax liability has been incurred for events such as tax claims or changes in tax laws. Tax contingencies are based upon their technical merits, relevant tax law and the specific facts and circumstances as of each reporting period. Changes in facts and circumstances could result in material changes to the amounts recorded for such tax contingencies.

Stock-Based Compensation—We apply ASC 718 (formerly referred to as SFAS No. 123R) to our stock option grants, which requires compensation expense related to share-based transactions, including employee stock options, to be measured and recognized in the financial statements based on fair value. Under ASC 718, the fair value of each option award is estimated on the grant date using the Black-Scholes option pricing model.

Research and Development Costs—Research and development costs are expensed as incurred.

Software Development Costs—The costs to develop software have not been capitalized as we believe our current software development process is essentially completed concurrent with the establishment of technological feasibility.

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

Effective January 1, 2011, we adopted the provisions of ASU 2009-13 and ASU 2009-14 for new and materially modified arrangements originating after December 31, 2010. The adoption of ASU 2009-13 and ASU 2009-14, increased revenues $5.7 million and $9.0 million for the three and six months ended June 30, 2011, respectively. The increase was primarily due to certain product revenue, which can now be recognized upon shipment, but would have been deferred under the previous revenue recognition rules. We expect the adoption of ASU 2009-13 and ASU 2009-14 to have an impact on future periods; however, we cannot reasonably estimate the effect of adopting these standards on future financial periods as the impact will vary depending on the nature and volume of new or materially modified arrangements in any given period.

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

The majority of our products are hardware appliances containing software components that function together to provide the essential functionality of the product, therefore, our hardware appliances are considered non-software deliverables and are no longer in scope of ASC 985-605 (formerly SOP 97-2, Software Revenue Recognition).

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

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

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

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

For our hardware appliances we use BESP as our selling price. For our support and services, we generally use VSOE as our selling price. When we are unable to establish a selling price using VSOE for our support and services, we use BESP in our allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if

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FORTINET, INC. AND SUBSIDIARIES
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(Unaudited)

the product or service were sold on a stand-alone basis. We determine BESP for a product or service by considering multiple factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies, customer classes and distribution channels. We will review our BESP estimates on a quarterly basis to coincide with our VSOE review process.

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

We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. Our appliances include operating system software that is integrated into the appliance hardware and is deemed essential to its functionality. As a result, we account for revenue in accordance with ASC 985-605 and all related interpretations.

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

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

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

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

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

For arrangements which include customer acceptance criteria, no revenue is recognized prior to acceptance. We recognize product revenue on sales to distributors that have no general right of return and end-customers upon shipment, once all other revenue recognition criteria have been met. We also make sales through distributors under agreements that allow for rights of returns that we estimate and reduce revenue for under our sales returns and allowances. We recognize product revenue on sales made through such distributors upon sale by the distributor to the end-customer, at which time the rights of return lapse. Substantially all of our products have been sold in combination with services, which consist of subscriptions and/or support. Subscription services provide access to our antivirus, intrusion prevention, web filtering, and anti-spam functionality. Support services include rights to unspecified software upgrades, maintenance releases and patches, telephone and Internet access to technical support personnel, and hardware support.

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

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

Accounts Receivable—Trade accounts receivable are recorded at the invoiced amount, net of allowances for doubtful accounts and reserves for sales returns and allowances. The allowance for doubtful accounts is based on our assessment of the collectability of customer accounts. We regularly review the allowance by considering factors such as historical experience, credit quality, age of the accounts receivable balances and current economic conditions that may affect a customer's ability to pay. The reserve for sales returns and allowances is based on specific criteria including agreements to provide rebates and other

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

factors known at the time, as well as estimates of the amount of goods shipped that will be returned. To determine the adequacy of the reserves for sales returns and allowances, we analyze historical experience of actual rebates and returns as well as current product return information.

Warranties—We generally provide a one-year warranty on hardware products and a 90-day warranty on software. A provision for estimated future costs related to warranty activities is recorded as a component of cost of product revenues when the product revenues are recognized, based upon historical product failure rates and historical costs incurred in correcting product failures. In the event we change our warranty reserve estimates, the resulting charge against future cost of sales or reversal of previously recorded charges may materially affect our gross margins and operating results.

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

	For The Six Months Ended And As Of June 30, 2011	For The Year Ended And As Of December 31, 2010
Accrued warranty balance - beginning of the period	1,878	2,257
Warranty costs incurred	(841)	(1,337)
Provision for warranty	551	1,069
Adjustments to previous estimates	(45)	(111)
Accrued warranty balance - end of the period	1,543	1,878

Foreign Currency Derivatives—Our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency translation risk. However, a substantial portion of our operating expenses incurred outside the U.S. are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Canadian Dollar (CAD), Euro (EUR), British Pound (GBP), and Japanese Yen (JPY). To help protect against significant fluctuations in the value and 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 EUR, GBP, and CAD. We do not use these contracts for speculative or trading purposes. All of the derivative instruments involved are with high quality financial institutions and we monitor the creditworthiness of these parties. These contracts typically have maturities between one and three months. We account for our hedges under ASC 815, Derivatives and Hedging. We record changes in the fair value of forward exchange contracts related to balance sheet accounts as other income (expense), net in the condensed consolidated statements of operations.

Additionally, independent of any hedging activities, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in our 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, long-term material changes in the value of the U.S. dollar versus the EUR, GBP, CAD or JPY 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, 2011 was (amounts in 000's):

To hedge balance sheet accounts:	Buy/Sell	Notional
Currency		
EUR	Buy	5,447
GBP	Buy	1,586
CAD	Buy	13,609

Recent Accounting Pronouncements

We did not adopt any new accounting standards during the quarter.

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

2. INVESTMENTS AND FAIR VALUE MEASUREMENTS

The following table summarizes our investments in available-for-sale securities ($ amounts in 000's):

	June 30, 2011			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
U.S. government and agency securities	16,115	14	—	16,129
Corporate debt securities	305,932	230	—	306,162
Commercial paper	49,476	25	—	49,501
Municipal bonds	6,587	14	—	6,601
Term deposits	12,086	—	—	12,086
Total available-for-sale securities	390,196	283	—	390,479

	December 31, 2010			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
U.S. government and agency securities	51,989	—	(46)	51,943
Corporate debt securities	213,237	159	—	213,396
Commercial paper	38,914	5	—	38,919
Municipal bonds	11,069	11	—	11,080
Term deposits	5,263	—	—	5,263
Total available-for-sale securities	320,472	175	(46)	320,601

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

	June 30, 2011	December 31, 2010
Due within one year	264,001	246,651
Due within one to three years	126,478	73,950
Total	390,479	320,601

Available-for-sale securities are reported at fair value, with unrealized gains and losses, net of tax, included as a separate component of stockholders' equity and in total comprehensive income. Realized gains and losses on available-for-sale securities are included in other income (expense), net in our consolidated statements of operations.

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

Fair Value Accounting—We apply ASC 820 which establishes a valuation hierarchy for disclosure of the inputs to fair value measurement. This hierarchy prioritizes the inputs into three broad levels as follows:

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

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

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

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The valuation techniques we use to measure the fair value of money market funds and term deposits were derived from quoted prices in active markets for identical assets or liabilities. The valuation techniques used to measure the fair value of all other financial instruments, all of which have counterparties with high credit ratings, were valued based on quoted market prices 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.

We classify items in Level 2 if the investments are valued using quoted prices for identical assets in markets that are not active, using quoted prices for similar assets in an active market, or using model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets.

The following table presents the fair value of our financial assets as of June 30, 2011 and December 31, 2010 using the ASC 820 input categories ($ amounts in 000's):

	June 30, 2011			December 31, 2010		
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)
Assets:						
U.S. government and agency securities	16,129	—	16,129	51,943	—	51,943
Corporate debt securities	306,162	—	306,162	213,396	—	213,396
Commercial paper	57,500	—	57,500	52,415	—	52,415
Municipal bonds	10,600	—	10,600	11,080	—	11,080
Term deposits	12,086	12,086	—	5,263	5,263	—
Money market funds	32,370	32,370	—	7,078	7,078	—
Foreign currency contracts	—	—	—	74	—	74
Total	434,847	44,456	390,391	341,249	12,341	328,908
Reported as:						
Cash and cash equivalents	44,368			20,574		
Short-term investments	264,001			246,651		
Prepaid expenses and other current assets	—			74		
Long-term investments	126,478			73,950		
Total	434,847			341,249		

We did not hold financial assets or liabilities which were recorded at fair value using inputs in the Level 3 category as of June 30, 2011 or December 31, 2010. There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the three or six months ended June 30, 2011.

3. INVENTORY—Net

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

	June 30, 2011	December 31, 2010
Raw materials	2,605	2,593
Finished goods	11,045	10,924
Inventory—net	13,650	13,517

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4. PROPERTY AND EQUIPMENT—Net

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

	June 30, 2011	December 31, 2010
Evaluation units	12,270	10,607
Computer equipment and software	10,833	9,561
Furniture and fixtures	1,205	1,087
Leasehold improvements and tooling	4,591	4,548
Total property and equipment	28,899	25,803
Less: accumulated depreciation	(21,560)	(18,747)
Property and equipment—net	7,339	7,056

Depreciation expense was $1.7 million and $1.5 million for the three months ended June 30, 2011 and June 30, 2010, respectively. Depreciation expense was $3.3 million and $2.8 million for the six months ended and June 30, 2011 and June 30, 2010, respectively.

5. INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding, plus the dilutive effects of stock options and warrants.

Potentially dilutive common shares are determined by applying the treasury stock method to the assumed exercise of outstanding stock options.

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

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Numerator:				
Net income	14,494	6,869	28,081	11,087
Denominator:				
Basic shares:				
Weighted-average common shares outstanding - basic	152,267	136,990	151,293	135,684
Diluted shares:				
Weighted-average common shares outstanding - basic	152,267	136,990	151,293	135,684
Effect of potentially dilutive securities:				
Employee stock options	11,620	14,114	12,100	15,010
Warrants to purchase common stock	—	170	—	172
Weighted-average shares used to compute diluted net income per share	163,887	151,274	163,393	150,866
Net income per share:				
Basic	0.10	0.05	0.19	0.08

Diluted	0.09	0.05	0.17	0.07

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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The following outstanding options were excluded from the computation of diluted net income per common share applicable to common stockholders for the periods presented as their effect would have been antidilutive (in 000's):

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Options to purchase common stock	3,571	2,788	2,598	2,120

6. DEFERRED REVENUE

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

	June 30, 2011	December 31, 2010
Product	5,464	4,466
Services	246,343	219,022
Ratable products and services	21,392	29,143
Total deferred revenue	273,199	252,631
Reported As:		
Current	192,450	169,648
Non-current	80,749	82,983
Total deferred revenue	273,199	252,631

7. COMMITMENTS AND CONTINGENCIES

Leases and Minimum Royalties—We lease our facilities under various noncancelable operating leases, which expire through 2015. Rent expense was $2.1 million and $1.8 million for the three months ended June 30, 2011 and June 30, 2010, respectively and $4.0 million and $3.5 million for the six months ended June 30, 2011 and June 30, 2010, respectively. Rent expense is recognized using the straight-line method over the term of the lease.

We entered into a Settlement and Patent License Agreement with Trend Micro Incorporated ("Trend Micro") in January 2006 (see "Litigation" below). The aggregate future noncancelable minimum rental payments on operating leases and minimum royalties payable if we continued paying under the Trend Micro Settlement and License Agreement as of June 30, 2011 are as follows ($ amounts in 000's):

	Rental Payment	Royalty (1)
Fiscal Years:		
2011 (remainder)	3,950	500
2012	5,881	1,000
2013	4,317	1,000
2014	2,429	500
2015	1,403	500
Total	17,980	3,500

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(1) Consists of minimum royalties claimed by Trend Micro pursuant to the January 2006 settlement and license agreement between Trend Micro and Fortinet, which are subject to dispute (see "Litigation" below). The $500,000 listed in the chart above as the "2011 (remainder)" represents the minimum royalties, pursuant to the settlement and license agreement, for the third and fourth quarters of fiscal 2011. We have accrued a total payment including interest of $5.6 million as of June 30, 2011, related to amounts under the settlement and license agreement with Trend Micro which have not been paid pursuant to the dispute.

Contract Manufacturer 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, 2011, we had $18.3 million of open purchase orders with our independent contract manufacturers that may not be cancelable.

Litigation—In August 2009, Trend Micro filed a complaint against us in the Superior Court of the State of California for Santa Clara County alleging breach of contract and seeking a declaratory judgment that we are obligated to make certain royalty payments to Trend Micro pursuant to a settlement and license agreement entered into in January 2006. We maintain that the patents that are the basis for the royalty payments are invalid, and, as a result of the patents' invalidity along with other defenses, we believe we have no contractual obligation to pay the royalties. We filed an action in the U.S. District Court for the Northern District of California that is stayed pending the resolution of the state court action. We have continued to accrue expense based on the quarterly royalties provided for in the settlement and license agreement. In May 2011, in response to petitions for re-examination we filed with the U.S. Patent and Trademark Office (“PTO”) on two Trend Micro patents, the PTO issued final office actions rejecting a number of the Trend Micro patent claims allegedly forming the basis for the royalty payments. Trend Micro has responded disputing one of the final office actions. We have determined that there is not a reasonable possibility that a loss exceeding amounts already recognized may be incurred.

In August 2009, Enhanced Security Research, LLC and Security Research Holdings LLC (collectively “ESR”), a non-practicing entity, filed a complaint against us in the United States District Court for the District of Delaware alleging infringement by us and other defendants of two patents. The plaintiffs are claiming unspecified damages and requesting an injunction against the alleged infringement. In June 2010, the Court granted our motion to stay pending the outcome of reexamination proceedings on both asserted patents. The PTO has finally rejected all of the claims of the patents in the suit and ESR has appealed this result to the Board of Patent Appeals and Interferences (“BPAI”). There was a related action that was dismissed by the District Court and appealed by ESR to the Federal Circuit. The Federal Circuit in June 2011 rejected ESR's appeal and confirmed the dismissal. We have determined that there is not a reasonable possibility that a loss may be incurred.

In July 2010, Network Protection Sciences, LLC ("NPS"), a non-practicing entity, filed a complaint in the United States District Court for the Eastern District of Texas alleging patent infringement by us and other defendants. NPS is claiming unspecified damages, including treble damages for willful infringement, and requests an injunction against such alleged infringement. Currently the case is in the early stages. In January 2011, we filed with the PTO a petition for re-examination of the patent asserted by NPS. In May 2011, the PTO issued an initial office action preliminarily rejecting a number of the claims of the asserted patent. We have determined that there is not a reasonable possibility that a loss may be incurred.

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us in the Superior Court of the State of California for the County of Los Angeles alleging violation of various California Corporations' Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company. In September 2010, the Court granted our motion to transfer the case to the California Superior Court for Santa Clara County and the plaintiff has filed an amended complaint in the Superior Court to add individual defendants, among other amendments. We have determined that there is not a reasonable possibility that a loss may be incurred.

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

8. STOCKHOLDERS' EQUITY

Stock Plans—We grant equity compensation awards to acquire our ordinary shares from three plans, and which collectively are referred to as our stock plans below. For further discussion of these Plans, refer to Note 11, "Stock Plans," of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2010.

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Common Shares Reserved for Issuance—At June 30, 2011, we had reserved 40.9 million common shares for issuance.

Stock-based compensation under ASC 718—Stock-based compensation is accounted for in accordance with ASC 718, which requires compensation costs related to share-based transactions, including employee stock options, to be recognized in the financial statements based on fair value. Under ASC 718, the fair value of each option award is estimated on the grant date using the Black-Scholes option pricing model. We determined weighted-average valuation assumptions as follows:

Expected Term—The expected term represents the period that our stock-based awards are expected to be outstanding. As we do not have sufficient historical experience for determining the expected term of the stock option awards granted, we have based our expected term on the simplified method available under ASC 718-10 (formerly referred to as Staff Accounting Bulletin 110).

Expected Volatility—The computation of expected volatility for the periods presented includes the historical and implied stock volatility of comparable companies from a representative peer group selected based on industry and market capitalization data and to a lesser extent, our weighted historical and implied volatility following our IPO in November 2009.

Fair Value of Common Stock—The fair value of our common stock is the closing sales price of the Common Stock (or the closing bid, if no sales were reported) on the effective grant date.

Risk-Free Interest Rate—We base the risk-free interest rate used in the Black-Scholes valuation model on the implied yield available on U.S. Treasury zero-coupon issues with an equivalent remaining term.

Expected Dividend—The expected dividend weighted-average assumption is based on our current expectations about our anticipated dividend policy.

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

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Expected term in years	4.6	4.6	4.6	4.6
Volatility (%)	43.4	37.6	40.4 - 43.4	37.6 - 40.5
Risk-free interest rate (%)	2.0	2.3	1.8 - 2.0	2.3 - 2.4
Dividend rate (%)	—	—	—	—

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

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Cost of product revenue	43	26	65	50

Cost of services revenue	362	234	560	442
Research and development	985	587	1,438	1,141
Sales and marketing	1,681	897	3,581	1,763
General and administrative	799	520	1,296	1,016
	3,870	2,264	6,940	4,412

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FORTINET, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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A summary of the option activity under our stock plans and changes during the reporting periods are presented below (in 000's, except per share amounts):

		Options Outstanding			
	Shares Available For Grant	Number Of Shares	Weighted-Average Exercise Price ($)	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value ($)
Balance-December 31, 2010	15,091	22,490	4.21		
Authorized	7,438	—	—		
Granted	(4,206)	4,206	21.01		
Forfeited	719	(719)	9.68		
Exercised (aggregate intrinsic value of $76,061)	—	(4,150)	2.70		
Balance—June 30, 2011	19,042	21,827	7.55		
Options vested and expected to vest—June 30, 2011		20,679	7.37	4.86	411,852
Options exercisable—June 30, 2011		10,789	3.11	4.06	260,853

At June 30, 2011, total compensation cost related to unvested stock-based awards granted to employees under our stock plans but not yet recognized was $44.4 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of 3.2 years. Future option grants will increase the amount of compensation expense to be recorded in these periods.

The total fair value of awards vested under our stock plans was $2.2 million and $1.7 million for the three months ended June 30, 2011 and June 30, 2010, respectively. The total fair value of awards vested under our stock plans was $5.8 million and $5.0 million for the six months ended June 30, 2011 and June 30, 2010, respectively. The weighted-average fair value of options granted during the three and six months ended June 30, 2011 was $8.90 and $7.71 per share, respectively.

Non-employees—During the three months ended June 30, 2011, we granted options to purchase 3,260 shares of Common Stock, at an exercise price of $23.04 per share, to non-employees in exchange for services. During the three months ended June 30, 2010, no options were granted to non-employees in exchange for service. During the six months ended June 30, 2011 and June 30, 2010, we granted to non-employees in exchange for services, options to purchase 28,384 and 9,400 shares of Common Stock, respectively, at a range of exercise prices of $16.86 to $20.24 per share. These options vest over periods of up to 48 months, and in accordance with ASC 505-50 (formerly referred to as Emerging Issues Task Force (EITF) Issue No. 96-18, Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services), we accounted for these options as variable awards. The options were valued using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Three Months Ended		Six Months Ended	
	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Expected term in years	3.9 - 6.1	4.8 - 6.5	3.9 - 6.3	4.8 - 6.8

Volatility (%)	43.4	37.6	40.4 - 43.4	37.6 - 40.5
Risk-free interest rate (%)	2.0	2.3	1.8 - 2.0	2.3 - 2.4
Dividend rate (%)	—	—	—	—

9. INCOME TAXES

The effective tax rate was 25.4% for the three months ended June 30, 2011, compared to an effective tax rate of 33.1% for the three months ended June 30, 2010. The effective tax rate was 25.3% for the six months ended June 30, 2011, compared to an effective tax rate of 34.7% for the six months ended June 30, 2010. The provision for income taxes for the three months and six months ended June 30, 2011 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The provision for income taxes for the three months and six months ended June 30, 2010 is comprised of foreign income taxes,

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U.S. federal and state taxes, and withholding tax.

As of June 30, 2011 and December 31, 2010, unrecognized tax benefits determined in accordance with authoritative guidance on accounting for uncertainty in income taxes, approximated $17.1 million and $11.2 million, respectively. The total amount of 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, 2011, we had approximately $0.3 million accrued for estimated interest related to uncertain tax positions. For the six months ended June 30, 2011, we recorded estimated interest of $0.2 million. Penalties were immaterial at June 30, 2011.

10. EMPLOYEE BENEFIT PLAN

We have established a 401(k) tax-deferred savings plan (the “401(k) Plan”) which permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code. Under the 401(k) Plan, participating employees may defer a portion of their pre-tax earnings, up to the IRS annual contribution limit ($16,500 for the calendar year 2011). In Canada, we have established a Group RRSP program (the "RRSP Plan") which permits participants to make tax deductible contributions up to the maximum RRSP contribution limits under the Income Tax Act. As of January 1, 2011, our board of directors approved 50% matching contributions on employee contributions, up to 4% of the employee's eligible earnings. Our matching contributions to the RRSP and 401(k) Plans for the three and six months ended June 30, 2011 were $390,449 and $756,663, respectively.

11. SEGMENT INFORMATION

ASC 280 (formerly referred to as SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information) establishes standards for reporting information about operating segments. 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 are considered to be in a single reportable segment and operating unit structure.

Revenue by geographic region is based on the billing address of the customer. The following tables set forth revenue, interest income and property and equipment by geographic region ($ amounts in 000's):

	Three Months Ended		Six Months Ended	
Revenue	June 30, 2011	June 30, 2010	June 30, 2011	June 30, 2010
Americas:				
United States	28,103	21,875	52,273	39,167
Other Americas	12,438	7,015	23,913	13,540

	40,541	28,890	76,186	52,707
Europe, Middle East and Africa (EMEA)	36,633	29,482	70,274	56,556
Asia Pacific and Japan (APAC)	25,849	17,959	49,829	36,863
Total revenue	103,023	76,331	196,289	146,126

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Property and Equipment—Net	June 30, 2011	December 31, 2010
Americas:		
United States	2,037	1,639
Canada	3,729	3,933
Other Americas	20	13
	5,786	5,585
Europe, Middle East and Africa (EMEA)	745	616
Asia Pacific and Japan (APAC)	808	855
Total property and equipment—net	7,339	7,056

12. ACQUISITIONS

On April 6, 2011, we completed the acquisition of TalkSwitch Corp. (TalkSwitch), a privately held company that provides voice over IP phone system, for a cash payment of $2.6 million. We accounted for this acquisition as a purchase of a business and, accordingly, the total purchase price has been allocated to TalkSwitch tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair market values as of the acquisition date. The purchase price allocation resulted in purchased tangible assets of approximately $0.9 million and liabilities of $0.1 million and purchased identifiable intangible assets of approximately $1.8 million. Identifiable intangible assets consist of purchased technology. The fair value assigned to identifiable intangible assets acquired is determined using the income approach, which discounts expected future cash flows to present value using estimates and assumptions determined by us. Purchased identifiable intangible assets are being amortized on a straight-line basis over three years.

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

In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, among other things, statements concerning our expectations regarding:

- variability in sales in certain product categories from year to year and between quarters;
- the continued realization of efficiency gains in our sales and marketing organization as well as efficiency gains in our overall headcount measured by revenue per employee;
- growth in our high-end business and further penetration in certain verticals;
- mix of billings between product and services, as well as, mix of a single year vs. multi-year support and subscription contracts;
- the significance of stock compensation as an expense;
-

the proportion of our revenue that consists of our product and service revenues and future trends with respect to service revenue as we renew existing services contracts and expand our customer base;

- our royalty payments to Trend Micro;
- the impact of our product innovation strategy;
- impact of the newly-adopted revenue recognition rules;
- trends in revenue, costs of revenue, and gross margin;
- trends in our operating expenses, including personnel costs, research and development expense, sales and marketing expense and general and administrative expense;

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- investments in research and development and sales and marketing staff to address market opportunities and to position ourselves for future growth;

- our effective tax rate;

- the impact of seasonality on our business; and

- the sufficiency of our existing cash and investments to meet our cash needs for at least the next 12 months;

as well as other statements regarding our future operations, financial condition and prospects and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and, in particular, the risks discussed under the heading “Risk Factors” included elsewhere in this Quarterly Report on Form 10-Q and in our other Securities and Exchange Commission filings, including our Annual Report on Form 10-K for the year ended December 31, 2010, which was filed on February 25, 2011. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Business Overview

We provide network security solutions, which enable broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and government entities worldwide. As of June 30, 2011, we had shipped over 750,000 appliances to more than 7,500 channel partners and to more than 100,000 end-customers worldwide, including a majority of the 2010 Fortune Global 100.

Our core UTM product line of FortiGate appliances ships with a set of security and networking capabilities, including firewall, VPN, antivirus, intrusion prevention, application control, Web filtering, antispam and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-30, designed for small businesses and branch offices, to the FortiGate-5000 series for large enterprises and service providers. Our UTM solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to the antivirus, intrusion prevention/application control, Web filtering and antispam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web application firewalls, databases, employee computers and mobile devices. Sales of these complimentary products have grown in recent quarters, although these products still represent less than 10% of our total revenue. During the past several quarters, we have also expanded and enhanced our FortiGate UTM and FortiAP secure wireless access product lines, as well as introduced software-based virtual appliances for our FortiGate and FortiManager product lines, which help secure the end-customer's cloud-based network infrastructures with the same functionality as the traditional physical appliance in their respective product lines.

Our sales strategy is based on a distribution model whereby we primarily sell our products and services directly to distributors who sell to resellers and service providers, who, in turn, sell to our end-customers. In certain cases, we sell directly to government-focused resellers, large service providers and major systems integrators, who have significant purchasing power and unique customer deployment requirements. Typically, FortiGuard security subscription services

and FortiCare technical support services are purchased along with our appliances. We invoice at the time of our sale for the total price of the products and subscription and support services, and the invoice generally becomes payable within 30 to 90 days. We generally recognize product revenue up-front based on the allocated revenue value and defer revenue for the sale of new and renewal subscription and support services contracts. We recognize the related services revenue over the service period, which is typically one year from the date the end-customer registers for these services (the date on which the services can first be used by the customer); although, it could be longer as we have historically experienced growth in sales of multi-year support and subscription contracts. Sales of new and renewal services increase our deferred revenue balance, which contributes significantly to our positive cash flow from operations.
During the second quarter of 2011, billings and revenues grew as a result of the leverage achieved on our investments in research and development and the successful execution of our global sales strategy. Sales of FortiGate products continued to be generally balanced across entry-level (FortiGate-30 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately one-third of FortiGate sales. We expect some degree of variability from year to year and between quarters, although we do not consider small percentage

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changes meaningful in terms of business trends. The percentage of our FortiGate related billings from the mid-range category increased to 33% in the second quarter of 2011 from 30% in the second quarter of 2010, while the high-end category decreased from 35% to 34%, and the entry-level category decreased from 35% to 33%.

We also believe continued product innovation, as evidenced by the increased demand for our recently introduced FortiGate appliance models such as the FortiGate-5001B, FortiGate-3040B, and FortiGate-3140B high-end UTM products, as well as our FortiAP WiFi devices, are reinforcing our competitive edge and driving market share gains. During the second quarter of 2011, we also continued to expand and enhance our sales teams, and focus on key verticals and emerging markets. We secured notable wins in the retail vertical, continued to gain traction in the financial services and government verticals and remained strong with notable wins in EMEA and APAC in the service provider vertical. We experienced a sizable increase in the number of deals involving sales greater than $100,000 and an increase in the number of deals greater than $250,000 compared to the second quarter of 2010. Although we experienced a decline in deals valued at greater than $500,000, there were a number of deals in this category which were above $1 million. We expect some variability in this metric, and remain focused on investing in our sales and research and development resources in order to expand our reach into new high-growth verticals and emerging markets.

Billings, a non-GAAP financial measure that we define as total revenue plus the change in deferred revenue (further described under "Non-GAAP Financial Measures"), were $110.2 million in the second quarter of 2011, an increase of 22% compared to the second quarter of 2010. Our billings growth rate was adversely impacted by slower billings growth in our EMEA region. Total revenue was $103.0 million for the second quarter of 2011, an increase of 35% compared to the second quarter of 2010. Revenue for the second quarter of 2011 includes a $5.7 million, or 6%, positive impact related to the adoption of the new revenue recognition rules, as described in our "Summary of Significant Accounting Policies" included in - Footnote 1 of our Condensed Consolidated Financial Statements. The increase was primarily due to certain product revenue, which can now be recognized upon shipment, and would have been deferred under the previous revenue recognition rules. Product revenue was $46.7 million, an increase of 50% compared to the second quarter of 2010, and a greater percentage of total revenue (45% in the second quarter of 2011, compared to 41% in the second quarter of 2010). The higher product revenue can be attributed to a richer mix of product, compared to services, billings compared to last year and upfront recognition of revenue related to sales in China previously amortized ratably. Services revenue in the second quarter of 2011 was $52.7 million, an increase of 29% compared to the second quarter of 2010. Services revenue is important to our future revenue and profitability as it provides a source of recurring revenue for us, representing 51% and 54% of total revenue for the second quarter of 2011 and 2010, respectively. Ratable product and services revenue in the second quarter of 2011 was $3.7 million, a decrease of 15% compared to the second quarter of 2010. Adoption of the new revenue recognition rules is expected to result in a decline in ratable revenue over time.

We are a global, geographically diversified business, with 61% of our total revenue generated outside of the Americas region in the second quarter of 2011. Our strong operating results were driven by strong performance across all geographies, especially in APAC and the Americas. During the quarter, $40.5 million, or 39%, of our total revenue was generated from the Americas, representing an increase of 40% from the second quarter of 2010. EMEA generated $36.6 million, or 36%, of our total revenue during the second quarter of 2011, representing an increase of 24% from the second quarter of 2010. APAC generated $25.8 million, or 25%, of our total revenue during the second quarter of 2011, representing an increase of 44% from the second quarter of 2010.

Our total operating expenses were $57.7 million for the second quarter of 2011, an increase of 24% compared to the same period in the prior year. The 35% increase in revenues compared to the 29% increase in sales and marketing expense from the second quarter of 2010 (as discussed under "Results of Operations" below) demonstrates the leverage that we are achieving from the investment in our sales force during the past year. We are achieving even higher leverage in the first half of 2011, as revenues increased 35% compared to the 24% increase in sales and marketing expense from the first half of 2010. Despite the negative impact of foreign currency fluctuations experienced during the quarter, operating expenses as a percentage of revenue decreased to 56% from 61% during the second quarter last year. We are also seeing improvements in productivity and efficiencies in our overall headcount as our annualized second quarter 2011 revenue per employee, defined as quarterly revenue, annualized and divided by average headcount, reached $288,000, up from $241,000 for the second quarter of 2010. Headcount increased during the second quarter of 2011 from 1,389 at the end of the first quarter of 2011 to 1,475, as our pace of hiring picked up this quarter (particularly in research and development), following a ramp up in our recruiting efforts over the past few quarters. A portion of the headcount (35 employees) increase was due to our TalkSwitch acquisition in the current quarter.

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Key Metrics

We monitor the key financial metrics set forth below on a quarterly basis to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. Our total deferred revenue increased by $7.2 million from $266.0 million at March 31, 2011 to $273.2 million at June 30, 2011. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the quarterly revenue that we recognize. We also ended the second quarter of 2011 with $468.5 million in cash, cash equivalents and investments and have had positive cash flow from operations for every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under “Components of Operating Results,” and we discuss our cash, cash equivalents, and investments under “Liquidity and Capital Resources.” Deferred revenue and cash flow from operations are discussed immediately below the following table.

	For The Three Months Ended Or As Of			
	June 30, 2011		June 30, 2010	
	($ amounts in 000's)			
Revenue	103,023		76,331	
Gross margin	74.2	%	73.6	%
Operating income[(1)]	18,779		9,780	
Operating margin	18.2	%	12.8	%
Total deferred revenue	273,199		225,521	
Increase in total deferred revenue over prior quarter	7,170		13,984	
Cash, cash equivalents and investments	468,498		308,960	
Cash flows from operating activities	34,068		17,950	
Free cash flow[(2)]	33,312		16,735	

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(1) Includes:		
Stock-based compensation expense	3,870	2,264
Patent settlement income	478	—

(2) Free cash flow is a non-GAAP financial measure, which we define as cash flow from operations minus capital expenditures, as further described below.

Deferred revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. The majority of our deferred revenue balance consists of the unamortized portion of services revenue from subscription and support service contracts. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods.

Cash flow from operations. We monitor cash flow from operations as a measure of our overall business performance. Our cash flow from operations is driven in large part by advance payments for both new and renewal contracts for subscription and support services, consistent with our billings for the period. Monitoring cash flow from operations enables us to analyze our financial performance excluding the non-cash effects of certain items such as depreciation, amortization and stock-based compensation expenses, thereby allowing us to better understand and manage the cash needs of our business. Our cash flow from operations was $34.1 million in the second quarter of 2011, and $18.0 million in the second quarter of 2010. In the second quarter of 2011, free cash flow (a non-GAAP financial measure, described under “Non-GAAP Financial Measures” below) was $33.3 million, compared to $16.7 million in the second quarter of 2010.

Non-GAAP Financial Measures

To supplement our condensed consolidated financial statements presented in accordance with U.S. GAAP, we consider certain financial measures that are not prepared in accordance with GAAP, including non-GAAP gross margin, non-GAAP income from operations and non-GAAP operating margin, non-GAAP operating expenses, non-GAAP net income and non-GAAP free cash flow. These non-GAAP financial measures are not based on any standardized methodology prescribed by GAAP and are not necessarily comparable to similar measures presented by other companies. Non-GAAP gross margin is gross margin as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense, which is a non-cash charge. Non-GAAP income from operations is operating income, as reported on our condensed

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consolidated statements of operations, excluding the impact of stock-based compensation expense and the income from the patent settlement. Non-GAAP operating margin is non-GAAP income from operations divided by revenue. Non-GAAP operating expenses exclude the impact of stock-based compensation expense and the income from the patent settlement. Non-GAAP net income is net income, as reported in our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense and income from the patent settlement. Free cash flow, an alternative non-GAAP financial measure of liquidity, is defined as net cash provided by operating activities less capital expenditures and the upfront cash payment related to the patent settlement.

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

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

The following tables reconcile GAAP gross margin, income from operations, operating margin, certain operating expenses and net income as reported on our condensed consolidated statements of operations to non-GAAP gross margin, non-GAAP income from operations, non-GAAP operating margin, certain non-GAAP operating expenses and non-GAAP net income for the second quarters of 2011 and 2010.

	Three Months Ended			
	June 30, 2011		June 30, 2010	
	Amount	% of Revenue	Amount	% of Revenue
	($ amounts in 000's)			
Total revenue	103,023		76,331	
GAAP gross profit and margin	76,465	74.2	56,166	73.6
Stock-based compensation expense	405	0.4	260	0.3
Non-GAAP gross profit and margin	76,870	74.6	56,426	73.9
GAAP income from operations and margin	18,779	18.2	9,780	12.8
Stock-based compensation expense:				
Cost of revenue	405	0.4	260	0.3
Research and development	985	1.0	587	0.8

Sales and marketing	1,681	1.6	897	1.2
General and administrative	799	0.8	520	0.7
Total stock-based compensation	3,870	3.8	2,264	3.0
Patent settlement	(478)	(0.5)	—	—
Non-GAAP income from operations and margin	22,171	21.5	12,044	15.8

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	Three Months Ended			
	June 30, 2011		June 30, 2010	
	Amount	% of Revenue	Amount	% of Revenue
	($ amounts in 000's)			
Operating Expenses:				
Research and development expenses:				
GAAP research and development expenses	15,942	15.5	12,676	16.6
Stock-based compensation	(985)	(1.0)	(587)	(0.8)
Non-GAAP research and development expenses	14,957	14.5	12,089	15.8
Sales and marketing expenses:				
GAAP sales and marketing expenses	35,896	34.8	27,777	36.4
Stock-based compensation	(1,681)	(1.6)	(897)	(1.2)
Non-GAAP sales and marketing expenses	34,215	33.2	26,880	35.2
General and administrative expenses:				
GAAP general and administrative expenses	5,848	5.7	5,933	7.8
Stock-based compensation	(799)	(0.8)	(520)	(0.7)
Patent settlement	478	0.5	—	—
Non-GAAP general and administrative expenses	5,527	5.4	5,413	7.1
Total operating expenses:				
GAAP operating expenses	57,686	56.0	46,386	60.8
Stock-based compensation	(3,465)	(3.4)	(2,004)	(2.7)
Patent settlement	478	0.5	—	—
Non-GAAP operating expenses	54,699	53.1	44,382	58.1

	Three Months Ended	
	June 30, 2011	June 30, 2010
	($ amounts in 000's)	
Net Income:		
GAAP net income	14,494	6,869
Stock-based compensation expense(1)	3,870	2,264
Patent settlement(2)	(478)	—
Provision for income taxes(3)	4,941	3,397
Non-GAAP income before provision for income taxes	22,827	12,530
Tax effects related to non-GAAP adjustments(4)	(7,533)	(4,386)
Non-GAAP net income	15,294	8,144
Non-GAAP net income per share - diluted	0.09	0.05
Shares used in per share calculation - diluted	163,887	151,274

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

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

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

(4) Pro-forma tax provision related to non-GAAP income before tax reflects 33.0% and 35.0% effective tax rates in the second quarter of 2011 and 2010, respectively. Based on the annual estimate for geographic split of income, as well as various tax credits we expect to achieve in various locations, we currently plan to use a 33.0% tax rate for the year, subject to discrete items that may occur in a particular quarter.

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	Three Months Ended June 30, 2011	June 30, 2010
	($ amounts in 000's)	
Billings:		
Revenue	103,023	76,331
Increase in deferred revenue	7,170	13,984
Total Billings (Non-GAAP)	110,193	90,315

	Three Months Ended June 30, 2011	June 30, 2010
	($ amounts in 000's)	
Cash Flow:		
Net cash provided by operating activities	34,068	17,950
Less purchases of property and equipment	(756)	(1,215)
Free cash flow (Non-GAAP)	33,312	16,735
Net cash used in investing activities*	(32,953)	(88,887)
Net cash provided by financing activities	7,635	14,012

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* Includes purchases of property and equipment

Components of Operating Results

Revenue

We derive our revenue from sales of our products and subscription and support services. We recognize our revenue in accordance with the guidance in ASC 985-605 and all related interpretations, which is discussed in further detail in Footnote 1 "Summary of Significant Accounting Policies - Revenue Recognition." Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collectability is probable.

Our total revenue is comprised of the following:

- Product revenue. Product revenue is generated from sales of our appliances and software. The substantial majority of our product revenue has been generated by our FortiGate line of appliances, and we do not expect this to change in the foreseeable future. Product revenue also includes revenue derived from sales of FortiManager, FortiAnalyzer, FortiSwitch, FortiMail, FortiDB, FortiWeb, FortiAP, FortiScan, FortiCarrier, FortiBalancer, FortiCache, and FortiBridge appliances, and our FortiClient and virtual domain, or VDOM, software. Additionally, we generate revenue from the TalkSwitch line of telephony products. We generally recognize revenue for products sold to distributors through the "sell-in" method upon shipment to the distributor, and for "sell-through" distributors, upon sale to their end-customer. As a percentage of total revenue, we expect our product revenue may vary from quarter-to-quarter based on seasonal and cyclical factors, but generally may remain at comparable levels or decline modestly over time, as services revenue becomes a larger portion of our business as our customers renew existing services contracts and we expand our customer base.

- Services revenue. Services revenue is generated primarily from FortiCare technical support services for software updates, maintenance releases and patches, Internet access to technical content, telephone and Internet access to technical support personnel and hardware support, and FortiGuard security subscription services related to antivirus, intrusion prevention, Web filtering, antispam and vulnerability management updates. We recognize revenue from subscription and support services over the service performance period. Our typical contractual support and subscription term is one year from the date of registration, although, we have experienced growth in the sales of multi-year support and subscription contracts. We also generate a small portion of our revenue from professional services and training services, and we recognize this revenue as the services are provided. As a percentage of total revenue, we expect our services revenue to remain at comparable levels or increase as our customers renew existing service contracts, as our services revenue growth rate depends significantly on the growth of our customer base.

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- Ratable product and services revenue. Ratable product and services revenue is generated from sales of our products and services in cases where the fair value of the services being provided cannot be separated from the value of the entire sale. In these cases, the value of the entire sale is deferred and recognized ratably over the service performance period. See Footnote 1 “Summary of Significant Accounting Policies - Revenue Recognition” for more details. In the second quarters of 2011 and 2010, ratable product and services revenue represented approximately 3.6% and 5.7% of total revenue, respectively. Over time we expect this category to continue to decline due to the new revenue recognition rules, which allow us to use BESP in our allocation of arrangement consideration when we do not have VSOE.

Cost of revenue

Our total cost of revenue is comprised of the following:

- Cost of product revenue. A substantial majority of the cost of product revenue consists of third-party manufacturing costs. Our cost of product revenue also includes product testing costs, write-offs for excess and obsolete inventory, royalty payments, amortization and any impairment of applicable acquired intangible assets, warranty costs, shipping and allocated facilities costs, stock-based compensation costs, and personnel costs associated with logistics and quality control. Personnel costs include cash-based personnel costs such as salaries, benefits and bonuses. Royalties reflect amounts related to Trend Micro since 2006, which Trend Micro claims are owed through 2015, as discussed in “Item 1 - Legal Proceedings.” For fiscal 2009, 2010 and the first two quarters of 2011, this royalty represented approximately one percent of total revenue, and we do not expect this percentage to increase substantially in the foreseeable future.

- Cost of services revenue. Cost of services revenue is primarily comprised of cash-based personnel costs associated with our FortiGuard Labs team and our technical support, professional services and training teams, as well as depreciation, supplies, data center, data communications, facility-related costs and stock-based compensation costs. We expect our cost of services revenue will increase as we continue to invest in subscription and support services to meet the needs of our growing customer base.

- Cost of ratable product and services revenue. Cost of ratable product and services revenue is comprised primarily of deferred product costs and services-related costs.

Gross profit. Gross profit as a percentage of revenue, or gross margin, has been and will continue to be affected by a variety of factors, including the average sales price of our products, any excess inventory write-offs, manufacturing costs, the mix of products sold and the mix of revenue between products and services. We believe our overall gross margin for the near term will remain comparable (or decrease slightly) to that achieved through the first two quarters of 2011.

Services revenue has historically increased as a percentage of total revenue since inception, and this trend has had a positive effect on our total gross margin given the higher services gross margins compared to product gross margins. We have generally maintained consistent services gross margins in 2010 and the first two quarters of 2011.

Operating expenses. Our operating expenses consist of research and development, sales and marketing and general and administrative expenses. Personnel costs are the most significant component of operating expenses and consist of cash-based personnel costs such as salaries, benefits, bonuses and, with regard to the sales and marketing expense, sales commissions. They also include non-cash charges, specifically, stock-based compensation. We expect personnel costs to continue to increase in absolute dollars as we hire new employees.

- Research and development. Research and development expense consists primarily of cash-based personnel costs. Additional research and development expenses include ASIC and system prototypes and certification-related expenses, depreciation of capital equipment, facility-related expenses and stock-based compensation expenses. The majority of our research and development is focused on both software development and the ongoing development of our hardware platform. We record all research and development expenses as incurred, except for capital equipment which is depreciated over time. Our development teams are primarily located in Canada, China, and California. We expect our spending for research and development to increase in absolute dollars but remain comparable to recent periods as a percentage of total revenue.

- Sales and marketing. Sales and marketing expense is the largest component of our operating expenses and primarily consists of cash-based personnel costs. Additional sales and marketing expenses include stock-based compensation, promotional and other marketing expenses, travel, depreciation of capital equipment and facility-related expenses.

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We intend to hire additional personnel focused on sales and marketing and expand our sales and marketing efforts worldwide in order to increase our presence in new geographic markets and enterprise verticals, add new customers and increase penetration within our existing customer base. Accordingly, we expect sales and marketing expenses to increase in absolute dollars and to continue to be our largest operating expense.

- General and administrative. General and administrative expense consists of cash-based personnel costs as well as professional fees, stock-based compensation, depreciation of capital equipment and software, and facility-related expenses. General and administrative personnel include our executive, finance, human resources, information technology and legal organizations. Our professional fees principally consist of outside legal, auditing, accounting, information technology and other consulting costs. We expect that general and administrative expense will increase in absolute dollars as we hire additional personnel, make improvements to our information technology infrastructure, and defend our intellectual property, but remain comparable or decrease compared to recent periods as a percentage of total revenue.

Interest income. Interest income consists of income earned on our cash, cash equivalents and investments. We have historically invested our cash in money market funds, commercial paper, corporate debt securities, municipal bonds, term deposits, and U.S. government and agency debt securities.

Other income (expense), net. Other income (expense), net consists primarily of foreign exchange and related hedging gains and losses. Foreign exchange gains and losses relate to foreign currency exchange re-measurement. The hedging gains and losses are related to our settled balance sheet hedges.

Provision for income taxes. Our income tax provision is based on our worldwide estimated annualized effective tax rate. We are subject to tax in the United States as well as other tax jurisdictions or countries in which we conduct business. Earnings from our non-U.S. activities are subject to local country income tax and may be subject to current U.S. income tax. Our effective tax rates differ from the statutory rate primarily due to foreign income subject to different tax rates than the U.S., research and development tax credits (when applicable), withholding tax, nondeductible compensation and adjustments related to our intercompany transfer pricing.

Critical Accounting Policies and Estimates

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

We believe the accounting policies and estimates discussed under Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, reflect our more significant judgments and estimates used in the preparation of the consolidated financial statements. Effective January 1, 2011, we prospectively adopted the new accounting standards related to software revenue recognition for applicable transactions originating or materially modified after December 31, 2010, which is discussed in further detail in Footnote 1 to our Condensed Consolidated Financial Statements, “Summary of Significant Accounting Policies - Revenue Recognition.”

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Results of Operations

Three Months Ended June 30, 2011 and June 30, 2010

Revenue

	Three Months Ended					
	June 30, 2011		June 30, 2010			
	Amount	% of Revenue	Amount	% of Revenue	$ Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	46,687	45.3	31,037	40.6	15,650	50.4
Services	52,671	51.1	40,964	53.7	11,707	28.6
Ratable product and services	3,665	3.6	4,330	5.7	(665)	(15.4)
Total revenue	103,023	100.0	76,331	100.0	26,692	35.0
Revenue by Geography:						
Americas	40,541	39.4	28,890	37.8	11,651	40.3
EMEA	36,633	35.5	29,482	38.8	7,151	24.3
APAC	25,849	25.1	17,959	23.4	7,890	43.9
Total revenue	103,023	100.0	76,331	100.0	26,692	35.0

Total revenue increased $26.7 million, or 35.0%, in the second quarter of 2011 compared to the second quarter of 2010. The adoption of the new revenue recognition rules, described in the notes to our financial statements, contributed $5.7 million of the increase. The Americas and APAC regions contributed the largest portion of this growth, while the EMEA region demonstrated solid year-over-year revenue growth as well. Product revenue increased $15.7 million, or 50.4%, compared to the second quarter of 2010, as we experienced higher sales volumes and increased sales to enterprise customers in the Americas and enterprise and service provider customers in APAC and EMEA. Services revenue increased $11.7 million, or 28.6%, in the second quarter of 2011 compared to the second quarter of 2010 due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable product and services revenue was minor and over time, this category of revenue is expected to decline due to the new revenue recognition rules. Revenue for the second quarter of 2011 includes a positive $5.7 million impact related to the adoption of the new revenue recognition rules, as described in our "Summary of Significant Accounting Policies" included in - Footnote 1 of our Condensed Consolidated Financial Statements.

Cost of revenue and gross margin

	Three Months Ended			
	June 30, 2011	June 30, 2010	$ Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	16,591	11,822	4,769	40.3
Services	8,596	6,818	1,778	26.1
Ratable product and services	1,371	1,525	(154)	(10.1)
Total cost of revenue	26,558	20,165	6,393	31.7

Gross margin (%):

Product	64.5	61.9	2.6
Services	83.7	83.4	0.3
Ratable product and services	62.6	64.8	(2.2)
Total gross margin	74.2	73.6	0.6

Total gross margin increased 0.6 percentage points in the second quarter of 2011 primarily due to improved product margins. Product gross margin increased 2.6 percentage points in the second quarter of 2011 compared to 2010 primarily due to an increase in the average selling price of our high-end product sales to enterprise and service provider customers combined

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with the fact that our lower-priced, entry-level products accounted for a smaller portion of our revenue during the quarter (33% compared to 35% in the second quarter last year). The 0.3 percentage points increase in services gross margin was primarily due to increased leverage in our cost structure. Services cost increased by $1.8 million primarily due to $1.5 million of higher cash-based personnel costs as we continued to scale our support and FortiGuard global security research organizations and to a lesser extent, a $0.2 million increase in professional services costs and a $0.1 million increase in stock-based compensation. Ratable product and services gross margin decreased 2.2 percentage points, as a result of higher indirect product costs, such as manufacturing overhead, and due to China sales being a higher percentage of ratable revenue, which have lower margins.

Operating Expenses

	Three Months Ended					
	June 30, 2011		June 30, 2010			
	Amount	% of Revenue	Amount	% of Revenue	$ Change	% Change
	($ amounts in 000's)					
Operating expenses:						
Research and development	15,942	15.5	12,676	16.6	3,266	25.8
Sales and marketing	35,896	34.8	27,777	36.4	8,119	29.2
General and administrative	5,848	5.7	5,933	7.8	(85)	(1.4)
Total operating expenses	57,686	56.0	46,386	60.8	11,300	24.4

Research and development expense

Research and development expense increased $3.3 million, or 25.8%, in the second quarter of 2011 compared to the second quarter of 2010 primarily due to an increase of $2.6 million in cash-based personnel costs related to increased salaries and benefits as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Increases in stock-compensation expense of $0.4 million, product development and certification expenses of $0.2 million and supplies expense of $0.1 million also contributed to the overall increase in research and development expense. A 6% year-over-year increase in the Canadian dollar exchange rate against the US dollar also significantly contributed to the increase in research and development expense.

Sales and marketing expense

Sales and marketing expense increased $8.1 million, or 29.2%, in the second quarter of 2011 compared to the second quarter of 2010 primarily due to increased cash-based personnel costs of $5.7 million including higher salaries, commissions, and benefits from increased headcount in sales in order to expand our global footprint. We also incurred a $0.8 million increase in stock-based compensation expense, a $0.5 million increase in travel expense, a $0.4 million increase in marketing activities, a $0.2 million increase in occupancy related costs, and supplies, professional services, and other operating expenses increased a combined $0.5 million. A 10% increase in the Euro exchange rate against the US dollar also contributed to the increase in sales and marketing expense. As a percentage of revenue, sales and marketing expenses decreased 1.6 percentage points due to the leverage we are achieving from the investment in our sales force during the past year, as evidenced by our revenue growth of 35.0% outpacing our sales and marketing expenses growth of 29.2%. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth.

General and administrative expense

In the second quarter of 2011, general and administrative expense decreased $0.1 million, or 1.4%, compared to the second quarter of 2010. The decrease was due to a $0.5 million reduction in legal fees and the recording of $0.5 million in patent settlement income, nearly offset by a $0.6 million increase in cash-based personnel costs and $0.3 million increase in stock-based compensation.

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Interest income and other income (expense), net

	Three Months Ended June 30, 2011	June 30, 2010	$ Change	% Change
	($ amounts in 000's)			
Interest income	863	399	464	116.3
Other income (expense), net	(207)	87	(294)	*

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* not meaningful

The $0.5 million increase in interest income in the second quarter of 2011 compared to the second quarter of 2010 was due to interest earned on higher invested balances. The change in other income (expense), net for the second quarter of 2011 when compared to the second quarter of 2010 was the result of foreign exchanges losses.

Provision for income taxes

	Three Months Ended June 30, 2011	June 30, 2010	$ Change	% Change
	($ amounts in 000's)			
Provision for income taxes	4,941	3,397	1,544	45.5
Effective tax rate (%)	25.4	33.1	(7.7)	(23.3)

Our effective tax rate was 25.4% for the three months ended June 30, 2011, compared with an effective tax rate of 33.1% for the three months ended June 30, 2010. The provision for income taxes for the three months ended June 30, 2011 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax, and includes the benefit from adjustments in our intercompany transfer pricing associated with the benefit of stock options exercised by employees in various foreign subsidiaries.

The decrease in the effective tax rate for the three months ended June 30, 2011, compared with the same period in the prior year, is attributable primarily to adjustments in our intercompany transfer pricing associated with the benefit of stock options exercised by employees in various foreign subsidiaries and the federal research tax credit.

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Six Months Ended June 30, 2011 and June 30, 2010

Revenue

	Six Months Ended June 30, 2011		June 30, 2010			
	Amount	% of Revenue	Amount	% of Revenue	$ Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	86,852	44.3	58,147	39.8	28,705	49.4
Services	101,357	51.6	79,589	54.5	21,768	27.4
Ratable product and services	8,080	4.1	8,390	5.7	(310)	(3.7)
Total revenue	196,289	100.0	146,126	100.0	50,163	34.3
Revenue by Geography:						
Americas	76,186	38.8	52,707	36.1	23,479	44.5
EMEA	70,274	35.8	56,556	38.7	13,718	24.3
APAC	49,829	25.4	36,863	25.2	12,966	35.2
Total revenue	196,289	100.0	146,126	100.0	50,163	34.3

Total revenue increased $50.2 million, or 34.3%, in the six months ended June 30, 2011 compared to the six months ended June 30, 2010, with all three regions growing over the prior year. Product revenue increased $28.7 million, or 49.4%, compared to the six months ended June 30, 2010. The increase in product revenue was primarily driven by higher sales volume coupled with significant growth in the high-end product line from increased sales to enterprise and service provider customers. Services revenue increased $21.8 million, or 27.4%, in the six months ended June 30, 2011 compared to the six months ended June 30, 2010, due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable product and services revenue was minor and over time, this category of revenue is expected to decline due to the above-mentioned adoption of new revenue recognition rules. Revenue for the six months ended June 30, 2011 includes a positive impact of $9.0 million related to the adoption of the new revenue recognition rules, as described in our "Summary of Significant Accounting Policies" included in - Footnote 1 of our Condensed Consolidated Financial Statements.

Cost of revenue and gross margin

	Six Months Ended June 30, 2011	June 30, 2010	$ Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	30,666	23,136	7,530	32.5
Services	16,377	13,286	3,091	23.3
Ratable product and services	2,931	3,118	(187)	(6.0)
Total cost of revenue	49,974	39,540	10,434	26.4
Gross margin (%):				
Product	64.7	60.2	4.5	
Services	83.8	83.3	0.5	
Ratable product and services	63.7	62.8	0.9	

Total gross margin	74.5	72.9	1.6

Total gross margin improved by 1.6 percentage points in the six months ended June 30, 2011 compared to the six months ended June 30, 2010 due to improved product gross margins, which increased 4.5 percentage points, but were significantly offset by an increase of product revenue in the overall revenue mix, which reduces the overall gross margin. Product gross margin increased 4.5 percentage points in the six months ended June 30, 2011 compared to the six months ended June 30, 2010 due to a greater mix of high-end products. From time to time, we have experienced sales of previously reserved inventory.

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During the six months ended June 30, 2011, we experienced a positive impact of 0.4 percentage points due to the sale of fully reserved inventory compared to a positive impact of 0.6 percentage points in the same period prior year. Services gross margin improved slightly as we continued to make investments in our Americas support, professional services and FortiGuard global security research organizations. Services cost increased by $3.1 million primarily due to $2.6 million of higher cash-based personnel costs. Professional services and supplies increased a combined $0.4 million. In addition, stock-based compensation increased $0.1 million. Ratable product and services gross margin increased 0.9 percentage points, as a result of higher margins realized on demo related sales.

Operating Expenses

	Six Months Ended					
	June 30, 2011		June 30, 2010			
	Amount	% of Revenue	Amount	% of Revenue	$ Change	% Change
	($ amounts in 000's)					
Operating expenses:						
Research and development	30,363	15.5	24,610	16.8	5,753	23.4
Sales and marketing	68,614	35.0	54,500	37.3	14,114	25.9
General and administrative	11,114	5.6	10,992	7.5	122	1.1
Total operating expenses	110,091	56.1	90,102	61.6	19,989	22.2

Research and development expense

Research and development expense increased $5.8 million, or 23.4%, in the six months ended June 30, 2011 compared to the six months ended June 30, 2010, primarily due to an increase of $4.8 million in cash-based personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, we incurred higher test and certification expense of $0.3 million, stock-based compensation expense of $0.3 million and depreciation, supplies and professional services increased a combined $0.4 million. A 6% year-over-year increase in the Canadian dollar exchange rate against the US dollar also significantly contributed to the increase in research and development expense.

Sales and marketing expense

Sales and marketing expense increased $14.1 million, or 25.9%, in the six months ended June 30, 2011 compared to the six months ended June 30, 2010 as we continued to increase our sales headcount in order to expand our global footprint. The increase consisted of $9.2 million in higher cash-based personnel costs based on increased headcount, a $1.8 million increase in stock-based compensation expense, a $1.0 increase in equipment, supplies, and professional services, a $0.9 million increase in travel expenses, a $0.9 increase in marketing-related expenses, and a $0.3 million increase in occupancy-related costs. A 4% year-over-year increase in the Euro exchange rate against the US dollar also contributed to the increase in sales and marketing expense. As a percentage of revenue, sales and marketing expenses decreased 2.3% percentage points due to the leverage we are achieving from the investment in our sales force during the past year, as evidenced by our revenue growth of 34.3% exceeding our sales and marketing expenses growth of 25.9%.

General and administrative expense

In the six months ended June 30, 2011, general and administrative expense increased $0.1 million, or 1.1%, compared to the six months ended June 30, 2010. The slight increase was due to increases in cash-based personnel costs of $1.2 million and stock-based compensation of $0.3 million as a result of increased headcount nearly offset by $1.0 million in amortization of the patent settlement income and a $0.4 million decrease in legal fees.

Interest income and other income (expense), net

	Six Months Ended			
	June 30, 2011	June 30, 2010	$ Change	% Change
	($ amounts in 000's)			
Interest income	1,656	667	989	148.3
Other income (expense), net	(302)	(163)	(139)	85.3

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The $1.0 million increase in interest income in the six months ended June 30, 2011 compared to the six months ended June 30, 2010 was due to higher balances of cash, cash equivalents and investments. The change in other income (expense), net for the six months ended June 30, 2011 when compared to the six months ended June 30, 2010 was the result of foreign currency losses. The loss for the six months ended June 30, 2011 was primarily due to the weakening of the U.S. dollar.

Provision for income taxes

	Six Months Ended June 30, 2011	June 30, 2010	$ Change	% Change
	($ amounts in 000's)			
Provision for income taxes	9,497	5,901	3,596	60.9
Effective tax rate (%)	25.3	34.7	(9.4)	(27.1)

Our effective tax rate was 25.3% for the six months ended June 30, 2011, compared with an effective tax rate of 34.7% for the six months ended June 30, 2010. The provision for income taxes for the six months ended June 30, 2011 was comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The decrease in the effective tax rate for the six months ended June 30, 2011, compared with the same period in the prior year, was attributable primarily to the federal research tax credit and to adjustment in our intercompany transfer pricing associated with the benefit of stock options exercised by employees at various foreign subsidiaries.

Liquidity and Capital Resources

	June 30, 2011	December 31, 2010
	($ amounts in 000's)	
Cash and cash equivalents	78,019	66,859
Investments	390,479	320,601
Total cash, cash equivalents and investments	468,498	387,460
Working capital	208,123	201,776

	Six Months Ended June 30, 2011	June 30, 2010
	($ amounts in 000's)	
Cash provided by operating activities	74,244	39,766
Cash used in investing activities	(79,887)	(149,859)
Cash provided by financing activities	15,710	15,321
Effect of exchange rates on cash and cash equivalents	1,093	(1,251)
Net increase (decrease) in cash and cash equivalents	11,160	(96,023)

At June 30, 2011, our cash, cash equivalents and investments of $468.5 million were invested primarily in money market funds, commercial paper, corporate debt securities, municipal bonds, term deposits and U.S. government and agency debt securities. We do not enter into investments for trading or speculative purposes. We believe that our cash from operations together with existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending necessary to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure the continuing market acceptance of our products, and any capital for acquisitions. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we were unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

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	Six Months Ended	
	June 30, 2011	June 30, 2010
	($ amounts in 000's)	
Net income	28,081	11,087
Adjustments for non-cash charges(1)	12,076	6,315
Net income before non-cash charges	40,157	17,402
Increase in deferred revenues	20,544	23,592
Increase in income tax payable and deferred tax assets, net	9,280	3,531
Increase in accrued payroll and compensation	357	2,686
Increase in accounts payable and accrued liabilities, net	4,015	2,635
Increase in deferred settlement and other liabilities	3,170	—
Decrease (increase) in accounts receivable	63	(5,255)
Increase in inventories	(1,455)	(3,002)
Increase in prepaid expenses and other assets, net	(1,887)	(1,823)
Net cash provided by operating activities	74,244	39,766

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(1) Non-cash charges primarily consist of stock-based compensation expense, depreciation and amortization, write-off of intangible assets, gain on disposal of fixed assets, amortization of investment premiums, and excess tax benefit from employee stock option plans.

Operating Activities

Cash generated by operating activities is our primary source of liquidity. Our operating activities during the six months ended June 30, 2011 provided $74.2 million in cash as a result of net income of $28.1 million, increased by non-cash adjustments of $12.1 million and sources of cash of $37.4 million partially offset by uses of cash of $3.4 million. Non-cash adjustments consisted of stock-based compensation of $6.9 million, amortization of investment premiums of $6.3 million, and depreciation and amortization of $3.3 million, offset partially by an excess tax benefit from employee stock option exercises of $4.4 million. Sources of cash were related to a $20.5 million increase in deferred revenue which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized as income, a $9.3 million increase in income tax payable, due to our continued profitability and timing of tax payments, a $3.2 million increase in other liabilities, mainly due to the deferral of the patent litigation settlement, which is being amortized over three years, a $4.0 million increase in accounts payable and accrued liabilities, and a $0.4 million increase in accrued payroll and compensation. Uses of cash were related to a $1.9 million increase in prepaid expenses and a $1.5 million increase in inventory to ensure adequate levels of inventory to support shipments of new product introductions in the second half of the year (net of evaluation equipment for internal use, which was transferred to fixed assets).

Our operating activities during the six months ended June 30, 2010 provided $39.8 million in cash as a result of net income of $11.1 million, increased by non-cash adjustments of $6.3 million and sources of cash of $32.4 million partially offset by uses of cash of $10.0 million. Non-cash adjustments consist of stock-based compensation of $4.4 million, depreciation and amortization of $2.8 million, and amortization of investment premiums of $2.7 million, offset by an excess tax benefit from employee stock option plans of $3.6 million. Sources of cash were related to a $23.6 million increase in deferred revenue, which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized as income, a $3.5 million increase in income tax payable and a $2.6 million increase in accounts payable and accrued liabilities, related to timing of payments, and a $2.7 million increase in accrued payroll and compensation primarily related to increased headcount and employer taxes related to the exercise of stock options. Uses of cash were related to a $5.2 million increase in accounts receivable due to a seven day increase (from 64 to 71 days) in our days sales outstanding and the overall growth of our business, a $3.0 million increase in inventory primarily to support our third quarter shipments, and a $1.8 million increase in prepaid expenses and other assets.

Investing Activities

Our investing activities during the six months ended June 30, 2011 and June 30, 2010 consisted primarily of purchases and sales of investments, and to a lesser extent capital expenditures. The $79.9 million of cash used by investing activities during the six months ended months ended June 30, 2011 was due to net purchases of investments of $75.8 million, $2.6

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million used for the TalkSwitch acquisition, and $1.5 million used for capital expenditures (net of evaluation equipment for internal use, which was transferred from inventory). The $149.9 million of cash used by investing activities during the six months ended June 30, 2010 was due primarily to net purchases of investments of $147.6 million and $2.2 million for capital expenditures.

Financing Activities

Our financing activities in the six months ended June 30, 2011 resulted in net cash provided of $15.7 million as a result of receiving proceeds of $11.2 million from the exercise of options to purchase our common stock and an excess tax benefit from employee stock option exercises of $4.5 million.

Our financing activities in the six months ended June 30, 2010 resulted in net cash provided of $15.3 million as a result of receiving proceeds of $12.5 million from the exercise of options to purchase our common stock and an excess tax benefit from employee stock option exercises of $3.7 million, offset by $0.9 million issuance cost paid in connection with our initial public offering, which had been accrued as of December 31, 2009.

Contractual Obligations and Commitments

The following summarizes our contractual obligations as of June 30, 2011:

	Payments Due By Period				
	Total	Remainder of 2011	1-3 Years	4-5 Years	More Than 5 Years
	($ amounts in 000's)				
Operating leases (1)	17,980	3,950	12,627	1,403	—
Purchase commitments (2)	18,282	18,282	—	—	—
Royalty commitments (3)	3,500	500	2,500	500	—
Total (4)	39,762	22,732	15,127	1,903	—

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(1) Consists of contractual obligations from non-cancelable office space under operating leases.

(2) Consists of minimum purchase commitments with independent contract manufacturers.

(3) Consists of minimum royalties claimed by Trend Micro pursuant to the January 2006 settlement and license agreement between Trend Micro and Fortinet, which are subject to dispute. See "Part II: Item 1 - Legal Proceedings." We have accrued $5.6 million as of June 30, 2011, related to amounts under the settlement and license agreement with Trend Micro which have not been paid pursuant to the dispute.

(4) No amounts related to ASC 740-10 (FIN 48) are included. As of June 30, 2011, we had approximately $17.1 million of tax liabilities, including interest, related to uncertain tax positions. Because of the high degree of uncertainty regarding the settlement of these liabilities, we are unable to estimate the years in which future cash outflows may occur.

Off-Balance Sheet Arrangements

As of June 30, 2011, 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.

Recent Accounting Pronouncements

See Note 1 of Notes to Condensed Consolidated Financial Statements for recent accounting pronouncements that could have an effect on us.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in our market risk during the six months ended June 30, 2011, compared to the disclosures in Part II, Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2010.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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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 Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of June 30, 2011. 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, 2011 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 the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during our second quarter of 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

ITEM 1. Legal Proceedings

In August 2009, Trend Micro filed a complaint against us in the Superior Court of the State of California for Santa Clara County alleging breach of contract and seeking a declaratory judgment that we are obligated to make certain royalty payments to Trend Micro pursuant to a settlement and license agreement entered into in January 2006. We maintain that the patents that are the basis for the royalty payments are invalid and as a result of the patents' invalidity along with other defenses, we believe we have no contractual obligation to pay the royalties. We filed an action in the U.S. District Court for the Northern District of California that is stayed pending the resolution of the state court action. We have continued to accrue expense based on the quarterly royalties provided for in the settlement and license agreement. In May 2011, in response to petitions for re-examination we filed with the U.S. Patent and Trademark Office (“PTO”) on two Trend Micro patents, the PTO issued final office actions rejecting a number of the Trend Micro patent claims allegedly forming the basis for the royalty payments. Trend Micro has responded disputing one of the final office actions.

In August 2009, Enhanced Security Research, LLC and Security Research Holdings LLC (collectively “ESR”), a non-practicing entity, filed a complaint against us in the United States District Court for the District of Delaware alleging infringement by us and other defendants of two patents. The plaintiffs are claiming unspecified damages and requesting an injunction against the alleged infringement. In June 2010, the Court granted our motion to stay pending the outcome of reexamination proceedings on both asserted patents. The PTO has finally rejected all of the claims of the patents in the suit and ESR has appealed this result to the Board of Patent Appeals and Interferences (“BPAI”). There was a related action that was dismissed by the District Court and appealed by ESR to the Federal Circuit. The Federal Circuit in June 2011 rejected ESR's appeal and confirmed the dismissal.

In July 2010, Network Protection Sciences, LLC ("NPS"), a non-practicing entity, filed a complaint in the United States District Court for the Eastern District of Texas alleging patent infringement by us and other defendants. NPS is claiming unspecified damages, including treble damages for willful infringement and requests an injunction against such alleged infringement. Currently the case is in the early stages. In January 2011, we filed with the PTO a petition for re-examination of the patent asserted by NPS. In May 2011, the PTO issued an initial office action preliminarily rejecting 30 of the 41 claims of the asserted patent.

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us claiming unspecified damages in the Superior Court of the State of California for the County of Los Angeles alleging violation of various California Corporations Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company. In September 2010, the Court granted our motion to transfer the case to the California Superior Court for Santa Clara County and the plaintiff has filed an amended complaint in the Superior Court to add individual defendants, among other amendments.

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ITEM 1A. Risk Factors

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

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

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

- the level of demand for our products and services;
- the timing of channel partner and end-customer orders;
- the timing of shipments, which may depend on many factors such as inventory levels and logistics, our ability to ship new products on schedule and accurately forecast inventory requirements, and potential delays in the manufacturing process;
- the mix of products sold, the mix of revenue between products and services and the degree to which products and services are bundled and sold together for a package price;
- the budgeting cycles and purchasing practices of our channel partners and end-customers;
- seasonal buying patterns of our end-customers;
- the timing of revenue recognition for our sales, which may be affected by both the mix of sales by our “sell-in” versus our “sell-through” channel partners, and by the extent to which we bring on new distributors;
- the accuracy and timing of point of sale reporting by our sell-through distributors, which impacts our ability to recognize revenue;
- the level of perceived threats to network security, which may fluctuate from period to period;
- changes in end-customer, distributor or reseller requirements or market needs;
- changes in the growth rate of the network security or UTM markets;
- the timing and success of new product and service introductions by us or our competitors or any other change in the competitive landscape of our industry, including consolidation among our competitors or end-customers;
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deferral of orders from end-customers in anticipation of new products or product enhancements announced by us or our competitors;

- increases or decreases in our expenses caused by fluctuations in foreign currency exchange rates, as a significant portion of our expenses are incurred and paid in currencies other than the U.S. dollar.
- decisions by potential end-customers to purchase network security solutions from larger, more established security vendors or from their primary network equipment vendors;
- price competition;

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- changes in customer renewal rates for our services;
- changes in the length of services contracts sold;
- insolvency or credit difficulties confronting our customers, affecting their ability to purchase or pay for our products and services;
- any disruption in our channel or termination of our relationship with important channel partners;
- insolvency or credit difficulties confronting our key suppliers, which could disrupt our supply chain;
- general economic conditions, both domestically and in our foreign markets; and
- future accounting pronouncements or changes in our accounting policies.

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

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

We may not be able to sustain profitability in future periods if we fail to increase billings, revenue or deferred revenue, manage our cost structure, or are subject to unanticipated liabilities. Billings and revenue growth may slow or billings and revenue may decline for a number of possible reasons, including slowing demand for our products or services, increasing competition, a decrease in the growth of our overall market, softness in demand in certain geographies, or if we fail for any reason to continue to capitalize on growth opportunities. Any failure by us to maintain profitability and continue our billings and revenue growth could cause the price of our common stock to materially decline.

Reliance on a concentration of shipments at the end of the quarter could cause our 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, historically we have received a substantial portion of a quarter's sales orders and generated a substantial portion of a quarter's revenue during the last two weeks or last days of the quarter. If expected revenue at the end of any quarter is delayed for any reason, including the failure of anticipated purchase orders to materialize, our or our logistics partners' inability to ship products prior to quarter-end to fulfill purchase orders received near the end of the quarter, our failure to manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, or any delays in shipments based on trade compliance requirements, our revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

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

Our services revenue accounted for 51% and 54% of our total revenue for the second quarters of fiscal 2011 and 2010, respectively. Sales of new or renewal subscription and services contracts may decline and fluctuate as a result of a number of factors, including end-customers' level of satisfaction with our products and services, the prices of our products and services, the prices of products and services offered by our competitors or reductions in our customers' spending levels. If our sales of new or renewal subscription and services contracts decline, our revenue and revenue growth may decline and our business will suffer. In addition, we recognize subscription and service revenue monthly over the term of the relevant service period, which is typically one year but has been as long as five years. As a result, much of the revenue we report each quarter is the recognition of deferred revenue from subscription and services contracts entered into during previous quarters. Consequently, a decline in new or renewed subscription or service contracts in any one quarter will not be fully reflected in revenue in that quarter, but will negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in new or renewed sales of our subscriptions or services is not reflected in full in our results of operations until future periods. Our subscription and service revenue also makes it difficult for us to rapidly increase our revenue through additional service sales in any period, as revenue

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from new and renewal service contracts must be recognized over the applicable service period. Furthermore increases in the average term of services contracts would result in revenue for services contracts being recognized over longer periods of time.

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.

Our channel partners may increase orders during periods of product shortages, cancel orders if their inventory is too high, return product or take advantage of price protection (if any), or delay orders in anticipation of new products. They also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them and in response to seasonal fluctuations in end-customer demand. Furthermore if the time required to manufacture certain products or ship products increases for any reason, this could result in inventory shortfalls. Management of our inventory is further complicated by the significant number of different products and models that we sell.

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

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

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

We provide sales channel partners with specific programs to assist them in selling our products, but there can be no assurance that these programs will be effective. In addition, our channel partners may be unsuccessful in marketing, selling and supporting our products and services. Our channel partners generally do not have minimum purchase requirements. They may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products. They may have incentives to promote our competitors' products to the detriment of our own. They may cease selling our products altogether. We cannot assure you that we will retain these channel partners or that we will be able to secure additional or replacement partners. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results. In addition, any new sales channel partner will require extensive training and may take several months or more to achieve productivity. Our channel partner sales structure could subject us to lawsuits, potential liability and reputational harm if, for example, any of our channel partners misrepresent the functionality of our products or services to end-customers or our channel partners violate laws or our corporate policies. If we fail to manage existing sales channels, our business will be seriously harmed.

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

An important part of our growth strategy is to increase sales of our products to large enterprises, service providers and government entities. Sales to enterprises, service providers and government entities involve risks that may not be present (or that are present to a lesser extent) with sales to small-to-mid-sized entities. These risks include:

- increased competition from larger competitors, such as Cisco Systems, Inc., Check Point Software Technologies Ltd., McAfee, Inc. (acquired by Intel, Inc.), and Juniper Networks, Inc., that traditionally target enterprises, service providers and government entities and that may already have purchase commitments from those end-customers;

- increased purchasing power and leverage held by large end-customers in negotiating contractual arrangements with

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us;

- more stringent requirements in our support service contracts, including stricter support response times, 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 who elects not to purchase our products and services.

Large enterprises, service providers and government entities often undertake a significant evaluation process that results in a lengthy sales cycle, in some cases over 12 months. Although we have a channel sales model, our sales representatives typically engage in direct interaction with our distributors and resellers in connection with sales to larger end-customers. Due to the lengthy nature, the size and scope, and stringent requirements of these evaluations, we typically provide evaluation products to these customers. We may spend substantial time, effort and money in our sales efforts without being successful in producing any sales. If we are unsuccessful in converting these evaluations into sales, we may experience an increased inventory of used products and potentially increased write-offs. In addition, product purchases by enterprises, service providers and government entities are frequently subject to budget constraints, multiple approvals, and unplanned administrative, processing and other delays. Finally, enterprise, service providers and government entities typically have longer implementation cycles, require greater product functionality and scalability and a broader range of services, including design services, demand that vendors take on a larger share of risks, sometimes require acceptance provisions that can lead to a delay in revenue recognition, and expect greater payment flexibility from vendors. All these factors can add further risk to business conducted with these customers. If sales expected from a large end-customer for a particular quarter are not realized in that quarter or at all, our business, operating results and financial condition could be materially and adversely affected.

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

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

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

Because our products and services are complex, they have contained and may contain defects or errors that are not detected until after their commercial release and deployment by our customers. Defects or vulnerabilities may impede or block network traffic or cause our products or services to be vulnerable to electronic break-ins or cause them to fail to help secure networks. Because the techniques used by computer hackers to access or sabotage networks change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques. In addition, defects or errors in our FortiGuard subscription updates or our FortiGate appliances could result in a failure of our FortiGuard services to effectively update end-customers' FortiGate appliances and thereby leave customers vulnerable to attacks. Furthermore, our solutions may also fail to detect or prevent viruses, worms or similar threats due to a number of reasons such as the evolving nature of such threats and the continual emergence of new threats that we may fail to add to our FortiGuard databases in time to protect our end-customers' networks. Our FortiGuard or FortiCare data centers and networks may also experience technical failures and downtime, and may fail to distribute appropriate updates, or fail to meet the increased requirements of a growing customer base. Any such technical failure, downtime, or failures in general may temporarily or permanently expose our end-customers' networks, leaving their networks unprotected against the latest security threats.

An actual 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. We may not be able to correct any security flaws or vulnerabilities promptly, or at all. Our products may also be misused by end-customers or third parties who obtain access to our products. For example, our products

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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 defects, errors or vulnerabilities in our products, or misuse of our products, could result in:

- expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;

- loss of existing or potential end-customers or channel partners;

- delayed or lost revenue;

- delay or failure to attain market acceptance;

- negative publicity, which will harm our reputation; and

- litigation, regulatory inquiries or investigations that may be costly and harm our reputation.

Our business and operations have experienced rapid 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.

We have a high volume business that has grown over the last several years. We rely heavily on information technology systems to help manage critical functions such as order processing, revenue recognition, financial forecasts, inventory and supply chain management and trade compliance reviews. However, we have been slow to adopt and implement certain automated functions, like Electronic Data Interchange, which could have a negative impact on our business. For example, a large part of our order processing relies on the manual processing of emails internally and from our customers. Combined with the fact that we may receive a majority of our orders in the last few weeks of any given quarter, a significant interruption in our email service or other systems could result in delayed order fulfillment and decreased revenue for that quarter. To manage any future growth effectively, we must continue to improve and expand our information technology and financial infrastructure, operating and administrative systems and controls, and continue to manage headcount, capital and processes in an efficient manner. We may not be able to successfully implement improvements to these systems and processes in a timely or efficient manner. In addition, our systems and processes may not prevent or detect all errors, omissions or fraud. Our failure to improve our systems and processes, or their failure to operate in the intended manner, may result in our inability to manage the growth of our business and to accurately forecast our revenue, expenses and earnings, or to prevent certain losses. Our productivity and the quality of our products and services may be adversely affected if we do not integrate and train our new employees quickly and effectively. Any future growth would add complexity to our organization and require effective coordination throughout our organization. Failure to manage any future growth effectively could result in increased costs and harm our results of operations.

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

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, as provided in “Management's Discussion and Analysis of

Financial Condition and Results of Operations" in this Form 10-Q, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price. Significant assumptions and estimates used in preparing our consolidated financial statements include those related to revenue recognition, stock-based compensation, valuation of inventory, warranty liabilities, and accounting for income taxes.

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

We provide certain of our major distributors with price protection rights for inventories of our products held by them. If we reduce the list price of our products, certain distributors receive refunds or credits from us that reduce the price of such

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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.

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. In the past, we have experienced turnover in our management-level personnel. None of our key employees has an employment agreement for a specific term, and any of our employees may terminate their employment at any time. Our ability to continue to attract and retain highly skilled personnel will be critical to our future success. Competition for highly skilled personnel is frequently intense, especially in the locations where we have a substantial presence and need for highly-skilled personnel: the San Francisco Bay Area, Vancouver, Canada and Beijing, China. A large portion of our employee base is substantially vested in significant stock option grants, and the ability to exercise those options and sell their stock may result in a larger than normal turnover rate. 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.

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 senior management, particularly Ken Xie, our Co-founder, President and Chief Executive Officer, Michael Xie, our Co-founder, Vice President of Engineering and Chief Technical Officer, and Ken Goldman, our Vice President and Chief Financial Officer, could significantly delay or prevent the achievement of our development and strategic objectives. In addition, key personnel may be distracted by activities unrelated to our business. The loss of the services, or distraction, of our senior management for any reason could adversely affect our business, financial condition and results of operations.

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

Our business depends on the overall demand for information technology and on the economic health of our current and prospective customers. In addition, the purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. Weak global economic conditions, weak economic conditions in certain geographies, or a reduction in information technology spending regardless of macro-economic conditions, could adversely impact our business, financial condition and results of operations in a number of ways, including longer sales cycles, lower prices for our products and services, higher default rates among our distributors, reduced unit sales and lower or no growth.

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.

We outsource the manufacturing of our security appliance products to a variety of contract manufacturing partners and original design manufacturing partners.

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

These manufacturers fulfill our supply requirements on the basis of individual purchase orders. We have no long-term contracts or arrangements with certain of our third-party manufacturers that guarantee capacity, the continuation of particular payment terms or the extension of credit limits. Accordingly, they are not obligated to continue to fulfill our supply requirements, and the prices we are charged for manufacturing services could be increased on short notice. If we are required to change third-party manufacturers, our ability to meet our scheduled product deliveries to our customers would be adversely

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affected, which could cause the loss of sales and existing or potential customers, delayed revenue or an increase in our costs which could adversely affect our gross margins. Our individual product lines are generally manufactured by only one manufacturing partner. Any production interruptions for any reason, such as a natural disaster, epidemic, capacity shortages, or quality problems, at one of our manufacturing partners would severely affect sales of our product lines manufactured by that manufacturing partner.

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

In addition, our reliance on third-party manufacturers and foundries limits our control over environmental regulatory requirements such as the hazardous substance content of our products and therefore our ability to ensure compliance with the EU RoHS and other similar laws. See “If we fail to comply with environmental requirements, our business, financial condition, operating results and reputation could be adversely affected” for information on the effects of the failure to comply with these laws.

Because some of the key components in our products come from limited sources of supply, we are susceptible to supply shortages or supply changes, which could disrupt or delay our scheduled product deliveries to our customers and may result in the loss of sales and customers.

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 in the supply of these components and the risk that component suppliers discontinue or modify components used in our products. We have faced component shortages in the past. Certain of our limited source components for particular appliances and suppliers of those components include: specific types of central processing units from Intel Corporation, Advanced Micro Devices, Inc., RMI Corporation and VIA Technologies, Inc. and network chips from Broadcom Corporation, Marvell Technology Group Ltd. and Intel. The introduction by component suppliers of new versions of their products, particularly if not anticipated by us or our contract manufacturers, could require us to expend significant resources to incorporate these new components into our products. In addition, if these suppliers were to discontinue production of a necessary part or component, we would be required to expend significant resources and time in locating and integrating replacement parts or components from another vendor. Qualifying additional suppliers for limited source parts or components can be time-consuming and expensive.

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

- a potential inability to obtain an adequate supply of required parts or components when required;

- financial or other difficulties faced by our suppliers;

- infringement or misappropriation of our intellectual property;
- price increases;
- failure of a component to meet environmental or other regulatory requirements;
- failure to meet delivery obligations in a timely fashion; and
- failure in component quality.

The occurrence of any of these 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

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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.

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

A majority of our operating expenses are incurred outside the United States, 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. For example, during the second quarter of 2011, we were impacted by the weakening of the dollar against the Canadian dollar and the Euro, which caused our operating expenses to increase. Although we have been hedging currency exposures relating to certain balance sheet accounts and have periodically entered into cashflow hedges relating to certain operating expenses incurred outside of the United States, if we stop hedging against any of these risks or if our attempts to hedge against these currency exposures are not successful, our financial condition and results of operations could be adversely affected. In addition, our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency risk. However, a strengthening of the U.S. dollar could increase the real cost of our products to our customers outside of the United States, which could adversely affect our financial condition and results of operations.

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

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

- economic or political instability in foreign markets;
- greater difficulty in enforcing contracts, accounts receivable collection and longer collection periods;
- changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;
- the uncertainty of protection for intellectual property rights in some countries;
- costs of compliance with foreign policies, laws and regulations and the risks and costs of non-compliance with such policies, laws and regulations;
- costs of complying with U.S. laws and regulations for foreign operations, including the Foreign Corrupt Practices Act, import and export control laws, tariffs, trade barriers, and economic sanctions;
- 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 arrangements that may impact financial results and result in restatements of financial statements and irregularities in

financial statements;

- the potential for political unrest, terrorism, hostilities or war;
- management communication and integration problems resulting from cultural differences and geographic dispersion; and
- multiple and possibly overlapping tax structures.

Product and service sales may be subject to foreign governmental regulations, which vary substantially from country to country. Further, we may be unable to keep up-to-date with changes in government requirements as they change from time to time. Failure to comply with these regulations could result in adverse affects 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.

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regulations applicable to us. Although we implemented policies and procedures designed to ensure compliance with these laws and policies, there can be no assurance that all of our employees, contractors, channel partners and agents will comply with these laws and policies. Violations of laws or key control policies by our employees, contractors, channel partners or agents could result in delays in revenue recognition, financial reporting misstatements, fines, penalties, or the prohibition of the importation or exportation of our products and services and could have a material adverse effect on our business and results of operations.

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

Certain of our products are subject to U.S. export controls and may be exported outside the U.S. only with the required export license or through an export license exception, because we incorporate encryption technology into our products. If we were to fail to comply with U.S. export licensing, U.S. Customs regulations, U.S. economic sanctions and other 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, we may also be adversely affected, through reputational harm and penalties. Obtaining the necessary export license for a particular sale may be time-consuming, and may result in the delay or loss of sales opportunities.

Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of certain products to U.S. embargoed or sanctioned countries, governments and persons. Even though we take precautions to prevent our product from being shipped to U.S. sanctions targets, our products could be shipped to those targets by our channel partners, despite such precautions. Any such shipment could have negative consequences including government investigations and penalties and in reputational harm. In addition, various countries regulate the import of certain encryption technology, including import permitting/licensing requirements, and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products globally or, in some cases, prevent the export or import of our products to certain countries, governments or persons altogether. Any change in export or import regulations, economic sanctions or related legislation, shift in the enforcement or scope of existing regulations, or change in the countries, governments, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, financial condition and results of operations.

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

We are subject to various environmental laws and regulations including laws governing the hazardous material content of our products and laws relating to the recycling of electrical and electronic equipment. The laws and regulations to which we are subject include the European Union, or EU, RoHS and the EU Waste Electrical and Electronic Equipment (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 incur more of these costs in the future. With respect to the EU RoHS, we and our competitors rely on an exemption for lead in network infrastructure equipment. It is possible this exemption will be revoked in the near future. If 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

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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 entities, which are subject to a number of challenges and risks.

Sales to U.S. and foreign federal, state and local governmental agency end-customers have accounted for a portion of our revenue in past periods, and we may in the future increase sales to government entities. Sales into government entities are subject to a number of risks. Selling to government entities can be highly competitive, expensive and time consuming, often requiring significant upfront time and expense without any assurance that we will win a sale. Government demand and payment for our products and services may be impacted by public sector budgetary cycles and funding authorizations, with funding reductions or delays adversely affecting public sector demand for our products. All of our sales to government entities have been made indirectly through our distribution channel. Government entities may have contractual or other legal rights to terminate contracts with our distributors and resellers for convenience or due to a default, and any such termination may adversely impact our future results of operations. For example, if the distributor receives a significant portion of its revenue from sales to such governmental entity, the financial health of the distributor could be substantially harmed, which could negatively affect our future sales to such distributor. Governments routinely investigate and audit government contractors' administrative processes, and any unfavorable audit could result in the government refusing to continue buying our products and services, a reduction of revenue or fines or civil or criminal liability if the audit uncovers improper or illegal activities. Any such penalties could adversely impact our results of operations in a material way. Finally, for purchases by the U.S. government, the 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 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 antispam and antispyware 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 antispam or spyware products. Parties whose emails or programs are blocked by our products may seek redress against us for labeling them as spammers or spyware, or for interfering with their business. In addition, false identification of emails or programs as unwanted spam or potentially unwanted programs may reduce the adoption of our products. If our system restricts important files or applications based on falsely identifying them as malware or some other item that should be restricted, this could adversely affect end-customers' systems and cause material system failures. Any such false identification of important files or applications could result in negative publicity, loss of end-customers and sales, increased costs to remedy any problem, and costly litigation.

If our internal network system is compromised by computer hackers, public perception of our products and services will be harmed.

We will not succeed unless the marketplace is confident that we provide effective network security protection. Because we provide network security products, we may be a more attractive target for attacks by computer hackers. Although we have not experienced significant damages from unauthorized access by a third-party of our internal network, if an actual or perceived breach of network security occurs in our internal systems it could adversely affect the market perception of our products and services. In addition, such a security breach could impair our ability to operate our business, including our ability to provide subscription and support services to our end-customers. If this happens, our revenue could decline and our business could suffer.

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

Once our products are deployed within our end-customers' networks, our end-customers depend on our technical support services, as well as the support of our channel partners, to resolve any issues relating to our products. If we or our channel

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partners do not effectively assist our customers in deploying our products, succeed in helping our customers quickly resolve post-deployment issues, and provide effective ongoing support, our ability to sell additional products and services to existing customers would be adversely affected and our reputation with potential customers could be damaged. Many enterprise, service provider and government entity end-customers require higher levels of support than smaller end-customers. If we fail to meet the requirements of the larger end-customers, it may be more difficult to execute on our strategy to increase our penetration with larger end-customers.

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

Changes in our provision for income taxes or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.

Our provision for income taxes is subject to volatility and could be adversely affected by several factors, many of which are outside of our control, including:

- earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates;

- changes in the valuation of our deferred tax assets and liabilities;

- expiration of, or lapses in the research and development tax credit laws;

- transfer pricing adjustments including the effect of acquisitions on our intercompany research and development and legal structure;

- an increase in non-deductible expenses for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development, and impairment of goodwill;

- tax costs related to intercompany realignments;

- tax assessments resulting from income tax audits or any related tax interest or penalties that could significantly affect our income tax provision for the period in which the settlement take place;

- a change in our decision to indefinitely reinvest foreign earnings;

- changes in accounting principles; or

- changes in tax laws and regulations including possible changes in the United States to the taxation of earnings of our foreign subsidiaries, and the deductibility of expenses attributable to foreign income, or the foreign tax credit rules, or changes to the United States 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 ASC 740-10 (formerly referred to as SFAS Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of SFAS No. 109 (FIN 48)). In addition, ASC 740-10 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 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 continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our results of operations.

Although we released our entire valuation allowance in fiscal 2009, we may in the future be required to establish a new valuation allowance. 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.

We are currently under audit by the Canada Revenue Agency for fiscal years 2006-2009 associated with our international transactions. The California Franchise Tax Board has notified us of their intent to examine our fiscal 2008 and 2009 California tax returns. The scope of the California Franchise Tax Board examinations is unclear at this time.

If the ultimate determination of income taxes assessed under the current Canadian or California audits or under audits being conducted, or to be conducted, in any of the other tax jurisdictions in which we operate results in an amount in excess of the tax provision we have recorded or reserved for, our operating results, cash flows and financial condition could be adversely affected.

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

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

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

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

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

In order to remain competitive, we may seek to acquire additional businesses, products, or technologies and intellectual property, such as patents. If we identify an appropriate acquisition candidate, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product, technology or intellectual property into our existing business and operations. We may have difficulty incorporating acquired technologies, intellectual property or products with our existing product lines and maintaining uniform standards, controls, procedures and policies. Our due diligence may fail to identify all of the problems, liabilities or other shortcomings or challenges of an acquired business, product or technology, including issues with intellectual property, product quality or product architecture, regulatory compliance practices, revenue recognition or other accounting practices or employee or customer issues. In addition, any acquisitions we are able to complete may not be accretive to earnings and may not result in any synergies or other benefits we had expected to achieve, which could result in write-offs that could be substantial. Further, completing a potential acquisition and integrating acquired businesses, products, technologies or intellectual property will significantly divert management time and resources.

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

Our products are very complex and, despite testing prior to their release, have contained and may contain undetected defects or errors, especially when first introduced or when new versions are released. For example, one of our high-end product models experienced a defect in limited deployments. 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-

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

Although we have limitation of liability provisions in our standard terms and conditions of sale, they may not fully or effectively protect us from claims as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The sale and support of our products also entail the risk of product liability claims. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management's time and other resources.

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

A significant natural disaster, such as an earthquake, fire, a flood, or significant power outage could have a material adverse impact on our business, operating results and financial condition. Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity. For example, we have sales operations in Japan that have been impacted by the earthquake in Japan and that could continue to be impacted by that disaster, and we have sales operations in the Middle East that have been, and continue to be, negatively impacted by softness in demand and civil unrest there. In addition, natural disasters could affect our manufacturing vendors 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. For example, our primary international logistics provider is located in Taiwan which is an area known for typhoons. 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 missing financial targets, such as revenue and shipment targets, for a particular quarter. In addition, regional instability, acts of terrorism and other geo-political unrest could cause disruptions in our business or the business of our manufacturers, logistics providers, partners, or end-customers or the economy as a whole. Given our typical concentration of sales at each quarter end, any disruption in the business of our manufacturers, logistics providers, partners or end-customers that impacts sales at the end of our quarter could have a significant adverse impact on our quarterly results. All of the aforementioned risks may be augmented if the disaster recovery plans for us and our suppliers prove to be inadequate. To the extent that any of the above results in delays or cancellations of customer orders, or the delay in the manufacture, deployment or shipment of our products, our business, financial condition and results of operations would be adversely affected.

Risks Related to Our Industry

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

The network security market is expected to continue to evolve rapidly. Moreover, many of our end-customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated techniques to gain access to and attack systems and networks. The technology in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, while minimizing the impact on network performance. Additionally, some of our new products and enhancements may require us to develop new hardware architectures and ASICs that involve complex, expensive and time consuming research and development processes. Although the market expects rapid introduction of new products or product enhancements to respond to new threats, the development of these products is difficult and the timetable for commercial release and availability is uncertain and there can be long time periods between releases and availability of new products. We have in the past and may in the future experience unanticipated delays in the availability of new products and services and fail to meet previously announced timetables for such availability. If we do not quickly respond to the rapidly changing and rigorous needs of our end-customers

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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 will impair the market acceptance of our products, which in turn will 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 users' 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 will 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;
- inability to protect against new types of attacks or techniques used by hackers;
- defects, 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;

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- easing of regulatory requirements around security; and

- reluctance of customers to purchase products incorporating open source software.

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

Unless we continue to develop better market awareness of our company and our products, our revenue may not continue to grow.

We are a relatively new entrant in the network security market and we believe that we have not yet established sufficient market awareness of our participation in that market. Market awareness of our capabilities and products is essential to our continued growth and our success in all of our markets, particularly for the large enterprise, service provider and government entities markets. If our marketing programs are not successful in creating market awareness of our company and products, our business, financial condition and results of operations will be adversely affected, and we will not be able to achieve sustained growth.

Demand for Unified Threat Management products may be limited by market perception that UTM products are inferior to network security solutions from multiple vendors.

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

We face intense competition in our market, especially from larger, better-known companies, and we may lack sufficient financial or other resources to maintain or improve our competitive position.

The market for network security products is intensely competitive and we expect competition to intensify in the future. Our competitors include networking companies such as Cisco Systems, Inc. and Juniper Networks, Inc., security vendors such as Check Point Software Technologies Ltd., McAfee, Inc. (acquired by Intel, Inc.), and SonicWALL, Inc. (acquired by Thoma Bravo), and other point solution security vendors.

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

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

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

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

Risks Related to Intellectual Property

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

We rely primarily on patent, trademark, copyright and trade secrets laws, confidentiality procedures and contractual provisions to protect our technology. We purchased most of our issued U.S. patents and many of our pending U.S. patent applications from other entities. Valid patents may not issue from our pending applications, and the claims eventually allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate defensive protection or competitive advantages to us. Patent applications in the United States are typically not published until 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. 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 (GPL), the GNU Lesser Public License (LGPL), the BSD License, the Apache License and others. From time-to-time, there have been claims against companies that distribute or use open source software in their products and services, asserting that open source software infringes the claimants' intellectual property rights. We could be subject to suits by parties claiming infringement of intellectual property rights in what we believe to be licensed open source software. Use and distribution of open source software may entail greater risks than use of third-party commercial software, as open source licensors generally do not provide warranties or other contractual protections regarding infringement claims or the quality of the code. Some open source licenses contain requirements that we make available source code for modifications or derivative works we create based upon the type of open source software we use. If we combine our proprietary software with open source software in a certain manner, we could, under certain open source licenses, be required to release the source code of our proprietary software to the public. This would allow our competitors to create similar products with lower development effort and time and ultimately could result in a loss of product sales for us.

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

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

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

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

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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.

We have been involved in patent disputes in the past, are currently involved in several patent disputes, and likely will be involved in additional disputes in the future. In May 2004, Trend Micro Incorporated filed a complaint against us alleging that we infringed a Trend Micro patent related to antivirus software. The International Trade Commission, or ITC, subsequently instituted an investigation which resulted in an exclusion order and a cease and desist order prohibiting us from selling a broad array of our products in the United States. In January 2006, we settled the lawsuit with Trend Micro, and subsequently the ITC terminated its action and rescinded the orders. Pursuant to the settlement and license agreement, we initially paid Trend Micro $15.0 million. The settlement and license agreement provides for additional quarterly royalty payments, not expected to exceed 1% of our total revenue each quarter, through 2015. In November 2008, we filed a complaint against Trend Micro in the United States District Court for the Northern District of California alleging, among other claims, that the patents that are the basis for the ongoing royalty payments are invalid and consequently that we have no contractual obligation to pay the royalties. Trend Micro moved to dismiss the case, and, in June 2009, the court dismissed the case without prejudice on procedural grounds, and we appealed the dismissal in July 2009. Based on the dispute, we ceased paying royalties under the settlement and license agreement. In August 2009, Trend Micro filed a complaint against us in the Superior Court of the State of California for Santa Clara County alleging breach of contract and seeking a declaratory judgment that we are obligated to make certain royalty payments to Trend Micro. In December 2009, we withdrew our appeal of the June 2009 dismissal by the United States District Court for the Northern District of California and filed a new complaint against Trend Micro in the United States District Court for the Northern District of California alleging, among other claims, that the patents that are the basis for the ongoing royalty payments are invalid and consequently that we have no contractual obligation to pay the royalties. In February 2010, Trend Micro filed demurrers in the state Superior Court action regarding Fortinet's affirmative defenses that Fortinet has no obligation to pay royalties because the Trend Micro patents are invalid or unenforceable. In March 2010, Trend Micro filed a motion to dismiss our new complaint that we filed in the United States District Court for the Northern District of California. In May 2010, the state Superior Court denied Trend Micro's demurrer in its entirety. Also in May 2010, the United States District Court for the Northern District of California denied Trend Micro's motion to dismiss without prejudice and stayed the action before that court pending the conclusion of the state Superior Court action. In May 2011, in response to petitions for re-examination we filed with the U.S. Patent and Trademark Office (“PTO”) on two Trend Micro patents, the PTO issued final office actions rejecting a number of the Trend Micro patent claims allegedly forming the basis for the royalty payments. Trend Micro has responded disputing one of the final office actions. At this stage it is not possible to predict the outcome. An adverse outcome in this dispute could result in accelerated royalty payments and additional damages.

As discussed in "Item 1-Legal Proceedings," from time to time we are subject to lawsuits claiming patent infringement and there are lawsuits claiming patent infringement currently pending. We are also subject to other litigation in addition to patent infringement claims. 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. In addition to the lawsuits described in "Legal Proceedings," several other non-practicing patent holding companies have sent us letters proposing that we license certain of their patents, and, given this and the proliferation of lawsuits in our industry and other similar industries by both non-practicing entities and operating entities, we expect that we will be sued for patent infringement in the future, regardless of the merits of any such lawsuits. The cost to defend such lawsuits and any adverse result in such lawsuits could have a material adverse effect on our results of operations and financial condition.

We rely on the availability of third-party licenses.

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

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Risks Related to Ownership of our Common Stock

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

The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as well as other rules implemented by the SEC and The NASDAQ Stock Market, impose various requirements on public companies, including requiring changes in corporate governance practices. These and proposed corporate governance laws and regulations under consideration may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management's attention from other business concerns, it could have a material adverse effect on our business, financial condition and results of operations. The Sarbanes-Oxley Act requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually and disclosure controls and procedures quarterly. We are in the early stages of completing our evaluation of our internal controls over financial reporting for fiscal 2011 as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing and evaluation resulted in our conclusion that as of December 31, 2010, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. If our internal controls or disclosure controls are ineffective in future periods, our business and reputation could be harmed. We may incur additional expenses and commitment of management's time in connection with further evaluations, both of which could materially increase our operating expenses and accordingly reduce our operating results.

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

A change in accounting standards or practices and varying interpretations of existing accounting pronouncements, such as changes to standards related to revenue recognition recently adopted by the FASB, the increased use of fair value measure, the recent proposed change to revenue recognition, lease accounting, financial instrument accounting standards, and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards (“IFRS”), could have a significant effect on our reported financial results or the way we conduct our business. Effective January 1, 2011, we started reporting revenue recognition based on the new revenue standards issued by the FASB. If we do not ensure that proper systems and processes for revenue recognition are aligned with the new standards, this could have a material adverse impact on our business.
If securities or industry analysts stop publishing research or publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.

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

The trading price of our common stock is likely to be volatile.

The market price of our common stock is subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, and other factors such as rumors or fluctuations in the valuation of companies perceived by investors to be comparable to us.

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.

Our failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in

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new products could reduce our ability to compete and could harm our business.

We expect that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. After that, we may need to raise additional funds, and we may not be able to obtain additional debt or equity financing on favorable terms, if at all. If we raise additional equity financing, our stockholders may experience significant dilution of their ownership interests and the per-share value of our common stock could decline. Furthermore, if we engage in debt financing, the holders of debt would have priority over the holders of common stock and we may be required to accept terms that restrict our ability to incur additional indebtedness. We may also be required to take other actions that would otherwise be in the interests of the stockholders and force us to maintain specified liquidity or other ratios, any of which could harm our business, operating results and financial condition. If we need additional capital and cannot raise it on acceptable terms, we may not be able to, among other things:

- develop or enhance our products and services;
- continue to expand our sales and marketing and research and development organizations;
- acquire complementary technologies, products or businesses;
- expand operations, in the United States or internationally;
- hire, train and retain employees; or
- respond to competitive pressures or unanticipated working capital requirements.

Our failure to do any of these things could seriously harm our business, financial condition and results of operations.

Concentration of ownership among our existing executive officers, directors and their affiliates may prevent new investors from influencing significant corporate decisions.

As of July 29, 2011, our executive officers, directors and their affiliates beneficially owned, in the aggregate, approximately 20.2% of our outstanding common stock. As a result, these stockholders are able to exercise a significant level of control over all matters requiring stockholder approval, including the election of directors, amendment of our certificate of incorporation and approval of significant corporate transactions. This control could have the effect of delaying or preventing a change of control of our company or changes in management and will make the approval of certain transactions difficult or impossible without the support of these stockholders.

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:

- creating a classified board of directors whose members serve staggered three-year terms;
- authorizing “blank check” preferred stock, which could be issued by the board without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;

- limiting the liability of, and providing indemnification to, our directors and officers;
- limiting the ability of our stockholders to call and bring business before special meetings;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;
- controlling the procedures for the conduct and scheduling of board and stockholder meetings; and
- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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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.

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

Not applicable.

ITEM 6. Exhibits

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

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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 4, 2011

FORTINET, INC.

By: /s/ KEN GOLDMAN

Ken Goldman
Vice President and Chief Financial Officer

Ken Goldman
Vice President and Chief Financial Officer

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EXHIBIT INDEX

Exhibit Number	Description	Incorporated By Reference Herein Form	Date
10.1	Fortinet, Inc. 2011 Employee Stock Purchase Plan	Current Report on Form 8-K	June 23, 2011
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 Extention 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.
** XBRL information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, and is not subject to liability under those sections, is not part of any registration statement or prospectus to which it relates and is not incorporated or deemed to be incorporated by reference into any registration statement, prospectus or other document.