FORTINET INC
Form 10-K
March 03, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark One)
T ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2013
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 001-34511

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

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

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

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $0.001 Par Value	The NASDAQ Stock Market LLC
(Title of each class)	(Name of exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

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

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

The aggregate market value of voting stock held by non-affiliates of the registrant, as of June 28, 2013, the last business day of the registrant’s most recently completed second quarter, was $2,122,539,878 (based on the closing price for shares of the registrant’s common stock as reported by The NASDAQ Global Select Market on that date). Shares of common stock held by each executive officer, director, and holder of 5% or more of the registrant’s outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 18, 2014, there were 162,853,313 shares of the registrant’s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant’s definitive Proxy Statement relating to its 2014 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated. Such Proxy Statement will be filed with the United States Securities and Exchange Commission (“SEC”) within 120 days after the end of the fiscal year to which this report relates.

FORTINET, INC.
ANNUAL REPORT ON FORM 10-K
For the Fiscal Year Ended December 31, 2013
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Part I

ITEM 1. Business

Overview

We provide high performance network security solutions that are designed to address the fundamental problems of an increasingly bandwidth-intensive network environment and a more sophisticated information technology ("IT") threat landscape. Through our products and subscription services, we provide broad and integrated protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and governmental entities worldwide. Our flagship integrated network security solution consists of our FortiGate physical and virtual appliance products that provide a broad array of security and networking functions to protect data, applications, and users from network- and content-level security threats. These functions provide Data Center Firewall ("DCFW")/Unified Threat Management ("UTM")/Next Generation Firewall ("NGFW") technologies, including firewall, virtual private network ("VPN"), application control, anti-malware, intrusion prevention, Web filtering, vulnerability management, anti-spam, wireless controller, and wide area network ("WAN") acceleration. Our FortiGate appliances, from the FortiGate-20 for small businesses and branch offices to the FortiGate-5000 series for large enterprises and service providers, are based on our proprietary technology platform. This platform includes our FortiASICs, which are specifically designed for accelerated processing of security and networking functions, and our FortiOS operating system, which provides the foundation for all of our security functions. Our FortiGuard security subscription services provide end-customers with access to dynamic updates to our application control, anti-malware, intrusion prevention, Web filtering and anti-spam functionality based on intelligence gathered by our dedicated FortiGuard Labs team. By combining multiple proprietary security and networking functions with our purpose-built FortiASIC and FortiOS, our FortiGate DCFW/UTM/NGFW solution delivers broad protection against dynamic security threats while reducing the operational burden and costs associated with managing multiple point products.

We complement our FortiGate product line with the FortiManager product family, which enables end-customers to manage the system configuration and security functions of multiple FortiGate devices from a centralized console, as well as the FortiAnalyzer product family, which enables collection, analysis and archiving of content and log data generated by our products. We also offer other product lines that provide additional protection, such as: (i) FortiAP, secure wireless access points, (ii) FortiWeb, security for Web-based applications, (iii) FortiMail, multi-featured, high performance messaging security, (iv) FortiDB, centrally managed database-specific security, (v) FortiClient, endpoint security for desktops, laptops and mobile devices and that is primarily used in conjunction with our FortiGate appliances, (vi) FortiScan, endpoint vulnerability assessment and remediation, (vii) FortiSwitch, Ethernet switches, (viii) FortiBridge, bypass appliances to help ensure network availability, (ix) FortiAuthenticator, scalable secure authentication for enterprise networks, (x) FortiADC, Application Delivery Controller ("ADC")optimizing the availability and performance of mobile, cloud, and enterprise applications, (xi) FortiSandbox, detecting and mitigating Advanced Persistent Threats ("APTs"), (xii) FortiCache, reducing the cost of and impact of cached internet content, (xiii) FortiDNS, providing secure Domain Name System ("DNS") caching, (xiv) FortiDDoS, protection against Distributed Denial of Service ("DDOS") attack, and (xv) FortiVoice, business telephone communication.

Additionally, we offer virtual appliances for the FortiGate, FortiManager, FortiAnalyzer, FortiWeb, FortiMail, FortiCache, and FortiADC product lines. These virtual appliances help secure network infrastructures with the same functionality as the traditional physical appliances in their respective product lines. They can be used in conjunction with traditional Fortinet appliances (such as FortiGate, FortiManager, and FortiAnalyzer) to help ensure the visibility, management, and protection of physical and virtual environments.

Since our inception through December 31, 2013, we have shipped over 1,400,000 appliances via more than 20,000 channel partners to more than 184,000 end-customers worldwide, including a majority of the 2013 Fortune Global

100. During our fiscal year ended December 31, 2013, we generated total revenue of $615.3 million and net income of $44.3 million. See Part II Item 8 of this Annual Report on Form 10-K for more information on our consolidated balance sheets as of December 31, 2013 and 2012 and our consolidated statements of operations, consolidated statements of comprehensive income, consolidated statements of cash flows, and consolidated statements of stockholders' equity for each of the three years ended December 31, 2013, 2012, and 2011.

We were incorporated in Delaware in November 2000. Our principal executive office is located at 1090 Kifer Road, Sunnyvale, California 94086 and our telephone number at that location is (408) 235-7700. In March 2014, we expect to move to our new corporate headquarters located at 899 Kifer Road, Sunnyvale, California 94086.

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Technology and Architecture

Our proprietary FortiASIC hardware architecture, FortiOS operating system and associated security and networking functions combine to form a platform that integrates security features and enables our products to perform sophisticated security processing for networks with high throughput requirements.

FortiASIC

Our FortiASIC family of Application-Specific Integrated Circuits (“ASICs”) is comprised of three lines of processors: the FortiASIC content processor (“CP”), the FortiASIC network processor (“NP”), and the FortiASIC system-on-a-chip (“SOC”). These custom ASICs are designed to enhance the sophisticated security processing capabilities implemented in software by accelerating the computation-intensive tasks such as firewall policy enforcement or intrusion prevention system ("IPS") anomaly detection. This architecture provides the flexibility of implementing accelerated processing of new threat detection without requiring a new ASIC release. The FortiASIC CP is currently included in most of our entry-level and all of our mid-range and high-end FortiGate appliances. The FortiASIC NP is currently included in some of our mid-range and high-end FortiGate appliances, delivering further accelerated firewall and VPN performance. During fiscal 2013, we introduced the latest version of our NP, the NP6 through our FGT 1500D and 3700D product lines providing enhanced firewall performance. The FortiASIC SOC2 is our second-generation processor that combines general purpose processing power with Fortinet's custom technology to provide hardware-accelerated network security performance for our smaller FortiGate appliances. It is currently included in our entry-level FortiGate-20, -30, -40, -60, and -90 product families.

FortiOS

Our FortiOS operating system provides the foundation for the operation of all FortiGate appliances, from the core kernel functions to the security processing feature sets. FortiOS provides multiple layers of security including a hardened kernel layer providing protection for the FortiGate system, a network security layer providing security for end-customers’ network infrastructures, and application content protection providing security for end-customers’ workstations and applications. FortiOS directs the operations of processors and ASICs and provides system management functions such as command-line and graphical user interfaces.

In the first quarter of fiscal 2013, we released an update to our FortiOS operating system, which offers advanced security, control, and intelligence designed to help protect organizations of all sizes from today’s sophisticated threats. These enhancements to FortiOS include:

- Advanced modern anti-malware detection system for identifying and mitigating APTs.

- Simplification of configurations and deployments by enabling enterprises to quickly and easily configure their FortiGate appliances based on their unique business and security requirements.

- Contextual visibility for enhanced security reporting and management by providing detailed analytics for deeper insight into historic or real-time network activities.

We make available updates to FortiOS through our FortiCare support services. FortiOS also enables advanced, integrated routing and switching, allowing end-customers to deploy FortiGate devices within a wide variety of networks, as well as providing a direct replacement solution option for legacy switching and routing equipment. FortiOS implements a suite of commonly used routing protocols as well as address translation technologies, allowing the FortiGate appliance to integrate and operate in a wide variety of network environments. Additional features include Virtual Domain (“VDOM”), capabilities and traffic queuing and shaping, enabling administrators to set the

appropriate configurations and policies that meet their infrastructure needs. FortiOS also provides capabilities for logging of traffic for forensic analysis purposes which are particularly important for regulatory compliance initiatives like payment card industry data security standard ("PCI DSS"). FortiOS is designed to help control network traffic in order to optimize performance by including functionality such as packet classification, queue disciplines, policy enforcement and congestion management.

Our FortiOS incorporates the following core security and networking technologies, including firewall, VPN, application control, anti-malware, intrusion prevention, Web filtering, vulnerability management, anti-spam, wireless controller, and WAN acceleration.

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We also incorporate additional technologies within FortiGate appliances that differentiate our DCFW/UTM/NGFW solution, including data leakage protection (DLP), traffic optimization, SSL inspection, threat vulnerability management, and wireless controller technology.

Products

Our core product offerings consist of our FortiGate product family, along with our FortiManager central management and FortiAnalyzer central logging and reporting product families, both of which are typically purchased to complement a large FortiGate deployment.

FortiGate

Our flagship FortiGate physical and virtual appliances offer a broad set of security and networking functions, including firewall, VPN, application control, antivirus, intrusion prevention, Web filtering, anti-spam and WAN acceleration. All FortiGate models are based on our proprietary operating system, FortiOS, and substantially all FortiGate physical appliances include our proprietary FortiASICs to accelerate content and network security features implemented within FortiOS. FortiGate platforms can be centrally managed through both embedded Web-based and command line interfaces, as well as through FortiManager which provides central management architecture for thousands of FortiGate physical and virtual appliances.

By combining multiple network security functions in our purpose-built security platform, the FortiGate provides high quality protection capabilities and deployment flexibility while reducing the operational burden and costs associated with managing multiple point products. With over 30 models in the FortiGate product line, FortiGate is designed to address security requirements for small- to mid-sized businesses, remote offices, large enterprises, and service providers.

Each FortiGate model runs our FortiOS operating system, and substantially all FortiGate physical appliances include our FortiASICs. The significant differences between each model are the performance and scalability targets each model is designed to meet, while the security features and associated services offered are common throughout all models. The FortiGate-20 through -100 series models are designed for perimeter protection for small- to mid-sized businesses. The FortiGate-200 through -800 series models are designed for perimeter deployment in mid-sized to large enterprise networks. And, the FortiGate-1000 through -5000 series models deliver high performance and scalable network security functionality for perimeter, data center and core deployment in large enterprise and service provider networks.

Fortinet Management and Analysis Products

Our FortiManager and FortiAnalyzer physical and virtual products are typically sold in conjunction with a large FortiGate deployment.

FortiManager. Our FortiManager family of products provides a central management solution for our FortiGate products, including the wide variety of network and security features offered within FortiOS. One FortiManager product is capable of effectively managing thousands of FortiGate units, and also provides central management for FortiClient software. FortiManager facilitates the coordination of policy-based provisioning, device configuration and operating system revision management, as well as network security monitoring and device control.

FortiAnalyzer. Our FortiAnalyzer family provides network logging, analyzing, and reporting products that securely aggregate content and log data from our FortiGate devices and other Fortinet products as well as third-party devices to enable network logging, analysis and reporting.

We also offer other physical and virtual appliances and software that protect our end-customers from security threats to other critical areas in the enterprise, such as messaging, Web-based applications and databases, and employees' computers or mobile devices as discussed above in the business overview.

Services

FortiGuard Security Subscription Services

Security requirements are dynamic due to the constantly changing nature of threats. Our FortiGuard Labs global threat research team uses automated processes to identify emerging threats, collects threat samples, and replicates, reviews and characterizes attacks. Based on this research, we develop updates for virus signatures, attack definitions, scanning engines, and other security solution components to distribute to end-customers through our FortiGuard global distribution network. Our

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FortiGuard security subscription services are designed to allow us to quickly deliver new threat detection capabilities to end-customers worldwide as new threats evolve. End-customers purchase FortiGuard security subscription services in advance, typically for a one-year term, to obtain coverage and access to regular updates for application control, antivirus, intrusion prevention, Web filtering, and anti-spam functions for our FortiGate products; antivirus, Web filtering and anti-spam functions for our FortiClient software; antivirus and anti-spam functions for our FortiMail products; vulnerability management for our FortiGate, FortiAnalyzer and FortiScan products, database functions for our FortiDB appliance, web functions for our FortiWeb appliances, and advanced threat protection for our FortiSandbox products. We provide FortiGuard services 24 hours a day, seven days a week.

FortiCare Technical Support Services

Our FortiCare services are our technical support services for the software, firmware and hardware in our products. In addition to our standard support service offering, we offer a premium service that offers faster response times and dedicated support oriented towards major accounts.

For our standard technical support offering for our products, channel partners often provide first level support to the end-customer, especially for small and mid-sized end-customers, and we typically provide second and third level support to our end-customers. We also provide knowledge management tools and customer self-help portals to help augment our support capabilities in an efficient and scalable manner. We provide technical support to partners and end-customers 24 hours a day, seven days a week through regional technical support managers located worldwide.

Training Services

We offer training services to our end-customers and channel partners through our training department and authorized training partners. We have also implemented a training certification program to ensure an understanding of our products and services.

Professional Services

We offer professional services to end-customers primarily for large implementations where expert technical resources are required. Our professional services consultants help in the design of deployments of our products and work closely with end-customer engineers, managers and other project team members to implement our products according to design, utilizing network analysis tools, attack simulation software and scripts.

Customers

We sell our security solutions through channel partners to end-customers of various sizes—from small businesses to large enterprises and service providers—and across a variety of industries including telecommunications, government, financial services, retail, education, technology, healthcare and manufacturing. An end-customer deployment may involve one of our appliances or thousands, depending on our end-customers' size and security requirements. Since our inception through December 31, 2013, we have shipped over 1,400,000 appliances via more than 20,000 channel partners to more than 184,000 end-customers worldwide, including a majority of the 2013 Fortune Global 100. For additional information regarding our sales by customer location, see Note 14 to our consolidated financial statements in Part II, Item 8 of this Annual Report on Form 10-K.

During fiscal 2011, no single customer or distributor accounted for 10% or more of total revenue. During fiscal 2012 and fiscal 2013, one distributor, Exclusive Networks Group, accounted for 11% and 12% of total revenue, respectively.

Sales and Marketing

We primarily sell our products and services directly to distributors that sell to resellers and service providers, which, in turn, sell to our end-customers. In certain cases, we sell directly to government-focused resellers, very large service providers and major systems integrator partners who have large purchasing power and unique customer deployment demands. As of December 31, 2013, our distribution channel program had more than 20,000 channel partners worldwide. We work with many of the world's leading technology distributors, including Arrow Electronics, Inc., Ingram Micro Inc. and Tech Data Corporation.

We support our channel partners that include distributors and resellers with a team of experienced channel account managers, sales professionals and sales engineers who provide business planning, joint marketing strategy, and pre-sales and operational sales support. Additionally, our sales team often helps drive and support large enterprise and service provider sales through a direct touch model. Our sales professionals and engineers typically work alongside our channel partners and directly

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engage with end-customers to address their unique security and deployment requirements. Our sales cycle for an initial end-customer purchase typically ranges from three to six months but can be longer especially for large enterprises, service providers and government customers. To support our broadly dispersed global channel and end-customer base, we have sales offices in over 30 countries around the world.

Our marketing strategy is focused on building our brand and driving end-customer demand for our security solutions. We execute this strategy by leveraging a combination of internal marketing professionals and a network of regional and global channel partners. Our internal marketing organization is responsible for branding, product marketing, channel marketing and sales support programs. We focus our resources on programs, tools and activities that can be leveraged by partners worldwide to extend our marketing reach, such as sales tools and collateral, product awards and technical certifications, training, regional seminars and conferences, webinars and various other demand-generation activities.

Manufacturing and Suppliers

We outsource the manufacturing of our security appliance products to a variety of contract manufacturers and original design manufacturers. Our current manufacturing partners include Flextronics International Ltd., Micro-Star International Co., Ltd., Adlink Technology, Inc., Senao Networks, Inc., and a number of Taiwan-based manufacturers. We submit purchase orders to our contract manufacturers that describe the type and quantities of our products to be manufactured, the delivery date and other delivery terms. Once our products are manufactured, they are sent to either our headquarters in Sunnyvale, California, or to our logistics partner in Taoyuan City, Taiwan, where accessory packaging and quality-control testing are performed. We believe that outsourcing our manufacturing and a substantial portion of our logistics enables us to conserve capital, better adjust manufacturing volumes to meet changes in demand and more quickly deliver products, while allowing us to focus resources on our core competencies. Our proprietary FortiASICs, which are the key to the performance of our appliances, are fabricated by contract manufacturers in foundries operated by United Microelectronics Corporation (“UMC”) and Taiwan Semiconductor Manufacturing Company Limited (“TSMC”). Faraday Technology Corporation (using UMC’s foundry), Kawasaki Microelectronics America, Inc. (“K-Micro”) (using TSMC’s foundry) and Renesas Electronics Corporation (“Renesas”) (using UMC’s foundry) manufacture our ASICs on a purchase order basis. Accordingly, they are not obligated to continue to fulfill our supply requirements, and the prices we are charged for the fabrication of our ASICs could be increased on short notice.

The components included in our products are sourced from various suppliers by us or more frequently by our contract manufacturers. Some of the components important to our business, including specific types of central processing units from Intel Corporation (“Intel”), network chips from Broadcom Corporation (“Broadcom”), Marvell Technology Group Ltd. (“Marvell”) and Intel, and solid-state drives (silicon-based storage device) from OCZ Technology Group, Inc. and Samsung Electronics Co., Ltd., are available from a limited or sole source of supply.

We have no long-term contracts related to the manufacturing of our ASICs or other components that guarantee any capacity or pricing terms.

For information regarding the geographical disbursement of our long-lived assets, see Note 14 to our consolidated financial statements in Part II, Item 8 of this Annual Report on Form 10-K.

Research and Development

We focus our research and development efforts on developing new products and systems, and adding new features to existing products and systems. Our development strategy is to identify features, products and systems for both software and hardware that are, or are expected to be, needed by our end-customers. Our success in designing,

developing, manufacturing and selling new or enhanced products will depend on a variety of factors, including the identification of market demand for new products, product selection, timely implementation of product design and development, product performance, effective manufacturing and assembly processes and sales and marketing.

As of December 31, 2013, our research and development organization had headcount of 702 people predominantly in Canada, the United States (“U.S.”) and China. Our research and development expense was $102.7 million in fiscal 2013, $81.1 million in fiscal 2012 and $63.6 million in fiscal 2011.

Intellectual Property

We rely primarily on patent, trademark, copyright and trade secrets laws, confidentiality procedures and contractual provisions to protect our technology. As of December 31, 2013, we had 130 issued U.S. patents, 21 issued Chinese patents, 4 issued Taiwanese patents and 1 issued Japanese patent, which expire at various dates between 2019 and 2031, and 105 patent

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applications pending for examination in the United States, and 7 patent applications pending for examination in China. We also license software from third parties for inclusion in our products, including open source software and other software available on commercially reasonable terms.

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 agreements with our employees, consultants, vendors and customers, and generally limit access to and distribution of our proprietary information. However, we cannot provide assurance that the steps we take will prevent misappropriation of our technology. 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.

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. Third parties have in the past asserted, and may in the future assert patent, copyright, trademark and other intellectual property rights against us, our channel partners or our end-customers. Successful claims of infringement by a third party could prevent us from distributing certain products or performing certain services or require us to pay substantial damages (including treble damages if we are found to have willfully infringed patents or copyrights), royalties or other fees. Even if 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, operating results or financial condition to be materially and adversely affected. We typically indemnify our end-customers, distributors and certain resellers against claims that our products infringe the intellectual property of third parties.

Seasonality

For information regarding seasonality, see the section entitled "—Quarterly Results of Operations—Seasonality, Cyclicality and Quarterly Revenue Trends" in Part II, Item 7 of this Annual Report on Form 10-K.

Competition

The markets for our products are extremely competitive and are characterized by rapid technological change. The principal competitive factors in our markets include the following:

•product performance, features, effectiveness, interoperability and reliability;

•technological expertise;

•price of products and services and total cost of ownership;

•brand recognition;

•customer service and support;

•sales and distribution capabilities;

•compliance with industry standards and certifications;

•size and financial stability of operations; and

•breadth of product line.

Our competitors include networking companies such as Cisco Systems, Inc. (“Cisco”) and Juniper Networks, Inc. (“Juniper”), security vendors such as Check Point Software Technologies Ltd. (“Check Point”), McAfee, Inc. (“McAfee”) (acquired by Intel), Sourcefire, Inc. (“Sourcefire”) (acquired by Cisco), Stonesoft Corporation (“Stonesoft”) (acquired by McAfee), SonicWALL, Inc. (“SonicWALL”) (acquired by Dell Inc. (“Dell”)), BlueCoat Systems, Inc. ("BlueCoat"), FireEye, Inc. and Palo Alto Networks, Inc. (“Palo Alto Networks”), and other point solution security vendors.

We believe we compete favorably based on our products’ performance, reliability and breadth, our ability to add and integrate new networking and security features and our technological expertise. Several competitors are significantly larger, have greater financial, technical, marketing, distribution, customer support and other resources, are more established than we are, and have significantly better brand recognition. Some of these 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. Based in part on these competitive pressures, we may lower prices or attempt to add incremental features and functionality.

Conditions in our markets could change rapidly and significantly as a result of technological advancements or continuing market consolidation. The development and market acceptance of alternative technologies could decrease the demand for our products or render them obsolete. Our competitors may introduce products that are less costly, provide superior performance or achieve greater market acceptance than our products. In addition, our 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. The above competitive pressures are likely to continue to impact our business. We may not be able to compete successfully in the future, and competition may harm our business.

Environment

Our business and operations are subject to environmental laws and regulations in various jurisdictions around the world including the Waste Electrical and Electronic Equipment and Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment regulations adopted by the European Union. Many of these laws and regulations are still evolving and being tested in courts, and could be interpreted in ways that could harm our business. We seek to operate our business in compliance with such laws. We are currently subject to laws relating to the materials and content of our products and certain requirements relating to product take back and recycling. Environmental regulation is increasing, particularly outside of the United States, and we expect that our international operations will be subject to additional environmental compliance requirements, which may expose us to additional costs. To date, our compliance costs relating to environmental regulations have not had a material impact on our business, results of operations or financial condition.

Employees

As of December 31, 2013, our total headcount was 2,308 people including contractors. We had 702 in research and development, 870 in sales and marketing, 540 in services and support, 49 in manufacturing operations, and 147 in a general and administrative capacity. As of December 31, 2013, our headcount was 595 people in the United States, 726 in Canada, 208 in China, 119 in France, and 660 in other countries.

None of our U.S. employees are represented by a labor union with respect to his or her employment with us; however, our employees in France, Spain and Italy are represented by collective bargaining agreements. We have not experienced any work stoppages, and we consider our relations with our employees to be good.

Available Information

Our web site is located at www.fortinet.com, and our investor relations web site is located at http://investor.fortinet.com. The information posted on our website is not incorporated by reference into this Annual Report on Form 10-K. Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed or furnished pursuant to Sections 13(a) and 15(d) of the Securities Act, are available free of charge on our investor relations web site as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. You may also access all of our public filings through the SEC’s website at www.sec.gov. Further, a copy of this Annual Report on Form 10-K is located at the SEC’s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330.

We webcast our earnings calls and certain events we participate in or host with members of the investment community on our investor relations web site. Additionally, we provide notifications of news or announcements regarding our financial performance, including SEC filings, investor events, press and earnings releases, as part of our investor relations web site. The contents of these web sites are not intended to be incorporated by reference into this report or in any other report or document we file.

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ITEM 1A. Risk Factors

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

Risks Related to Our Business

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

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

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

- 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, and increased competitiveness in general in our market;

- changes in customer renewal rates for our services;

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

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

- insolvency or credit difficulties confronting our customers, affecting their ability to purchase or pay for our products and services;

- disruptions 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 in our domestic and foreign markets; and

- future accounting pronouncements or changes in our accounting policies.

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

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

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

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

Billings and revenue growth may slow, or we may experience a decrease in billings and revenue, for a number of reasons, including a slowdown in demand for our products or services, an increase in 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. For example, we experienced lower than expected billings during the first quarter of 2013 due to a number of factors, including decreased sales in the service provider market and slower sales in Latin America, and Europe, Middle East and Africa (“EMEA”). Our expenses as a percentage of total revenue may be higher

than expected if our revenue is lower than expectations, and we may not be able to sustain profitability in future periods if we fail to increase billings, revenue or deferred revenue, do not appropriately manage our cost structure, or encounter unanticipated liabilities. Any failure by us to maintain profitability and continue our billings and revenue growth could cause the price of our common stock to materially decline.

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

Our subscription and support services revenue has historically accounted for a significant percentage of our total revenue. Sales of new or renewal subscription and support services contracts may decline and fluctuate as a result of a number

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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 support services contracts decline, our revenue and revenue growth may decline and our business will suffer. In addition, in the event significant customers require payment terms for subscription or support services in arrears or for shorter periods of time than annually, such as monthly or quarterly, this may negatively impact subscription and support revenue. Furthermore, we recognize subscription and support services revenue monthly over the term of the relevant service period, which is typically from one to three years, but in some instances has been as long as five years. As a result, much of the subscription and support services revenue we report each quarter is the recognition of deferred revenue from subscription and support services contracts entered into during previous quarters. Consequently, a decline in new or renewed subscription or support services contracts in any one quarter will not be fully reflected in revenue in that quarter but will negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in new or renewed sales of our subscriptions or support services is not reflected in full in our statements of operations until future periods. Our subscription and support services revenue also makes it difficult for us to rapidly increase our revenue through additional service sales in any period, as revenue from new and renewal support services contracts must be recognized over the applicable service period.

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

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

- economic or political instability in foreign markets;
- greater difficulty in enforcing contracts, accounts receivable collection and longer collection periods;
- changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;
- the uncertainty of protection for intellectual property rights in some countries;
- costs of compliance with foreign policies, laws and regulations and the risks and costs of non-compliance with such policies, laws and regulations;
- 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 and sales-related arrangements that may result in disruption in the sales team through terminations of employment or otherwise, and may adversely impact financial results as compared to those already reported or the forecasted results and result in restatements of financial statements and irregularities in financial statements;
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our ability to effectively implement and maintain adequate internal controls to properly manage our international sales and operations;

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

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

time. Failure to comply with these regulations could result in adverse effects to our business. In many foreign countries it is common for others to engage in business practices that are prohibited by our internal policies and procedures or U.S. regulations applicable to us. Although we implemented policies and procedures designed to ensure compliance with these laws and policies, there can be no assurance that all of our employees, contractors, channel partners and agents will comply with these laws and policies. Violations of laws or key control policies by our employees, contractors, channel partners or agents could result in 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.

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 governmental entities. Sales to enterprises, service providers and governmental 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 competitors, such as Cisco Systems, Inc. (“Cisco”), Sourcefire, Inc. (“Sourcefire”) (acquired by Cisco), Check Point Software Technologies Ltd. (“Check Point”), McAfee, Inc. (“McAfee”) (acquired by Intel Corporation (“Intel”)), Blue Coat Systems, Inc. ("Blue Coat"), FireEye, Inc., Palo Alto Networks, Inc. (“Palo Alto Networks”), SonicWALL, Inc. (“SonicWALL”) (acquired by Dell Inc. (“Dell”)), Juniper Networks, Inc. (“Juniper”), and Stonesoft Corporation (“Stonesoft”) (acquired by McAfee) that traditionally target enterprises, service providers and governmental 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;

- unanticipated changes in the capital resources of or purchasing behavior of large end-customers, including changes in the volume and frequency of their purchases;

- more stringent support requirements in our support service contracts, including stricter support response times, more complex customer requirements, and increased penalties for any failure to meet support requirements; and

- longer sales cycles and the associated risk that substantial time and resources may be spent on a potential end-customer that elects not to purchase our products and services.

Large enterprises, service providers and governmental 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 governmental entities are frequently subject to budget constraints, multiple approvals, and unplanned administrative, processing and other delays. Furthermore, service providers represent our largest industry vertical and consolidation or changes in buying behavior by larger customers within this industry could negatively impact our business. Finally, enterprises, service providers and governmental 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.

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

Managing our inventory is complex. Our channel partners may increase orders during periods of product shortages, cancel orders if their inventory is too high, return products or take advantage of price protection (if any is available to the

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particular partner), or delay orders in anticipation of new products. They also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them and in response to seasonal fluctuations in end-customer demand. Furthermore, if the time required to manufacture 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. For example, we experienced inventory shortages in the first quarter of 2013 due to more demand for certain products than we had forecasted. If we are unable to effectively manage our inventory and that of our channel partners, our results of operations could be adversely affected.

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

Our future performance depends on the continued services and continuing contributions of our senior management to execute on our business plan, and to identify and pursue new opportunities and product innovations. The loss of services of members of senior management, particularly Ken Xie, our Co-founder and Chief Executive Officer and Michael Xie, our Co-founder, President and Chief Technology Officer, and any of our senior sales leaders or functional area leaders, could significantly delay or prevent the achievement of our development and strategic objectives. For example, our prior Chief Financial Officer and Chief Operating Officer departed in December 2013. 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.

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

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

The average sales prices of our products 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.

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

As a result of customer-buying patterns and the efforts of our sales force and channel partners to meet or exceed quarterly quotas, we have historically received a substantial portion of each quarter's sales orders and generated a substantial portion of each quarter's billings and revenue during the last two weeks of the quarter. For example, on average over the past eight quarters, our shipments during the last two weeks of each quarter accounted for approximately 36% of aggregate billings for each quarter. If expected orders at the end of any quarter are delayed for any reason, including the failure of anticipated purchase orders to materialize, our logistics partners' inability to ship products prior to quarter-end to fulfill purchase orders received near the end of the quarter, our failure to manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, or any delays in shipments based on trade compliance requirements, our billings and revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

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 also 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 or that existing channel partners will continue to perform. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results. 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 optimize our channel partner model or fail to manage existing sales channels, our business will be seriously harmed.

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

Because our products and services are complex, they have contained and may contain defects or errors that are not detected until after their commercial release and deployment by our customers. Defects or vulnerabilities may impede or block network traffic 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, possible or perceived security breach or infection of the network of one of our end-customers, regardless of whether the breach is attributable to the failure of our products or services to prevent the security breach, could adversely affect the market's perception of our security products and services. We may not be able to correct any security flaws or

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

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

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

- delayed or lost revenue;

- delay or failure to attain market acceptance;

- negative publicity, which will harm our reputation; and

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

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

Our business has grown over the last several years. We rely heavily on information technology 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, 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 requisite improvements to these systems, controls and processes, such as system access and change management controls, in a timely or efficient manner. We are moving our U.S. headquarters at the end of February, which move could cause system and other disruption. We are also in the planning stages for a new enterprise resource planning system and when the new system is implemented, such change may cause disruption and additional cost. 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 Annual Report on Form 10-K, 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 expense, valuation of inventory, warranty liabilities, goodwill and other long-lived assets, investments, and accounting for income taxes.

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

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

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

We outsource the manufacturing of our security appliance products to 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 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. Furthermore manufacturing cost increases for any reason could result in lower gross margins.

Our proprietary FortiASIC, which is the key to the performance of our appliances, is fabricated by contract manufacturers in foundries operated by UMC and TSMC. Faraday (using UMC's foundry), "K-Micro (using TSMC's foundry) and Renesas (using UMC's foundry) manufacture our ASICs on a purchase order basis, and UMC and TSMC do not guarantee any capacity and could reject orders from Faraday, K-Micro or Renesas or could try to increase pricing. Accordingly, the foundries are not obligated to continue to fulfill our supply requirements, and due to the long lead time that a new foundry would require, we could suffer temporary or long term inventory shortages of our FortiASIC as well as increased costs. Our suppliers may also prioritize orders by other companies that order higher volumes 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 European Union's ("EU") Restriction of Hazardous Substances Directive ("RoHS") and other similar laws. It also exposes us to the risk that certain minerals and metals that originated in the Democratic Republic of Congo or an adjoining country, known as "conflict minerals," are contained within our products. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC adopted new disclosure requirements for public companies using conflict minerals in their products. Under these rules, we are required to perform due diligence, disclose and report our efforts to prevent the sourcing of such conflict minerals. Our first conflict minerals report is due by May 31, 2014. As a result of these new rules, we have incurred and expect to incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the conflict minerals that may be used in our products. Moreover, the implementation of these new requirements could adversely affect the sourcing, availability, and pricing of materials used in the manufacture of our products

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to the extent that there may be only a limited number of suppliers offering "conflict free" minerals that can be used in our products. There can be no assurance that we will be able to obtain such minerals in sufficient quantities or at competitive prices. We may also encounter customers who require that all of the components of our products be certified as conflict free. If we are not able to meet customer requirements, such customers may choose to not purchase our products, which could impact our sales and the value of portions of our inventory.

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

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

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

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

- financial or other difficulties faced by our suppliers;

- infringement or misappropriation of our intellectual property;

- price increases;

- failure of a component to meet environmental or other regulatory requirements;

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

- failure in component quality.

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

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

A majority of our operating expenses is incurred outside the United States. These expenses are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro and Canadian dollar. Although we have been hedging currency exposures relating to certain balance sheet accounts and have periodically entered into cash flow 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, while substantially all of our revenue is not subject to foreign currency

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risk, it does not serve as a hedge to our foreign currency-denominated operating expenses. In addition, a strengthening of the U.S. dollar could increase the real cost of our products to our customers outside of the United States, which could also adversely affect our financial condition and results of operations.

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

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

Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of 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 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 EU, RoHS and the EU Waste Electrical and Electronic Equipment Directive ("WEEE Directive") as well as the implementing legislation of the EU member states. Similar laws and regulations have been passed or are pending in China, South Korea, Norway and Japan and may be enacted in other regions, including in the United States, and we are, or may in the future be, subject to these laws and regulations.

The EU RoHS and the similar laws of other jurisdictions ban the use of certain hazardous materials such as lead, mercury and cadmium in the manufacture of electrical equipment, including our products. We have incurred costs to comply with these laws, including research and development costs, costs associated with assuring the supply of compliant components and costs associated with writing off noncompliant inventory. We expect to continue to incur

costs related to environmental laws and regulations in the future. With respect to the EU RoHS, we and our competitors rely on an exemption for lead in network infrastructure equipment. It is possible this exemption will be revoked in the near future. If this exemption is revoked, if there are other changes to these laws (or their interpretation) or if new similar laws are passed in other jurisdictions, we may be required to reengineer our products to use components compatible with these regulations. This reengineering and component substitution could result in additional costs to us or disrupt our operations or logistics.

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

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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 governmental 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 governmental entities. Sales to governmental entities are subject to a number of risks. Selling to governmental 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, sales, and payment for our products and services may be negatively impacted by numerous factors and requirements unique to selling to government agencies, such as:

- public sector budgetary cycles,
- funding authorizations and requirements unique to government agencies, with funding or purchasing reductions or delays adversely affecting public sector demand for our products,
- geopolitical matters, and
- rules and regulations applicable to certain government sales.

The rules and regulations applicable to government sales may also negatively impact sales to non-governmental entities. To date we have had limited traction in sales to U.S. federal government agencies, and any future sales to governmental entities is uncertain. All of our sales to governmental entities have been made indirectly through our distribution channel. Governmental 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, purchases by the U.S. government may require certain products to be manufactured in the United States and other high cost manufacturing locations, and we may not manufacture all products in locations that meet the requirements of the U.S. government.

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

Our antivirus and our intrusion prevention services may falsely detect viruses or other threats that do not actually exist. This risk is heightened by the inclusion of a "heuristics" feature in our products, which attempts to identify viruses and other threats not based on any known signatures but based on characteristics or anomalies that may indicate that a particular item is a threat. When our end-customers enable the heuristics feature in our products, the risk of falsely identifying viruses and other threats significantly increases. These false positives, while typical in the industry, may impair the perceived reliability of our products and may therefore adversely impact market acceptance of our products. Also, our anti-spam and anti-malware services may falsely identify emails or programs as unwanted spam or potentially unwanted programs, or alternatively fail to properly identify unwanted emails or programs, particularly as

spam emails or spyware are often designed to circumvent anti-spam or spyware products. Parties whose emails or programs are blocked by our products may seek redress against us for labeling them as spammers or spyware, or for interfering with their business. In addition, false identification of emails or programs as unwanted spam or potentially unwanted programs may reduce the adoption of our products. If our system restricts important files or applications based on falsely identifying them as malware or some other item that should be restricted, this could adversely affect end-customers' systems and cause material system failures. 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.

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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 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 large end-customers, service provider and governmental entity end-customers require higher levels of support than smaller end-customers because of their more complex deployments. If we fail to meet the requirements of our larger end-customers, it may be more difficult to execute on our strategy to increase our penetration with enterprises, service providers and governmental entities.

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;

- a decrease in the stock option exercises by our employees in some of our foreign subsidiaries that can cause an adverse transfer pricing adjustment;

- 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 takes place;
- a change in our decision to indefinitely reinvest foreign earnings;
- changes in accounting principles; or

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- 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 U.S. income tax rate, which would necessitate a revaluation of our deferred tax assets and liabilities.

Significant judgment is required to determine the recognition and measurement attribute prescribed in the Financial Accounting Standards Board ("FASB") standard. In addition, the standard applies to all income tax positions, including the potential recovery of previously paid taxes, which if settled unfavorably could adversely impact our provision for income taxes or additional paid-in capital. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain foreign countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the examination of our income tax returns by the Internal Revenue Service ("IRS") and other tax authorities. For example, the California Franchise Tax Board is examining our tax returns for 2010 and 2011. 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 currently do not have a valuation allowance, we may in the future be required to establish one. We will continue to assess the need for a valuation allowance on the deferred tax asset by evaluating both positive and negative evidence that may exist.

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

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

In order to remain competitive, we may seek to acquire additional businesses, products, or technologies and intellectual property, such as patents. 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, and we may not accurately forecast the financial impact of an acquisition. In addition, any acquisitions we are able to complete may be dilutive to revenue growth and earnings and may not result in any synergies or other benefits we had expected to achieve, which could result in write-offs that could be substantial. Acquisitions during a quarter may result in increased operating expenses and adversely affect our results of operations for that period or future periods compared to the results that we have previously forecasted or achieved. Further, completing a potential acquisition and integrating acquired businesses, products, technologies or intellectual property could significantly divert management time and resources.

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

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

Although we 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. In addition, natural disasters could affect our manufacturing vendors, suppliers or logistics providers' ability to perform services such as obtaining product components and manufacturing products on a timely basis and assisting with shipments on a timely basis. 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 us 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,

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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 by developing and releasing and making available on a timely basis new products and services or enhancements that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

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

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

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

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

We spend substantial amounts of time and money to research and develop new products and enhanced versions of our existing products to incorporate additional features, improved functionality or other enhancements in order to meet our customers’ rapidly evolving demands for network security in our highly competitive industry. When we develop a new product or an enhanced version of an existing product, we typically incur expenses and expend resources upfront

to market, promote and sell the new offering. Therefore, when we develop and introduce new or enhanced products, they must achieve high levels of market acceptance in order to justify the amount of our investment in developing and bringing them to market.

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

- delays in releasing our new products or enhancements to the market;
- failure to accurately predict market demand in terms of product functionality and to supply products that meet this demand in a timely fashion;
- failure of our sales force and partners to focus on selling new products;

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

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

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

Increased market awareness of our capabilities and products and increased lead generation are essential to our continued growth and our success in all of our markets, particularly for the large enterprise, service provider and governmental entities markets. We have historically had relatively low spending on certain marketing activities, and, 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 UTM 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 governmental 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 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 and Juniper, security vendors such as Check Point, McAfee (acquired by Intel), Sourcefire (acquired by Cisco), Stonesoft (acquired by McAfee), SonicWALL (acquired by Dell), Blue Coat, FireEye, and Palo Alto Networks, 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;

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

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

Large, well-established providers of networking equipment such as Cisco and Juniper 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.

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

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

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

Our products contain software modules licensed to us by third-party authors under “open source” licenses, including the GNU Public License, the GNU Lesser Public License (LGPL), the BSD License, the Apache License 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.

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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, 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.

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

From time to time we are subject to lawsuits claiming patent infringement, and there are lawsuits claiming patent infringement currently pending, as discussed in the section entitled "Legal Proceedings" in Part I, Item 3 of this Annual Report on Form 10-K. We are also subject to other litigation in addition to patent infringement claims, such as employment-related litigation and disputes, general commercial litigation, and could become subject to other forms of litigation and disputes, including stockholder litigation. If we are unsuccessful in defending any such claims, our operating results and financial condition and results may be materially and adversely affected. For example, we may be required to pay substantial damages and could be prevented from selling certain of our products. Litigation, with or without merit, could negatively impact our business, reputation, and sales in a material fashion. 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.

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 completed our evaluation of our internal controls over financial reporting for fiscal 2013 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, 2013, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in 2014 or 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, the increased use of fair value measure, financial instruments, and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards, could have a significant effect on our reported financial results or the way we conduct our business. If we do not ensure that our systems and processes are aligned with the new standards, we could encounter difficulties generating quarterly and annual financial statements in a timely manner, which would have an adverse effect on our business and our ability to meet our reporting obligations.

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

The trading market for our common stock will depend in part on the research and reports that securities or industry analysts publish about us or our business. If we do not maintain adequate research coverage or if one or more of the analysts who 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. For example, in fiscal 2013, the closing price of our common stock ranged from $16.53 to $25.00.

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

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

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

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

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

- limiting the ability of our stockholders to call and bring business before special meetings;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;
- 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.

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 1B. Unresolved Staff Comments

Not applicable.

ITEM 2. Properties

In March 2014, we expect to move to our new corporate headquarters located at 899 Kifer Road, Sunnyvale, California, where we own approximately 164,000 square feet of office and building space and approximately ten acres of developable land to accommodate anticipated future growth. Our lease for 1090 Kifer Road, Sunnyvale, California, which is our current corporate headquarters, expires in March 2014.

Internationally, we lease approximately 14,000 square feet of data center space and a total of approximately 72,000 square feet of office space in two buildings in Burnaby, Canada under various leases that expire in July 2015 and July 2020, respectively, approximately 24,000 square feet and 26,000 square feet of office space in Ottawa, Canada under a lease that expires in February 2015 and June 2018, respectively, approximately 19,000 square feet of office space in Sophia, France under a lease that expires in December 2017, and approximately 26,000 square feet of office space in Beijing, China under a lease that expires in August 2015. We also lease sales and support offices in Australia, Austria, Belgium, Egypt, Germany, Hong Kong, India, Indonesia, Israel, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, New Zealand, Philippines, Poland, Russia, Saudi Arabia, Singapore, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Arab Emirates, and the United Kingdom. We believe that our existing properties are sufficient and suitable for the conduct of our business.

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ITEM 3. Legal Proceedings

In June 2012, we received a letter from SRI International (“SRI”) claiming that we infringed certain SRI patents. We settled this matter in December 2013.

We do not currently have any other litigation matters that we expect to have a material adverse effect on our business.

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

ITEM 4. Mine Safety Disclosure

Not applicable.

Part II

ITEM 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is traded on The NASDAQ Global Select Market under the symbol “FTNT.” The following table sets forth, for the time periods indicated, the high and low closing sales price of our common stock, as reported on The NASDAQ Global Select Market.

	2013		2012	
	High ($)	Low ($)	High ($)	Low ($)
Fourth Quarter	21.98	16.76	24.80	17.81
Third Quarter	21.43	17.28	27.68	20.93
Second Quarter	22.98	16.53	28.44	20.41
First Quarter	25.00	19.06	27.83	19.90

Holders of Record

As of February 18, 2014, there were 80 holders of record of our common stock. A substantially greater number of holders of our common stock are “street name” or beneficial holders, whose shares are held by banks, brokers and other financial institutions.

Dividends

We have never declared or paid cash dividends on our capital stock. We do not anticipate paying any cash dividends in the foreseeable future. Any future determination to declare cash dividends will be made at the discretion of our board of directors and will depend on our financial condition, operating results, capital requirements, general business conditions and other factors that our board of directors may deem relevant.

Stock Performance Graph

This performance graph shall not be deemed “filed” for purposes of Section 18 of the Exchange Act, or incorporated by reference into any filing of Fortinet under the Securities Act of 1933, as amended (the “Securities Act”), or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

The following graph shows a comparison from November 18, 2009 through December 31, 2013, of the cumulative total return for our common stock, the NASDAQ Composite Index, and the NASDAQ Computer Index. Such returns are based on historical results and are not intended to suggest future performance. Data for The NASDAQ Composite Index and The NASDAQ Computer Index assume reinvestment of dividends. We have never declared or paid cash dividends on our capital stock nor do we anticipate paying any such cash dividends in the foreseeable future.

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COMPARISON OF CUMULATIVE TOTAL RETURN*
Among Fortinet, Inc., The NASDAQ Composite Index and
The NASDAQ Computer Index

	November 2009	December 2009	December 2010	December 2011	December 2012	December 2013
Fortinet, Inc.	$100	$106	$195	$263	$253	$230
NASDAQ Composite	$100	$106	$124	$121	$141	$195
NASDAQ Computer	$100	$107	$127	$127	$143	$188

* $100 invested on November 18, 2009 in stock or index, including reinvestment of dividends.

Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Share Repurchase Program

On December 6, 2013, our board of directors authorized a Share Repurchase Program (“the Program”), to repurchase up to $200.0 million of our outstanding common stock through December 31, 2014. Under the Program, share repurchases may be made by us from time to time in privately negotiated transactions or in open market transactions. The Program does not require us to purchase a minimum number of shares, and may be suspended, modified or discontinued at any time without prior notice. In December 2013, we repurchased 2.1 million shares of common stock under the Program in open market transactions for an aggregate purchase price of $38.9 million. The timing and amounts of these purchases were based on market conditions and other factors, including price, and regulatory requirements. The share repurchases were financed by available cash balances. As of December 31, 2013, $161.1 million remained available for future share repurchases under the Program.

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The following table provides information with respect to the shares of common stock we repurchased in December 2013 (in thousands, except number of shares and per share amounts):

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
December 1 - December 31, 2013	2,131,128	$18.28	2,131,128	$161,051

ITEM 6. Selected Financial Data

The following selected consolidated financial data set forth below was derived from our historical audited consolidated financial statements and should be read in conjunction with the section titled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Financial Statements and Supplementary Data,” and other financial data included elsewhere in this Annual Report on Form 10-K. Our historical results of operations are not indicative of our future results of operations.

	Fiscal Year				
	2013	2012	2011	2010	2009
	($ amounts in 000’s, except per share amounts)				
Consolidated Statement of Operations Data:					
Total revenue	615,297	533,639	433,576	324,696	252,115
Operating income	72,090	100,475	88,904	55,341	25,334
Net income	44,273	66,836	62,492	41,245	60,179
Net income per share:					
Basic	0.27	0.42	0.41	0.29	0.97
Diluted	0.26	0.40	0.38	0.26	0.39
Weighted-average shares outstanding:					
Basic	162,435	158,074	152,581	140,726	52,668
Diluted	168,183	166,329	163,781	156,406	130,438

	As of Fiscal Year End				
	2013	2012	2011	2010	2009
	($ amounts in 000’s)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents and investments	843,045	739,586	538,687	387,460	260,314
Total assets	1,168,464	975,497	734,747	545,422	387,213
Total stockholders’ equity	585,760	510,934	358,354	232,454	142,452

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

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

- variability in sales in certain product categories from year to year and between quarters;
- expected impact of certain acquisitions, asset purchases and strategic investments;
- expected impact of sales of certain products;
- the significance of stock-based compensation as an expense;
- the proportion of our revenue that consists of our product and service revenues, and the mix of billings between products and services;
- the impact of our product innovation strategy;
- expanding our reach into new high growth verticals and emerging markets and continuing to sell to large enterprises and service providers;
- our ability to meet increasing customer expectations about the quality and functionality of our products;
- trends in revenue, costs of revenue, and gross margin;
- trends in our operating expenses, including personnel costs, research and development expense, sales and marketing expense and general and administrative expense, and expectations regarding these expenses as a percentage of revenue;
- continued investments in research and development to strengthen our technology leadership position and in sales and marketing;
- expectations regarding uncertain tax benefits and our effective tax rate;
- the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next 12 months;
- 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 Annual Report on Form 10-K and, in particular, the risks discussed under the heading "Risk Factors" in Part I, Item 1A of this Annual Report on Form 10-K and those discussed in other documents we file with the SEC. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Business Overview

We provide high performance network security solutions, which enable broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and governmental entities worldwide. Since inception through December 31, 2013, we had shipped over 1,400,000 appliances via more than 20,000 channel partners to more than 184,000 end-customers worldwide, including a majority of the 2013 Fortune Global 100.

Our core DCFW/UTM/NGFW product line of FortiGate physical and virtual appliances ships with a set of security and networking capabilities, including firewall, VPN, application control, antivirus, intrusion prevention, Web filtering,

vulnerability management, anti-spam, wireless controller, and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-20, designed for small businesses, to the FortiGate-5000 series for large enterprises, telecommunications carriers, and service providers. Our DCFW/UTM/NGFW solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to intrusion prevention, application control, antivirus, Web filtering, vulnerability management and anti-spam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. End-customers also often use FortiManager and FortiAnalyzer products in conjunction with a FortiGate deployment to provide centralized management, analysis and reporting capabilities. We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web application firewalls, databases, protection against denial of service attacks (DDoS) and endpoint security for employee computers and mobile devices. Sales of these complementary products have grown in recent quarters, although these products still represent less than 10% of our total revenue. During fiscal 2013, we expanded and enhanced our FortiGate DCFW/UTM/NGFW and FortiAP secure wireless access product lines. We also introduced software-based virtual appliances for many of 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.

In fiscal 2013, we completed certain acquisitions as part of our strategy to expand our product offerings, around load balancing solutions and add patents to our patent portfolio.

Financial Highlights

- We recorded total revenue of $615.3 million in fiscal 2013. This represents an increase of 15% in fiscal 2013, compared to fiscal 2012. Revenue in fiscal 2013 and fiscal 2012 included $2.8 million and $3.7 million, respectively, from the sales of previously-acquired patents. Product revenue was $278.0 million, an increase of 12% in fiscal 2013, compared to fiscal 2012. Services revenue was $329.7 million in fiscal 2013, an increase of 20% in fiscal 2013, compared to fiscal 2012.

- Cash, cash equivalents and investments were $843.0 million as of December 31, 2013, an increase of $103.5 million from December 31, 2012.

- Deferred revenue was $432.6 million as of December 31, 2013, an increase of $69.4 million from December 31, 2012.

- We generated cash flows from operating activities of $147.4 million in fiscal 2013, a decrease of 20% compared to fiscal 2012.

- In December 2013, our board of directors authorized a Share Repurchase Program (“the Program”), which authorizes us to repurchase up to $200.0 million of our outstanding common stock. In fiscal 2013, we repurchased 2.1 million shares of common stock under the Program in open market transactions for an aggregate purchase price of $38.9 million.

We continue to invest in research and development to strengthen our technology leadership position. We believe that continued product innovation has strengthened our technology advantage and resulted in market share gains, as evidenced by the recent introduction of several noteworthy new FortiGate appliance models, including new FortiGate entry-level appliances, such as the FG-60D and FG-90D with its WIFI counterparts and FG-100D; the FG-200D and FG-800C mid-range appliance; and the FG-3600C and FG-5001C for large enterprises and service providers. During fiscal 2013, we also made a significant investment in sales and marketing to increase brand awareness and grow our global sales force and distribution channels to expand our global presence both geographically and by industry

segment. As a result, we experienced increased deal volumes driven by traction in enterprise data center deployments and large enterprise deals, with particular strength in the retail, financial and telecommunication sectors.

We remain focused on investing in our sales and research and development resources in order to expand our reach into new high-growth verticals and emerging markets, and meet increasing customer expectations about the quality and functionality of our products, as we continue to sell to large customers, such as enterprise and service providers. While we have experienced some success selling into certain vertical customer segments, such as service providers and enterprise, we have experienced less traction selling into other verticals such as the U.S. federal government and there can be no assurance we will be successful selling into certain vertical customer segments.

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Sales of FortiGate products have generally been balanced across entry-level (FortiGate-20 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately one-third of FortiGate sales, with some degree of variability from year to year and between quarters over the three-year period ended December 31, 2013. The percentage of our FortiGate related billings from the entry-level category increased from 32% in fiscal 2012 to 38% in fiscal 2013, while the mid-range category decreased from 33% in fiscal 2012 to 29% in fiscal 2013 and the high-end category decreased from 35% to 34%.

In fiscal 2013, operating expenses increased by 27% compared to fiscal 2012. The increase was primarily driven by our accelerated pace of hiring to support our growth as we continued to invest in expanding our sales coverage, developing new products and scaling our customer support organization to meet the needs of our growing customer base. This resulted in revenue per employee, defined as annual revenue divided by average headcount, of $286,000, down from $303,000 for fiscal 2012.

Business Model

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 physical and virtual 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 can be as long as five years. Sales of new and renewal services increase our deferred revenue balance, which contributes significantly to our positive cash flow from operations.

Key Metrics

We monitor the key financial metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts, and assess operational efficiencies. Our total deferred revenue increased by $69.4 million from $363.2 million as of December 31, 2012 to $432.6 million as of December 31, 2013. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period less any deferred revenue balances acquired from business combinations is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the revenue that we recognize in a typical quarter. We ended fiscal 2013 with $843.0 million in cash, cash equivalents and investments and have had positive cash flow from operations every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under "—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.

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	Fiscal Year or as of Fiscal Year End		
	2013	2012	2011
	($ amounts in 000's)		
Revenue	615,297	533,639	433,576
Gross margin	71 %	72 %	74 %
Operating income [1]	72,090	100,475	88,904
Operating margin	12 %	19 %	21 %
Total deferred revenue	432,628	363,185	294,833
Increase in total deferred revenue	69,443	68,352	42,202
Cash, cash equivalents and investments	843,045	739,586	538,687
Cash provided by operating activities	147,384	183,866	132,842
Free cash flow [2]	133,507	161,783	135,218

(1) Includes:

Stock-based compensation expense	44,471	30,690	19,015
Amortization expense of certain intangible assets	1,551	826	394
Impairment charges related to certain intangible assets	469	—	—
Patent settlement income	1,912	1,912	1,911

(2) Free cash flow is defined as net cash provided by operating activities less capital expenditures.

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

	Fiscal Year		
	2013	2012	2011
	($ amounts in 000's)		
Billings:			
Revenue	615,297	533,639	433,576
Increase in deferred revenue	69,443	68,352	42,202
Less deferred revenue balance acquired in business combination	(550)	—	—
Total billings (Non-GAAP)	684,190	601,991	475,778

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

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	Fiscal Year		
	2013	2012	2011
	($ amounts in 000's)		
Free Cash Flow:			
Net cash provided by operating activities	147,384	183,866	132,842
Less purchases of property and equipment	(13,877)	(22,083)	(3,624)
Free cash flow (Non-GAAP)	133,507	161,783	129,218

Other Non-GAAP Financial Measures

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

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

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

Non-GAAP gross margin is gross margin as reported on our consolidated statements of operations, excluding the impact of stock-based compensation expense, amortization expense and impairment charges related to certain intangible assets, all of which are non-cash charges. Non-GAAP operating income is operating income, as reported on our consolidated statements of operations, excluding the impact of stock-based compensation expense, amortization expense and impairment charges related to certain intangible assets, and the income we received from a patent settlement. Non-GAAP operating margin is non-GAAP operating income divided by revenue. The following tables reconcile GAAP gross margin, operating income, and operating margin to non-GAAP gross margin, non-GAAP operating income, and non-GAAP operating margin for fiscal 2013, 2012 and 2011.

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	Fiscal Year 2013		2012		2011	
	Amount ($)	% of Revenue	Amount ($)	% of Revenue	Amount ($)	% of Revenue
	($ amounts in 000's)					
Total revenue	615,297		533,639		433,576	
Gross and Non-GAAP gross profit and margin						
GAAP gross profit and margin	434,654	71	386,219	72	319,978	74
Stock-based compensation expense	5,224	1	4,069	1	1,973	—
Amortization expense of certain intangible assets	1,551	—	826	—	394	—
Impairment charges related to certain intangible assets	469	—	—	—	—	—
Non-GAAP gross profit and margin	441,898	72	391,114	73	322,345	74
Gross and Non-GAAP operating income and margin						
GAAP operating income and margin	72,090	12	100,475	19	88,904	21
Stock-based compensation expense:						
Cost of revenue	5,224	1	4,069	1	1,973	—
Research and development	13,271	2	9,226	1	4,691	1
Sales and marketing	19,526	3	12,793	2	9,325	3
General and administrative	6,450	1	4,602	1	3,026	—
Total stock-based compensation expense	44,471	7	30,690	5	19,015	4
Amortization expense of certain intangible assets	1,551	—	826	—	394	—
Impairment charges related to certain intangible assets	469	—	—	—	—	—
Patent settlement income	(1,912)	—	(1,912)	—	(1,911)	(1)
Non-GAAP operating income and margin	116,669	19	130,079	24	106,402	24

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Non-GAAP operating expenses represent operating expenses, as reported on our consolidated statements of operations, excluding the impact of stock-based compensation expense and the income from a patent settlement. The following tables reconcile GAAP operating expenses to non-GAAP operating expenses for fiscal 2013, 2012 and 2011.

	Fiscal Year					
	2013		2012		2011	
	Amount ($)	% of Revenue	Amount ($)	% of Revenue	Amount ($)	% of Revenue
	($ amounts in 000’s)					
Operating Expenses:						
Research and development expenses:						
GAAP research and development expenses	102,660	17	81,078	15	63,577	15
Stock-based compensation expense	(13,271)	(2)	(9,226)	(1)	(4,691)	(1)
Non-GAAP research and development expenses	89,389	15	71,852	14	58,886	14
Sales and marketing expenses:						
GAAP sales and marketing expenses	224,991	36	179,155	33	145,532	34
Stock-based compensation expense	(19,526)	(3)	(12,793)	(2)	(9,325)	(3)
Non-GAAP sales and marketing expenses	205,465	33	166,362	31	136,207	31
General and administrative expenses:						
GAAP general and administrative expenses	34,913	6	25,511	5	21,965	4
Stock-based compensation expense	(6,450)	(1)	(4,602)	(1)	(3,026)	—
Patent settlement income	1,912	—	1,912	—	1,911	1
Non-GAAP general and administrative expenses	30,375	5	22,821	4	20,850	5
Total operating expenses:						
GAAP operating expenses	362,564	59	285,744	53	231,074	53
Stock-based compensation expense	(39,247)	(6)	(26,621)	(4)	(17,042)	(4)
Patent settlement income	1,912	—	1,912	—	1,911	1
Non-GAAP operating expenses	325,229	53	261,035	49	215,943	50

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Non-GAAP net income represents net income, as reported in our consolidated statements of operations, excluding the impact of stock-based compensation expense, amortization expense and impairment charges related to certain intangible assets, and income from a patent settlement. The following tables reconcile GAAP net income as reported on our consolidated statements of operations to non-GAAP net income for fiscal 2013, 2012 and 2011.

	Fiscal Year		
	2013	2012	2011
	($ and share amounts in 000's, except per share amounts)		
Net Income:			
GAAP net income	44,273	66,836	62,492
Stock-based compensation expense [1]	44,471	30,690	19,015
Amortization expense of certain intangible assets [1]	1,551	826	394
Impairment charges related to certain intangible assets [1]	469	—	—
Patent settlement income [2]	(1,912)	(1,912)	(1,911)
Provision for income taxes [3]	31,668	38,160	29,581
Non-GAAP income before provision for income taxes	120,520	134,600	109,571
Non-GAAP provision for income tax [4]	(39,772)	(45,764)	(36,158)
Non-GAAP net income	80,748	88,836	73,413
Non-GAAP net income per share—diluted	0.48	0.53	0.45
Shares used in per share calculation—diluted	168,183	166,329	163,781

(1) Stock-based compensation expense, amortization expense and impairment charges related to certain intangible assets are added back to GAAP net income to reconcile to non-GAAP income before provision for income taxes. Prior period amounts have been adjusted to conform to current period presentation.

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

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

(4) We used non-GAAP effective tax rates of 33%, 34%, and 33%, which could differ from the GAAP tax rates, to calculate non-GAAP net income for fiscal 2013, 2012, and 2011, respectively.

Components of Operating Results

Revenue

We derive our revenue from sales of our products and subscription and support services. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the sales price is fixed or determinable and collectibility is reasonably assured.

Our total revenue is comprised of the following:

- Product revenue. Product revenue is generated from sales of our appliances. 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, FortiVoice, FortiBridge, FortiDDoS, FortiDNS, FortiSandbox, FortiADC, and FortiAuthenticator appliances, and our FortiClient and virtual domain, or VDOM, software. For arrangements which include end-customer acceptance criteria, revenue is recognized upon acceptance. We recognize product revenue on sales to distributors that have no general right of

return and direct sales to end-customers upon shipment, once all other revenue recognition criteria have been met. Certain distributors that stock our products are granted stock rotation rights, limited rights of return, as well as rebates for sales of our products. The arrangement fee for this group of distributors is not fixed and determinable when products are shipped and revenue is therefore deferred and recognized upon sell-through. As a percentage of total revenue, we expect our product revenue may vary from quarter-to-quarter based on seasonal and cyclical factors discussed below under "—Quarterly Results of Operations" but generally may remain at relatively 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.

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- 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 application control, antivirus, intrusion prevention, Web filtering, anti-spam 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 do offer 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 and we expand our customer base. Our services revenue growth rate depends significantly on the growth of our customer base and the renewal of service contracts by our current customers.

- Ratable and other revenue. Ratable and other 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 "—Critical Accounting Policies and Estimates—Revenue Recognition." In fiscal 2013 and 2012, this category included a $2.8 million and $3.7 million sale of previously-acquired patents, respectively. In fiscal 2013 and 2012, ratable and other revenue represented 1% and 2% of total revenue, respectively. Over time, excluding the impact of any patent sales, we expect this category to continue to decline due to the current revenue recognition rules, which allow us to use best estimate of selling price ("BESP") in our allocation of arrangement consideration when vendor-specific objective evidence ("VSOE") is not available.

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 expense, and personnel costs associated with logistics and quality control. Personnel costs include stock-based compensation and cash-based personnel costs such as salaries, benefits and bonuses.

- 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 expense. We expect our cost of services revenue will increase slightly as a percentage of revenue as we continue to invest in subscription and support services to meet the needs of our growing customer base and service levels expected by our enterprise customers.

- Cost of ratable and other revenue. Cost of ratable and other 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, product 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 at levels comparable or slightly lower to that achieved in fiscal 2013.

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. During fiscal 2013 service margins decreased slightly from fiscal 2012 as we made the decision to invest in support

services infrastructure that will allow us to both expand our base of enterprise customers and to support future growth and higher service levels to our existing enterprise customers.

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 sales commissions. They also include non-cash charges, specifically, stock-based compensation expense. We expect personnel costs to continue to increase in absolute dollars as we hire new employees.

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- 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 the United States.

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

- General and administrative. General and administrative expense consists of cash-based personnel costs as well as professional fees, stock-based compensation expense, 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.

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, certificates of deposit and term deposits, and U.S. government and agency debt securities.

Other expense, net. Other 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. 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 income taxes in the local country which are generally lower than U.S. tax rates, and may be subject to U.S. income taxes. Our effective tax rate differs from the U.S. statutory rate primarily due to foreign income subject to different tax rates than the U.S., research and development tax credits, withholding taxes, nondeductible stock-based compensation expense and adjustments related to our intercompany transfer pricing.

The income tax provision for fiscal 2013 was comprised primarily of domestic income taxes, foreign income taxes and withholding taxes. Our effective tax rate approximates the U.S. federal statutory tax rates plus the impact of state taxes, research and development tax credits (when applicable), withholding tax, nondeductible stock-based compensation expense, foreign income subject to lower tax than the U.S., and adjustments related to 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 GAAP. These principles require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, cost of revenue and expenses, cash flow and related disclosure of contingent assets and liabilities. Our estimates include those related to revenue recognition, stock-based compensation expense, valuation of inventory, warranty liabilities, goodwill and other long-lived assets and accounting for income taxes. We base our estimates on historical experience and on various other assumptions

that we believe to be reasonable under the circumstances. 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 that of our significant accounting policies, which are described in Note 1 to our consolidated financial statements included in Part II, Item 8 of this Annual Report on Form 10-K, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, we believe these are the most critical to fully understand and evaluate our financial condition and results of operations.

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Revenue Recognition

We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. The majority of our products are hardware appliances containing software components that function together to provide the essential functionality of the product. We record revenue from our hardware appliances in accordance with general revenue recognition accounting guidance.

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 are subject to the industry-specific software revenue recognition guidance. Certain of our software, when sold with our appliances, is considered essential to the functionality of the appliances and, as a result, is accounted for as non-software deliverables. However, this same software, if sold separately, is accounted for under industry-specific software revenue recognition guidance.

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 a 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. When applying the relative selling price method, we determine the selling price for each deliverable using vendor-specific objective evidence (“VSOE”) of selling price, if it exists, or third-party evidence (“TPE”) of selling price. If neither VSOE nor TPE of selling price exist for a deliverable, we use our best estimate of selling price ("BESP") for that deliverable. Revenue allocated to each element is then recognized when the basic revenue recognition criteria are met for each element.

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 establishing 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.

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, which is generally unavailable.

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

We recognize revenue for our software sales based on industry-specific software revenue recognition guidance. Under industry-specific software revenue recognition guidance, 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.

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

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

- Delivery has occurred or services have been rendered. Delivery occurs when we fulfill an order and title and risk of loss has been transferred. Services revenue is deferred and recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Professional service revenue is recognized upon delivery or completion of performance.

- Sales price is fixed or determinable. We assess whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. In the event payment terms differ from our standard business practices, the sales price is deemed to be not fixed or determinable and revenue is recognized when the payments become due, provided the remaining

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criteria for revenue recognition have been met. In the event the sales price is subject to refund or adjustment, the sales price is deemed to be not fixed or determinable and revenue is recognized when the refund or adjustment privileges expire provided the remaining criteria for revenue recognition have been met.

- Collectibility is reasonably assured. We assess collectibility based primarily on creditworthiness as determined by credit checks and analysis, as well as payment history.

For arrangements which include end-customer acceptance criteria, revenue is recognized upon acceptance. We recognize product revenue on sales to distributors that have no general right of return and direct sales to end-customers upon shipment, once all other revenue recognition criteria have been met. Certain distributors that stock our products are granted stock rotation rights, limited rights of return as well as rebates for sales of our products. The arrangement fee for this group of distributors is not fixed and determinable when products are shipped and revenue is therefore deferred and recognized upon sell-through. 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.

Stock-Based Compensation Expense

Employees Stock Options. We estimate the fair value of employee stock options using the Black-Scholes-Merton (“Black-Scholes”) pricing model. For all employee stock options, we recognize expense over the requisite service period using the straight-line method. Our option pricing model requires the input of highly subjective assumptions, including the expected stock price volatility, expected term, and forfeiture rate. Any changes in these highly subjective assumptions could significantly impact stock-based compensation expense.

Employee Stock Purchase Plan. We estimate the fair value of the rights to acquire stock under our employee stock purchase plan (“ESPP”) using the Black-Scholes pricing model and is amortized over the requisite service period using the straight-line method. Our ESPP provides for consecutive six-month offering periods and we use our own historical volatility data in the valuation of ESPP shares.

Restricted Stock Units. We account for the fair value of restricted stock units (“RSUs”) awarded to employees and members of our board of directors using the closing market price of our common stock on the date of grant. RSUs are payable in shares of our common stock as the periodic vesting requirements are satisfied. RSUs generally vest over a four-year period if the employees, non-employees, or directors, as applicable, remain with us for the duration of the vesting period. For all RSUs, we recognize expense over the requisite service period using the straight-line method.

Performance Stock Units. Performance Stock Units (“PSUs”) are RSUs that contain both service-based and market-based vesting conditions. PSUs vest over a specified service period upon the satisfaction of certain market-based vesting conditions, and settle into shares of our common stock upon vesting over a two- or three-year period. The fair value of a PSU is calculated using the Monte Carlo simulation model on the date of grant and is based

on the market price of our common stock on the date of grant modified to reflect the impact of the market-based vesting condition, including the estimated payout level based on that condition. We do not adjust compensation cost for subsequent changes in the expected outcome of the market-based vesting conditions.

Valuation of Inventory

Inventory is recorded at the lower of average cost 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

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inventory write-downs which would be charged to cost of product revenue. Any write-downs could have an adverse impact on our gross margins and profitability.

Warranty Liabilities

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 charged to cost of product revenue based upon historical product failure rates and historical costs incurred in correcting product failures. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our gross margin could be adversely affected.

Accounting for 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. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized.

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.

We account for uncertain tax positions in accordance with GAAP, which defines the confidence level that a tax position must meet in order to be recognized in the financial statements. The tax effects of a position are recognized only if it is “more likely than not” to be sustained based solely on its technical merits as of the reporting date. 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.

As part of the process of preparing our consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions in which we operate. We estimate actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets, which are included in our consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in our consolidated statements of operations become deductible expenses under applicable income tax laws, or loss or credit carryforwards are utilized.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We continue to assess the need for a valuation allowance on the deferred tax assets by evaluating both positive and negative evidence that may exist. Any adjustment to the net deferred tax asset valuation allowance would be recorded in the income statement for the period that the adjustment is determined to be required.

We make estimates and judgments about our future taxable income that are based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our tax expense and liabilities could be materially impacted.

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Results of Operations

The following tables set forth our results of operations for the periods presented and as a percentage of our total revenue for those periods. The period-to-period comparison of financial results is not necessarily indicative of financial results to be achieved in future periods.

	Fiscal Year		
	2013	2012	2011
	($ amounts in 000's)		
Consolidated Statement of Operations Data:			
Revenue:			
Product	278,046	248,948	197,408
Services	329,723	274,043	220,268
Ratable and other revenue	7,528	10,648	15,900
Total revenue	615,297	533,639	433,576
Cost of revenue			
Product	114,611	93,971	73,201
Services	64,123	50,682	35,486
Ratable and other revenue	1,909	2,767	4,911
Total cost of revenues	180,643	147,420	113,598
Gross profit:			
Product	163,435	154,977	124,207
Services	265,600	223,361	184,782
Ratable and other revenue	5,619	7,881	10,989
Total gross profit	434,654	386,219	319,978
Operating expenses:			
Research and development	102,660	81,078	63,577
Sales and marketing	224,991	179,155	145,532
General and administrative	34,913	25,511	21,965
Total operating expenses	362,564	285,744	231,074
Operating income	72,090	100,475	88,904
Interest income	5,306	5,006	3,523
Other expense, net	(1,455)	(485)	(354)
Income before income taxes	75,941	104,996	92,073
Provision for income taxes	31,668	38,160	29,581
Net income	44,273	66,836	62,492

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	Fiscal Year		
	2013	2012	2011
	(as % of total revenue)		
Revenue:			
Product	45	47	45
Services	54	51	51
Ratable and other revenue	1	2	4
Total revenue	100	100	100
Total cost of revenue	29	28	26
Total gross profit	71	72	74
Operating expenses:			
Research and development	17	15	15
Sales and marketing	36	33	34
General and administrative	6	5	4
Total operating expenses	59	53	53
Operating income	12	19	21
Interest income	—	1	1
Other expense, net	—	—	—
Income before income taxes	12	20	22
Provision for income taxes	5	7	7
Net income	7	13	15

Fiscal Years 2013 and 2012

Revenue

	Fiscal Year					
	2013		2012			
	Amount ($)	% of Revenue	Amount ($)	% of Revenue	Change	% Change
	($ amounts in 000's)					
Revenue:						
Product	278,046	45	248,948	47	29,098	12
Services	329,723	54	274,043	51	55,680	20
Ratable and other revenue	7,528	1	10,648	2	(3,120)	(29)
Total revenue	615,297	100	533,639	100	81,658	15
Revenue by geography:						
Americas	252,786	41	217,056	41	35,730	16
Europe, Middle East and Africa ("EMEA")	208,979	34	184,175	35	24,804	13
Asia Pacific and Japan ("APAC")	153,532	25	132,408	24	21,124	16
Total revenue	615,297	100	533,639	100	81,658	15

Total revenue increased by $81.7 million, or 15%, in fiscal 2013 compared to fiscal 2012. The Americas region contributed the largest portion of our revenue growth on an absolute dollar basis and all three regions showed growth on a percentage basis. The growth in EMEA was slightly lower due to a slowdown in the macroeconomic environment in that area. Product revenue increased by $29.1 million, or 12%, compared to fiscal 2012. The increase in product revenue was primarily driven by greater sales volume in our FortiGate product family due to increased demand across all product categories from our entry-level and mid-range products for smaller enterprises and branch

deployments to our high-end products for large enterprise and service provider customers. Services revenue increased by $55.7 million, or 20%, in fiscal 2013 compared to fiscal 2012 due to the recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable and other revenue of $3.1 million was primarily due to the

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continuing decline in amortization of ratable revenue. Ratable and other revenue for fiscal 2013 included a $2.8 million sale of previously-acquired patents, as compared to a $3.7 million sale of previously-acquired patents in fiscal 2012.

Cost of revenue and gross margin

	Fiscal Year			
	2013	2012	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	114,611	93,971	20,640	22
Services	64,123	50,682	13,441	27
Ratable and other revenue	1,909	2,767	(858)	(31)
Total cost of revenue	180,643	147,420	33,223	23
Gross margin (%):				
Product	58.8	62.3	(3.5)	
Services	80.6	81.5	(0.9)	
Ratable and other revenue	74.6	74.0	0.6	
Total gross margin	70.6	72.4	(1.8)	

Total gross margin decreased by 1.8 percentage points in fiscal 2013 compared to fiscal 2012, as both product and services gross margins declined. Product gross margin decreased by 3.5 percentage points in fiscal 2013 compared to fiscal 2012 primarily due to a slightly higher mix of sales of entry-level products, particularly several high-volume distributed enterprise, retail and education deals sold in the fourth quarter of fiscal 2013. We also experienced the impact from higher costs related to warranty-related costs which increased by $2.5 million, freight costs which increased by $1.5 million, occupancy-related costs which increased by $1.1 million and higher excess inventory write-offs of $0.7 million. Services gross margin decreased by 0.9 percentage points during fiscal 2013 primarily due to our continued investments in our technical support organization to accommodate our expanding customer base and higher service level expectations from our enterprise customers. In addition, we experienced growth in our professional consulting services which have lower gross margins than our support and subscription businesses. Cost of services revenue increased by $13.4 million primarily due to a $9.9 million increase in cash-based personnel costs related to headcount increases, a $1.1 million increase in stock-based compensation expense, and a $2.4 million increase in depreciation and other expenses.

Operating expenses

	Fiscal Year					
	2013		2012		Change	% Change
	Amount ($)	% of Revenue	Amount ($)	% of Revenue		
	($ amounts in 000's)					
Operating expenses:						
Research and development	102,660	17	81,078	15	21,582	27
Sales and marketing	224,991	36	179,155	33	45,836	26
General and administrative	34,913	6	25,511	5	9,402	37
Total operating expenses	362,564	59	285,744	53	76,820	27

Research and development

Research and development expense increased by $21.6 million, or 27%, in fiscal 2013 compared to fiscal 2012 primarily due to an increase of $11.7 million in cash-based personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, we incurred higher stock-based compensation expense of $4.0 million, product development expenses, such as third-party testing and prototypes, of $2.0 million, acquisition-related costs of $1.9 million, and depreciation and other expenses of $2.1 million. We intend to continue to invest in our research and development organization but expect research and development expense as a percentage of revenue to remain at comparable levels in fiscal 2014.

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Sales and marketing

Sales and marketing expense increased by $45.8 million, or 26%, in fiscal 2013 compared to fiscal 2012, primarily due to an increase of $25.6 million in cash-based personnel costs as we continued to increase our sales headcount in order to expand our global footprint. In addition, we incurred increases in stock-based compensation expense of $6.7 million, marketing-related expenses of $5.4 million, travel expenses of $3.9 million, depreciation expenses of $2.1 million, and other expenses of $2.1 million. As a percentage of revenue, sales and marketing expenses increased as we accelerated the investment in our sales force during fiscal 2013 to support future growth. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth and expect sales and marketing expense as a percentage of revenue to increase in fiscal 2014.

General and administrative

General and administrative expense increased by $9.4 million, or 37%, in fiscal 2013 compared to fiscal 2012. Cash-based personnel costs increased by $3.4 million and stock-based compensation expense increased by $1.8 million as we continued to increase our headcount in order to support our expanding business. In addition, we incurred an additional $3.9 million of legal and accounting fees and $0.3 million in higher depreciation. We expect general and administrative expense as a percentage of revenue to remain at comparable levels in fiscal 2014.

Interest income and other expense, net

	Fiscal Year			
	2013	2012	Change	% Change
	($ amounts in 000's)			
Interest income	5,306	5,006	300	6
Other expense, net	(1,455)	(485)	(970)	200

The $0.3 million increase in interest income in fiscal 2013 compared to fiscal 2012 was primarily due to interest earned on higher invested balances of cash, cash equivalents and investments. The change in other expense, net, for fiscal 2013 when compared to fiscal 2012, was the result of higher foreign exchange losses.

Provision for income taxes

	Fiscal Year		Change	% Change
	2013	2012		
	($ amounts in 000's)			
Provision for income taxes	31,668	38,160	(6,492)	(17)
Effective tax rate (%)	42	36	6	—

Our effective tax rate was 42% for fiscal 2013, compared with an effective tax rate of 36% for fiscal 2012. The provision for income taxes for fiscal 2013 was comprised primarily of federal, state and foreign income taxes as well as the inclusion of stock option benefits and cost allocations, which affected the transfer pricing calculations among the U.S. and some of our foreign subsidiaries. The increase in the effective tax rate for fiscal 2013 as compared to fiscal 2012 was primarily due to an increase in profits subject to U.S. tax, a decrease in stock option benefits, and their corresponding impact on the transfer pricing calculations among the U.S. and some of our foreign subsidiaries

During January 2013, the U.S. Federal Research and Development Tax Credit was reinstated retroactively to fiscal 2012. The U.S. Federal Research and Development Tax Credit benefit was recorded in the first quarter of fiscal 2013,

which was the period of enactment.

Beginning with fiscal 2013, we operate under a tax incentive agreement in Singapore, which is effective through December 31, 2023, and may be extended if certain additional requirements are satisfied. The tax incentive agreement is conditional upon our meeting certain employment and investment thresholds. We did not realize any tax savings from the Singapore tax incentives in fiscal 2013 because of net tax losses in that jurisdiction.

It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of December 31, 2013, we had accrued approximately $1.0 million for estimated interest related to uncertain tax provisions compared to an accrual of $1.5 million as of December 31, 2012.

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

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

Fiscal Years 2012 and 2011

Revenue

	Fiscal Year 2012		2011		Change	% Change
	Amount ($)	% of Revenue	Amount ($)	% of Revenue		
	($ amounts in 000's)					
Revenue:						
Product	248,948	47	197,408	45	51,540	26
Services	274,043	51	220,268	51	53,775	24
Ratable and other revenue	10,648	2	15,900	4	(5,252)	(33)
Total revenue	533,639	100	433,576	100	100,063	23
Revenue by Geography:						
Americas	217,056	41	172,494	40	44,562	26
EMEA	184,175	35	152,385	35	31,790	21
APAC	132,408	24	108,697	25	23,711	22
Total revenue	533,639	100	433,576	100	100,063	23

Total revenue increased by $100.1 million, or 23%, in fiscal 2012 compared to fiscal 2011. The Americas region contributed the largest portion of our revenue growth on a percentage basis, while the EMEA and APAC regions both demonstrated growth of over 20%. Product revenue increased by $51.5 million, or 26%, compared to fiscal 2011. The increase in product revenue was primarily driven by greater sales volume in our FortiGate product family due to increased demand across all product categories from our entry-level and mid-range products for smaller enterprises and branch deployments to our high-end products for large enterprise and service provider customers. Services revenue increased by $53.8 million, or 24%, in fiscal 2012 compared to fiscal 2011 due to the recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decrease in ratable and other revenue of $5.3 million was primarily due to the continuing decline in amortization of ratable revenue. Ratable and other revenue for fiscal 2012 included a $3.7 million sale of previously-acquired patents, which was an increase from a $2.6 million sale of previously-acquired patents in fiscal 2011. Excluding the decline in ratable and other revenue, product and services revenue combined together increased by 25% compared to fiscal 2011.

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Cost of revenue and gross margin

	Fiscal Year 2012	2011	Change	% Change
	($ amounts in 000's)			
Cost of revenue:				
Product	93,971	73,201	20,770	28
Services	50,682	35,486	15,196	43
Ratable and other revenue	2,767	4,911	(2,144)	(44)
Total cost of revenue	147,420	113,598	33,822	30
Gross margin (%):				
Product	62.3	62.9	(0.6)	
Services	81.5	83.9	(2.4)	
Ratable and other revenue	74.0	69.1	4.9	
Total gross margin	72.4	73.8	(1.4)	

Total gross margin decreased by 1.4 percentage points in fiscal 2012 compared to fiscal 2011, as both product and services gross margins declined. Product gross margin decreased by 0.6 percentage points in fiscal 2012 compared to fiscal 2011 primarily related to a higher quantity of mid-range products purchased by a large retail customer with lower than average gross margins. We also experienced the impact from cost increases related to higher material costs incurred to support higher density storage requirements for our recent release of FortioOS 5.0, our next generation operating system. From time to time, we have experienced sales of previously reserved inventory. During fiscal 2012, we experienced a positive impact to gross margin of 0.2 percentage points due to the sale of fully reserved inventory compared to a positive impact to gross margin of 0.4 percentage points in the prior year. Services gross margin decreased by 2.4 percentage points during fiscal 2012 primarily due to our continued investments in our technical support organization to accommodate our expanding customer base and higher service level expectations from our enterprise customers. In addition, we experienced growth in our professional consulting services which have lower gross margins than our support and subscription businesses. Cost of services revenue increased by $15.2 million primarily due to an $8.6 million increase in cash-based personnel costs related to headcount increases, a $1.9 million increase in stock-based compensation expense, a $1.8 million increase in costs associated with extended support contracts, a $0.7 million increase in occupancy-related costs, a $0.5 million increase in professional services expenses, a $0.5 million increase in travel expenses, and a $1.1 million increase in depreciation and other expenses.

Operating expenses

	Fiscal Year 2012		2011		Change	% Change
	Amount ($)	% of Revenue	Amount ($)	% of Revenue		
	($ amounts in 000's)					
Operating expenses:						
Research and development	81,078	15	63,577	15	17,501	28
Sales and marketing	179,155	33	145,532	34	33,623	23
General and administrative	25,511	5	21,965	4	3,546	16
Total operating expenses	285,744	53	231,074	53	54,670	24

Research and development expense

Research and development expense increased by $17.5 million, or 28%, in fiscal 2012 compared to fiscal 2011 primarily due to an increase of $9.3 million in cash-based personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, we incurred higher stock-based compensation expense of $4.5 million, product development expenses of $1.2 million, depreciation expense of $0.9 million, supplies expense of $0.6 million, occupancy-related costs of $0.4 million, and other expenses of $0.5 million. The increase in research and development expense was partially offset by a 2% year-over-year increase in the U.S. dollar exchange rate against the CAD, as a majority of our research and development personnel are located in Canada.

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Sales and marketing expense

Sales and marketing expense increased by $33.6 million, or 23%, in fiscal 2012 compared to fiscal 2011, primarily due to an increase of $21.6 million in cash-based personnel costs as we continued to increase our sales headcount in order to expand our global footprint. In addition, we incurred increases in stock-based compensation expense of $3.5 million, marketing-related expenses of $3.2 million, depreciation expenses of $1.6 million, occupancy-related costs of $0.7 million, travel expenses of $1.0 million, supplies expense of $0.4 million, and other expenses of $1.2 million. As a percentage of revenue, sales and marketing expenses remained flat as we accelerated the investment in our sales force during the past year to support future growth. The increase in sales and marketing expense was partially offset by a 9% year-over-year increase in the U.S. dollar exchange rate against the Euro.

General and administrative expense

General and administrative expense increased by $3.5 million, or 16%, in fiscal 2012 compared to fiscal 2011. Stock-based compensation expense increased by $1.6 million and cash-based personnel costs increased by $0.7 million. In addition, we incurred $1.0 million of litigation settlement expense.

Interest income and other expense, net

	Fiscal Year		Change	% Change
	2012	2011		
	($ amounts in 000’s)			
Interest income	5,006	3,523	1,483	42
Other expense, net	(485)	(354)	(131)	37

The $1.5 million increase in interest income in fiscal 2012 compared to fiscal 2011 was primarily due to interest earned on higher invested balances of cash, cash equivalents and investments. The change in other expense, net, for fiscal 2012 when compared to fiscal 2011, was the result of higher foreign exchange losses.

Provision for income taxes

	Fiscal Year		Change	% Change
	2012	2011		
	($ amounts in 000’s)			
Provision for income taxes	38,160	29,581	8,579	29
Effective tax rate (%)	36	32	4	—

Our effective tax rate was 36% for fiscal 2012, compared with an effective tax rate of 32% for fiscal 2011. The provision for income taxes for fiscal 2012 was comprised primarily of federal, state and foreign income taxes as well as the inclusion of stock option benefits, which affected the transfer pricing calculations between some of our foreign subsidiaries. The 2011 effective tax rate was impacted by the inclusion of stock option benefits, which affected the transfer pricing calculations between some of our foreign subsidiaries, as well as research and development tax credit. The increase in the provision for income taxes for fiscal 2012 compared to fiscal 2011 was primarily due to an increase in profits subject to U.S. tax, a decrease in stock option benefits, and their corresponding impact on the transfer pricing calculations between some of our foreign subsidiaries, and the reduction in U.S. Federal Research and Development Tax Credit that was reinstated in fiscal 2013, but not recognized in fiscal 2012.

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Quarterly Results of Operations

The following table sets forth our unaudited quarterly statements of operations data for the last eight fiscal quarters. The information for each of these quarters has been prepared on the same basis as the audited annual financial statements included elsewhere in this Annual Report and, in the opinion of management, includes all adjustments, which includes only normal recurring adjustments, necessary for the fair presentation of the results of operations for these periods. This data should be read in conjunction with our audited consolidated financial statements and related notes included elsewhere in this annual report. These quarterly operating results are not necessarily indicative of our operating results for any future period.

	Three Months Ended							
	Mar 31, 2012	Jun 30, 2012	Sept 30, 2012	Dec 31, 2012	Mar 31, 2013	Jun 30, 2013	Sept 30, 2013	Dec 31, 2013
	($ amounts in 000's, except per share amounts)							
Consolidated Statements of Operations Data:								
Revenue:								
Product	53,204	61,692	63,027	71,025	57,950	66,525	69,687	83,884
Services	62,138	65,412	69,782	76,711	75,896	79,668	83,883	90,276
Ratable and other revenue (1)	1,905	1,858	3,459	3,426	1,974	1,235	1,129	3,190
Total revenue	117,247	128,962	136,268	151,162	135,820	147,428	154,699	177,350
Cost of revenue:								
Product (2)(3)	19,067	23,935	23,995	26,974	22,958	26,948	27,126	37,579
Services (2)	11,213	12,467	13,166	13,836	15,574	16,259	16,374	15,916
Ratable and other revenue	763	725	647	632	596	501	430	382
Total cost of revenue	31,043	37,127	37,808	41,442	39,128	43,708	43,930	53,877
Total gross profit	86,204	91,835	98,460	109,720	96,692	103,720	110,769	123,473
Operating expenses:								
Research and development (2)	19,667	20,388	20,498	20,525	23,334	25,158	26,421	27,747
Sales and marketing (2)	42,036	44,259	44,743	48,117	49,976	55,997	56,687	62,331
General and administrative (2)(4)	5,786	6,238	7,449	6,038	7,991	8,788	9,382	8,752
Total operating expenses	67,489	70,885	72,690	74,680	81,301	89,943	92,490	98,830
Operating income (5)	18,715	20,950	25,770	35,040	15,391	13,777	18,279	24,643
Interest income	1,085	1,203	1,318	1,400	1,369	1,337	1,282	1,318
Other (expense) income, net	(71)	73	(317)	(170)	215	(100)	(1,151)	(419)
Income before income taxes	19,729	22,226	26,771	36,270	16,975	15,014	18,410	25,542
Provision for income taxes	5,556	8,276	9,565	14,763	4,726	6,035	7,381	13,526
Net income (5)	14,173	13,950	17,206	21,507	12,249	8,979	11,029	12,016
Net income per share attributable to common stockholders:								

Basic	0.09	0.09	0.11	0.13	0.08	0.06	0.07	0.07
Diluted	0.09	0.08	0.10	0.13	0.07	0.05	0.07	0.07

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(1) Ratable and other revenue included the sales of previously-acquired patents of $1.8 million, $1.9 million, $0.6 million, and $2.2 million for the three months ended September 30, 2012, December 31, 2012, March 31, 2013, and December 31, 2013, respectively.

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(2) Includes stock-based compensation expense as follows:

	Three Months Ended							
	Mar 31, 2012	Jun 30, 2012	Sept 30, 2012	Dec 31, 2012	Mar 31, 2013	Jun 30, 2013	Sept 30, 2013	Dec 31, 2013
	($ amounts in 000's)							
Cost of product revenue	64	88	85	96	90	96	91	106
Cost of services revenue	745	941	1,018	1,032	1,020	1,226	1,297	1,298
Research and development	1,957	2,292	2,525	2,452	2,766	3,291	3,548	3,666
Sales and marketing	3,443	3,475	3,879	1,996	4,118	4,594	5,215	5,599
General and administrative	1,037	1,056	1,323	1,186	1,305	1,500	1,627	2,018
Total stock-based compensation expense	7,246	7,852	8,830	6,762	9,299	10,707	11,778	12,687

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(3) Includes amortization expense and impairment charges related to certain intangible assets as follows:

	Three Months Ended							
	Mar 31, 2012	Jun 30, 2012	Sept 30, 2012	Dec 31, 2012	Mar 31, 2013	Jun 30, 2013	Sept 30, 2013	Dec 31, 2013
	($ amounts in 000's)							
Amortization expense of certain intangible assets	148	226	226	226	266	354	423	508
Impairment charges related to certain intangible assets	—	—	—	—	—	—	—	469
Total amortization expense and impairment charges related to certain intangible assets	148	226	226	226	266	354	423	977

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(4) Includes quarterly patent settlement income of $0.5 million.

(5) During the three months ended December 31, 2012, we recorded a $1.5 million non-recurring cumulative out-of-period adjustment to reflect a true-up related to forfeitures of stock awards granted to employees. Of this amount, $0.9 million and $0.6 million were related to fiscal 2011 and the first three quarters of fiscal 2012, respectively. The adjustment resulted in lower stock-based compensation expense and higher operating income and net income during the three months ended December 31, 2012.

Seasonality, Cyclicality and Quarterly Revenue Trends

Our quarterly results reflect seasonality in the sale of our products, subscriptions and services. In general, a pattern of increased customer buying at year-end has positively impacted sales activity in the fourth quarter. In the first quarter we generally experience lower sequential billings and product revenues, which results in lower revenue. In the third quarter, we generally experience lower revenue in Europe compared to the second quarter due to reduced economic activity in Europe during the summer months, but this may not always be the case. Similarly, our operating income has been affected by these historical trends because operating expenses are relatively fixed in the near-term. Although

these seasonal factors are common in the technology sector, historical patterns should not be considered a reliable indicator of our future sales activity or performance. On a quarterly basis, we have usually generated the majority of our product revenue in the final month of each quarter and a significant amount in the last two weeks of a quarter. We believe this is due to customer buying patterns typical in this industry.

Our total quarterly revenue over the past eight quarters has increased sequentially in each quarter except the first quarter of fiscal 2013 which was down due to the seasonality referenced above and macro-economic challenges experienced in Europe. Product revenue in all of the quarters of fiscal 2013 was higher as compared to the same periods in fiscal 2012, which we believe was due in part to the investments made in our sales organization and continued product innovation.

Total gross margin has fluctuated on a quarterly basis primarily due to shifts in the mix of sales between products and services. Product gross margins were lower in each quarter of fiscal 2013 compared to the same quarter of fiscal 2012 due to a higher mix of sales of entry-level products. Product gross margin varies based on the types of products sold and the average selling prices of our products. Services gross margins were lower in the first three quarters of fiscal 2013 compared to the same

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periods of fiscal 2012 as we made investments in our support organizations at a rate slightly greater than the increase in services revenue.

Liquidity and Capital Resources

	December 31		
	2013	2012	2011
	($ amounts in 000's)		
Cash and cash equivalents	115,873	122,975	71,990
Investments	727,172	616,611	466,697
Total cash, cash equivalents and investments	843,045	739,586	538,687
Working capital	322,485	249,970	256,706

	Fiscal Year		
	2013	2012	2011
	($ amounts in 000's)		
Cash provided by operating activities	147,384	183,866	132,842
Cash used in investing activities	(146,734)	(182,711)	(166,826)
Cash (used in) provided by financing activities	(6,423)	50,156	39,797
Effect of exchange rates on cash and cash equivalents	(1,329)	(326)	(682)
Net (decrease) increase in cash and cash equivalents	(7,102)	50,985	5,131

Liquidity and capital resources may be impacted by our operating activities, as well as acquisitions, capital expenditures and investments in strategic relationships that we have made or may make in the future. We expect to spend approximately $15.0 million related to the improvement of our new corporate headquarters in fiscal 2014. Additionally, our liquidity may be impacted, if we were to repurchase additional shares of our common stock under our Share Repurchase Program. As of December 31, 2013, $161.1 million remains available for future share repurchases under this program, which will be financed through our available working capital.

As of December 31, 2013, our cash, cash equivalents, and investments of $843.0 million were held for working-capital purposes and were invested primarily in corporate debt securities, commercial paper, municipal bonds, certificates of deposit and term deposits, money market funds, and U.S. government and agency debt securities. It is our investment policy to invest excess cash in a manner that preserves capital, provides liquidity and maximizes return.

As of December 31, 2013, $88.9 million of our cash and investments was held by our international subsidiaries and is therefore not immediately available to fund domestic operations unless the cash is repatriated. While we do not intend to do so, should this amount be repatriated, it would be subject to U.S. federal income tax which would be partially offset by foreign tax credits. We do not enter into investments for trading or speculative purposes. We believe that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure access to adequate manufacturing capacity and the continuing market acceptance of our products. Historically, we have required capital principally to fund our working capital needs, capital expenditures, share repurchases, and acquisition activities. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results and financial condition would be adversely affected.

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	Fiscal Year		
	2013	2012	2011
	($ amounts in 000's)		
Net income	44,273	66,836	62,492
Adjustments for non-cash charges [1]	69,153	44,028	18,712
Net income before non-cash charges	113,426	110,864	81,204
Increase in deferred revenue	68,871	68,292	42,177
Increase in income taxes payable	22,522	28,265	35,964
Increase in accounts payable and accrued liabilities, net	12,139	1,262	8,566
Increase in accrued payroll and compensation	6,013	4,599	4,773
Decrease in other assets	1,243	2,470	227
Increase in inventory	(35,093)	(11,303)	(6,034)
Increase in accounts receivable—net	(22,080)	(12,120)	(23,246)
Increase in deferred tax assets	(18,750)	(9,254)	(7,874)
(Increase) decrease in prepaid expenses and other current assets	(907)	791	(2,915)
Net cash provided by operating activities	147,384	183,866	132,842

(1) Non-cash charges consist of stock-based compensation expense, depreciation and amortization, amortization of investment premiums, an excess tax benefit from our employee stock option plans, and other non-cash items, net. For additional information regarding such non-cash charges, see our consolidated statements of cash flows in Part II, Item 8 of this Annual Report on Form 10-K.

Operating Activities

In fiscal 2013, operating activities provided $147.4 million in cash as a result of our billings growth, profitability, and the ability to successfully manage our working capital. Net income was $44.3 million, increased by non-cash adjustments of $69.2 million and sources of cash of $110.8 million partially offset by uses of cash of $76.8 million from changes in operating assets and liabilities. Non-cash adjustments consist of stock-based compensation expense of $43.9 million, amortization of investment premiums of $11.6 million, depreciation and amortization of $15.6 million, and other non-cash items, net, of $1.0 million, partially offset by an excess tax benefit from employee stock option plans of $3.0 million. Sources of cash were related to a $68.9 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 $22.5 million increase in income tax payable, due to our continued profitability and timing of tax payments, a $6.0 million increase in accrued payroll and compensation primarily related to increased headcount and employer taxes related to the exercise of stock options, a $1.2 million decrease in other assets, a $12.1 million increase in accounts payable and accrued liabilities related to timing of payments. Uses of cash were related to a $22.1 million increase in accounts receivable due to the overall growth of our business, a $35.1 million increase in inventory due to investing in adequate levels of inventory to reduce the risk of product stockouts to support new product releases combined with the overall growth in the business, a $18.8 million increase in deferred tax assets, and a $0.9 million increase in prepaid expenses and other current assets.

In fiscal 2012, operating activities provided $183.9 million in cash as a result of our billings growth, profitability, and the ability to successfully manage our working capital. Net income was $66.8 million, increased by non-cash adjustments of $44.0 million and sources of cash of $105.7 million partially offset by uses of cash of $32.7 million from changes in operating assets and liabilities. Non-cash adjustments consist of stock-based compensation expense of $30.7 million, amortization of investment premiums of $13.0 million, depreciation and amortization of $11.6 million, and other non-cash items, net, of $0.9 million, partially offset by an excess tax benefit from employee stock option plans of $12.1 million. Sources of cash were related to a $68.3 million increase in deferred revenue which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized in

income, a $28.3 million increase in income tax payable, due to our continued profitability and timing of tax payments, a $4.6 million increase in accrued payroll and compensation primarily related to increased headcount and employer taxes related to the exercise of stock options, a $2.5 million decrease in other assets, a $1.3 million increase in accounts payable and accrued liabilities related to timing of payments, and a $0.8 million decrease in prepaid expenses and other current assets. Uses of cash were related to a $12.1 million increase in accounts receivable due to the overall growth of our business and stronger collections experience, a $11.3 million increase in inventory primarily to support new product releases combined with the overall growth of our business, and a $9.3 million increase in deferred tax assets.

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In fiscal 2011, operating activities provided $132.8 million in cash as a result of our strong performance primarily driven by billings growth, profitability, and the ability to successfully manage our working capital. Net income was $62.5 million, increased by non-cash adjustments of $18.7 million and sources of cash of $91.5 million partially offset by uses of cash of $39.8 million from changes in operating assets and liabilities. Non-cash adjustments consist of stock-based compensation expense of $19.0 million, amortization of investment premiums of $12.5 million, and depreciation and amortization of $7.0 million, partially offset by an excess tax benefit from employee stock option plans of $19.8 million. Sources of cash were related to a $42.2 million increase in deferred revenue which was attributable primarily to increased sales of our subscription and support services, which have yet to be recognized in income, a $36.0 million increase in income tax payable, due to our continued profitability and timing of tax payments, an $8.6 million increase in accrued liabilities and accounts payable related to timing of payments, a $4.7 million increase in accrued payroll and compensation primarily related to increased headcount and employer taxes related to the exercise of stock options, and a $0.2 million decrease in other assets. Uses of cash were related to a $23.2 million increase in accounts receivable due to the overall growth of our business, a $7.9 million increase in deferred tax assets, a $6.0 million increase in inventory primarily to support new product releases combined with the overall growth of our business, and a $2.9 million increase in prepaid expenses and current other assets.

Investing Activities

In fiscal 2013, our investing activities consisted primarily of purchases and sales of investments, and to a much lesser extent, capital expenditures. The $146.7 million of cash used by investing activities was due to net purchases of investments of $125.2 million, purchases of property and equipment of $13.9 million and acquisitions for $7.6 million.

In fiscal 2012, our investing activities consisted primarily of purchases and sales of investments, and to a much lesser extent, capital expenditures. The $182.7 million of cash used by investing activities was due to net purchases of investments of $159.4 million, purchases of property and equipment of $22.1 million (including $14.5 million to purchase land and building to support the growth in our business operations) and acquisitions for $1.2 million.

In fiscal 2011, our investing activities consisted primarily of purchases and sales of investments, and to a much lesser extent, capital expenditures. The $166.8 million of cash used by investing activities was due to net purchases of investments of $160.6 million, purchases of property and equipment of $3.6 million, and an acquisition for $2.6 million.

Financing Activities

In fiscal 2013, our financing activities resulted in net cash used of $6.4 million as a result of our repurchase and retirement of $33.5 million of common stock and our net-share settlement of equity awards of $1.5 million. This was offset by receiving proceeds of $12.9 million and $12.7 million from the issuance of common stock under our stock option plans and ESPP, respectively, and an excess tax benefit from employee stock option exercises of $3.0 million.

In fiscal 2012, our financing activities resulted in net cash provided of $50.2 million as a result of receiving proceeds of $27.2 million and $10.9 million from the issuance of common stock under our stock option plans and ESPP, respectively, and an excess tax benefit from employee stock option exercises of $12.1 million.

In fiscal 2011, our financing activities resulted in net cash provided of $39.8 million as a result of receiving proceeds of $20.0 million from the issuance of common stock under our stock option plans and an excess tax benefit from employee stock exercises of $19.8 million.

Contractual Obligations and Commitments

The following summarizes our contractual obligations as of December 31, 2013:

	Payments Due by Period				
	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
	($ amounts in 000's)				
Operating leases [1]	31,905	8,759	15,291	6,230	1,625
Purchase commitments [2]	37,794	37,794	—	—	—
Other contracts [3]	9,946	9,632	264	50	—
Total	79,645	56,185	15,555	6,280	1,625

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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 an estimate of all open purchase orders and contractual obligations in the ordinary course of business, other than commitments with contract manufacturers and suppliers, for which we have not received the goods or services. Purchase obligations do not include contracts that may be cancelled without penalty. Although open purchase orders are considered enforceable and legally binding, the terms generally allow us the option to cancel, reschedule, and adjust our requirements based on our business needs prior to the delivery of goods or performance of services. No tax liabilities related to uncertain tax positions have been included in the table. As of December 31, 2013, we had $30.2 million of long-term 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

During fiscal 2013, 2012 and 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.

Recently Adopted Accounting Pronouncements

See Note 1 of the notes to our consolidated financial statements in Part II, Item 8 of this Annual Report on Form 10-K for a full description of recently adopted accounting pronouncements.

ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Fluctuation Risk

The primary objectives of our investment activities are to preserve principal, provide liquidity and maximize income without significantly increasing risk. Some of the securities we invest in are subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. To minimize this risk, we maintain our portfolio of cash, cash equivalents and investments in a variety of securities, including commercial paper, money market funds, government and corporate debt securities and certificates of deposit. The risk associated with fluctuating interest rates is limited to our investment portfolio. A 10% decrease in interest rates in fiscal 2013, 2012 and 2011 would have resulted in a decrease in our interest income by $0.5 million, $0.5 million, and $0.4 million, respectively.

Foreign Currency Exchange Risk

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). To help protect against significant fluctuations in value and the volatility of future cash flows caused by changes in currency exchange rates, we engage in foreign currency risk management activities to hedge balance sheet items denominated in CAD. We do not use these contracts for speculative or trading purposes. All of the derivative instruments are with high quality financial institutions, and we monitor the creditworthiness of these parties. These contracts typically have maturities between one and three months. We record changes in the fair value of forward exchange contracts related to balance sheet accounts as other expense, net in the consolidated statement of operations. We recognized an expense of $1.5 million in other expense,

net, in fiscal 2013 due to foreign currency transaction losses.

Our hedging activities are intended to reduce, but not eliminate, the impact of currency exchange rate movements. As our hedging activities are relatively short-term in nature and are focused on CAD, long-term material changes in the value of the U.S. dollar against other foreign currencies, such as the Euro (EUR), British pound (GBP), and Japanese yen (JPY) could adversely impact our operating expenses in the future. We assessed the risk of loss in fair values from the impact of hypothetical changes in foreign currency exchange rates. For foreign currency exchange rate risk, a 10% increase or decrease of foreign currency exchange rates against the U.S. dollar with all other variables held constant would have resulted in a $1.7 million change in the value of our foreign currency cash accounts as of December 31, 2013.

Inflation Risk

Our monetary assets, consisting primarily of cash, cash equivalents and short-term investments, are not affected significantly by inflation because they are short-term. We believe the impact of inflation on replacement costs of equipment, furniture and leasehold improvements will not materially affect our operations. The rate of inflation, however, affects our cost

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of revenue and expenses, such as those for employee compensation, which may not be readily recoverable in the price of products and services offered by us.

ITEM 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS
For the years ended December 31, 2013, 2012, and 2011

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The supplementary financial information required by this Item 8 is included in Part II, Item 7 of this Annual Report on Form 10-K under the caption "Quarterly Results of Operations."

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Fortinet, Inc.
Sunnyvale, California

We have audited the accompanying consolidated balance sheets of Fortinet, Inc. and subsidiaries ("Company") as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Fortinet, Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on Internal Control-Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2014 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP
San Jose, California
February 27, 2014

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

	December 31, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$115,873	$122,975
Short-term investments	375,497	290,719
Accounts receivable, net of allowance for doubtful accounts and sales returns of $4,605 and $2,382 as of December 31, 2013 and 2012, respectively	130,471	107,642
Inventory	48,672	21,060
Deferred tax assets	50,980	13,663
Prepaid expenses and other current assets	14,053	13,215
Total current assets	735,546	569,274
PROPERTY AND EQUIPMENT—Net	36,652	25,638
DEFERRED TAX ASSETS—Non-current	30,058	48,525
LONG-TERM INVESTMENTS	351,675	325,892
GOODWILL	2,872	—
OTHER INTANGIBLE ASSETS—Net	6,841	2,117
OTHER ASSETS	4,820	4,051
TOTAL ASSETS	$1,168,464	$975,497
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$35,599	$20,816
Accrued liabilities	27,380	18,481
Accrued payroll and compensation	34,997	28,957
Income taxes payable	21,421	3,782
Deferred revenue	293,664	247,268
Total current liabilities	413,061	319,304
DEFERRED REVENUE—Non-current	138,964	115,917
INCOME TAXES PAYABLE—Non-current	30,208	28,778
OTHER LIABILITIES	471	564
Total liabilities	582,704	464,563
COMMITMENTS AND CONTINGENCIES (Note 10)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value — 300,000 shares authorized; 161,535 and 161,757 shares issued and 161,535 and 160,348 shares outstanding as of December 31, 2013 and December 31, 2012, respectively	161	162
Additional paid-in capital	462,644	400,075
Treasury stock	—	(2,995)
Accumulated other comprehensive income	1,092	3,091
Retained earnings	121,863	110,601
Total stockholders' equity	585,760	510,934
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,168,464	$975,497

See notes to consolidated financial statements.

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

	Fiscal Year		
	2013	2012	2011
REVENUE:			
Product	$278,046	$248,948	$197,408
Services	329,723	274,043	220,268
Ratable and other revenue	7,528	10,648	15,900
Total revenue	615,297	533,639	433,576
COST OF REVENUE:			
Product	114,611	93,971	73,201
Services	64,123	50,682	35,486
Ratable and other revenue	1,909	2,767	4,911
Total cost of revenue	180,643	147,420	113,598
GROSS PROFIT:			
Product	163,435	154,977	124,207
Services	265,600	223,361	184,782
Ratable and other revenue	5,619	7,881	10,989
Total gross profit	434,654	386,219	319,978
OPERATING EXPENSES:			
Research and development	102,660	81,078	63,577
Sales and marketing	224,991	179,155	145,532
General and administrative	34,913	25,511	21,965
Total operating expenses	362,564	285,744	231,074
OPERATING INCOME	72,090	100,475	88,904
INTEREST INCOME	5,306	5,006	3,523
OTHER EXPENSE—Net	(1,455)	(485)	(354)
INCOME BEFORE INCOME TAXES	75,941	104,996	92,073
PROVISION FOR INCOME TAXES	31,668	38,160	29,581
NET INCOME	$44,273	$66,836	$62,492
Net income per share attributable to common stockholders (Note 8):			
Basic	$0.27	$0.42	$0.41
Diluted	$0.26	$0.40	$0.38
Weighted-average shares outstanding:			
Basic	162,435	158,074	152,581
Diluted	168,183	166,329	163,781

See notes to consolidated financial statements.

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

	Fiscal Year		
	2013	2012	2011
Net income	$44,273	$66,836	$62,492
Other comprehensive (loss) income:			
Foreign currency translation (losses) gains	(1,617)	524	(553)
Unrealized (losses) gains on investments	(587)	3,331	(1,702)
Unrealized losses on cash flow hedges	—	—	(74)
Tax benefit (provision) related to items of other comprehensive income or loss	205	(1,166)	550
Other comprehensive (loss) income, net of tax	(1,999)	2,689	(1,779)
Comprehensive income	$42,274	$69,525	$60,713

See notes to consolidated financial statements.

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FORTINET, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)
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	Common Stock		Treasury Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
BALANCE—December 31, 2010	150,172	150	(1,409)	(2,995)	251,844	2,181	(18,727)	232,453
Exercise of stock options	6,229	6	—	—	19,962	—	—	19,968
Stock-based compensation expense	—	—	—	—	19,015	—	—	19,015
Income tax benefit associated with stock-based compensation	—	—	—	—	26,205	—	—	26,205
Net unrealized loss on investments - net of taxes	—	—	—	—	—	(1,153)	—	(1,153)
Net unrealized loss on derivatives qualifying as cash flow hedges						(74)		(74)
Net change in cumulative translation adjustments	—	—	—	—	—	(552)	—	(552)
Net income	—	—	—	—	—	—	62,492	62,492
BALANCE—December 31, 2011	156,401	156	(1,409)	(2,995)	317,026	402	43,765	358,354
Issuance of common stock upon exercise of stock options	4,779	5	—	—	27,178	—	—	27,183
Issuance of common stock in connection with employee stock purchase plan	577	1	—	—	10,903	—	—	10,904
Stock-based compensation expense	—	—	—	—	30,690	—	—	30,690
Income tax benefit associated with stock-based compensation	—	—	—	—	14,278	—	—	14,278
Net unrealized gain on investments - net of taxes	—	—	—	—	—	2,165	—	2,165
Net change in cumulative translation adjustments	—	—	—	—	—	524	—	524
Net income	—	—	—	—	—	—	66,836	66,836
BALANCE—December 31, 2012	161,757	$ 162	(1,409)	$ (2,995)	$ 400,075	$ 3,091	$ 110,601	$ 510,934
Issuance of common stock upon exercise of stock options	2,488	2	—	—	12,886	—	—	12,888
Issuance of common stock in connection with employee	672	1	—	—	12,695	—	—	12,696

stock purchase plan								
Issuance of common stock upon vesting of restricted stock units	228	—	—	—	—	—	—	—
Tax withholding upon vesting of restricted stock awards	(70)	—	—	—	(1,452)	—	—	(1,452)
Repurchase and retirement of common stock	(3,540)	(4)	1,409	2,995	(8,929)	—	(33,011)	(38,949)
Stock-based compensation expense	—	—	—	—	43,909	—	—	43,909
Income tax benefit associated with stock-based compensation	—	—	—	—	3,460	—	—	3,460
Net unrealized loss on investments - net of taxes	—	—	—	—	—	(382)	—	(382)
Net change in cumulative translation adjustments	—	—	—	—	—	(1,617)	—	(1,617)
Net income	—	—	—	—	—	—	44,273	44,273
BALANCE—December 31, 2013	161,535	$ 161	—	$—	$462,644	$ 1,092	$ 121,863	$ 585,760

See notes to consolidated financial statements.

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

	Fiscal Year 2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$44,273	$66,836	$62,492
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	15,623	11,564	6,989
Amortization of investment premiums	11,634	12,962	12,515
Stock-based compensation expense	43,909	30,690	19,015
Excess tax benefit from stock-based compensation	(2,974)	(12,069)	(19,829)
Other non-cash items, net	961	881	22
Changes in operating assets and liabilities:			
Accounts receivable—net	(22,080)	(12,120)	(23,246)
Inventory	(35,093)	(11,303)	(6,034)
Deferred tax assets	(18,750)	(9,254)	(7,874)
Prepaid expenses and other current assets	(907)	791	(2,915)
Other assets	1,243	2,470	227
Accounts payable	10,485	961	6,801
Accrued liabilities	1,654	301	1,765
Accrued payroll and compensation	6,013	4,599	4,773
Deferred revenue	68,871	68,292	42,177
Income taxes payable	22,522	28,265	35,964
Net cash provided by operating activities	147,384	183,866	132,842
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of investments	(552,778)	(601,087)	(516,906)
Sales of investments	57,897	26,268	44,503
Maturities of investments	369,659	415,440	311,824
Purchase of property and equipment	(13,877)	(22,083)	(3,624)
Payments made in connection with acquisitions, net of cash acquired	(7,635)	(1,249)	(2,623)
Net cash used in investing activities	(146,734)	(182,711)	(166,826)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock	25,584	38,087	19,968
Taxes paid related to net share settlement of equity awards	(1,452)	—	—
Excess tax benefit from stock-based compensation	2,974	12,069	19,829
Repurchase and retirement of common stock	(33,529)	—	—
Net cash (used in) provided by financing activities	(6,423)	50,156	39,797
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(1,329)	(326)	(682)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(7,102)	50,985	5,131
CASH AND CASH EQUIVALENTS—Beginning of year	122,975	71,990	66,859
CASH AND CASH EQUIVALENTS—End of year	$115,873	$122,975	$71,990
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid (refunded) for income taxes, net	$25,445	$17,088	$(305)
NON-CASH INVESTING AND FINANCING ACTIVITIES:			

Purchase of property and equipment not yet paid	$4,253	$398	$440
Liability incurred in connection with business acquisition	$100	$201	$—
Liability incurred for repurchase of common stock	$5,420	$—	$—

See notes to consolidated financial statements.

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FORTINET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 UTM network security solutions to enterprises, service providers and governmental entities worldwide. Fortinet's solutions are designed to integrate multiple levels of security protection, including firewall, virtual private networking, application control, anti-malware, intrusion prevention, web filtering, vulnerability management, anti-spam and WAN acceleration.

Basis of Presentation and Preparation—The consolidated financial statements of Fortinet and its wholly owned subsidiaries (collectively, the "Company," "we," "us" or "our") have been prepared in accordance with GAAP. All intercompany transactions and balances have been eliminated in consolidation.

During the third quarter of fiscal 2013, we recorded an out-of-period adjustment of $3.0 million to correct the presentation on our consolidated balance sheets relating to our repurchase of 1,409,264 shares during fiscal 2009. This reclassification adjustment resulted in a decrease to the outstanding treasury stock balance and a corresponding decrease to additional paid-in capital. We believe the impact of the correction is not material to the current or prior fiscal periods. The shares that we repurchased in fiscal 2009 were retired immediately after repurchase. There was no outstanding treasury stock balance as of December 31, 2013.

Use of Estimates—The preparation of consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Such management estimates include implicit service periods for revenue recognition, litigation and settlement costs and other loss contingencies, sales returns and allowances, reserve for bad debt, inventory valuation, warranty reserve, goodwill and other long-lived assets, investments, stock-based compensation, the accounting for income taxes related to deferred tax asset balances and reserves, and the accounting for business combinations. 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, the timing and success of new product and service introductions by us or our competitors, price and sales competition and our ability to adapt to changing market conditions and dynamics such as changes in end-customer, distributor or reseller requirements or market needs, changes in expenses caused, for example, by 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, seasonality, failure of our channel partners to perform or other disruption in our channel, the quality of our products and services and the market perception of our response to new viruses or security breaches, general economic conditions, challenges in doing business outside of the United States, changes in customer relationships, litigation, or claims against us based on intellectual property, patent, product regulatory or other factors, product obsolescence, and our ability to attract and retain qualified employees.

We rely solely on suppliers and independent contract manufacturers for certain of our components and one third-party logistics company for distribution of certain of our products, which is located outside of U.S. The inability of any of these parties to fulfill our supply and logistics requirements could negatively impact our future operating results.

Concentration of Credit Risk—Financial instruments that subject us to concentrations of credit risk consist primarily of cash, cash equivalents, short-term and long-term investments, and accounts receivable. We maintain our cash, cash equivalents, and investments 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.

As of December 31, 2013, one distributor, Exclusive Networks Group accounted for 13% of total accounts receivable. As of December 31, 2012, no single customer accounted for more than 10% of total accounts receivable.

During fiscal 2013 and fiscal 2012, one distributor, Exclusive Networks Group accounted for 12% and 11% of total revenue, respectively. During fiscal 2011, no single customer or distributor accounted for more than 10% of total revenue.

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 liabilities, and accrued payroll and compensation.

Comprehensive Income—Comprehensive income includes certain changes in equity from non-owner sources that are excluded from net income. Specifically, cumulative foreign currency translation adjustments, unrealized gains and losses on available-for-sale investments, and unrealized gains and losses on cash flow hedges are included in comprehensive income.

Foreign Currency Translation and Transaction Gains and Losses—Assets and liabilities of foreign subsidiaries with non-U.S. dollar functional currency are translated into U.S. dollars using the exchange rates in effect at the balance sheet dates and expenses are translated using average exchange rates during the period. The resulting foreign translation adjustments are included in the consolidated balance sheets in the stockholders' equity section as a component of accumulated other comprehensive income (loss) and are included in the consolidated statements of comprehensive income. Foreign currency transaction losses of $1.5 million, $0.5 million and $0.4 million, are included in other expense, net for fiscal 2013, 2012 and 2011, respectively.

Cash, Cash Equivalents and Available-for-sale 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 balances with banks, and highly liquid investments in money market funds, commercial paper, and certificates of deposit and term deposits.

We classify our investments as available-for-sale at the time of purchase since it is our intent that these investments are available for current operations, and 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 is 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.

Other Investments—Investments in privately held companies where we own less than 20% of the voting stock and have no indicators of significant influence over operating and financial policies of those companies are included in Other assets in the consolidated balance sheets and are accounted for under the cost method. For these non-quoted investments, we regularly review the assumptions underlying the operating performance and cash flow forecasts based on information provided by these privately held companies. If it is determined that an other-than-temporary decline exists in an equity security, we write down the investment to its fair value and record the related impairment as an investment loss in our consolidated statements of operations.

Inventory—Inventory is recorded at the lower of average cost or market, after we give appropriate consideration to obsolescence and inventory in excess of anticipated future demand. Certain inventories are held at consignment locations. This

consigned inventory was $4.3 million as of December 31, 2013, of which $4.1 million is raw materials and $0.2 million is finished goods and $2.3 million as of December 31, 2012, of which $2.1 million is raw materials and $0.2 million is finished goods. 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.

Property and Equipment—Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets as follows:

	Estimated Useful Lives
Building and building improvements	2 years
Evaluation units	1 year
Computer software	1 year
Computer equipment and tooling	2 years
Furniture and fixtures	3 years
Leasehold improvements	Shorter of useful life or 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. Certain purchased intangible assets were measured at fair value resulting in an impairment charge of $0.5 million, which is recorded as Cost of sales in the consolidated statements of operations during fiscal 2013.

Goodwill —Goodwill represents the excess of purchase consideration over the estimated fair value of net assets of businesses acquired in a business combination. Goodwill acquired in a business combination are not amortized, but instead tested for impairment at least annually during the fourth quarter. We perform our annual goodwill impairment analysis at the reporting unit level. As of December 31, 2013, we had one reporting unit.

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

estimated using significant judgment based on a combination of the income and the market approaches. Under the income approach, we estimate fair value of the reporting unit based on the present value of forecasted future cash flows that the reporting unit is expected to generate over its remaining life. Under the market approach, we estimate fair value of our reporting unit based on an analysis that compares the value of the reporting unit to values of other companies in similar lines of business. If the fair value of the reporting unit is less than its carrying value, then we perform the second step to measure the amount of impairment loss. The amount of impairment is determined by comparing the implied fair value of reporting unit goodwill to the carrying value of the goodwill. When the carrying value of the reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference. We have not been required to perform this second step of the process because the fair value of our reporting unit exceeded the net book value as of December 31, 2013.

Determining the fair value of the reporting unit requires us to make judgments and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, operating trends, risk-adjusted discount rates, future economic and market conditions and determination of appropriate market comparables. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. Actual future results may differ from those estimates. We may also test goodwill for impairment between annual tests in the presence of impairment indicators.

Other Intangible Assets—Intangible assets with finite lives are carried at cost, less accumulated amortization. Amortization is computed using the straight-line method over the estimated economic lives of the assets, which range from one to six years.

Deferred Revenue—Deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. This generally includes subscription and support services which are invoiced upfront and delivered over twelve months or longer.

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 account for uncertain tax positions in accordance with GAAP, which defines the confidence level that a tax position must meet in order to be recognized in the financial statements. The tax effects of a position are recognized only if it is “more likely than not” to be sustained based solely on its technical merits as of the reporting date. 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 Expense—We have elected to use the Black-Scholes option pricing model to determine the fair value of our employee stock options and ESPP. The fair value of RSUs is based on the closing market price of our common stock on the date of grant. Stock-based compensation expense is amortized on a straight-line basis, net of estimated forfeitures. PSUs are RSUs that contain both service-based and market-based vesting conditions. PSUs vest over a specified service period upon the satisfaction of certain market-based vesting conditions, and settle into shares of our common stock upon vesting over a two- or three-year period. The fair value of a PSU is calculated using the Monte Carlo simulation model on the date of grant and is based on the market price of our common stock on the date of grant modified to reflect the impact of the market-based vesting condition, including the estimated payout level

based on that condition. We do not adjust compensation cost for subsequent changes in the expected outcome of the market-based vesting conditions.

Advertising Expense—Advertising costs are expensed when incurred and are included in operating expenses in the accompanying consolidated statements of operations. Our advertising expenses were not significant for any periods presented.

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—We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. The majority of our products are hardware appliances containing software

components that function together to provide the essential functionality of the product.We record revenue from our hardware appliances in accordance with general revenue recognition accounting guidance.

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 are subject to industry-specific software revenue recognition guidance. Certain of our software, when sold with our appliances, are considered essential to their functionality and as a result are accounted for as non-software deliverables. However, this same software, if sold separately, is accounted for under industry-specific software revenue recognition guidance.

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 a 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. When applying the relative selling price method, we determine the selling price for each deliverable using vendor-specific objective evidence ("VSOE") of selling price, if it exists, or third-party evidence ("TPE") of selling price. If neither VSOE nor TPE of selling price exist for a deliverable, we use our best estimate of selling ("BESP") price for that deliverable. Revenue allocated to each element is then recognized when the basic revenue recognition criteria are met for each element.

VSOE of fair value for elements of an arrangement is based upon the normal pricing practices for those services when sold separately. In establishing 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.

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 which is generally unavailable.

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

We recognize revenue for our software sales based on industry-specific software revenue recognition guidance. Under industry-specific software revenue recognition guidance, 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.

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

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

- Delivery has occurred or services have been rendered. Delivery occurs when we fulfill an order and title and risk of loss has been transferred. Services revenue is deferred and recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Professional service revenue is recognized upon delivery or completion of performance.

- Sales price is fixed or determinable. We assess whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. In the event payment terms differ from our standard business practices, the sales price is 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. In the event the sales price is subject to refund or adjustment,

the sales price is deemed to be not fixed or determinable and revenue is recognized when the refund or adjustment privileges expire provided the remaining criteria for revenue recognition have been met.

- Collectibility is probable. We assess collectibility based primarily on creditworthiness as determined by credit checks and analysis, as well as payment history.

For arrangements which include end-customer acceptance criteria, revenue is recognized upon acceptance. We recognize product revenue on sales to distributors that have no general right of return and direct sales to end-customers upon shipment, once all other revenue recognition criteria have been met. Certain distributors that stock our products are granted stock rotation rights,limited rights of return as well as rebates for sales of our products. The arrangement fee for this group of distributors is not fixed and determinable when products are shipped and revenue is therefore deferred and recognized upon sell-through. 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.

Shipping charges billed to customers are included in revenues and related costs are included in cost of revenue. Sales commissions and other incremental costs to acquire contracts are expensed as incurred.

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 collectibility of customer accounts. The allowance for doubtful accounts was not significant as of December 31, 2013 and 2012. The reserve for sales returns and allowances is based on specific criteria including agreements to provide rebates and other 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. The reserve for sales returns was $4.6 million and $2.3 million as of December 31, 2013 and 2012, respectively.

Warranties—We generally provide a 1-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):

	Fiscal Year		
	2013	2012	2011
Accrued warranty balance—beginning of the period	2,309	2,582	1,878
Warranty costs incurred	(3,444)	(2,669)	(1,778)
Provision for warranty for the year, including warranty liabilities assumed in connection with an acquisition	3,965	2,639	2,103
Changes in prior period estimates	207	(243)	379
Accrued warranty balance—end of the period	3,037	2,309	2,582

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"). To help protect against significant fluctuations in value and the volatility of future cash flows caused by changes in currency exchange rates, we engage in foreign currency risk management activities to hedge balance sheet items denominated in CAD. We do not use these contracts for speculative or trading purposes. All of the derivative instruments are with high quality financial institutions and we monitor the creditworthiness of these parties. These contracts typically have maturities between one and three months. We record changes in the fair value of forward exchange contracts related to balance sheet accounts as other expense, net in the consolidated statement of operations.

Additionally, independent of any hedging activities, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in 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 and are focused on CAD, long-term material changes in the value of the U.S. dollar against other foreign currencies, such as the EUR, GBP and JPY could adversely impact our operating expenses in the future.

The notional amount of forward exchange contracts to hedge balance sheet accounts as of December 31, 2013 was (amounts in 000’s):

	Buy/Sell	Notional
Balance Sheet Contracts:		
Currency—As of December 31, 2013		
CAD	Buy	21,867
Currency—As of December 31, 2012		
CAD	Buy	17,968

Recently Adopted Accounting Pronouncements

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

In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740)-Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (“ASU 2013-11”). ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit

when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. This new standard requires the netting of unrecognized tax benefits ("UTBs") against a deferred tax asset for a loss or other carryforward that would apply in settlement of the uncertain tax positions. UTBs will be netted against all available same-jurisdiction loss or other tax carryforwards that would be utilized, rather than only against carryforwards that are created by the UTBs. ASU 2013-11 will be effective for us beginning in the first quarter of fiscal 2014. Early adoption is permitted. Since ASU 2013-11 only impacts financial statement disclosure requirements for unrecognized tax benefits, we do not expect its adoption to have an impact on our financial position or results of operations.

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

2. INVESTMENT IN PRIVATELY-HELD COMPANY

In August 2013, we invested $2.0 million in equity securities in HyTrust, a privately-held company. This investment is accounted for as a cost-basis investment, as we own less than 20% of the voting securities and do not have the ability to exercise significant influence over operating and financial policies of the entity. This investment is carried at historical cost and is within Other assets on our consolidated balance sheet and measured at fair value on a nonrecurring basis when indicators of impairment exist. As of December 31, 2013, no events have occurred that would adversely affect the carrying value of this investment.

3. FINANCIAL INSTRUMENTS AND FAIR VALUE

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

	December 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	603,185	1,506	(374)	604,317
Commercial paper	69,356	7	—	69,363
Municipal bonds	38,815	48	(20)	38,843
Certificates of deposit and term deposits	12,645	3	—	12,648
U.S. government and agency securities	2,000	1	—	2,001
Total available-for-sale securities	726,001	1,565	(394)	727,172

	December 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	529,738	1,814	(161)	531,391
Commercial paper	39,229	22	(6)	39,245
Municipal bonds	36,787	83	—	36,870
Certificates of deposit and term deposits	9,099	6	—	9,105
Total available-for-sale securities	614,853	1,925	(167)	616,611

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

	December 31, 2013					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	182,795	(374)	500	—	183,295	(374)
Commercial paper	7,897	—	—	—	7,897	—
Municipal bonds	14,736	(20)	—	—	14,736	(20)
Total available-for-sale securities	205,428	(394)	500	—	205,928	(394)

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

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

	December 31, 2012					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	133,006	(156)	5,010	(5)	138,016	(161)
Commercial paper	8,464	(6)	—	—	8,464	(6)
Total available-for-sale securities	141,470	(162)	5,010	(5)	146,480	(167)

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

	December 31, 2013	December 31, 2012
Due within one year	375,497	290,719
Due within one to three years	351,675	325,892
Total	727,172	616,611

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

The unrealized losses on our available-for-sale securities were caused by fluctuations in market value and interest rates as a result of the economic environment. As the decline in market value are attributable to changes in market conditions and not credit quality, and because we have concluded currently that we neither intend to sell nor is it more likely than not that we will be required to sell these investments prior to a recovery of par value, we do not consider these investments to be other-than temporarily impaired as of December 31, 2013.

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

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

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

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

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

We measure the fair value of money market funds using quoted prices in active markets for identical assets. The fair value of all other financial instruments was based on quoted prices for similar asserts in active markets, or model

driven valuations using significant inputs derived from or corroborated by observable market data.

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

We classify items within Level 2 if the investments are valued using model driven valuations using observable inputs such as quoted market prices, benchmark yields, reported trades, broker/dealer quotes or alternative pricing sources with

reasonable levels of price transparency. Investments are held by custodians who obtain investment prices from a third-party pricing provider that incorporates standard inputs in various asset price models.

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

	December 31, 2013				December 31, 2012			
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Significant Other Unobservable Remaining Inputs (Level 3)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Significant Other Unobservable Remaining Inputs (Level 3)
Assets:								
Corporate debt securities	604,317	—	604,317	—	531,391	—	531,391	—
Commercial paper	71,363	—	71,363	—	41,994	—	41,994	—
Municipal bonds	38,843	—	38,843	—	36,870	—	36,870	—
Certificates of deposit and term deposits	12,648	—						