

FORTINET INC
Form 10-Q
May 07, 2012

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012
Or

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

For the transition period from _____ to _____

Commission file number: 001-34511

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

Delaware
(State or other jurisdiction of
incorporation or organization)
1090 Kifer Road
Sunnyvale, California
(Address principal executive offices)

77-0560389
(I.R.S. Employer
Identification No.)
94086
(Zip Code)

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

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of April 27, 2012, there were 157,322,947 shares of the registrant's common stock outstanding.

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QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended March 31, 2012
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Part I

ITEM 1. Financial Statements

FORTINET, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands)

	March 31, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$74,783	\$71,990
Short-term investments	353,287	318,283
Accounts receivable, net of allowance for doubtful accounts of \$316 and \$336 at March 31, 2012 and December 31, 2011, respectively	84,759	95,522
Inventory	17,959	16,249
Deferred tax assets	6,963	7,578
Prepaid expenses and other current assets	13,749	13,948
Total current assets	551,500	523,570
PROPERTY AND EQUIPMENT—Net	9,560	7,966
DEFERRED TAX ASSETS—Non-current	46,523	46,523
LONG-TERM INVESTMENTS	172,236	148,414
OTHER ASSETS	8,625	8,274
TOTAL ASSETS	\$788,444	\$734,747
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$13,764	\$19,768
Accrued liabilities	16,721	15,971
Accrued payroll and compensation	23,918	24,197
Deferred revenue	216,558	206,928
Total current liabilities	270,961	266,864
DEFERRED REVENUE—Non-current	98,014	87,905
OTHER LIABILITIES	21,142	21,624
Total liabilities	390,117	376,393
COMMITMENTS AND CONTINGENCIES (Note 7)		
STOCKHOLDERS' EQUITY:		
Common stock, \$0.001 par value - 300,000 shares authorized; 158,491 and 156,401 shares issued and 157,082 and 154,992 shares outstanding at March 31, 2012 and December 31, 2011, respectively	158	156
Additional paid-in-capital	341,096	317,026
Treasury stock	(2,995	) (2,995)
Accumulated other comprehensive income	2,130	402
Retained earnings	57,938	43,765
Total stockholders' equity	398,327	358,354
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$788,444	\$734,747
See notes to condensed consolidated financial statements.		

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

	Three Months Ended		
	March 31, 2012	March 31, 2011	
REVENUE:			
Product	\$53,204	\$40,165	
Services	62,138	48,686	
Ratable and other revenue	1,905	4,415	
Total revenue	117,247	93,266	
COST OF REVENUE:			
Product	19,067	14,075	
Services	11,213	7,781	
Ratable and other revenue	763	1,560	
Total cost of revenue	31,043	23,416	
GROSS PROFIT:			
Product	34,137	26,090	
Services	50,925	40,905	
Ratable and other revenue	1,142	2,855	
Total gross profit	86,204	69,850	
OPERATING EXPENSES:			
Research and development	19,667	14,421	
Sales and marketing	42,036	32,718	
General and administrative	5,786	5,266	
Total operating expenses	67,489	52,405	
OPERATING INCOME	18,715	17,445	
INTEREST INCOME	1,085	793	
OTHER EXPENSE—Net	(71) (95)
INCOME BEFORE INCOME TAXES	19,729	18,143	
PROVISION FOR INCOME TAXES	5,556	4,556	
NET INCOME	\$14,173	\$13,587	
Net income per share:			
Basic	\$0.09	0.09	
Diluted	\$0.09	0.08	
Weighted-average shares outstanding:			
Basic	156,010	150,308	
Diluted	165,751	162,864	
See notes to condensed consolidated financial statements.			

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

	Three Months Ended	
	March 31, 2012	March 31, 2011
Net income	\$14,173	\$13,587
Other comprehensive income:		
Foreign currency translation	558	654
Unrealized gains (losses) on investments	1,799	(5)
Unrealized losses on cash flow hedges	—	(74)
Tax provision related to items of other comprehensive income	(629) —
Net change in accumulated other comprehensive income	1,728	575
Comprehensive income	\$15,901	\$14,162
See notes to condensed consolidated financial statements.		

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

	Three Months Ended	
	March 31, 2012	March 31, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$14,173	\$13,587
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,082	1,678
Loss on disposal of fixed assets	19	—
Amortization of investment premiums	3,255	3,261
Stock-based compensation	7,246	3,070
Excess tax benefit from employee stock option plans	(2,320)	(1,115)
Changes in operating assets and liabilities:		
Accounts receivable—net	10,763	1,009
Inventory	(3,409)	550
Deferred tax assets	(15)	(17)
Prepaid expenses and other current assets	(330)	(510)
Other assets	569	(1,149)
Accounts payable	(6,319)	(4,225)
Accrued liabilities	42	2,389
Accrued payroll and compensation	(547)	(23)
Other liabilities	(273)	3,623
Deferred revenue	19,696	13,398
Income taxes payable	3,886	4,650
Net cash provided by operating activities	48,518	40,176
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(192,567)	(129,695)
Sales of investments	17,416	11,591
Maturities of investments	115,026	71,864
Purchases of property and equipment	(1,624)	(694)
Payment made in connection with business acquisition	(550)	—
Net cash used in investing activities	(62,299)	(46,934)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	13,551	6,960
Excess tax benefit from employee stock option plans	2,320	1,115
Net cash provided by financing activities	15,871	8,075
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	703	805
NET INCREASE IN CASH AND CASH EQUIVALENTS	2,793	2,122
CASH AND CASH EQUIVALENTS—Beginning of period	71,990	66,859
CASH AND CASH EQUIVALENTS—End of period	\$74,783	\$68,981
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (refunded) for income taxes	\$1,010	\$(767)
NON-CASH INVESTING ACTIVITIES:		
Purchases of property and equipment not yet paid	\$688	\$225
Liability incurred in connection with business acquisition	\$400	\$—

See notes to condensed consolidated financial statements.

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation

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

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

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

Recently Adopted Accounting Pronouncements

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

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

2. INVESTMENTS AND FAIR VALUE MEASUREMENTS

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

	March 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
U.S. government and agency securities	23,600	9	—	23,609
Corporate debt securities	392,806	637	(470)	392,973
Commercial paper	65,787	10	(2)	65,795
Municipal bonds	27,024	51	(5)	27,070
Certificates of deposit and term deposits	16,075	1	—	16,076
Total available-for-sale securities	525,292	708	(477)	525,523

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

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

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	204,830	(470)	—	—	204,830	(470)
Commercial paper	14,949	(2)	—	—	14,949	(2)
Municipal bonds	9,407	(5)	—	—	9,407	(5)
Total available-for-sale securities	229,186	(477)	—	—	229,186	(477)

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

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government and agency securities	10,996	(2)	—	—	10,996	(2)
Corporate debt securities	258,159	(1,832)	—	—	258,159	(1,832)

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Commercial paper	9,279	(5)	—	—	9,279	(5)
Municipal bonds	8,067	(5)	—	—	8,067	(5)
Certificates of deposit and term deposits	7,499	(2)	—	—	7,499	(2)
Total available-for-sale securities	294,000	(1,846)	—	—	294,000	(1,846)

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

	March 31, 2012	December 31, 2011
Due within one year	353,287	318,283
Due within one to three years	172,236	148,414
Total	525,523	466,697

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

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

	March 31, 2012			December 31, 2011		
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)
Assets:						
U.S. government and agency securities	23,609	—	23,609	38,908	—	38,908
Corporate debt securities	399,501	—	399,501	337,497	—	337,497
Commercial paper	82,644	—	82,644	64,890	—	64,890
Municipal bonds	27,070	—	27,070	20,504	—	20,504
Certificates of deposit and term deposits	16,076	—	16,076	18,761	—	18,761
Money market funds	6,095	6,095	—	31,438	31,438	—
Total	554,995	6,095	548,900	511,998	31,438	480,560
Reported as:						
Cash equivalents	29,472			45,301		
Short-term investments	353,287			318,283		
Long-term investments	172,236			148,414		
Total	554,995			511,998		

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

3. INVENTORY

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

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	March 31, 2012	December 31, 2011
Raw materials	3,855	3,447
Finished goods	14,104	12,802
Inventory	17,959	16,249

4. PROPERTY AND EQUIPMENT—Net

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

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

	March 31, 2012		December 31, 2011
Evaluation units	15,254		13,912
Computer equipment and software	13,945		12,219
Furniture and fixtures	1,370		1,307
Leasehold improvements and tooling	4,608		4,381
Total property and equipment	35,177		31,819
Less: accumulated depreciation	(25,617	)	(23,853
Property and equipment—net	9,560		7,966

Depreciation expense was \$2.1 million and \$1.6 million for the first quarter of 2012 and 2011, respectively.

5. NET INCOME PER SHARE

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

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

	Three Months Ended	
	March 31, 2012	March 31, 2011
Numerator:		
Net income	14,173	13,587
Denominator:		
Basic shares:		
Weighted-average common shares outstanding - basic	156,010	150,308
Diluted shares:		
Weighted-average common shares outstanding - basic	156,010	150,308
Effect of potentially dilutive securities:		
Employee stock option and purchase plans	9,741	12,556
Weighted-average shares used to compute diluted net income per share	165,751	162,864
Net income per share:		
Basic	0.09	0.09
Diluted	0.09	0.08

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

	Three Months Ended	
	March 31, 2012	March 31, 2011
Options to purchase common stock	6,028	2,416
ESPP	262	—
	6,290	2,416

6. DEFERRED REVENUE

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

	March 31, 2012	December 31, 2011
Product	6,552	5,817
Services	293,752	272,843
Ratable and other revenue	14,268	16,173
Total deferred revenue	314,572	294,833
Reported As:		
Current	216,558	206,928
Non-current	98,014	87,905
Total deferred revenue	314,572	294,833

7. COMMITMENTS AND CONTINGENCIES

Leases—We lease our facilities under various noncancelable operating leases, which expire through 2015. Rent expense was \$2.2 million and \$1.9 million for the first quarter of 2012 and 2011, respectively.

The aggregate future noncancelable minimum rental payments on operating leases as of March 31, 2012 are as follows (\$ amounts in 000's):

	Rental Payment
Fiscal years:	
2012 (remainder)	6,045
2013	5,402
2014	3,476
2015	1,705
Total	16,628

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

March 31, 2012, we had \$29.3 million of open purchase orders with our independent contract manufacturers that are not cancelable.

In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations associated with our ordinary course of business for which we have not received goods or services. As of March 31, 2012, we had \$0.8 million in other purchase commitments.

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

	For The Three Months Ended And As Of March 31, 2012	For The Year Ended And As Of December 31, 2011
Accrued warranty balance - beginning of the period	2,582	1,878
Warranty costs incurred	(529	) (1,778
Provision for warranty	219	2,103
Adjustments to previous estimates	(290	) 379
Accrued warranty balance - end of the period	1,982	2,582

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

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us claiming unspecified damages in the California Superior Court for the County of Los Angeles alleging violation of various California Corporations Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company. The plaintiff is claiming unspecified damages. In September 2010, the Court granted our motion to transfer the case to the California Superior Court for Santa Clara County and the plaintiff has filed an amended complaint in the Superior Court to add individual defendants, among other amendments. The Superior Court recently set a trial date for November 2012. We have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

In July 2010, Network Protection Sciences, LLC (“NPS”), a non-practicing entity, filed a complaint in the United States District Court for the Eastern District of Texas alleging patent infringement by us and other defendants. NPS is claiming unspecified damages, including treble damages for willful infringement, and requests an injunction against such alleged infringement. In December 2011, in the United States District Court for the Eastern District of Texas ordered the case to be transferred to the Northern District of California. Currently the case is in the early stages, and we have determined that, as of this time, there is not a reasonable possibility that a loss has been incurred.

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

8. STOCKHOLDERS' EQUITY

Stock Options

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

	Three Months Ended	
	March 31, 2012	March 31, 2011
Expected term in years	4.6	4.6
Volatility (%)	52	40
Risk-free interest rate (%)	0.7	1.8
Dividend rate (%)	—	—
Estimated fair value (\$)	11.23	7.25
Total stock-based compensation expense (\$ amounts in 000's)	6,316	3,070

A summary of the option activity under our stock plans and changes during the reporting periods are presented below (in 000's, except per share amounts):

	Shares Available For Grant	Options Outstanding		Weighted- Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (\$)
		Number Of Shares	Weighted- Average Exercise Price (\$)		
Balance-December 31, 2011	17,399	21,389	3.57		
Authorized	7,750	—	—		
Granted	(2,782)	2,782	26.70		
Forfeited	379	(379)	18.83		
Exercised (aggregate intrinsic value of \$38,102)	—	(1,801)	4.72		
Balance—March 31, 2012	22,746	21,991	11.56		
Options vested and expected to vest—March 31, 2012		21,046	11.33	4.72	343,525
Options vested and exercisable—March 31, 2012		10,900	4.89	3.67	248,134

At March 31, 2012, total compensation cost related to unvested stock-based awards granted to employees under our stock plans but not yet recognized was \$85.3 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of 3.1 years. Future option grants will increase the amount of compensation expense to be recorded in these periods.

Employee Stock Purchase Plan

In June 2011, our Board of Directors (the “Board”) approved and authorized the issuance of 8,000,000 shares of common stock. Under the ESPP, we can grant stock purchase rights to all eligible employees during a six months offering period with purchase dates at the end of each offering period. Shares are purchased through employees' payroll deductions, up to a maximum of 15% of employees' compensation for each purchase period, at purchase prices equal to 85% of the lesser of the fair market value of our common stock at the first trading date of the applicable offering period or the purchase date. No participant may purchase more than 4,000 shares of common stock in any one calendar year period.

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The following table summarizes the weighted-average assumptions relating to our ESPP during the first quarter of 2012 as follows:

Expected term in years	0.5
Volatility (%)	58
Risk-free interest rate (%)	0.2
Dividend rate (%)	—
Estimated fair value (\$)	8.08
Total stock-based compensation expense (\$ amount in 000's)	930

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

Stock-based Compensation Expense

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

	Three Months Ended	
	March 31, 2012	March 31, 2011
Cost of product revenue	64	22
Cost of services revenue	745	198
Research and development	1,957	453
Sales and marketing	3,443	1,900
General and administrative	1,037	497
	7,246	3,070

9. INCOME TAXES

The effective tax rate was 28% for the first quarter of 2012, compared to an effective tax rate of 25% for the first quarter of 2011. The provision for income taxes for the first quarters of 2012 and 2011 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax.

As of March 31, 2012 and December 31, 2011, unrecognized tax benefits were \$22.4 million and \$19.3 million, respectively. The total amount of unrecognized tax benefits, if recognized, would favorably impact the effective tax rate.

It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of March 31, 2012, we had approximately \$0.9 million accrued for estimated interest related to uncertain tax positions. We do not expect any material unrecognized tax benefits to expire within the next twelve months.

10. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

Our chief operating decision maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. We have one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, we are considered to be in a single reportable segment and operating unit structure.

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

	Three Months Ended
Revenue	

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	March 31, 2012	March 31, 2011
Americas:		
United States	31,119	24,170
Other Americas	15,312	11,475
Total Americas	46,431	35,645
Europe, Middle East and Africa ("EMEA")	40,886	33,641
Asia Pacific and Japan ("APAC")	29,930	23,980
Total revenue	117,247	93,266

During the first quarter of 2012, one distributor, Exclusive Networks, accounted for 11% of revenue. During the first quarter of 2011, no single customer accounted for more than 10% of revenue.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(Unaudited)

	March 31, 2012	December 31, 2011
Property and Equipment—Net		
Americas:		
United States	2,965	2,225
Canada	4,640	4,062
Other Americas	27	33
Total Americas	7,632	6,320
EMEA	1,092	805
APAC	836	841
Total property and equipment—net	9,560	7,966

11. FOREIGN CURRENCY DERIVATIVES

The notional value of our outstanding forward exchange contracts that were entered into in order to hedge balance sheet accounts as of March 31, 2012 consisted of the following (\$ amounts in 000's):

	Buy/Sell	Notional
To hedge balance sheet accounts:		
Currency		
CAD	Buy	13,769
EUR	Buy	5,933
GBP	Buy	2,278

12. ACQUISITION

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

13. INTANGIBLE ASSETS

The following table presents the detail of our intangible assets with definite lives included in other assets as of March 31, 2012 (\$ amounts in 000's):

Gross	Accumulated Amortization	Net
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Existing technology	3,041	589	2,452
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Amortization expense, for the first quarter of 2012 was \$0.2 million. The following table summarizes estimated future amortization expense of intangible assets with definite lives as of March 31, 2012 (\$ amounts in 000's):

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

	Amount
Fiscal Years:	
2012 (remainder)	835
2013	964
2014	540
2015	108
2016	5
Total	2,452

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

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

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

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

Business Overview

We provide network security solutions, which enable broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and governmental entities

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worldwide. As of March 31, 2012, we had shipped over 900,000 appliances to more than 10,000 channel partners and to more than 125,000 end-customers worldwide, including a majority of the Fortune Global 100.

Our core UTM product line of FortiGate physical and virtual appliances ships with a set of security and networking capabilities, including firewall, VPN, application control, antivirus, intrusion prevention, Web filtering, antispy 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. Sales of FortiGate products are generally balanced across entry-level (FortiGate-20 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately one-third of FortiGate sales. Our UTM solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to the application control, antivirus, intrusion prevention, Web filtering, vulnerability management and antispy 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, employee computers and mobile devices. Sales of these complementary products have grown in recent quarters, although these products still represent less than 10% of our revenue.

Financial Highlights

We recorded revenue of \$117.2 million during the first quarter of 2012, an increase of 26% compared to \$93.3 million during the same period last year.

We generated cash flows from operating activities of \$48.5 million during the first quarter of 2012, an increase of 21% compared to \$40.2 million during the same period last year.

Cash, cash equivalents and investments were \$600.3 million as of March 31, 2012, an increase of \$61.6 million from December 31, 2011.

Deferred revenue was \$314.6 million, an increase of \$19.7 million from December 31, 2011.

During the first quarter of 2012, revenues grew as a result of the successful execution of our global sales strategy and the continued product innovation that has strengthened our technology advantages and resulted in market share gains. The recent introduction of several new FortiGate appliance models such as the FortiGate-20C and -40C with their WIFI counterparts, the FortiGate-300C and -600C in the mid-range and FortiGate-1000C for large enterprises continued to gain traction and contribute to the revenue growth. We also recently released new FortiGate models including the FortiGate-100D, FortiGate-3240C and FortiGate-5140B which we expect to drive sales in future quarters.

We continue to invest in research and development to strengthen our technology leadership position, as well as sales and marketing to expand brand awareness, strengthen our value proposition, and expand our global sales team and distribution channels. We experienced healthy deal volumes driven by traction in enterprise data center deployments, core enterprise deals, and continued strength in the retail and telecommunications sectors. The number of deals involving sales greater than \$100,000 was 153 in the first quarter of 2012, compared to 111 in the first quarter of 2011. The number of deals involving sales greater than \$250,000 was 47 in the first quarter of 2012, compared to 34 in the first quarter of 2011. The number of deals involving sales greater than \$500,000 was 19 in the first quarter of

2012, compared to 18 in the first quarter of 2011; however, the combined value of these deals was significantly larger, as we had an increase in the number of deals involving sales greater than \$1.0 million during the quarter. We expect some variability in this metric, and remain focused on investing in our sales and research and development resources in order to expand our reach into new high-growth verticals and emerging markets, and in an effort to ensure the quality and functionality of our products meet increasing customer expectations 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.

During the first quarter of 2012, operating expenses increased 29% compared to the first quarter of 2011. The increase was primarily driven by additional headcount to support our growth as we continued to invest in the development of new products and expand our sales coverage. We continued to see improvements in productivity and efficiencies in our overall headcount during the quarter, compared to the first quarter of 2011. Headcount increased to 1,655 at the end of the first quarter

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of 2012 from 1,583 at the end of fiscal 2011, and 1,389 at the end of the first quarter of 2011. Our pace of hiring accelerated this quarter, particularly in sales and marketing and research and development.

Key Metrics

We monitor the key financial metrics set forth below on a quarterly basis to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. Our total deferred revenue increased by \$19.7 million from \$294.8 million at December 31, 2011 to \$314.6 million at March 31, 2012. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the quarterly revenue that we recognize. We also ended the first quarter of 2012 with \$600.3 million in cash, cash equivalents and investments and have had positive cash flow from operations for every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under "Components of Operating Results," and we discuss our cash, cash equivalents, and investments under "Liquidity and Capital Resources." Deferred revenue and cash flow from operations are discussed immediately below the following table.

	For The Three Months Ended Or As Of			
	March 31, 2012	March 31, 2011		
	(\$ amounts in 000's)			
Revenue	117,247	93,266		
Gross margin	74	% 75		%
Operating income ⁽¹⁾	18,715	17,445		
Operating margin	16	% 19		%
Total deferred revenue	314,572	266,029		
Increase in total deferred revenue over prior quarter	19,739	13,398		
Cash, cash equivalents and investments	600,306	432,703		
Cash flows from operating activities	48,518	40,176		
Free cash flow ⁽²⁾	46,894	39,482		

(1) Includes:

Stock-based compensation expense	7,246	3,070
Patent settlement income	478	477

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

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

	Three Months Ended	
	March 31, 2012	March 31, 2011
	(\$ amounts in 000's)	
Billings:		
Revenue	117,247	93,266
Increase in deferred revenue	19,739	13,398

Total billings (Non-GAAP)	136,986	106,664
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Cash flow from operations. We monitor cash flow from operations as a measure of our overall business performance. Our cash flow from operations is driven in large part by advance payments for both new and renewal contracts for subscription and support services, consistent with our billings for the period. Monitoring cash flow from operations enables us to analyze our financial performance excluding the non-cash effects of certain items such as depreciation, amortization and stock-based

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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.

	Three Months Ended	
	March 31, 2012	March 31, 2011
	(\$ amounts in 000's)	
Free Cash Flow:		
Net cash provided by operating activities	48,518	40,176
Less purchases of property and equipment	(1,624	) (694
Free cash flow (Non-GAAP)	46,894	39,482

Other Non-GAAP Financial Measures

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

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

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

Non-GAAP gross margin is gross margin as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense, which is a non-cash charge. Non-GAAP income from operations is operating income, as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense and the income from a patent settlement. Non-GAAP operating margin is non-GAAP income from operations divided by revenue. The following tables reconcile GAAP gross margin, income from operations, and operating margin to non-GAAP gross margin, non-GAAP income from operations, and

non-GAAP operating margin for the first quarters of 2012 and 2011.

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	Three Months Ended March 31, 2012		March 31, 2011	
	Amount	% of Revenue	Amount	% of Revenue
	(\$ amounts in 000's)			
Total revenue	117,247		93,266	
GAAP gross profit and margin	86,204	74	69,850	75
Stock-based compensation expense	809	—	220	—
Non-GAAP gross profit and margin	87,013	74	70,070	75
GAAP income from operations and margin	18,715	16	17,445	19
Stock-based compensation expense:				
Cost of revenue	809	—	220	—
Research and development	1,957	2	453	—
Sales and marketing	3,443	3	1,900	2
General and administrative	1,037	1	497	1
Total stock-based compensation	7,246	6	3,070	3
Patent settlement	(478)	) —	(477)	) (1)
Non-GAAP income from operations and margin	25,483	22	20,038	21

Non-GAAP operating expenses exclude the impact of stock-based compensation expense and the income from a patent settlement. The following tables reconcile GAAP operating expenses to non-GAAP operating expenses for the first quarters of 2012 and 2011.

	Three Months Ended March 31, 2012		March 31, 2011	
	Amount	% of Revenue	Amount	% of Revenue
	(\$ amounts in 000's)			
Operating Expenses:				
Research and development expenses:				
GAAP research and development expenses	19,667	17	14,421	16
Stock-based compensation	(1,957)	) (2)	(453)	) (1)
Non-GAAP research and development expenses	17,710	15	13,968	15
Sales and marketing expenses:				
GAAP sales and marketing expenses	42,036	36	32,718	35
Stock-based compensation	(3,443)	) (3)	(1,900)	) (2)
Non-GAAP sales and marketing expenses	38,593	33	30,818	33
General and administrative expenses:				
GAAP general and administrative expenses	5,786	5	5,266	6
Stock-based compensation	(1,037)	) (1)	(497)	) (1)
Patent settlement	478	—	477	1
Non-GAAP general and administrative expenses	5,227	4	5,246	6
Total operating expenses:				

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GAAP operating expenses	67,489	58	52,405	57
Stock-based compensation	(6,437)	(6)	(2,850)	(4)
Patent settlement	478	—	477	1
Non-GAAP operating expenses	61,530	52	50,032	54

Non-GAAP net income is net income, as reported in our condensed consolidated statements of operations, excluding the

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impact of stock-based compensation expense and income from a patent settlement. The following tables reconcile GAAP net income as reported on our condensed consolidated statements of operations to non-GAAP net income for the first quarters of 2012 and 2011.

	Three Months Ended	
	March 31, 2012	March 31, 2011
	(\$ amounts in 000's)	
Net Income:		
GAAP net income	14,173	13,587
Stock-based compensation expense ⁽¹⁾	7,246	3,070
Patent settlement ⁽²⁾	(478	) (477
Provision for income taxes ⁽³⁾	5,556	4,556
Non-GAAP income before provision for income taxes	26,497	20,736
Tax effects related to non-GAAP adjustments ⁽⁴⁾	(9,009	) (6,843
Non-GAAP net income	17,488	13,893
Non-GAAP net income per share - diluted	0.11	0.09
Shares used in per share calculation - diluted	165,751	162,864

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

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

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

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

Critical Accounting Policies and Estimates

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

We believe the accounting policies and estimates discussed under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Form 10-K, reflect our more significant judgments and estimates used in the preparation of the consolidated financial statements. There have been no significant changes to our critical accounting policies and estimates as filed in such report.

Recently Adopted Accounting Pronouncements

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

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Results of Operations

Revenue

	Three Months Ended		March 31, 2011		Change	% Change
	March 31, 2012		Amount	% of		
	Amount	% of Revenue	Amount	Revenue		
	(\$ amounts in 000's)					
Revenue:						
Product	53,204	45	40,165	43	13,039	32
Services	62,138	53	48,686	52	13,452	28
Ratable and other revenue	1,905	2	4,415	5	(2,510)	(57)
Total revenue	117,247	100	93,266	100	23,981	26
Revenue by Geography:						
Americas	46,431	40	35,645	38	10,786	30
EMEA	40,886	35	33,641	36	7,245	22
APAC	29,930	25	23,980	26	5,950	25
Total revenue	117,247	100	93,266	100	23,981	26

Total revenue increased \$24.0 million, or 26%, in the first quarter of 2012 compared to the first quarter of 2011 as all three regions demonstrated year-over-year growth. Product revenue increased \$13.0 million, or 32%, compared to the first quarter of 2011, as we experienced higher sales volumes and increased demand for our mid-range products which enabled us to further penetrate into the enterprise market in the retail sector. The higher mix of mid-range products also resulted in slightly lower average selling price compared to the first quarter of 2011. Services revenue increased \$13.5 million, or 28%, in the first quarter of 2012 compared to the first quarter of 2011 due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The decline in ratable and other revenue was primarily due to the decline in amortization of ratable revenue. Excluding the decline in ratable revenue, product and services revenue combined together increased by 30% compared to the first quarter of 2011.

Cost of revenue and gross margin

	Three Months Ended		Change	% Change
	March 31, 2012	March 31, 2011		
	(\$ amounts in 000's)			
Cost of revenue:				
Product	19,067	14,075	4,992	35
Services	11,213	7,781	3,432	44
Ratable and other revenue	763	1,560	(797)	(51)
Total cost of revenue	31,043	23,416	7,627	33
Gross margin (%):				
Product	64.2	65.0	(0.8))
Services	82.0	84.0	(2.0))
Ratable and other revenue	59.9	64.7	(4.8))
Total gross margin	73.5	74.9	(1.4))

Total gross margin decreased 1.4 percentage points in the first quarter of 2012 as both product and services gross margins declined slightly. An increase in stock-based compensation expense negatively impacted total gross margin by 0.7 percentage point. Product gross margin decreased 0.8 percentage point in the first quarter of 2012 compared to the first quarter of 2011, primarily related to an increased mix of sales of our mid-range products which have slightly lower gross margins than our high-end products. From time to time, we have experienced sales of previously reserved inventory. During the first quarter of 2012, we experienced a positive impact of 0.2 percentage point due to the sale of fully reserved inventory compared to a positive impact of 0.4 percentage point in the first quarter of 2011. The 2.0 percentage points decrease in services gross margin was primarily due to our continued investment in our technical support organization to accommodate our expanding customer

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base and higher demands from enterprise customers. In addition, we experienced growth in our professional consulting services which has lower gross margins than our support and subscription services. A \$3.4 million increase in services costs consisted primarily of \$1.9 million of higher cash-based personnel costs related to headcount growth, a \$0.3 million increase in warranty and other expenses, and a \$0.2 million increase in outside contractor costs. Higher stock-based compensation expense of \$0.5 million also reduced services gross margin by 0.8 percentage point compared to the first quarter of 2011.

Operating Expenses

	Three Months Ended		March 31, 2011		Change	% Change
	March 31, 2012		Amount	% of		
	Amount	% of Revenue	Amount	Revenue		
	(\$ amounts in 000's)					
Operating expenses:						
Research and development	19,667	17	14,421	15	5,246	36
Sales and marketing	42,036	36	32,718	35	9,318	28
General and administrative	5,786	5	5,266	6	520	10
Total operating expenses	67,489	58	52,405	56	15,084	29

Research and development expense

Research and development expense increased \$5.2 million, or 36%, in the first quarter of 2012 compared to the first quarter of 2011, primarily due to an increase in personnel costs. Cash-based personnel costs increased \$2.4 million primarily due to increased headcount to support the development of new products and continued enhancements of our existing products, and merit increases. Increases in stock-compensation expense of \$1.5 million, product development and certification expenses of \$0.7 million, supplies, depreciation and other expenses of \$0.5 million, and occupancy-related cost of \$0.2 million also contributed to the overall increase in research and development expense. We intend to continue to invest in our research and development organization but expect expense as a percentage of revenue to decline in the second half of fiscal 2012.

Sales and marketing expense

Sales and marketing expense increased \$9.3 million, or 28%, in the first quarter of 2012 compared to the first quarter of 2011, primarily due to increased personnel costs. Cash-based personnel costs increased \$6.1 million due to higher salaries, commissions, and benefits resulting from increased headcount in order to expand our sales infrastructure. We also incurred a \$1.5 million increase in stock-based compensation expense and a \$1.0 million increase due to marketing related activities. We intend to continue to make investments in our sales resources and infrastructure, which are critical to support sustainable growth but expect sales and marketing expense as a percentage of revenue to decline in the second half of 2012.

General and administrative expense

General and administrative expense increased \$0.5 million, or 10% in the first quarter of 2012, compared to the first quarter of 2011. The increase was primarily due to a \$0.5 million increase in stock-based compensation expense. We expect general and administrative expense as a percentage of revenue to remain at comparable levels during the remainder of fiscal 2012.

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Interest income and other expense, net

	Three Months Ended			
	March 31, 2012	March 31, 2011	Change	% Change
Interest income	1,085	793		