FORTINET INC
Form 10-Q
May 03, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2017
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 001-34511

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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 |
| | | Emerging growth company | o |

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

As of April 28, 2017, there were 175,760.937 shares of the registrant's common stock outstanding.

FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended March 31, 2017
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Part I

ITEM 1. Financial Statements

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

| | March 31, 2017 | December 31, 2016 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $823,249 | $709,003 |
| Short-term investments | 375,423 | 376,522 |
| Accounts receivable—Net of reserves for sales returns and doubtful accounts of $11,685 and $11,235 at March 31, 2017 and December 31, 2016, respectively | 270,111 | 312,998 |
| Inventory | 104,978 | 106,887 |
| Prepaid expenses and other current assets | 42,321 | 33,306 |
| Total current assets | 1,616,082 | 1,538,716 |
| LONG-TERM INVESTMENTS | 242,333 | 224,983 |
| DEFERRED TAX ASSETS | 199,186 | 182,745 |
| PROPERTY AND EQUIPMENT—NET | 155,476 | 137,249 |
| OTHER INTANGIBLE ASSETS—NET | 22,535 | 24,828 |
| GOODWILL | 14,553 | 14,553 |
| OTHER ASSETS | 17,218 | 16,867 |
| TOTAL ASSETS | $2,267,383 | $2,139,941 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | $48,689 | $56,732 |
| Accrued liabilities | 43,449 | 35,640 |
| Accrued payroll and compensation | 73,204 | 78,138 |
| Income taxes payable | 14,129 | 13,588 |
| Deferred revenue | 677,114 | 645,342 |
| Total current liabilities | 856,585 | 829,440 |
| DEFERRED REVENUE | 420,937 | 390,007 |
| INCOME TAX LIABILITIES | 72,993 | 68,551 |
| OTHER LIABILITIES | 18,619 | 14,262 |
| Total liabilities | 1,369,134 | 1,302,260 |
| COMMITMENTS AND CONTINGENCIES (Note 9) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock, $0.001 par value—300,000 shares authorized; 175,443 and 173,078 shares issued and outstanding at March 31, 2017 and December 31, 2016, respectively | 175 | 173 |
| Additional paid-in capital | 850,226 | 800,653 |
| Accumulated other comprehensive loss | (489) | (765) |
| Retained earnings | 48,337 | 37,620 |
| Total stockholders' equity | 898,249 | 837,681 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $2,267,383 | $2,139,941 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| REVENUE: | | |
| Product | $135,253 | $124,572 |
| Service | 205,323 | 160,004 |
| Total revenue | 340,576 | 284,576 |
| COST OF REVENUE: | | |
| Product | 55,297 | 49,313 |
| Service | 35,267 | 28,331 |
| Total cost of revenue | 90,564 | 77,644 |
| GROSS PROFIT: | | |
| Product | 79,956 | 75,259 |
| Service | 170,056 | 131,673 |
| Total gross profit | 250,012 | 206,932 |
| OPERATING EXPENSES: | | |
| Research and development | 51,195 | 44,754 |
| Sales and marketing | 170,400 | 146,103 |
| General and administrative | 22,577 | 19,439 |
| Restructuring charges | 430 | 328 |
| Total operating expenses | 244,602 | 210,624 |
| OPERATING INCOME (LOSS) | 5,410 | (3,692) |
| INTEREST INCOME | 2,392 | 1,746 |
| OTHER INCOME (EXPENSE)—NET | 302 | (1,312) |
| INCOME (LOSS) BEFORE INCOME TAXES | 8,104 | (3,258) |
| BENEFIT FROM INCOME TAXES | (2,613) | (5,376) |
| NET INCOME | $10,717 | $2,118 |
| Net income per share (Note 7): | | |
| Basic | $0.06 | $0.01 |
| Diluted | $0.06 | $0.01 |
| Weighted-average shares outstanding: | | |
| Basic | 174,489 | 171,745 |
| Diluted | 178,278 | 174,421 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Net income | $10,717 | $2,118 |
| Other comprehensive income: | | |
| Change in unrealized loss on investments | 425 | 1,888 |
| Tax provision related to change in unrealized loss on investments | 149 | 661 |
| Other comprehensive income—net of taxes | 276 | 1,227 |
| Comprehensive income | $10,993 | $3,345 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $10,717 | $2,118 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 13,493 | 10,550 |
| Amortization of investment premiums | 973 | 1,497 |
| Stock-based compensation | 33,331 | 28,902 |
| Other non-cash items—net | 1,469 | (372) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable—net | 42,437 | 38,920 |
| Inventory | (3,545) | (527) |
| Deferred tax assets | (16,589) | (16,709) |
| Prepaid expenses and other current assets | (8,261) | 1,029 |
| Other assets | 653 | (911) |
| Accounts payable | (8,287) | (11,426) |
| Accrued liabilities | 2,923 | 300 |
| Accrued payroll and compensation | (5,267) | (2,945) |
| Other liabilities | (1,057) | (1,332) |
| Deferred revenue | 61,776 | 46,106 |
| Income taxes payable | 4,983 | 5,391 |
| Net cash provided by operating activities | 129,749 | 100,591 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of investments | (133,006) | (115,672) |
| Sales of investments | 6,000 | 2,867 |
| Maturities of investments | 109,207 | 108,557 |
| Purchases of property and equipment | (13,526) | (29,956) |
| Net cash used in investing activities | (31,325) | (34,204) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock | 29,515 | 17,785 |
| Taxes paid related to net share settlement of equity awards | (13,693) | (9,441) |
| Repurchase and retirement of common stock | — | (50,000) |
| Net cash provided by (used in) financing activities | 15,822 | (41,656) |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 114,246 | 24,731 |
| CASH AND CASH EQUIVALENTS—Beginning of period | 709,003 | 543,277 |
| CASH AND CASH EQUIVALENTS—End of period | $823,249 | $568,008 |
| NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Liability for purchase of property and equipment | $18,704 | $7,843 |
| Transfers of evaluation units from inventory to property and equipment | $5,681 | $6,671 |

See notes to condensed consolidated financial statements.

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FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation—The unaudited condensed consolidated financial statements of Fortinet, Inc. and its wholly owned subsidiaries (collectively, "we," "us" or "our") have been prepared in accordance with generally accepted accounting principles in the United States ("GAAP") for interim financial information, as well as the instructions to Form 10-Q pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2016, contained in our Annual Report on Form 10-K filed with the SEC on March 1, 2017. In the opinion of management, all adjustments, which includes normal recurring adjustments, considered necessary for a fair presentation have been included. All intercompany balances, transactions and cash flows have been eliminated. The results of operations for the three months ended March 31, 2017 are not necessarily indicative of the results for the full year or for any future periods. The condensed consolidated balance sheet as of December 31, 2016 is derived from the audited consolidated financial statements for the year ended December 31, 2016.

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

There have been no material changes to our significant accounting policies as of and for the three months ended March 31, 2017, except for changes to our policies related to inventory and business combinations. For more information, refer to the "Recently Adopted Accounting Standards."

Recently Adopted Accounting Standards

In January 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") ASU 2017-01—Business Combinations: Clarifying the Definition of a Business, which clarifies the definition of a business to assist organizations with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The definition of a business affects many areas of accounting including acquisitions, disposals, goodwill and consolidation. We elected to early adopt ASU 2017-01 on a prospective basis beginning on January 1, 2017. The adoption of ASU 2017-01 did not have a material impact on our consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11—Inventory: Simplifying the Measurement of Inventory, which requires entities to measure most inventory at the lower of cost and net realizable value, replacing the former methodology of measuring inventory at the lower of cost or market. We adopted ASU 2015-11 on a prospective basis beginning on January 1, 2017. The adoption of ASU 2015-11 did not have a significant impact on our consolidated financial statements.

Recent Accounting Standards Not Yet Effective

In January 2017, the FASB issued ASU 2017-04—Intangibles - Goodwill and Other: Simplifying the Test for Goodwill Impairment. ASU 2017-04 eliminates Step 2 from the goodwill impairment test which measures a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Under ASU 2017-04, an entity should perform its annual or interim goodwill impairment test by comparing

the fair value of the reporting unit with its carrying amount, and should recognize an impairment loss for the amount by which the carrying amount exceeds the reporting unit's fair value, with the loss not exceeding the total amount of goodwill allocated to that reporting unit. ASU 2016-06 will be effective for us beginning on January 1, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed after January 1, 2017. At adoption, this update will require a prospective approach. We intend to adopt ASU 2017-04 in the fourth quarter of 2017. We do not believe that ASU 2017-04 will have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16—Income Taxes: —Intra-Entity Transfer of Assets Other Than Inventory, which requires the recognition of the income tax consequences of an intra-entity transfer of an asset, other than

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

inventory, when the transfer occurs. ASU 2016-06 will be effective for us beginning on January 1, 2018. We are currently evaluating the impact of adopting ASU 2016-16 on our consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13—Financial Instruments—Credit Losses—Measurement of Credit Losses on Financial Instruments, which requires measurement and recognition of expected credit losses for financial assets held. ASU 2016-13 is effective for us beginning on January 1, 2020, with the option to adopt early on January 1, 2019. We are currently evaluating the impact of adopting ASU 2016-13 on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02—Leases, which requires the recognition of right-of-use assets and lease liabilities on the consolidated balance sheet for substantially all leases. The new guidance includes a number of optional practical expedients that entities may elect to apply. The new guidance will also require significant additional disclosures about the amount, timing and uncertainty of cash flows from leases. This new guidance will be effective for us beginning on January 1, 2019, using a modified retrospective approach. We currently anticipate to early adopt ASU 2016-02 on January 1, 2018. Our ability to early adopt is dependent on system readiness, including software procured from third-party providers, if any, and the completion of our analysis of information necessary to quantify the impact on the prior period financial statements. Based on our current lease portfolio, we estimate the value of leased assets and liabilities that may be recognized could be at least $50.0 million. We are continuing to evaluate the impact of ASU 2016-02 and our estimate is subject to change. We do not believe that ASU 2016-02 will have a material impact on our consolidated statements of operations.

In May 2014, the FASB issued ASU 2014-09—Revenue from Contracts with Customers, which outlines a single, comprehensive model for entities to use in accounting for revenue arising from contracts with customers. The core principle of ASU 2014-09 is to recognize revenue when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, accordingly, it is possible more judgment and estimates may be required within the revenue recognition process than is required under existing U.S. GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The FASB has recently issued several amendments to ASU 2014-09, including clarification on accounting for licenses of intellectual property and identifying performance obligations. ASU 2014-09 will be effective for us beginning January 1, 2018.

The two permitted transition methods under ASU 2014-09 are the full retrospective method, in which case ASU 2014-09 would be applied to each prior reporting period presented and the cumulative effect of applying ASU 2014-09 would be recognized at the earliest period shown, or the modified retrospective method, in which case the cumulative effect of applying ASU 2014-09 would be recognized at the date of initial application. Currently, we are in the process of reviewing our historical contracts to quantify the impact on our consolidated financial statements. Depending on the results of our review, there could be changes to the timing of revenue recognition and certain sales commission and related costs associated with obtaining and fulfilling our customer contracts. These changes may include the acceleration of revenue and associated costs on sales to certain channel partners that are currently accounted for only once the product is sold through to the end-customer. We will be required to capitalize and amortize incremental costs related to obtaining customer contracts, such as sales commission costs. We are also in the process of assessing the appropriate changes to our business processes and upgrading our systems and controls to support recognition and disclosure under ASU 2014-09. We otherwise expect to complete our assessment process, including selecting a transition method for adoption, in the next two quarters of 2017.

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

2. FINANCIAL INSTRUMENTS AND FAIR VALUE

The following tables summarize our investments (in thousands):

| | March 31, 2017 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Corporate debt securities | $405,681 | $ 80 | $ (754) | $405,007 |
| Commercial paper | 110,434 | 68 | (26) | 110,476 |
| U.S. government and agency securities | 55,764 | 2 | (89) | 55,677 |
| Municipal bonds | 46,227 | 24 | (59) | 46,192 |
| Certificates of deposit and term deposits [1] | 404 | — | — | 404 |
| Total available-for-sale securities | $618,510 | $ 174 | $ (928) | $617,756 |

| | December 31, 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Corporate debt securities | $379,494 | $ 43 | $ (925) | $378,612 |
| Commercial paper | 95,110 | 23 | (25) | 95,108 |
| U.S. government and agency securities | 64,604 | 16 | (79) | 64,541 |
| Municipal bonds | 59,257 | 3 | (235) | 59,025 |
| Certificates of deposit and term deposits [1] | 4,219 | — | — | 4,219 |
| Total available-for-sale securities | $602,684 | $ 85 | $ (1,264) | $601,505 |

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

The following tables show the gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position (in thousands):

| | March 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | $325,615 | $ (751) | $11,751 | $ (3) | $337,366 | $ (754) |
| U.S. government and agency securities | 46,388 | (89) | — | — | 46,388 | (89) |
| Municipal bonds | 26,833 | (59) | — | — | 26,833 | (59) |
| Commercial paper | 31,172 | (26) | — | — | 31,172 | (26) |
| Total available-for-sale securities | $430,008 | $ (925) | $11,751 | $ (3) | $441,759 | $ (928) |

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

| | December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 12 Months | | 12 Months or Greater | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | $311,980 | $ (910) | $13,541 | $ (15) | $325,521 | $ (925) |
| Municipal bonds | 52,200 | (235) | — | — | 52,200 | (235) |
| U.S. government and agency securities | 33,430 | (79) | — | — | 33,430 | (79) |
| Commercial paper | 17,394 | (25) | — | — | 17,394 | (25) |
| Total available-for-sale securities | $415,004 | $ (1,249) | $13,541 | $ (15) | $428,545 | $ (1,264) |

The contractual maturities of our investments were as follows (in thousands):

| | March 31, 2017 | December 31, 2016 |
|---|---|---|
| Due within one year | $375,423 | $ 376,522 |
| Due within one to three years | 242,333 | 224,983 |
| Total | $617,756 | $ 601,505 |

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 comprehensive income. Realized gains and losses on available-for-sale securities are insignificant in the periods presented and are included in Other income (expense)—net in our condensed consolidated statements of operations. We use the specific identification method to determine the cost basis of investments sold.

The unrealized losses on our available-for-sale securities were caused by fluctuations in market value and interest rates as a result of the economic environment. As the decline in market value are attributable to changes in market conditions and not credit quality, and because we have concluded currently that we neither intend to sell nor is it more likely than not that we will be required to sell these investments prior to a recovery of par value, we do not consider these investments to be other-than temporarily impaired as of March 31, 2017.

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Fair Value of Financial Instruments

Assets Measured at Fair Value on a Recurring Basis

The following tables present the fair value of our financial assets measured at fair value on a recurring basis as of March 31, 2017 and December 31, 2016 (in thousands):

| | March 31, 2017 | | | | December 31, 2016 | | | |
|---|---|---|---|---|---|---|---|---|
| | 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 | $405,007 | $ — | $405,007 | $ — | $378,612 | $ — | $378,612 | $ — |
| Commercial paper | 119,965 | — | 119,965 | — | 105,097 | — | 105,097 | — |
| U.S. government and agency securities | 55,677 | 45,222 | 10,455 | — | 64,541 | 52,082 | 12,459 | — |
| Municipal bonds | 46,192 | — | 46,192 | — | 59,025 | — | 59,025 | — |
| Money market funds | 21,069 | 21,069 | — | — | 38,649 | 38,649 | — | — |
| Certificates of deposit and term deposits | 404 | — | 404 | — | 4,219 | — | 4,219 | — |
| Total | $648,314 | $ 66,291 | $582,023 | $ — | $650,143 | $ 90,731 | $559,412 | $ — |
| | | | | | | | | |
| Reported as: | | | | | | | | |
| Cash equivalents | $30,558 | | | | $48,638 | | | |
| Short-term investments | 375,423 | | | | 376,522 | | | |
| Long-term investments | 242,333 | | | | 224,983 | | | |
| Total | $648,314 | | | | $650,143 | | | |

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the three months ended March 31, 2017.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

3. INVENTORY

Inventory consisted of the following (in thousands):

| | March 31, 2017 | December 31, 2016 |
|---|---|---|
| Raw materials | $16,540 | $ 18,924 |
| Finished goods | 88,438 | 87,963 |
| Inventory | $104,978 | $ 106,887 |

4. PROPERTY AND EQUIPMENT—NET

Property and equipment—net consisted of the following (in thousands):

| | March 31, 2017 | December 31, 2016 |
|---|---|---|
| Computer equipment and software | $70,048 | $ 65,323 |
| Building and building improvements | 56,373 | 49,783 |
| Land | 44,198 | 35,079 |
| Leasehold improvements | 20,542 | 18,699 |
| Evaluation units | 19,701 | 20,173 |
| Furniture and fixtures | 14,153 | 13,995 |
| Construction-in-progress | 6,201 | 4,669 |
| Total property and equipment | 231,216 | 207,721 |
| Less: accumulated depreciation | (75,740) | (70,472) |
| Property and equipment—net | $155,476 | $ 137,249 |

Depreciation expense was $11.2 million and $9.4 million for the three months ended March 31, 2017 and March 31, 2016, respectively.

5. INVESTMENTS IN PRIVATELY HELD COMPANIES

Our investments in the equity securities of privately held companies totaled $11.3 million and $10.3 million as of March 31, 2017 and December 31, 2016, respectively. These investments are accounted for as cost-basis investments, as we own less than 20% of the voting securities in each these investments and do not have the ability to exercise significant influence over operating and financial policies of the respective entities. These investments are carried at historical cost and are recorded as other assets on our condensed consolidated balance sheets and would be measured at fair value if indicators of impairment existed. As of March 31, 2017, no events have occurred that would adversely affect the carrying value of these investments.

As of March 31, 2017, we determined that we had a variable interest in these privately held companies. However, we determined that we were not the primary beneficiary as we did not have the power to direct their activities that most significantly affect their economic performance. The variable interest entities are not required to be consolidated in our condensed consolidated financial statements.

6. GOODWILL AND OTHER INTANGIBLE ASSETS—NET

Goodwill

As of March 31, 2017, we had goodwill of $14.6 million. There were no impairments to goodwill during the three months ended March 31, 2017 or during previous periods.

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

Other Intangible Assets—net

The following tables present other intangible assets—net as of March 31, 2017 and December 31, 2016 (in thousands, except years):

| | March 31, 2017 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Life (in Years) | Gross | Accumulated Amortization | Net |
| Other intangible assets—net: | | | | |
| Finite-lived intangible assets: | | | | |
| Developed technologies and other | 3.8 | $23,984 | $ 10,000 | $13,984 |
| Customer relationships | 4.7 | 14,500 | 7,549 | 6,951 |
| | | 38,484 | 17,549 | 20,935 |
| Indefinite-lived intangible assets: | | | | |
| In-process research and development | | 1,600 | — | 1,600 |
| Total other intangible assets—net | | $40,084 | $ 17,549 | $22,535 |

| | December 31, 2016 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Life (in Years) | Gross | Accumulated Amortization | Net |
| Other intangible assets—net: | | | | |
| Finite-lived intangible assets: | | | | |
| Developed technologies and other | 3.8 | $23,984 | $ 8,750 | $15,234 |
| Customer relationships | 4.7 | 14,500 | 6,506 | 7,994 |
| | | 38,484 | 15,256 | 23,228 |
| Indefinite-lived intangible assets: | | | | |
| In-process research and development | | 1,600 | — | 1,600 |
| Total other intangible assets—net | | $40,084 | $ 15,256 | $24,828 |

Amortization expense was $2.3 million and $1.2 million during the three months ended March 31, 2017 and March 31, 2016, respectively. The following table summarizes estimated future amortization expense of finite-lived intangible assets—net (in thousands):

| | Amount |
|---|---|
| Years: | |
| 2017 (remainder) | $6,280 |
| 2018 | 6,885 |
| 2019 | 5,406 |
| 2020 | 2,364 |
| Total | $20,935 |

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

7. NET INCOME PER SHARE

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

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Numerator: | | |
| Net income | $10,717 | $ 2,118 |
| Denominator: | | |
| Basic shares: | | |
| Weighted-average common stock outstanding-basic | 174,489 | 171,745 |
| Diluted shares: | | |
| Weighted-average common stock outstanding-basic | 174,489 | 171,745 |
| Effect of potentially dilutive securities: | | |
| RSUs | 2,216 | 1,020 |
| Stock options | 1,523 | 1,632 |
| ESPP | 50 | 24 |
| Weighted-average shares used to compute diluted net income per share | 178,278 | 174,421 |
| Net income per share: | | |
| Basic | $0.06 | $ 0.01 |
| Diluted | $0.06 | $ 0.01 |

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 thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| RSUs | 2,505 | 6,351 |
| Stock options | 1,118 | 1,559 |
| ESPP | 262 | 282 |
| | 3,885 | 8,192 |

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

8. RESTRUCTURING CHARGES

In 2016 and 2015, we implemented plans to restructure and further improve efficiencies in our operations due primarily to acquisitions. The remaining restructuring reserve as of March 31, 2017 is included in accrued liabilities on the condensed consolidated balance sheets and is expected to be paid in 2017. Restructuring charges related to these plans consisted primarily of employee severance and other one-time benefits paid in cash and are included in operating expense in the condensed consolidated statements of operations.

Activities related to the restructuring actions are summarized as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Balance at beginning of period | $1,151 | $3,918 |
| Costs incurred | 430 | 328 |
| Cash payments | (567) | (1,407) |
| Non-cash items | — | (89) |
| Balance at end of period | $1,014 | $2,750 |

9. COMMITMENTS AND CONTINGENCIES

The following table summarizes our future principal contractual obligations as of March 31, 2017 (in thousands):

| | Total | 2017 (remainder) | 2018 | 2019 | 2020 | 2021 | Thereafter |
|---|---|---|---|---|---|---|---|
| Operating lease commitments | $61,354 | $ 13,083 | $14,401 | $11,972 | $9,497 | $4,088 | $ 8,313 |
| Inventory purchase commitments | 68,846 | 68,846 | — | — | — | — | — |
| Other contractual commitments and open purchase orders | 71,534 | 60,959 | 8,402 | 1,522 | 560 | 91 | — |
| Total | $201,734 | $ 142,888 | $22,803 | $13,494 | $10,057 | $4,179 | $ 8,313 |

Operating Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2024. Certain leases require us to pay variable costs such as taxes, maintenance, and insurance. The terms of certain operating leases also provide for renewal options and escalation clauses. Rent expense was $4.5 million and $4.6 million during the three months ended March 31, 2017 and March 31, 2016, respectively. Rent expense is recognized using the straight-line method over the term of the lease.

Inventory Purchase Commitments—Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of March 31, 2017, we had $68.8 million of open purchase orders with our independent contract manufacturers that may not be

cancelable.

Other Contractual Commitments and Open Purchase Orders—In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations in the ordinary course of business for which we have not received goods or services. As of March 31, 2017, we had $71.5 million in other contractual commitments that may not be cancelable. We also had other contractual commitments for the purchase of certain real estate properties adjacent to our corporate headquarters amounting to $12.8 million, which we capitalized as part of property and equipment.

Litigation—We are involved in disputes, litigation, and other legal actions. For lawsuits where we are the defendant, we are in the process of defending these litigation matters, and while there can be no assurances and the outcome of these matters is currently not determinable, we currently believe that there are no existing claims or proceedings that are likely to have a material adverse effect on our financial position. There are many uncertainties associated with any litigation and these

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

actions or other third-party claims against us may cause us to incur costly litigation fees, including contingent legal fees with related parties, costs and substantial settlement charges, and possibly subject us to damages and other penalties. In addition, the resolution of any intellectual property litigation may require us to make royalty payments, which could adversely affect our gross margins in future periods. If any of those events were to occur, our business, financial condition, results of operations, and cash flows could be adversely affected. The actual liability in any such matters may be materially different from our estimates, if any, which could result in the need to adjust the liability and record additional expenses. As required under ASC 450, Contingencies, issued by the FASB, we accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss.

In October 2016, we received a letter from the United States Attorney's Office for the Northern District of California requesting information relating to our compliance with the Trade Agreements Act. This inquiry is ongoing and we are fully cooperating with this inquiry.

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

10. STOCKHOLDERS' EQUITY

Stock-Based Compensation Plans

We have stock-based compensation plans pursuant to which we have granted stock options and RSUs. We also have an ESPP for all eligible employees. As of March 31, 2017, there were a total of 50,087,833 shares of common stock available for grant under our stock-based compensation plans.

Restricted Stock Units

The following table summarizes the activity and related information for RSUs for the periods presented below (in thousands, except per share amounts):

| | Restricted Stock Units Outstanding | |
|---|---|---|
| | Number of Shares | Weighted-Average Grant Date Fair Value per Share |
| Balance—December 31, 2016 | 6,509 | $ 31.01 |
| Granted | 2,582 | 37.21 |
| Forfeited | (301) | 33.80 |

| | | |
|---|---|---|
| Vested | (1,299 ) | 27.43 |
| Balance—March 31, 2017 | 10,491 | $ 33.04 |

As of March 31, 2017, total compensation expense related to unvested RSUs that were granted to employees and non-employees under the 2009 Plan, but not yet recognized, was $310.3 million. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.9 years.

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

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

The following summarizes the number and value of the shares withheld for employee taxes (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Shares withheld for taxes | 413 | 343 |
| Amount withheld for taxes | $13,693 | $ 9,441 |

Employee Stock Options

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

| | Three months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Expected term in years | 4.4 | 4.3 |
| Volatility | 36 % | 43 % |
| Risk-free interest rate | 1.9% | 1.1 % |
| Dividend rate | — % | — % |

The following table summarizes the stock option activity and related information for the periods presented below (in thousands, except exercise prices and contractual life):

| | Options Outstanding | | | |
|---|---|---|---|---|
| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value |
| Balance—December 31, 2016 | 6,187 | $ 23.79 | | |
| Granted | 498 | 37.24 | | |
| Forfeited | (46 ) | 27.24 | | |
| Exercised | (855 ) | 14.67 | | |
| Balance—March 31, 2017 | 5,784 | $ 26.27 | | |
| Options vested and expected to vest—March 31, 2017 | 5,784 | $ 26.27 | 3.4 | $ 71,951 |
| Options exercisable—March 31, 2017 | 3,820 | $ 23.91 | 2.2 | $ 56,071 |

The aggregate intrinsic value represents the pre-tax difference between the exercise price of stock options and the quoted market price of our common stock on March 31, 2017, for all in-the-money stock options. As of March 31, 2017, total compensation expense related to unvested stock options granted to employees but not yet recognized was $19.5 million. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 3.0 years.

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

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Weighted-average fair value per share granted | $12.22 | $ 8.68 |
| Intrinsic value of options exercised | 17,898 | 19,424 |
| Fair value of options vested | 3,395 | 2,084 |

Employee Stock Purchase Plan

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Expected term in years | 0.5 | 0.5 |
| Volatility | 33 % | 48 % |
| Risk-free interest rate | 0.7% | 0.4 % |
| Dividend rate | — % | — % |

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Weighted-average fair value per share granted | $9.28 | $ 7.19 |
| Shares issued under the ESPP | 634 | 614 |
| Weighted-average price per share issued | $27.97 | $ 20.49 |

Stock-based Compensation Expense

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Cost of product revenue | $342 | $ 280 |
| Cost of service revenue | 2,310 | 2,134 |
| Research and development | 7,898 | 7,143 |
| Sales and marketing | 19,026 | 15,815 |

| | | |
|---|---|---|
| General and administrative | 3,755 | 3,530 |
| Total stock-based compensation expense | $33,331 | $ 28,902 |

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

The following table summarizes stock-based compensation expense by award type (in thousands):

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| RSUs | $29,041 | $ 25,103 |
| Stock options | 1,845 | 1,954 |
| ESPP | 2,445 | 1,845 |
| Total stock-based compensation expense | $33,331 | $ 28,902 |

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| Income tax benefit associated with stock-based compensation | $6,645 | $ 7,321 |

Share Repurchase Program

In January 2016, our board of directors approved the 2016 Share Repurchase Program (the "2016 Repurchase Program"), which authorizes the repurchase of up to $200.0 million of our outstanding common stock through December 31, 2017. In October 2016, our board of directors authorized the purchase of an additional $100.0 million of shares of our common stock under the 2016 Repurchase Program, increasing our current authorization to $300.0 million through December 31, 2017. Under the 2016 Repurchase Program, share repurchases may be made by us from time to time in privately negotiated transactions or in open market transactions. The 2016 Repurchase Program does not require us to purchase a minimum number of shares, and may be suspended, modified or discontinued at any time without prior notice. There were no shares repurchased under the 2016 Repurchase Program during the three months ended March 31, 2017. As of March 31, 2017, $189.2 million remained available for future share repurchases under the 2016 Repurchase Program.

11. INCOME TAXES

Our effective tax rate was a benefit of (32)% for the three months ended March 31, 2017, compared to an effective tax rate of 165% for the same period last year. The effective tax rates for the periods presented are comprised of U.S. federal and state taxes, withholding taxes and foreign income taxes. The tax rate for the three months ended March 31, 2017 was impacted by the excess tax benefits of $5.5 million on stock options, which was a significant benefit on our income before income taxes. The tax rate for the three months ended March 31, 2016 was also impacted by significant excess tax benefits of $3.6 million on stock options on our loss before income taxes.

As of March 31, 2017 and December 31, 2016, unrecognized tax benefits were $69.4 million and $65.5 million, respectively. The total amount of $67.7 million in unrecognized tax benefits, if recognized, would favorably affect our effective tax rate.

It is our policy to classify accrued interest and penalties related to uncertain tax benefits in the provision for income taxes. As of March 31, 2017 and December 31, 2016, accrued interest and penalties were $10.5 million and $9.5 million, respectively.

As of March 31, 2017, there was no unrecognized tax benefits that we expect would change significantly over the next 12 months.

We file income tax returns in the U.S. federal jurisdiction and in various U.S. state and foreign jurisdictions. Generally, we are no longer subject to U.S. state and non-U.S. income tax examinations by tax authorities for tax years prior to 2009. We are no longer subject to examination by U.S federal income tax authorities for tax years prior to 2012. We are currently under examination by U.S federal income tax authorities for tax years 2012, 2013 and 2014. We have filed a waiver extending the statute of limitations to September 15, 2018 for U.S. federal income tax returns for tax years 2012 and 2013. In addition, the tax authorities in France are examining the inter-company relationship between Fortinet, Inc., Fortinet France and

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Fortinet Singapore. Subsequent to the three months ended March 31, 2017, we received a notice from the French tax authorities that an audit was officially opened for tax years from 2007 to 2015. Our Japan tax audit for tax years 2013, 2014 and 2015 was closed with no material adjustment.

12. DEFINED CONTRIBUTION PLANS

Our tax-deferred savings plan under our 401(k) Plan, permits participating employees to defer a portion of their pre-tax earnings. In Canada, we have a Group Registered Retirement Savings Plan Program (the "RRSP"), which permits participants to make tax deductible contributions. Our board of directors approved 50% matching contributions on employee contributions up to 4% of each employee's eligible earnings. Our matching contributions to our 401(k) Plan and the RRSP for the three months ended March 31, 2017 and March 31, 2016 were $1.3 million and $1.0 million, respectively.

13. SEGMENT AND SIGNIFICANT CUSTOMER INFORMATION

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

| Revenue | Three Months Ended March 31, 2017 | March 31, 2016 |
|---|---|---|
| Americas: | | |
| U.S. | $90,772 | $75,558 |
| Canada | 37,345 | 31,305 |
| Latin America ("LATAM") | 18,247 | 13,183 |
| Total Americas | 146,364 | 120,046 |
| Europe, Middle East and Africa ("EMEA") | 126,149 | 105,491 |
| Asia Pacific ("APAC") | 68,063 | 59,039 |
| Total revenue | $340,576 | $284,576 |

| Property and Equipment—net | March 31, 2017 | December 31, 2016 |
|---|---|---|
| Americas: | | |
| U.S. | $111,464 | $96,414 |
| Canada | 16,274 | 12,881 |

| | | |
|---|---|---|
| LATAM | 475 | 607 |
| Total Americas | 128,213 | 109,902 |
| EMEA: | | |
| France | 12,854 | 13,241 |
| Other EMEA | 6,232 | 6,391 |
| Total EMEA | 19,086 | 19,632 |
| APAC | 8,177 | 7,715 |
| Total property and equipment—net | $155,476 | $137,249 |

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

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

| | Three Months Ended March 31, 2017 | March 31, 2016 |
|---|---|---|
| Exclusive Networks Group | 20% | 19 % |
| Fine Tec Computers | 12% | * |

* Represents less than 10%

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

| | March 31, 2017 | December 31, 2016 |
|---|---|---|
| Exclusive Networks Group | 22 % | 26 % |
| Fine Tec Computers | 15 % | 10 % |

14. ACCUMULATED OTHER COMPREHENSIVE LOSS

The following table summarizes the changes in accumulated balances of other comprehensive loss (in thousands):

| | March 31, 2017 | | |
|---|---|---|---|
| | Unrealized losses on investments | Tax provision related to items of other comprehensive income or loss | Total |
| Beginning balance | $(1,179) | $ 414 | $(765) |
| Other comprehensive income before reclassifications | 424 | (149) | 275 |
| Amounts reclassified from accumulated other comprehensive loss | 1 | — | 1 |
| Net current-period other comprehensive income | 425 | (149) | 276 |
| Ending balance | $(754) | $ 265 | $(489) |

Amounts reclassified from accumulated other comprehensive loss for unrealized losses on investments and tax provision related to items of other comprehensive income or loss are recorded in Other income (expense)—net and in Benefit from income taxes, respectively.

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

15. RELATED PARTY TRANSACTIONS

The son of one member of our board of directors is a partner of an outside law firm that we utilize for certain complex litigation matters. Expenses for legal services provided by the law firm were $0.1 million and $0.3 million during the three months ended March 31, 2017 and March 31, 2016, respectively. Of such amounts, $0.2 million was incurred under contingent fee arrangements in the three months ended March 31, 2016. There were no expenses incurred under contingent fee arrangements during the three months ended March 31, 2017. Amounts due and payable to the law firm were $0.1 million as of March 31, 2017 and December 31, 2016.

16. SUBSEQUENT EVENT

In April 2017, we purchased real estate property in Vancouver, Canada totaling approximately 282,000 square feet for a total cash payment of approximately $85.0 million.

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

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

- continued growth and market share gains;
- variability in sales in certain product categories from year to year and between quarters;
- expected impact of sales of certain products and services;
- the impact of macro-economic and geopolitical factors on our international sales;
- the proportion of our revenue that consists of our product and service revenue, and the mix of billings between products and services, and the duration of service contracts;
- the impact of our product innovation strategy;
- drivers of long-term growth and operating leverage, such as increased sales productivity, increased functionality and value in our standalone and bundled security subscription and support service offerings;
- growing our sales to enterprise, service provider and government organizations, the impact of sales to these organizations on our long-term growth, expansion and operating results, and the effectiveness of our internal sales organization;
- trends in revenue, costs of revenue and gross margin;
- trends in our operating expenses, including sales and marketing expense, research and development expense, general and administrative expense, and expectations regarding these expenses as a percentage of revenue;
- continued investments in research and development;
- managing our continued investments in sales and marketing, and the impact of those investments;
- expectations regarding uncertain tax benefits and our effective tax rate;
- expectations regarding spending related to real estate and other capital expenditures and the impact on free cash flows;
- competition in our markets;
- integration of acquired companies and technologies and expectations related to acquisitions;
- success and expansion of our enterprise resource planning system;
- our intentions regarding repatriation of cash, cash equivalents and investments held by our international subsidiaries and the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next

12 months;

- other statements regarding our future operations, financial condition and prospects and business strategies; and
- adoption of new accounting standards, including those related to revenue recognition and accounting for leases.

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

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differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and, in particular, the risks discussed under the heading "Risk Factors" in Part II, Item 1A of this Quarterly Report on Form 10-Q and those discussed in other documents we file with the Securities and Exchange Commission (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 cybersecurity solutions to a wide variety of enterprises, service providers and government organizations of all sizes across the globe, including a majority of the 2016 Fortune 100. Our cybersecurity solutions are designed to provide broad, rapid protection against dynamic and sophisticated security threats, while simplifying the information technology ("IT") and security infrastructure of our end-customers.

The three key areas driving our business are the changing cyber threat landscape, expanding need for regulatory compliance and evolving network security infrastructure. The cyber threat landscape continues to change at a rapid pace, with network attacks continually morphing into vehicles for malware, such as ransomware, and the challenge of having to comply with a variety of constantly changing regulatory requirements. Our end-customers' infrastructures are rapidly evolving to leverage new technologies such as on-demand cloud and internet on demand, and changing web traffic patterns require end-customers to increase the bandwidth available across their network. These three drivers mean end-customers are constantly evaluating upgrades or deployments of new cybersecurity solutions.

The Fortinet Security Fabric has been developed to provide unified security across the entire network, including network core, endpoints, applications, data centers, access and private and public cloud, and is designed to enable traditionally disparate security devices to work together as an integrated and collaborative whole. It delivers integrated scalability, access control, awareness, security, traffic segmentation, centralized management and orchestration. It is built around an open framework to ensure interoperability and synchronization of intelligence and response, and does so across the distributed network security infrastructure, including both from the cloud and for the cloud. At the core of the Fortinet Security Fabric are our FortiGate physical products and software licenses, which ship with a broad set of security services, including firewall, virtual private network, anti-malware, anti-spam, application control, intrusion prevention, access control, web filtering, traffic and device segmentation and advanced threat protection ("ATP"). Through these security services, our FortiGuard Labs team provides updates using threat research and a global cloud network of data collection and intelligence resources to deliver subscription-based security services to FortiGate appliances and software products. We continually certify the security effectiveness of our security updates through independent test organizations, such as NSS Labs. Our FortiOS operating system provides the foundation for all FortiGate security functions. The latest enhancements to the FortiOS 5.6 offers end-customers the ability to manage security capabilities across their cloud assets' and software-defined wireless area networks.

Enterprise customers select the form and deployment method that best meet their specific security requirements, such as a high-speed data center firewall at the network core, a next generation firewall at the edge, an internal segmentation firewall between network zones, a distributed enterprise firewall at branch sites or software- and hardware-based solutions designed for virtualized and cloud environments. Many smaller businesses also tend to deploy unified threat management devices. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-20 to -100 series, designed for small businesses, FortiGate-200 to -900 series for medium-sized businesses, to the FortiGate-1000 to -7000 series for large enterprises and service providers. Our network security platform also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to application control, anti-virus, intrusion prevention, web filtering and anti-spam functionality. End-customers may also purchase FortiManager and FortiAnalyzer products in conjunction with a FortiGate deployment to provide enterprise-class centralized management, analysis and reporting capabilities. FortiSIEM provides organizations with a solution for analyzing and managing network security,

performance and compliance standards across our and other vendors' products. Finally, end-customers may purchase FortiCare technical support services for our products and FortiCare professional services to assist in the design, implementation and maintenance of their networks.

We complement our core FortiGate product line with other products and software that offer additional protection from security threats to other critical areas of the enterprise. These products include our FortiMail email security, FortiSandbox ATP, FortiWeb web application firewall and FortiDDoS security appliances, as well as our FortiClient endpoint security software, FortiSIEM software, FortiAP secure wireless access points and FortiSwitch secure switch connectivity products. Our technology also positions us to deliver security to the cloud and for the cloud. Sales of our cloud-related products and services across public, private and hybrid cloud environments continue to grow faster on a percentage basis than other parts of our business.

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Financial Highlights

- We recorded total revenue of $340.6 million in the three months ended March 31, 2017, an increase of 20% compared to the same period last year. Product revenue was $135.3 million in the three months ended March 31, 2017, an increase of 9% compared to the same period last year. Service revenue was $205.3 million in the three months ended March 31, 2017, an increase of 28% compared to the same period last year.

- Cash, cash equivalents and investments were $1.44 billion as of March 31, 2017, an increase of $130.5 million, or 10%, from December 31, 2016.

- Deferred revenue was $1.10 billion as of March 31, 2017, an increase of $62.7 million, or 6%, from December 31, 2016.

- We generated cash flows from operating activities of $129.7 million in the three months ended March 31, 2017, an increase of $29.2 million, or 29%, compared to the same period last year.

During the three months ended March 31, 2017, our revenue growth was driven by the strength in sales of our products, including FortiGate products, our renewals of service contracts and the sale of our enterprise bundles. Our high-end products accounted for 36% of billings, which reflected strong sales to large enterprises and an increase in large deals. Our mid-range products accounted for 31% of billings, and our entry-level products accounted for 33% of billings. In addition, we continue to see a shift to higher services growth, which reflects our ongoing success in driving higher-priced subscription bundles and metered model business. On a geographic basis, revenue continues to be diversified globally, which remains a key strength of our business.

During the three months ended March 31, 2017, operating expenses increased by $34.0 million, or 16%, as compared to the same period last year. The increase was primarily driven by our investments made to expand our sales coverage, grow our marketing capabilities, develop new products and scale our customer support. We also continued to invest in research and development to strengthen our technology. We believe that continued product innovation has strengthened our technology and resulted in market share gains. Headcount increased by 1% to 4,711 employees and contractors as of March 31, 2017, up from 4,665 as of December 31, 2016.

Business Model

Our sales strategy is based on a distribution model whereby we primarily sell our products, software licenses and services directly to distributors which sell to resellers and service providers, which, in turn, sell to our end-customers. In certain cases, we sell directly to large service providers and major systems integrators. We also offer our products through Amazon Web Services and Microsoft Azure. While the revenue from such sales are still relatively insignificant, they have increased significantly in recent periods on a percentage basis and are aligned with the networking trends of our customers and the industry as a whole.

Typically, FortiGuard security subscription services and FortiCare technical support services are purchased along with our physical products and software licenses, most frequently as part of a bundle offering that includes hardware and services functionality. We generally invoice at the time of our sale for the total price of the products and security and technical support services, and the invoice is payable within 30 to 90 days. We also invoice certain software licenses and services on a monthly basis.

We generally recognize product revenue up front, and recognize revenue for the sale of new and the renewal of existing FortiGuard security subscription services and FortiCare technical support services contracts ratably. We

recognize revenue for certain software licenses up front as product revenue and, to a lesser extent, recognize other software licenses over the term of the agreement as services revenue. We recognize the security and support revenue over the service period, which is typically one to three years, but can be as long as five years. Sales of new and renewal services are a source of recurring revenue and increase our deferred revenue balance, which has contributed to our positive cash flow from operations.

Our approach to network security is defined by our Security Processing Unit (“SPU”) hardware architecture. The SPU includes three lines of proprietary Applications-Specific Integrated Circuits (“ASICs”), content processor, network processor and the system on a chip. The ASICs are designed for highly efficient execution of computationally intensive tasks such as policy enforcement, threat detection and encryption. As such ASIC based solutions can run many security applications simultaneously without a significant reduction in performance.

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Key Metrics

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

| | Three Months Ended Or As Of | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| | (in thousands) | |
| Revenue | $340,576 | $284,576 |
| Deferred revenue | $1,098,051 | $837,188 |
| Billings (non-GAAP) | $403,278 | $330,461 |
| Cash, cash equivalents and investments | $1,441,005 | $1,194,487 |
| Net cash provided by operating activities | $129,749 | $100,591 |
| Free cash flow (non-GAAP) | $116,223 | $70,635 |

Deferred revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. The majority of our deferred revenue balance consists of the unrecognized portion of service revenue from FortiGuard security subscription and FortiCare technical support service contracts, which is recognized as revenue ratably over the contractual service period. We monitor our deferred revenue balance, growth and the mix of short-term and long-term deferred revenue because it represents a significant portion of revenue to be recognized in future periods. Deferred revenue was $1.10 billion as of March 31, 2017, an increase of $62.7 million, or 6%, from December 31, 2016.

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

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

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| | (in thousands) | |
| Billings: | | |
| Revenue | $340,576 | $284,576 |

| | | |
|---|---|---|
| Add change in deferred revenue | 62,702 | 45,885 |
| Total billings (non-GAAP) | $403,278 | $330,461 |

Free cash flow (non-GAAP). We define free cash flow as net cash provided by operating activities minus capital expenditures such as purchases of real estate and other property and equipment. We believe free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after capital expenditures, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, repurchasing outstanding common stock and strengthening the balance sheet. However, free cash flow is not intended to represent our residual cash flow available for discretionary expenditures, since we may have other non-discretionary expenditures that are not deducted from the measure. A limitation of using free cash flow rather than the GAAP

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measure of net cash provided by operating activities is that free cash flow does not represent the total increase or decrease in the cash, cash equivalents and investments balance for the period because it excludes cash provided by or used for other investing and financing activities. Management accounts for this limitation by providing information about our capital expenditures and other investing and financing activities on the face of the cash flow statement and under "—Liquidity and Capital Resources" and by presenting cash flow from investing and financing activities in our reconciliation of free cash flows. In addition, it is important to note that other companies, including companies in our industry, may not use free cash flow, may calculate free cash flow in a different manner than we do or may use other financial measures to evaluate their performance, all of which could reduce the usefulness of free cash flows as a comparative measure. A reconciliation of free cash flow to net cash provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below:

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| | (in thousands) | |
| Free Cash Flow: | | |
| Net cash provided by operating activities | $129,749 | $100,591 |
| Less purchases of property and equipment | (13,526) | (29,956) |
| Free cash flow (non-GAAP) | $116,223 | $70,635 |
| Net cash used in investing activities | $(31,325) | $(34,204) |
| Net cash provided by (used in) financing activities | $15,822 | $(41,656) |

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with GAAP. These principles require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, cost of revenue and expenses, and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

There were no material changes to our critical accounting policies and estimates as of and for the three months ended March 31, 2017, as compared to the critical accounting policies and estimates described in our Annual Report on Form 10-K filed with the SEC on March 1, 2017 (the "Form 10-K").

Recent Accounting Pronouncements

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

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Results of Operations

Three Months Ended March 31, 2017 and March 31, 2016

Revenue

| | Three Months Ended March 31, 2017 | | | March 31, 2016 | | | | |
|---|---|---|---|---|---|---|---|---|
| | Amount | % of Revenue | | Amount | % of Revenue | | Change | % Change |
| | (in thousands, except percentages) | | | | | | | |
| Revenue: | | | | | | | | |
| Product | $135,253 | 40 | % | $124,572 | 44 | % | $10,681 | 9 % |
| Service | 205,323 | 60 | | 160,004 | 56 | | 45,319 | 28 |
| Total revenue | $340,576 | 100 | % | $284,576 | 100 | % | $56,000 | 20 % |
| Revenue by geography: | | | | | | | | |
| Americas | $146,364 | 43 | % | $120,046 | 42 | % | $26,318 | 22 % |
| Europe, Middle East and Africa | 126,149 | 37 | | 105,491 | 37 | | 20,658 | 20 |
| Asia Pacific | 68,063 | 20 | | 59,039 | 21 | | 9,024 | 15 |
| Total revenue | $340,576 | 100 | % | $284,576 | 100 | % | $56,000 | 20 % |

Total revenue increased by $56.0 million, or 20%, during the three months ended March 31, 2017 compared to the same period last year. On a geographic basis, we continued to experience diversification globally. Revenue from all our regions grew, with the Americas contributing the largest portion of our revenue growth both on an absolute dollar and on a percentage basis. Product revenue increased by $10.7 million, or 9%, in the three months ended March 31, 2017 compared to the same period last year. The increase in product revenue was primarily driven by the strength in sales of our FortiGate products and our enterprise bundles. Service revenue increased by $45.3 million, or 28%, in the three months ended March 31, 2017 compared to the same period last year. The increase in service revenue was primarily due to the recognition of revenue from our growing deferred revenue balance consisting of FortiGuard security subscription and FortiCare technical support contracts sold to a larger customer base, as well as the renewals of similar contracts sold in earlier periods. We continued to see the shift from product revenue to higher-margin, recurring service revenue, which reflected our ongoing success in driving sales of enterprise bundles.

Cost of revenue and gross margin

| | Three Months Ended March 31, 2017 | March 31, 2016 | Change | % Change |
|---|---|---|---|---|
| | (in thousands, except percentages) | | | |
| Cost of revenue: | | | | |
| Product | $55,297 | $49,313 | $5,984 | 12 % |
| Service | 35,267 | 28,331 | 6,936 | 25 |
| Total cost of revenue | $90,564 | $77,644 | $12,920 | 17 % |
| Gross margin: | | | | |
| Product | 59.1 % | 60.4 % | (1.3 )% | |
| Service | 82.8 | 82.3 | 0.5 | |
| Total gross margin | 73.4 % | 72.7 % | 0.7 % | |

Total gross margin increased by 0.7 percentage points in the three months ended March 31, 2017 compared to the same period last year. Product gross margin decreased by 1.3 percentage points in the three months ended March 31, 2017

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compared to the same period last year. The decrease in product gross margin was primarily due to higher inventory reserves and other charges.

Service gross margin increased by 0.5 percentage points in the three months ended March 31, 2017 as compared to the same period last year, as we scaled efficiencies resulting from an increased mix of higher-margin service revenue. Cost of service revenue increased by $6.9 million and was comprised primarily of personnel costs.

Operating expenses

| | Three Months Ended | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | March 31, 2017 | | | March 31, 2016 | | | Change | % Change | |
| | Amount | % of Revenue | | Amount | % of Revenue | | | | |
| | (in thousands, except percentages) | | | | | | | | |
| Operating expenses: | | | | | | | | | |
| Research and development | $51,195 | 15 | % | $44,754 | 16 | % | $6,441 | 14 | % |
| Sales and marketing | 170,400 | 50 | | 146,103 | 51 | | 24,297 | 17 | |
| General and administrative | 22,577 | 7 | | 19,439 | 7 | | 3,138 | 16 | |
| Restructuring charges | 430 | — | | 328 | — | | 102 | 31 | |
| Total operating expenses | $244,602 | 72 | % | $210,624 | 74 | % | $33,978 | 16 | % |

Research and development

Research and development expense increased by $6.4 million, or 14%, in the three months ended March 31, 2017 compared to the same period last year, primarily due to an increase of $4.5 million in personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Historically, we have refreshed our ASICs on a three- to four-year cycle and the refreshes have demonstrated significant performance improvements. We intend to continue to invest in our research and development organization, but expect research and development expense as a percentage of total revenue to remain at a relatively comparable level during the remainder of 2017.

Sales and marketing

Sales and marketing expense increased by $24.3 million, or 17%, in the three months ended March 31, 2017 compared to the same period last year, primarily due to an increase of $19.4 million in personnel costs as we continued to increase our sales and marketing headcount. In addition, amortization expense increased by $1.5 million related to intangible assets acquired from AccelOps, Inc. (“AccelOps”). As a percentage of total revenue, sales and marketing expense decreased as we focused on scaling our investments in our sales force and marketing programs. We intend to continue to make investments in our sales resources and infrastructure and marketing strategy, which are critical to support growth, but expect sales and marketing expense as a percentage of total revenue to decrease during the remainder of 2017.

General and administrative

General and administrative expense increased by $3.1 million, or 16%, in the three months ended March 31, 2017 compared to the same period last year. Personnel costs increased by $1.7 million as we continued to increase headcount. In addition, litigation settlement expense increased by $1.6 million. We also incurred expense of $1.1 million due to third-party costs related to the preparation and implementation of the new revenue recognition

standards. As a percentage of total revenue, we expect general and administrative expense to increase during the remainder of 2017 as we continue to implement the new revenue recognition standard.

Restructuring

Restructuring expenses of $0.4 million in the three months ended March 31, 2017 primarily relate to our restructuring activities to improve operating efficiencies due to the acquisition of AccelOps and certain other activities. Restructuring charges of $0.3 million during the three months ended March 31, 2016 primarily related to continued restructuring activities related to the acquisition of Meru Networks, Inc. (“Meru”) and reducing our combined cost structure relative to Meru. See Note 8 of the

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notes to our condensed consolidated financial statements for additional details, including the types of expenses incurred and cash payments made. See also the “Liquidity and Capital Resources” below.

Interest income and other income (expense)—net

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2017 | March 31, 2016 | Change | % Change |
| | (in thousands, except percentages) | | | |
| Interest income | $2,392 | $1,746 | $646 | 37% |
| Other income (expense)—net | 302 | (1,312) | 1,614 | (123)% |

Interest income increased by $0.6 million, or 37%, during the three months ended March 31, 2017 as compared to the same period last year due to interest earned on higher invested balances of cash, cash equivalents and investments. Interest income varies depending on our average investment balances during the period, types and mix of investments, and market interest rates. The increase in other income (expense)—net in the three months ended March 31, 2017 as compared to the same period last year was the result of higher foreign currency exchange gains.

Benefit from income taxes

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2017 | March 31, 2016 | Change | % Change |
| | (in thousands, except percentages) | | | |
| Benefit from income taxes | $(2,613) | $(5,376) | $2,763 | (51)% |
| Effective tax rate (%) | (32)% | 165.0% | (197)% | — |

Our effective tax rate was a benefit of (32)% for the three months ended March 31, 2017, compared to an effective tax rate of 165% for the same period last year. The effective tax rates for the periods presented are comprised of U.S. federal and state taxes, withholding taxes and foreign income taxes. The tax rate for the three months ended March 31, 2017 is impacted by the excess tax benefits of $5.5 million on stock options, which was a significant benefit on our income before income taxes. The tax rate for the three months ended March 31, 2016 was also impacted by significant excess tax benefits of $3.6 million on stock options on our loss before income taxes.

Within the next 12 months, we do not believe there will be a decrease in uncertain tax benefits that could significantly impact our effective tax rate.

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Liquidity and Capital Resources

| | As of | |
|---|---|---|
| | March 31, 2017 | December 31, 2016 |
| | (in thousands) | |
| Cash and cash equivalents | $823,249 | $709,003 |
| Investments | 617,756 | 601,505 |
| Total cash, cash equivalents and investments | $1,441,005 | $1,310,508 |
| Working capital | $759,497 | $709,276 |

| | Three Months Ended | |
|---|---|---|
| | March 31, 2017 | March 31, 2016 |
| | (in thousands) | |
| Cash provided by operating activities | $129,749 | $100,591 |
| Cash used in investing activities | (31,325) | (34,204) |
| Cash provided by (used in) financing activities | 15,822 | (41,656) |
| Net increase in cash and cash equivalents | $114,246 | $24,731 |

Liquidity and capital resources may be impacted by our operating activities, as well as by our business acquisitions, real estate and other capital expenditures, stock repurchases, proceeds associated with stock option exercises and issuances of common stock under our employee stock purchase plan (the "ESPP"), payment of taxes in connection with the net settlement of equity awards and investments in strategic relationships that we have made or may make in the future. As of March 31, 2017, $189.2 million remained available for future share repurchase under our 2016 Repurchase Program (the "2016 Repurchase Program"). In recent years we have received significant capital resources as a result of the exercise of stock options. We expect proceeds in future years to be impacted by the increased mix of restricted stock units ("RSUs") granted versus stock options and also to vary based on our share price. In April 2017, we purchased a real estate in Vancouver, Canada for approximately $85.0 million which will affect our free cash flows in the second quarter of 2017. We expect our free cash flows to improve in the second half of 2017.

As of March 31, 2017, our cash, cash equivalents and investments of $1.44 billion were invested primarily in corporate debt securities, commercial paper, U.S. government and agency securities, municipal bonds, money market funds, certificates of deposit and term deposits. It is our investment policy to invest excess cash in a manner that preserves capital, provides liquidity and maximizes return without significantly increasing risk.

As of March 31, 2017, $599.5 million of our cash and investments were held by our international subsidiaries and are therefore not immediately available to fund domestic operations unless the cash is repatriated. While we do not intend to do so, should this amount be repatriated, most of it would be subject to U.S. federal income tax that would be partially offset by foreign tax credits. We do not enter into investments for trading or speculative purposes.

We believe that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure access to adequate manufacturing capacity, the continuing market acceptance of our products and our investments in real estate through purchases or long-term leases. 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.

Operating Activities

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

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Our operating activities during the three months ended March 31, 2017 provided $129.7 million in cash as a result of our continued growth in the sales of FortiGuard security subscriptions and FortiCare support contracts, as well as product sales, and the ability to successfully manage our working capital. The increase in sales of our FortiGuard security subscription and FortiCare technical supports to new and existing customers was reflected in the increase in our deferred revenue. We continued to see the shift from product revenue to higher-margin, recurring service revenue. For example, our total revenue grew 20% during the three months ended March 31, 2017 compared to the same period last year, while our total deferred revenue balance grew 31% during the three months ended March 31, 207 compared to the same period last year.

Our operating activities during the three months ended March 31, 2016 provided $100.6 million in cash as a result of our continued growth in billings and our ability to successfully manage our working capital. Changes in operating assets and liabilities primarily resulted from an increase in payments received from customers, which was partially offset by an increase in payments to vendors.

Investing Activities

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

During the three months ended March 31, 2017, cash used for investing activities was primarily due to the $13.5 million we spent on capital expenditures and $17.8 million due to purchases, net of maturities, of our investments.

During the three months ended March 31, 2016, cash used for investing activities was primarily due to the $30.0 million we spent on capital expenditures, including our purchase of certain real property in Union City, California for total cash of $18.5 million. Cash outflows due to sales and maturities of our investments, net of purchases, amounted to $4.2 million.

Financing Activities

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

During the three months ended March 31, 2017, cash used for financing activities was $15.8 million, proceeds from the issuance of common stock, net of tax withholding.

During the three months ended March 31, 2016, cash used for financing activities was $41.7 million, primarily due to $50.0 million used to repurchase our common stock. This was partially offset by $8.3 million of proceeds from the issuance of common stock, net of taxes paid, related to withholding upon issuance of RSUs.

Contractual Obligations and Commitments

There were no material changes outside the ordinary course of business during the three months ended March 31, 2017 to the contractual obligations and commitments disclosed in Management’s Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II, Item 7, of the Form 10-K. See Note 9 to the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information regarding contractual obligations and commitments.

Off-Balance Sheet Arrangements

As of March 31, 2017, 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.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There were no material changes in our market risk during the three months ended March 31, 2017 compared to the disclosures in Part II, Item 7A of the Form 10-K.

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ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act) as of March 31, 2017. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of March 31, 2017 to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the three months ended March 31, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II

ITEM 1. Legal Proceedings

We are subject to various claims, complaints and legal actions that arise from time to time in the normal course of business. We accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss. 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.

In October 2016, we received a letter from the United States Attorney's Office for the Northern District of California requesting information relating to our compliance with the Trade Agreements Act. This inquiry is ongoing and we are fully cooperating with this inquiry.

ITEM 1A. Risk Factors

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

Risks Related to Our Business

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

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

- the level of demand for our products and services, which may render forecasts inaccurate;
- the timing of channel partner and end-customer orders, and our reliance on a concentration of shipments at the end of each quarter;
- the timing of shipments, which may depend on factors such as inventory levels, logistics, manufacturing or shipping delays, our ability to ship new products on schedule and our ability to accurately forecast inventory requirements;
- inventory management;
- the mix of products sold and the mix of revenue between products and services, as well as the degree to which products and services are bundled and sold together for a package price;
- the purchasing practices and budgeting cycles of our channel partners and end-customers;
- the effectiveness of our sales organization, generally or in a particular geographic region, and the time it takes for our sales personnel to reach productivity;

- seasonal buying patterns of our end-customers;

- the timing and level of our investments in sales and marketing, and the impact of such investments on our operating expenses and operating margin, and on the productivity and effectiveness of execution of our sales and marketing teams;

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

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- the level of perceived threats to network security, which may fluctuate from period to period;
- changes in the requirements, market needs or buying practices and patterns of our distributors, resellers or end-customers;
- changes in the growth rate of the network security markets;
- the timing and success of new product and service introductions or enhancements by us (including product development pursuant to our non-recurring engineering agreements) or our competitors, or any other change in the competitive landscape of our industry, including consolidation among our competitors, partners or end-customers;
- the deferral of orders from distributors, resellers or end-customers in anticipation of new products or product enhancements announced by us or our competitors;
- increases or decreases in our billings, revenue and expenses caused by fluctuations in foreign currency exchange rates or a strengthening of the U.S. dollar, as a significant portion of our expenses is incurred and paid in currencies other than the U.S. dollar, and the impact such fluctuations may have on the actual prices that our partners and customers are willing to pay for our products and services;
- compliance with existing laws and regulations that are applicable to our ability to conduct business with the public sector;
- the impact of cloud-based platforms on the timing of our revenue recognition, billings and free cash flow;
- decisions by potential end-customers to purchase network security solutions from newer technology providers, from larger, more established security vendors or from their primary network equipment vendors;
- price competition and increased competitiveness in our market;
- changes in customer renewal rates for our services;
- changes in the payment terms of services contracts or the length of services contracts sold;
- changes in our estimated annual effective tax rates;
- changes in circumstances and challenges in business conditions, including decreased demand, which may negatively impact our channel partners' ability to sell the current inventory they hold and negatively impact their future purchases of products from us;
- increased demand for cloud-based services and the uncertainty associated with transitioning to providing such services;
- increased expenses, unforeseen liabilities or write-downs and any impact on results of operations from any acquisition consummated;
- our channel partners having insufficient financial resources to withstand changes and challenges in business conditions;

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

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

- policy changes and uncertainty with respect to immigration laws, trade policy, foreign imports and tax laws related to international commerce;

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- political, economic and social instability;
- general economic conditions, both in domestic and foreign markets;
- future accounting pronouncements or changes in our accounting policies, such as changes in the revenue recognition standards or accounting for leases, as well as the significant costs that may be incurred to adopt and comply with these new pronouncements;
- possible impairments or acceleration of depreciation of our existing real estate due to our future expansion plans; and
- legislative or regulatory changes, such as with respect to privacy, information and cybersecurity, exports, the environment and applicable accounting standards.

Any one of the factors above or the cumulative effect of some of the factors referred to above may result in significant fluctuations in our quarterly financial and other operating results. This variability and unpredictability could result in our failing to meet our internal operating plan or the expectations of securities analysts or investors for any period. If we fail to meet or exceed such expectations for these or any other reasons, the market price of our shares could fall substantially and we could face costly lawsuits, including securities class action suits. In addition, a significant percentage of our operating expenses are fixed in nature over the near term. 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 and spending environments, weak economic conditions in certain regions or a reduction in information technology spending regardless of macro-economic conditions could have adverse impacts on our business, financial condition and results of operations, including longer sales cycles, lower prices for our products and services, higher default rates among our channel partners, reduced unit sales and slower or declining growth.

Our billings, revenue and free cash flow growth may slow or may not continue.

Billings, revenue and free cash flow growth may slow, or we may experience a decrease in billings, revenue and free cash flow for a number of reasons, including a slowdown in demand for our products or services, a shift in demand from products to services, increased competition, a decrease in the growth of our overall market or softness in demand in certain geographies or industry verticals, such as the service provider industry, and our failure for any reason to continue to capitalize on growth opportunities and due to other risks identified in the risk factors described in this periodic report. Our expenses as a percentage of total revenue may be higher than expected if our revenue is lower than expected and, if our investments in sales and marketing and other functional areas do not result in expected billings and revenue growth, we may experience margin declines and 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 and free cash flow or encounter unanticipated liabilities. Any failure by us to maintain profitability, maintain our margins and continue our billings, revenue and free cash flow growth could cause the price of our common stock to materially decline.

We rely significantly on revenue from FortiGuard security subscription and FortiCare technical support services which may decline, and because we recognize revenue from FortiGuard security subscription and FortiCare technical

support services over the term of the relevant service period, downturns or upturns in sales of FortiGuard security subscription and FortiCare technical support services are not immediately reflected in full in our operating results.

Our FortiGuard security subscription revenue and our FortiCare technical support services revenue have historically accounted for a significant percentage of our total revenue. Revenue from the sale of new, or from the renewal of existing, FortiGuard security subscription and FortiCare technical support services contracts may decline and fluctuate as a result of a number of factors, including fluctuations in purchases of FortiGate appliances, changes in the sales mix between products and services, end-customers' level of satisfaction with our products and services, the prices of our products and services, the prices of products and services offered by our competitors, reductions in our customers' spending levels and the timing of revenue recognition with respect to these arrangements. If our sales of new, or renewals of existing FortiGuard security subscription and

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

We generate a majority of revenue from sales to distributors, resellers and end-customers outside of the U.S., 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. Our international sales have represented a majority of our total revenue in recent periods. Therefore, we are subject to risks associated with having worldwide operations. We are also subject to a number of risks typically associated with international sales and operations, including:

- economic or political instability in foreign markets;
- greater difficulty in enforcing contracts and accounts receivable collection, including 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;
- protectionist policies and penalties, and local laws, requirements, policies and perceptions that may adversely impact U.S. headquartered business' sales in certain countries outside of the U.S.;
- costs of complying with U.S. or other foreign laws and regulations for foreign operations, including the U.S. Foreign Corrupt Practices Act, the United Kingdom ("UK") Bribery Act 2010, import and export control laws, tariffs, trade barriers and economic sanctions;
- other regulatory or contractual limitations on our ability to sell our products in certain foreign markets, and the risks and costs of non-compliance;
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heightened risks of unfair or corrupt business practices in certain geographies and of improper or fraudulent sales or sales-related arrangements that could disrupt the sales team through terminations of employment or otherwise, and may adversely impact financial results as compared to those already reported or forecasted and result in restatements of financial statements and irregularities in financial statements;

- our ability to effectively implement and maintain adequate internal controls to properly manage our international sales and operations;

- the potential for political unrest, changes and uncertainty, and for terrorism, hostilities, war or natural disasters;

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- changes in foreign currency exchange rates;
- management communication and integration problems resulting from cultural differences and geographic dispersion; and
- changes in tax, employment and other laws.

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

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

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

- increased competition from competitors that traditionally target large enterprises and medium-sized businesses, service providers and government organizations 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 or purchasing behavior of large end-customers, including changes in the volume and frequency of their purchases and changes in the mix of products and services and related payment terms;
- more stringent support requirements in our support service contracts, including stricter support response times, more complex requirements and increased penalties for any failure to meet support requirements;
- 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; and
- longer ramp-up periods for enterprise sales personnel as compared to other sales personnel.

Large enterprises and medium-sized businesses, service providers and government organizations often undertake a significant evaluation process that results in a lengthy sales cycle, in some cases longer than 12 months. Although we have a channel sales model, our sales representatives typically engage in direct interaction with end-customers, along

with our distributors and resellers, in connection with sales to large and medium-sized end-customers. We may spend substantial time, effort and money in our sales efforts without being successful in producing any sales. In addition, product purchases by large enterprises and medium-sized businesses, service providers and government organizations are frequently subject to budget constraints, multiple approvals and unplanned administrative, processing and other delays. Furthermore, service providers represent our largest industry vertical and consolidation or changes in buying behavior by larger customers within this industry could negatively impact our business. Large enterprises and medium-sized businesses, service providers and government organizations typically have longer implementation cycles, require greater product functionality and scalability, expect a broader range of services, including design services, demand that vendors take on a larger share of risks, require acceptance

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provisions that can lead to a delay in revenue recognition and expect greater payment flexibility from vendors. In addition, large enterprises and medium-sized businesses, service providers and government organizations may require that our products and services be sold differently from how we offer our products and services, which could negatively impact our operating results. Our large enterprise and service provider customers may also become more deliberate in their purchases as they plan their next-generation network security architecture, leading them to take more time in making purchasing decisions or to purchase based only on their immediate needs. All these factors can add further risk to business conducted with these customers. In addition, if sales expected from a large and medium-sized end-customer for a particular quarter are not realized in that quarter or at all, our business, operating results and financial condition could be materially and adversely affected.

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

Managing our inventory is complex. Our channel partners may increase orders during periods of product shortages, cancel orders or not place orders commensurate with our expectations if their inventory is too high, return products or take advantage of price protection (if any is available to the particular partner) or delay orders in anticipation of new products, and accurately forecasting inventory requirements and demand can be challenging. Our channel partners also may adjust their orders in response to the supply of our products and the products of our competitors that are available to them and in response to seasonal fluctuations in end-customer demand. Furthermore, if the time required to manufacture or ship certain products increases for any reason, inventory shortfalls could result. Management of our inventory is further complicated by the significant number of different products and models that we sell which may impact our free cash flow. For example, our inventory levels increased $23.0 million, or 27% from December 31, 2015 to December 31, 2016, impacting our free cash flow. Mismanagement of our inventory, whether due to imprecise forecasting, employee errors or malfeasance, inaccurate information or otherwise, may adversely affect our results of operations.

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, or excess inventory levels. If we ultimately determine that we have excess inventory, we may have to reduce our prices and write-down inventory, which in turn could result in lower gross margins. Alternatively, insufficient inventory levels may lead to shortages that result in delayed revenue or loss of sales opportunities altogether as potential end-customers turn to competitors' products that are readily available. For example, we have in the past experienced inventory shortages and excesses due to the variance in demand for certain products from forecasted amounts. 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. If we are unable to effectively manage our inventory and that of our channel partners, our results of operations could be adversely affected.

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

Our future performance depends on the continued services and continuing contributions of our senior management to execute on our business plan and to identify and pursue new opportunities and product innovations. The loss of services of members of senior management, particularly Ken Xie, our Co-Founder, Chairman and Chief Executive Officer, and Michael Xie, our Co-Founder, President and Chief Technology Officer, and any of our senior sales leaders or functional area leaders, could significantly delay or prevent the achievement of our development and strategic objectives. The loss of the services or the 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, sales and marketing, may seriously harm our business, financial condition and results of operations. From time to time, we experience turnover in our management-level personnel. None of our key employees has an employment agreement for a specific term, and any of our employees may terminate their employment at any time. Our ability to continue to attract and retain highly skilled personnel will be critical to our future success. Competition for highly skilled personnel is frequently intense, especially for qualified employees in network security and especially in the locations where we have a substantial presence and need for highly skilled personnel, such as the San Francisco Bay Area and Vancouver, Canada. We may not be successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs. Also, to the extent we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited or

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divulged proprietary or other confidential information. Changes in immigration laws, including changes to the rules regarding H1-B visas, may also harm our ability to attract personnel from other countries.

If we do not increase the effectiveness of our sales organization in some regions, we may have difficulty adding new end-customers or increasing sales to our existing end-customers and our business may be adversely affected.

Although we have a channel sales model, members of our sales organization often engage in direct interaction with our prospective end-customers. Therefore, we continue to be substantially dependent on our sales organization to obtain new end-customers and sell additional products and services to our existing end-customers. There is significant competition for sales personnel with the skills and technical knowledge that we require. Our ability to grow our revenue depends, in large part, on our success in recruiting, training and retaining sufficient numbers of sales personnel to support our growth and on the effectiveness of those personnel. New hires require substantial training and may take significant time before they achieve full productivity. Our recent hires and planned hires may not become productive as quickly as we expect, and we may be unable to hire or retain sufficient numbers of qualified individuals in the markets where we do business or plan to do business. For example, we realigned our sales organization in early 2016 and it has taken more time than we expected to ramp up the productivity of our realigned sales organization, which negatively impacted our revenue growth in the third quarter of 2016 in some regions. Furthermore, hiring sales personnel in new countries requires additional setup and upfront costs that we may not recover if the sales personnel fail to achieve full productivity. If our new sales employees do not become fully productive on the timelines that we have projected, our revenue will not increase at anticipated levels and our ability to achieve long term projections may be negatively impacted. If we are unable to hire and train sufficient numbers of effective sales personnel, or the sales personnel are not successful in obtaining new end-customers or increasing sales to our existing customer base, our business, operating results and prospects will be adversely affected.

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

The sales prices for our products and services may decline for a variety of reasons, including competitive pricing pressures, discounts or promotional programs we offer, a change in our mix of products and services and anticipation of the introduction of new products and services. Competition continues to increase in the market segments in which we participate, and we expect competition to further increase in the future, thereby leading to increased pricing pressures. Larger competitors with more diverse product offerings may reduce the price of products and services that compete with ours in order to promote the sale of other products or services or may bundle them with other products or services. Additionally, although we price our products and services worldwide in U.S. dollars, currency fluctuations in certain countries and regions have in the past, and may in the future, negatively impact actual prices that partners and customers are willing to pay in those countries and regions. Furthermore, we anticipate that the sales prices and gross profits for our products or services will decrease over product life cycles. We cannot ensure that we will be successful in developing and introducing new offerings with enhanced functionality on a timely basis, or that our product and service 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 billings during the last two weeks have accounted for 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 accurately forecast our inventory requirements and to appropriately manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, any delays in shipments due to trade compliance requirements, labor disputes or logistics changes at shipping ports or otherwise, our billings and revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

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

Increased market awareness of our capabilities and products and increased lead generation are essential to our continued growth and our success in all of our markets, particularly for the large enterprise, service provider and government

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

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

A significant portion of our sales is generated through a limited number of distributors, and substantially all of our revenue is generated through sales by our channel partners, including distributors and resellers. We depend on our channel partners to generate a significant portion of our sales opportunities and to manage our 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, or if we are unable to keep them motivated to sell our products, our ability to sell our products and operating results will be harmed. The termination of our relationship with any significant channel partner may adversely impact our sales and operating results.

We provide sales channel partners with specific programs to assist them in selling our products and incentivize them to sell our products, but there can be no assurance that these programs will be effective. In addition, our channel partners may be unsuccessful in marketing, selling and supporting our products and services and may purchase more inventory than they can sell. Our channel partners generally do not have minimum purchase requirements. Some of our channel partners may have insufficient financial resources to withstand changes and challenges in business conditions. In addition, if our channel partners' financial condition or operations weaken, it could negatively impact their ability to sell our product and services. Our channel partners may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products. They may also have incentives to promote our competitors' products to the detriment of our own, or they may cease selling our products altogether. We cannot ensure that we will retain these channel partners or that we will be able to secure additional or replacement partners or that existing channel partners will continue to perform. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results. During the three months ended March 31, 2017, Exclusive Networks Group and Fine Tec Computers, which distributed our solutions to a large group of resellers and end-customers, accounted for 20% and 12% of our total revenue, respectively. During the three months ended March 31, 2016, Exclusive Networks Group accounted for 19% of our total revenue. In addition, any new sales channel partner will require extensive training and may take several months or more to achieve productivity. Our channel partner sales structure could subject us to lawsuits, potential liability and reputational harm if, for example, any of our channel partners misrepresent the functionality of our products or services to end-customers or our channel partners violate laws or our corporate policies. We depend on our global channel partners to comply with applicable legal and regulatory requirements. To the extent that they fail to do so, that could have a material adverse effect on our business, operating results and financial condition. If we fail to optimize our channel partner model or fail to manage existing sales channels, our business will be seriously harmed.

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

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

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failure, downtime or failures in general may temporarily or permanently expose our end-customers' networks, leaving their networks unprotected against the latest security threats.

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

Our business and operations have experienced growth, and if we do not appropriately manage any future growth, including through the expansion of our real estate holdings, or are unable to improve our systems and processes, our operating results will be negatively affected.

Our business has grown over the last several years. We rely heavily on information technology and accounting systems to help manage critical functions such as order processing, revenue recognition, financial forecasts, inventory and supply chain management and trade compliance reviews. Certain of these systems were developed by us for our internal use and, as such, may have a higher risk of failure or not receive the same level of support as systems purchased from and supported by external technology companies. In addition, we have been slow to adopt and implement certain automated functions, which could have a negative impact on our business. For example, a large part of our order processing relies on manual data entry of customer purchase orders received through email and, to a lesser extent, through electronic data interchange from our customers. Combined with the fact that we may receive a large amount of our orders in the last few weeks of any given quarter, a significant interruption in our email service or other systems could result in delayed order fulfillment and decreased billings and revenue for that quarter.

To manage any future growth effectively, we must continue to improve and expand our information technology and financial, operating and administrative systems and controls, and continue to manage headcount, capital and processes in an efficient manner. We may not be able to successfully implement requisite improvements to these systems, controls and processes, such as system capacity, access and change management controls, in a timely or efficient manner. Our failure to improve our systems and processes, or their failure to operate in the intended manner, whether as a result of the significant growth of our business or otherwise, may result in our inability to manage the growth of

our business and to accurately forecast our revenue, expenses and earnings, or to prevent certain losses. Moreover, the failure of our systems and processes could undermine our ability to provide accurate, timely and reliable reports on our financial and operating results and could impact the effectiveness of our internal control over financial reporting. In addition, our systems and processes may not prevent or detect all errors, omissions or fraud. Our productivity and the quality of our products and services may also be adversely affected if we do not integrate and train our new employees quickly and effectively. Any future growth would add complexity to our organization and require effective coordination throughout our organization. Failure to manage any future growth effectively could result in increased costs and harm our results of operations.

Further, it may be necessary to expand our real estate holdings to meet our projected growth need for office space. In March 2017 and April 2017, we purchased office buildings in Ottawa and Vancouver, Canada, respectively, and we are

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considering plans to significantly expand our headquarters in Sunnyvale, California. These plans will require significant capital expenditure over the next several years and involve certain risks, including impairment charges and acceleration of depreciation, changes in future business strategy that may decrease the need for expansion (such as a decrease in headcount) and, with respect to our potential expansion plans in California, risks related to construction. Future changes in growth or fluctuations in cash flow may also negatively impact our ability to pay for these projects. Additionally, inaccuracies in our projected capital expenditures could negatively impact our business, operating results and financial condition.

We may experience difficulties maintaining and expanding our enterprise resource planning ("ERP") system.

In July 2016, we implemented a new ERP system. The ERP system is critical to our ability to provide important information to our management, obtain and deliver products, provide services and customer support, send invoices and track payments, fulfill contractual obligations, accurately maintain books and records, provide accurate, timely and reliable reports on our financial and operating results and otherwise operate our business. ERP system implementations also require transformation of business and financial processes in order to reap the benefits of the ERP system; any such transformation involves risks inherent in the conversion to a new computer system, including potential disruption to our normal operations. The implementation and maintenance of the new ERP system has required, and will continue to require, the investment of significant financial and human resources. In addition, we may choose to upgrade or expand the functionality of our ERP system, leading to additional costs. We may also discover deficiencies in our design or implementation or maintenance of the new ERP system that could adversely affect our ability to process orders, ship products, provide services and customer support, send invoices and track payments, fulfill contractual obligations, accurately maintain books and records, provide accurate, timely and reliable reports on our financial and operating results, or otherwise operate our business. Additionally, if the system does not operate as intended, the effectiveness of our internal control over financial reporting could be adversely affected or our ability to assess it adequately could be delayed. Further, to the extent our systems require upgrades to enable us to comply with new revenue recognition standards, our operating results may be adversely affected if these upgrades are delayed or if the upgraded systems do not function as intended or is not sufficient to meet with our revenue recognition requirements.

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 Quarterly Report on Form 10-Q, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price. Significant assumptions and estimates used in preparing our consolidated financial statements include those related to revenue recognition and sales return reserves, stock-based compensation expense, valuation of inventory, investments, accounting for business combination, goodwill and other long-lived assets, restructuring, accounting for income taxes and litigation and settlement costs.

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

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

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

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

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

Our proprietary SPU, which is the key to the performance of our appliances, are built by contract manufacturers including Faraday Technology Corporation, Kawasaki Microelectronics America, Inc. and Renesas Electronics Corporation. These contract manufacturers use foundries operated by United Microelectronics Corporation (“UMC”) and Taiwan Semiconductor Manufacturing Company Limited (“TSMC”) on a purchase order basis, and UMC and TSMC do not guarantee any capacity and could reject orders or could try to increase pricing. Accordingly, the foundries are not obligated to continue to fulfill our supply requirements, and due to the long lead time that a new foundry would require, we could suffer temporary or long term inventory shortages of our SPU as well as increased costs. Our suppliers may also prioritize orders by other companies that order higher volumes or more profitable products. If any of these manufacturers materially delays its supply of ASICs or specific product models to us, or requires us to find an alternate supplier and we are not able to do so on a timely and reasonable basis, or if these foundries materially increase their prices for fabrication of our ASICs, our business would be harmed.

In addition, our reliance on third-party manufacturers and foundries limits our control over environmental regulatory requirements such as the hazardous substance content of our products and therefore our ability to ensure compliance with the Restriction of Hazardous Substances Directive (“RoHS”) adopted in the European Union (the “EU”) and other similar laws. It also exposes us to the risk that certain minerals and metals, known as “conflict minerals,” that are contained in our products have originated in the Democratic Republic of the Congo or an adjoining country. As a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), the SEC adopted disclosure requirements for public companies whose products contain conflict minerals that are necessary to the functionality or production of such products. Under these rules, we are required to obtain sourcing data from suppliers, perform supply chain due diligence, and file annually with the SEC a specialized disclosure report

on Form SD covering the prior calendar year. Although the SEC has recently provided guidance with respect to a portion of the conflict minerals filing requirements that will somewhat reduce the reporting required, we have incurred and expect to incur additional costs to comply with the rules, including costs related to the determination of the origin, source and chain of custody of the conflict minerals used in our products and the adoption of conflict minerals-related governance policies, processes and controls. Moreover, the implementation of these compliance measures could adversely affect the sourcing, availability and pricing of materials used in the manufacture of our products to the extent that there may be only a limited number of suppliers that are able to meet our sourcing requirements. There can be no assurance that we will be able to obtain such materials in sufficient quantities or at competitive prices. We may also encounter customers who require that all of the components of our products be certified as conflict-free. If we are not able to meet customer requirements, such customers may choose to not purchase our products, which could impact our sales and the value of portions of our inventory.

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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, cause loss of sales and customers or increase component costs resulting in lower gross margins.

We and our contract manufacturers currently purchase several key parts and components used in the manufacture of our products from limited sources of supply. We are therefore subject to the risk of shortages and long lead times in the supply of these components and the risk that component suppliers discontinue or modify components used in our products. We have in the past experienced, and are currently experiencing, shortages and long lead times for certain components. Certain of our limited source components for particular appliances and suppliers of those components include: specific types of CPUs from Intel Corporation ("Intel"), network chips from Broadcom Corporation, Marvell Technology Group Ltd. and Intel, and memory devices from Intel, ADATA Technology Co., Ltd., Samsung Electronics Co., Ltd. and 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 significant portion of our operating expenses are incurred outside the U.S. These expenses are denominated in foreign currencies and are subject to fluctuations due to changes in foreign currency exchange rates, particularly

changes in the Euro and Canadian dollar and, to a lesser extent, the British pound. Additionally, fluctuations in the exchange rate of the Canadian dollar may negatively impact our real estate purchase and development plans in Vancouver and Ottawa. While we are not currently engaged in material hedging activities, we have been hedging currency exposures relating to certain balance sheet accounts through the use of forward exchange contracts. If we stop hedging against any of these risks or if our attempts to hedge against these currency exposures are not successful, our financial condition and results of operations could be adversely affected. In addition, our sales contracts are primarily denominated in U.S. dollars and therefore, while substantially all of our revenue is not subject to foreign currency risk, it does not serve as a hedge to our foreign currency-denominated operating expenses. In addition, a strengthening of the U.S. dollar may increase the real cost of our products to our customers outside of the U.S., which may also adversely affect our financial condition and results of operations.

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Failure to comply with laws and regulations applicable to our business could subject us to fines and penalties and could also cause us to lose end-customers in the public sector or negatively impact our ability to contract with the public sector.

Our business is subject to regulation by various federal, state, local and foreign governmental agencies, including agencies responsible for monitoring and enforcing employment and labor laws, workplace safety, product safety, product labeling, environmental laws, consumer protection laws, anti-bribery laws, import and export controls, federal securities laws and tax laws and regulations. In certain jurisdictions, these regulatory requirements may be more stringent than in the U.S. Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, enforcement actions, disgorgement of profits, fines, damages and civil and criminal penalties or injunctions. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, operating results and financial condition could be adversely affected. In addition, responding to any action will likely result in a significant diversion of management's attention and resources and an increase in professional fees. Enforcement actions and sanctions could harm our business, operating results and financial condition.

Selling our solutions to the U.S. government, whether directly or through channel partners, also subjects us to certain regulatory and contractual requirements. Failure to comply with these requirements by either us or our channel partners could subject us to investigations, fines, other penalties and damages, which could have an adverse effect on our business, operating results, financial condition and prospects. As an example, the U.S. Department of Justice (the "DOJ"), on its own behalf or on behalf of the General Services Administration (the "GSA"), as well as individuals, has in the past pursued claims against, reached financial settlements with or otherwise obtained damages from companies that sell electronic equipment and from IT vendors under the False Claims Act and other statutes related to pricing, discount practices and compliance with laws related to sales to the federal government, such as the Trade Agreements Act. The DOJ continues to actively pursue such claims. Violations of certain regulatory and contractual requirements could also result in us being suspended or debarred from future government contracting. Any of these outcomes could have an adverse effect on our revenue, operating results, financial condition and prospects.

These laws and regulations impose added costs on our business, and failure to comply with these or other applicable regulations and requirements, including non-compliance in the past, could lead to claims for damages from our channel partners, penalties, termination of contracts, loss of exclusive rights in our intellectual property and temporary suspension or permanent debarment from government contracting. Any such damages, penalties, disruptions or limitations in our ability to do business with the public sector could have an adverse effect on our business and operating results.

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

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

Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of 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 and licensing requirements, and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products globally or, in some cases, prevent the export or import of our products to certain countries, governments or persons altogether. Any change in export or import regulations, economic sanctions or related legislation, shift in the enforcement or scope of existing regulations, or change in the countries, governments, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Any decreased use of our products or

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limitation on our ability to export or sell our products would likely adversely affect our business, financial condition and results of operations.

Efforts to withdraw from or materially modify NAFTA or other international trade agreements, to change tax provisions related to global manufacturing and sales or to impose new tariffs, economic sanctions or related legislation, any of which could our adversely affect our financial condition and results of operations.

Our business benefits from free trade agreements, such as the North American Free Trade Agreement ("NAFTA"), and we also rely on various U.S. corporate tax provisions related to international commerce, as we develop, market and sell our products and services globally. Efforts to withdraw from or materially modify NAFTA or other international trade agreements, or to change corporate tax policy related to international commerce, could adversely affect our financial condition and results of operations as could the continuing uncertainty regarding whether such actions will be taken. Moreover, efforts to implement changes related to export or import regulations (including the imposition of new border taxes or tariffs on foreign imports), economic sanctions or related policies. Any modification in these areas, any shift in the enforcement or scope of existing regulations or any 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 end-customers with international operations and could result in increased costs. 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, laws relating to our real property and future expansion plans and laws concerning 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 (the "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 U.S., 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. Additionally, though we have filed for an extension, it is possible that this exemption may expire in the near future without being extended. If this exemption is revoked or expires without extension, if there are other changes to these laws (or their interpretation) or if new similar laws are passed in other jurisdictions, we may be required to reengineer our products to use components compatible with these regulations. This reengineering and component substitution could result in additional costs to us or disrupt our operations or logistics.

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

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

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

Sales to U.S. and foreign federal, state and local governmental agency end-customers have accounted for a portion of our revenue in past periods, and we may in the future increase sales to government organizations. Sales to government organizations are subject to a number of risks. Selling to government organizations can be highly competitive, expensive and

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time consuming, often requiring significant upfront time and expense, with long sales cycles and without any assurance of winning a sale.

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

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

The rules and regulations applicable to sales to government organizations may also negatively impact sales to other organizations. To date, we have had limited traction in sales to U.S. federal government agencies, and any future sales to government organizations is uncertain. Government organizations may have contractual or other legal rights to terminate contracts with our distributors and resellers for convenience or due to a default, and any such termination may adversely impact our future results of operations. For example, if the distributor receives a significant portion of its revenue from sales to such government organization, the financial health of the distributor could be substantially harmed, which could negatively affect our future sales to such distributor. Governments routinely investigate and audit government contractors' administrative processes, and any unfavorable audit could result in the government refusing to continue buying our products and services, a reduction of revenue or fines or civil or criminal liability if the audit uncovers improper or illegal activities. Any such penalties 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 U.S. and other high cost manufacturing locations, and we may not manufacture all products in locations that meet the requirements of the U.S. government.

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

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

to remedy any problem and costly litigation.

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

Our success depends on the market's confidence in our ability to provide effective network security protection. Despite our efforts and processes to prevent breaches of our internal network system and website, we are still vulnerable to computer viruses, break-ins, phishing attacks, attempts to overload our servers with denial-of-service and other cyber-attacks and similar disruptions from unauthorized access to our internal network system or our website. Our security measures may also be breached due to employee error, malfeasance or otherwise, and third parties may attempt to fraudulently induce our employees to transfer funds or disclose information in order to gain access to our network and confidential information. We

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cannot guarantee that the measures we have taken to protect our network and website will provide absolute security. Moreover, because we provide network security products, we may be a more attractive target for attacks by computer hackers. Although we have not yet experienced significant damages from unauthorized access by a third party of our internal network or website, an actual or perceived breach of network security occurs in our internal systems or website could adversely affect the market perception of our products and services and investor confidence in our company. Any breach of our network system or website could impair our ability to operate our business, including our ability to provide FortiGuard security subscription and FortiCare technical support services to our end-customers, lead to interruptions or system slowdowns, cause loss of critical data or lead to the unauthorized disclosure or use of confidential, proprietary or sensitive information. We could also be subject to liability and litigation and reputational harm and our channel partners and end-customers may be harmed, lose confidence in us and decrease or cease using our products and services. Any breach of our internal network system or our website could have an adverse effect on our business, operating results and stock price.

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

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

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

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

- earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates;
- the mix of earnings in countries with differing statutory tax rates or withholding taxes;
- changes in the valuation of our deferred tax assets and liabilities;
- transfer pricing adjustments;
- an increase in non-deductible expenses for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development and impairment of goodwill;
- tax costs related to intercompany realignments;

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

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

- changes in accounting principles;

- court decisions, tax rulings and interpretations of tax laws, and regulations by international, federal or local governmental authorities; or

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- changes in tax laws and regulations, including possible changes in the U.S. to the taxation of earnings of our foreign subsidiaries, the deductibility of expenses attributable to foreign income or the foreign tax credit rules, or changes to the U.S. income tax rate, which would necessitate a revaluation of our deferred tax assets and liabilities.

Significant judgment is required to determine the recognition and measurement attribute prescribed in the Financial Accounting Standards Board 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 (the "IRS") and other tax authorities. Tax authorities in France are currently examining the inter-company relationship between Fortinet, Inc., Fortinet France and Fortinet Singapore. Subsequent to the three months ended March 31, 2017, we received a notice from the French tax authorities that an audit was officially opened for tax years from 2007 to 2015. We regularly assess the likelihood of adverse outcomes resulting from such examinations to determine the adequacy of our provision for income taxes.

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

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

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

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

The Organisation for Economic Co-operation and Development (the "OECD"), an international association comprised of 34 countries, including the U.S., has been working on a Base Erosion and Profit Sharing Project. As part of this project, the OECD issued in 2015, and is expected to continue to issue, guidelines and proposals that may change

various aspects of the existing framework under which our tax obligations are determined in many of the countries in which we do business. Due to our extensive international business activities, any changes in the taxation of such activities could increase our tax obligations in many countries and may increase our worldwide effective tax rate.

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

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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, technologies or intellectual property, such as patents. For example, we closed our acquisitions of Meru and AccelOps in the third quarter of 2015 and the second quarter of 2016, respectively. For any past acquisition or possible future acquisition, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product, technology or intellectual property and sales force into our existing business and operations. We may have difficulty incorporating acquired technologies, intellectual property or products with our existing product lines, integrating reporting systems and procedures, and maintaining uniform standards, controls, procedures and policies. For example, we may experience difficulties integrating an acquired company's ERP system, sales support and other processes and systems, with our current systems and processes. Our due diligence may fail to identify all of the problems, liabilities or other shortcomings or challenges of an acquired business, product or technology, including issues with intellectual property, product quality or product architecture, regulatory compliance practices, revenue recognition or other accounting practices or employee or customer issues, and we may not accurately forecast the financial impact of an acquisition. In addition, any acquisitions we are able to complete may be dilutive to revenue growth and earnings and may not result in any synergies or other benefits we had expected to achieve, which could result in impairment charges that could be substantial. We may have to pay cash, incur debt or issue equity securities to pay for any acquisition, each of which could affect our financial condition or the value of our capital stock and could result in dilution to our stockholders. Acquisitions during a quarter may result in increased operating expenses and adversely affect our results of operations for that period or future periods compared to the results that we have previously forecasted or achieved. Further, completing a potential acquisition and integrating acquired businesses, products, technologies or intellectual property could significantly divert management time and resources.

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

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

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

result in our expenditure of funds in litigation and divert management's time and other resources.

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

A significant natural disaster, such as an earthquake, fire, power outage, flood or other catastrophic event could have a material adverse impact on our business, operating results and financial condition. Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity, and our research and development and data office center in Vancouver, Canada is subject to the risk of flooding and is also in a region known for seismic activity. In addition, natural disasters could affect our manufacturing vendors, suppliers or logistics providers' ability to perform services, such as obtaining product components and manufacturing products, or assisting with shipments, on a timely basis, as well as our customers'

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ability to order from us and our employees' ability to perform their duties. In the event our or our service providers' information technology systems or manufacturing or logistics abilities are hindered by any of the events discussed above, shipments could be delayed, resulting in our missing financial targets, such as revenue and shipment targets, for a particular quarter. In addition, regional instability, civil unrest, labor disruptions, acts of terrorism and other geo-political unrest could cause disruptions in our business or the business of our manufacturers, logistics providers, partners or end-customers, or of the economy as a whole. Given our typical concentration of sales at the end of each quarter, any disruption in the business of our manufacturers, logistics providers, partners or end-customers that impacts sales at the end of our quarter could have a significant adverse impact on our quarterly results. To the extent that any of the above results in delays or cancellations of customer orders, or in the delay of the manufacture, deployment or shipment of our products, our business, financial condition and results of operations would be adversely affected.

Risks Related to Our Industry

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

The network security market is expected to continue to evolve rapidly. Moreover, many of our end-customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated techniques to gain access to and attack systems and networks. The technology in our products is 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. For example, we enter into development agreements with third parties. If our contract development projects are not successfully completed, or are not completed in a timely fashion, our product development could be delayed and our business generally could suffer. Costs for contract development can be substantial and our profitability may be harmed if we are unable to recover these costs. 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.

Moreover, business models based on software-as-a-service ("SaaS") and infrastructure-as-a-service ("Iaas"), both of which are hosted or cloud-based services, have become increasingly in-demand by our end-customers and adopted by other providers, including our competitors. While part of our platform is cloud-based, most of our platform is currently deployed on premise, and therefore, if customers demand that our platform be provided through a SaaS or IaaS business model, we would be required to make additional investments in our infrastructure and personnel to be able to more fully provide our platform through a SaaS or IaaS model in order to maintain the competitiveness of our platform. Such investments may involve expanding our data centers, servers and networks, and increasing our technical operations and engineering teams. These risks are compounded by the uncertainty concerning the future viability of SaaS and IaaS business models and the future demand for such models by customers. Additionally, if we are unable to meet the demand to provide our services through a SaaS or IaaS model, we may lose customers to

competitors.

Our uniform resource locator ("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,

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

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

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

- changes to the 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.

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

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

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

The market for network security products is intensely competitive and we expect competition to intensify in the future. Our competitors include companies such as Check Point Software Technologies Ltd., Cisco Systems, Inc. ("Cisco"), F5 Networks, Inc. ("F5 Networks") FireEye, Inc., Intel, Juniper Networks, Inc. ("Juniper"), Palo Alto Networks, Inc., SonicWALL, Inc., Sophos Group Plc and Symantec Corporation.

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

- greater name recognition and longer operating histories;
- larger sales and marketing budgets and resources;
- broader distribution and established relationships with distribution partners and end-customers;
- access to larger customer bases;
- greater customer support resources;
- greater resources to make acquisitions;
- lower labor and development costs; and
- substantially greater financial, technical and other resources.

In addition, some of our larger competitors have substantially broader product offerings, and leverage their relationships based on other products or incorporate functionality into existing products in a manner that discourages customers from purchasing our products. These larger competitors often have broader product lines and market focus, and are in a better position to withstand any significant reduction in capital spending by end-customers in these markets. Therefore, these competitors will not be as susceptible to downturns in a particular market. Also, many of our smaller competitors that specialize in providing protection from a single type of network security threat are often able to deliver these specialized network security products to the market more quickly than we can. Some of our smaller competitors are using third-party chips designed to accelerate performance. Conditions in our markets could change rapidly and significantly as a result of technological advancements or continuing market consolidation. Our competitors and potential competitors may also be able to develop products or services that are equal or superior to ours, achieve greater market acceptance of their products and services, and increase sales by utilizing different distribution channels than we do. Our current and potential competitors may also establish cooperative relationships among themselves or with third parties that may further enhance their resources. In addition, current or potential competitors may be acquired by third parties with greater available resources, and new competitors may arise

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pursuant to acquisitions of network security companies or divisions. As a result of such acquisitions, competition in our market may continue to increase and our current or potential competitors might be able to adapt more quickly to new technologies and customer needs, devote greater resources to the promotion or sale of their products and services, initiate or withstand substantial price competition, take advantage of acquisition or other opportunities more readily, or develop and expand their product and service offerings more quickly than we do. In addition, our competitors may bundle products and services competitive with ours with other products and services. Customers may accept these bundled products and services rather than separately purchasing our products and services. Due to budget constraints or economic downturns, organizations may be more willing to incrementally add solutions to their existing network security infrastructure from competitors than to replace it with our solutions. These competitive pressures in our market or our failure to compete effectively may result in price reductions, fewer customer orders, reduced revenue and gross margins and loss of market share.

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

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

Risks Related to Intellectual Property

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

We rely primarily on patent, trademark, copyright and trade secrets laws and confidentiality procedures and contractual provisions to protect our technology. Valid patents may not issue from our pending applications, and the claims eventually allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate defensive protection or competitive advantages to us. Patent applications in the U.S. 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 U.S. 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 guarantee 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 U.S., and many foreign countries do not enforce these laws as diligently as government agencies and private parties in the U.S. 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),

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

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

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

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

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

Alternatively, we may be required to develop non-infringing technology, which could require significant time, effort and expense, and may ultimately not be successful. Furthermore, a successful claimant could secure a judgment or we may agree to a settlement that prevents us from distributing certain products or performing certain services or that requires us to pay substantial damages (including treble damages if we are found to have willfully infringed such

claimant’s patents or copyrights), royalties or other fees. Any of these events could seriously harm our business, financial condition and results of operations.

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

We have several ongoing patent lawsuits, several non-practicing entity patent holding companies have sent us letters

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proposing that we license certain of their patents and organizations have sent letters demanding that we provide indemnification for patent claims. 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 (“Sarbanes-Oxley”), Dodd-Frank and other rules implemented by the SEC and The NASDAQ Stock Market impose various requirements on public companies, including requiring changes in corporate governance practices. These requirements, as well as proposed corporate governance laws and regulations under consideration, may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management’s attention from other business concerns, it could have a material adverse effect on our business, financial condition and results of operations. Sarbanes-Oxley requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually, and of our disclosure controls and procedures quarterly. Although our most recent assessment, testing and evaluation resulted in our conclusion that as of December 31, 2016, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in 2017 or future periods. We may incur additional expenses and commitment of management’s time in connection with further evaluations, both of which could materially increase our operating expenses and accordingly reduce our operating results.

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

A change in accounting standards or practices, and varying interpretations of existing or new accounting pronouncements, such as changes to standards related to revenue recognition (which are effective for us beginning on January 1, 2018) and accounting for leases, as well as the significant costs that may be incurred to adopt and to comply with these new pronouncements, 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 cover us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price could decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price and trading volume to decline.

The trading price of our common stock may be volatile.

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

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announcements regarding any stock repurchase programs and the timing and amount of shares we purchase under such programs. For example, during the three months ended March 31, 2017, the closing price of our common stock ranged from $30.12 to $38.35 per share.

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

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

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

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

- providing for a classified board of directors whose members serve staggered three-year terms;
- authorizing "blank check" preferred stock, which could be issued by the board without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;
- limiting the liability of, and providing indemnification to, our directors and officers;
- limiting the ability of our stockholders to call and bring business before special meetings;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;
- providing that certain litigation matters may only be brought against us in state or federal courts in the State of Delaware;
- controlling the procedures for the conduct and scheduling of board and stockholder meetings; and
- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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

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

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

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

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

2016 Repurchase Program

During the three months ended March 31, 2017, there were no shares repurchased under the 2016 Repurchase Program. As of March 31, 2017, $189.2 million remained available for future share repurchases under the 2016 Repurchase Program.

ITEM 6. Exhibits

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

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SIGNATURES

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

Date: May 2, 2017

FORTINET, INC.

By: /s/ Ken Xie
Ken Xie, Chief Executive Officer and Chairman
(Duly Authorized Officer and Principal Executive Officer)

FORTINET, INC.

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

FORTINET, INC.

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

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EXHIBIT INDEX

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

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* Filed herewith.