FORTINET INC
Form 10-Q
May 13, 2010
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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, 2010

Or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission file number: 001-34511

FORTINET, INC.

(Exact name of registrant as specified in its charter)

Delaware	**77-0560389**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
1090 Kifer Road	
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 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

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

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

As of April 30, 2010, there were 67,447,019 shares of the registrant s common stock outstanding.

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FORTINET INC

QUARTERLY REPORT ON FORM 10-Q

For the Quarter Ended March 31, 2010

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Part I

ITEM 1. Financial Statements

FORTINET, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	March 31, 2010	December 31, 2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 174,255	$ 212,458
Short-term investments	73,905	47,856
Accounts receivable, net of allowance for doubtful accounts of $303 and $367 at March 31, 2010 and December 31, 2009, respectively	51,315	54,551
Inventory	9,867	10,649
Deferred tax asset Current	9,662	9,652
Prepaid expenses and other current assets	3,591	3,100
Deferred cost of revenues	3,958	3,951
Total current assets	326,553	342,217
PROPERTY AND EQUIPMENT Net	6,663	6,387
DEFERRED COST OF REVENUES	5,357	5,743
DEFERRED TAX ASSET Non-current	31,671	31,671
OTHER ASSETS	1,188	1,195
LONG-TERM INVESTMENTS	32,777	
TOTAL ASSETS	$ 404,209	$ 387,213
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 10,186	$ 10,987
Accrued liabilities	14,003	15,050
Accrued payroll and compensation	14,541	13,991
Deferred revenue Current	145,140	140,537
Total current liabilities	183,870	180,565
DEFERRED REVENUE Non-current	66,397	61,393
OTHER NON-CURRENT LIABILITIES	2,836	2,803
Total liabilities	253,103	244,761
COMMITMENTS AND CONTINGENCIES (Note 7)		
STOCKHOLDERS EQUITY:		
Common stock, $0.001 par value 300,000 shares authorized; 68,082 and 67,517 shares issued and 67,377 and 66,813 shares outstanding at March 31, 2010 and December 31, 2009 respectively	68	67

Additional paid-in-capital	208,596	204,268
Treasury stock	(2,995)	(2,995)
Accumulated other comprehensive income	1,191	1,084
Accumulated deficit	(55,754)	(59,972)
Total stockholders equity	151,106	142,452
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 404,209	$ 387,213

See notes to condensed consolidated financial statements.

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FORTINET, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Three Months Ended	
	March 31, 2010	March 29, 2009
REVENUE:		
Product	$ 27,110	$ 19,326
Services	38,625	31,573
Ratable product and services	4,060	3,295
Total revenue	69,795	54,194
COST OF REVENUE:		
Product	11,314	8,305
Services	6,468	5,048
Ratable product and services	1,593	1,301
Total cost of revenue	19,375	14,654
GROSS PROFIT:		
Product	15,796	11,021
Services	32,157	26,525
Ratable product and services	2,467	1,994
Total gross profit	50,420	39,540
OPERATING EXPENSES:		
Research and development	11,934	9,876
Sales and marketing	26,723	21,763
General and administrative	5,059	4,672
Total operating expenses	43,716	36,311
OPERATING INCOME	6,704	3,229
INTEREST INCOME	268	714
OTHER INCOME (EXPENSE) Net	(250)	494
INCOME BEFORE INCOME TAXES	6,722	4,437
PROVISION FOR INCOME TAXES	2,504	663
NET INCOME	$ 4,218	$ 3,774
Net income (loss) per share attributable to common stockholders (Note 5):		
Basic	$ 0.06	$ (0.07)
Diluted	$ 0.06	$ (0.07)

Weighted-average shares outstanding:		
Basic	67,181	20,960
Diluted	74,878	20,960

See notes to condensed consolidated financial statements

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FORTINET, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Three Months Ended	
	March 31, 2010	March 29, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 4,218	$ 3,774
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,375	1,353
Amortization of investment premiums	1,090	269
Stock-based compensation	2,148	1,550
Excess tax benefit from employee stock option plans	(795)	
Changes in operating assets and liabilities:		
Accounts receivable Net	3,236	5,478
Inventory	(27)	69
Deferred tax assets	(10)	
Prepaid expenses and other current assets	(529)	(738)
Deferred cost of revenues	379	(169)
Other assets	3	174
Accounts payable	(505)	341
Accrued liabilities	(576)	(919)
Accrued payroll and compensation	839	(1,313)
Deferred revenue	9,607	5,994
Income taxes payable	1,363	(292)
Net cash provided by operating activities	21,816	15,571
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investments	(73,903)	(46,393)
Maturities and sales of investments	13,945	33,950
Purchases of property and equipment	(1,014)	(2,625)
Net cash used in investing activities	(60,972)	(15,068)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options and warrants	1,386	723
Offering costs paid in connection with Initial Public Offering	(872)	
Repurchase of convertible preferred shares		(6,273)
Repurchase of common shares		(1,769)
Excess tax benefit from employee stock option plans	795	
Net cash provided by (used in) financing activities	1,309	(7,319)
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(356)	(240)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(38,203)	(7,056)
CASH AND CASH EQUIVALENTS Beginning of period	212,458	56,571
CASH AND CASH EQUIVALENTS End of period	$ 174,255	$ 49,515

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:				
Cash paid for taxes	$	302	$	1,289
NON-CASH INVESTING AND FINANCING ACTIVITIES:				
Purchase of property and equipment not yet paid	$	572	$	249

See notes to condensed consolidated financial statements.

FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Basis of Presentation and Preparation The condensed consolidated financial statements include the accounts of Fortinet and its wholly owned subsidiaries (collectively, the Company, we, us or our). All intercompany transactions and balances have been eliminated in consolidation. The accompanying condensed consolidated balance sheet as of March 31, 2010, the condensed consolidated statements of operations for the three months ended March 31, 2010 and March 29, 2009, and the condensed consolidated statements of cash flows for the three months ended March 31, 2010 and March 29, 2009 are unaudited. The condensed consolidated balance sheet data as of December 31, 2009 was derived from the audited condensed consolidated financial statements which are included in our Annual Report on Form 10-K (Form 10-K). The accompanying statements should be read in conjunction with the audited condensed consolidated financial statements and related notes contained in our Form 10-K.

The accompanying unaudited interim condensed consolidated financial statements for the three months ended and as of March 31, 2010 and March 29, 2009 have been prepared on the same basis as the audited condensed consolidated statements and reflect all adjustments, consisting of normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of our financial position, results of operations, and cash flows for the interim period presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP or GAAP) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The results of operations for the three months ended March 31, 2010 are not necessarily indicative of the operating results for any subsequent quarter, for the full fiscal year or any future periods.

Until the second quarter of fiscal 2009, we had a 52- to 53-week year ending on the Sunday closest to December 31 of each year. Commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our first quarter of fiscal 2009 ended on March 29, 2009. The first quarters of 2010 and 2009 comprised of 90 days and 91 days, respectively.

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

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

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

At March 31, 2010 and December 31, 2009, one distributor customer accounted for 11% and 15%, respectively, of net accounts receivable.

During the quarters ended March 31, 2010 and March 29, 2009, one distributor customer accounted for 11% and 12%, respectively, of total net revenues.

Fair Value of Financial Instruments Accounting Standards Codification (ASC) 825 (formerly referred to as Financial Accounting Standards Board Statement No. 107, *Disclosures about Fair Value of Financial Instruments*) requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. Due to their short-term nature, the carrying amounts reported in the condensed consolidated financial statements approximate the fair value for cash and cash equivalents, accounts receivable, and accounts payable.

Comprehensive Income ASC 220 (formerly referred to as FASB Statement No. 130, *Reporting Comprehensive Income*) establishes standards for the reporting and displaying of comprehensive income and its components. Comprehensive income includes certain changes in equity from non-owner sources that are excluded from net income. Specifically, cumulative foreign currency translation adjustments and unrealized gains and losses are included in comprehensive income. Comprehensive income has been reflected in the condensed consolidated statements of stockholders equity and comprehensive income.

Foreign Currency Translation Assets and liabilities of foreign subsidiaries are translated into U.S. dollars using the exchange rates in effect at the balance sheet dates and revenue and expenses are translated using average exchange rates during the period. The resulting foreign translation adjustments are recorded in accumulated other comprehensive income (loss). Foreign currency transaction gains and (losses) of $(0.3) million and $0.5 million, are included in other income (expense), net for the quarter ended March 31, 2010 and March 29, 2009, respectively.

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

We classify our investments as available-for-sale at the time of purchase since it is our intent that these investments are available for current operations, and include these investments on our balance sheet as either short-term or long-term investments depending on their maturity at the time of purchase. Investments with original maturities greater than three months that mature less than one year from the condensed consolidated balance sheet date are classified as short-term investments. Investments with maturities greater than one year from the condensed consolidated balance sheet date are classified as long-term investments.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

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

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

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

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

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

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

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

Stock-Based Compensation Effective January 2, 2006, we adopted ASC 718 (formerly referred to as SFAS 123R). For our stock option grants made subsequent to January 2, 2006, we have accounted for such stock-based awards to employees in accordance with ASC 718, which requires compensation expense related to share-based transactions, including employee stock options, to be measured and recognized in the financial statements based on fair value. Under ASC 718, the fair value of each option award is estimated on the grant date using the Black-Scholes option pricing model.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

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

Revenue Recognition We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. Our appliances include operating system software that is integrated into the appliance hardware and is deemed essential to its functionality. As a result, we account for revenue in accordance with ASC 985-605 (formerly referred to as Statement of Position 97-2 (SOP 97-2) *Software Revenue Recognition*), and all related interpretations.

No revenue can be recognized until all of the following criteria have been met:

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

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

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

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

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

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

We use the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and vendor-specific objective evidence (VSOE) of the fair value of all undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the contract fee is recognized as product revenue. In cases where VSOE of fair value of the undelivered elements does not exist, it is typically due to a lack of VSOE on the subscription and support services for that specific arrangement; revenue for the entire arrangement is recognized ratably over the performance period of the undelivered elements. Revenue related to these arrangements is included in ratable product and services revenue in the accompanying condensed consolidated statements of operations.

VSOE of fair value for elements of an arrangement is based upon the pricing for those services when sold separately. Revenue for professional services and training is recognized upon completion of the related services.

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Accounts Receivable Trade accounts receivable are recorded at the invoiced amount, net of allowances for doubtful accounts and sales returns and allowances. The allowance for doubtful accounts is based on our assessment of the collectability of customer accounts. We regularly review the allowance by considering factors such as historical experience, credit quality, age of the accounts receivable balances and current economic conditions that may affect a customer s ability to pay. The reserve for sales returns and allowances is based on specific criteria including agreements to provide rebates and other factors known at the time, as well as estimates of the amount of goods shipped that will be returned. To determine the adequacy of the sales returns and allowances, we analyze historical experience of actual rebates and returns as well as current product return information.

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

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

	For The 3 Months Ended And As Of March 31, 2010	For The Year Ended And As Of December 31, 2009
Accrued warranty balance beginning of the period	$ 2,257	$ 2,882
Warranty costs incurred	(334)	(1,502)
Provision for warranty	88	1,169
Adjustments to previous estimates	30	(292)
Accrued warranty balance end of the period	$ 2,041	$ 2,257

Recent Accounting Pronouncements

In January 2010, the FASB issued revised guidance on disclosures related to fair value measurements. This guidance requires new disclosures about significant transfers in and out of Level 1 and Level 2 and separate disclosures about purchases, sales, issuances, and settlements with respect to Level 3 measurements. The guidance also clarifies existing fair value disclosures about valuation techniques and inputs used to measure fair value. The new disclosures and clarifications of existing disclosures are effective for us beginning in the first quarter of 2010, except for the disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements, which will be effective for us in the first quarter of 2011. We do not expect the adoption to have a material impact on our financial statements.

In September 2009, the EITF reached a consensus on ASC 605-25 (formerly referred to as EITF 08-1, *Revenue Arrangements with Multiple Deliverables*). ASC 605-25 eliminates the criterion for objective and reliable evidence of fair value for the undelivered products or services. Instead, revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables meet both of the following criteria:

The delivered items have value to the customer on a stand-alone basis

If the arrangement includes a general right of return relative to the delivered items, delivery or performance of the undelivered items is considered probable and substantially in the control of the vendor.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

ASC 605-25 eliminates the use of the residual method of allocation and requires, instead, that arrangement consideration be allocated, at the inception of the arrangement, to all deliverables based on their relative selling price (i.e., the relative selling price method). When applying the relative selling price method, a hierarchy is used for estimating the selling price for each of the deliverables. The hierarchy establishes that the method for determining estimated selling price should be chosen in the following order of priority:

VSOE of the selling price;

Third-party evidence (TPE) of the selling price prices of the vendor s or any competitor s largely interchangeable products or services, in standalone sales to similarly situated customers; and

Best estimate of the selling price.

In September 2009, the FASB reached a consensus on ASC 985-605 (formerly referred to as EITF 09-3, *Certain Revenue Arrangements That Include Software Elements*). Arrangements to sell joint hardware and software products where the software and non-software components function together to deliver the product s essential functionality will no longer be scoped into software accounting rules, but will be subject to non-software multiple element accounting guidance (ASC 605-25). ASC 985-605 and ASC 605-25 provide a list of items to consider when determining whether the software and non-software components function together to deliver a product s essential functionality. ASC 985-605 must be adopted for arrangements entered into beginning January 1, 2011, and may be early-adopted. We plan to adopt ASC 985-605 and ASC 605-25 in the first quarter of 2011, and are currently evaluating the impact of adoption on our consolidated financial statements.

2. INVESTMENTS AND FAIR VALUE MEASUREMENTS

The following table summarizes our investments in available-for-sale securities (in thousands):

	March 31, 2010			
	Amortized Cost	Unrealized Gains	Unrealized Loss	Estimated Fair Value
Available-for-sale securities:				
U.S. government and agency securities	$ 14,286	$ 4	$	$ 14,290
Corporate debt securities	88,408		(13)	88,395
Commercial paper	3,997			3,997
Total available-for-sale securities	$ 106,691	$ 4	$ (13)	$ 106,682
	December 31, 2009			
Available-for-sale securities:				
U.S. government and agency securities	$ 2,000	$	$ (2)	$ 1,998
Corporate debt securities	41,840	35		41,875
Commercial paper	3,983			3,983

Total available-for-sale securities	$ 47,823	$ 35	$ (2)	$ 47,856

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

	March 31, 2010	December 31, 2009
Due within one year	$ 73,905	$ 47,856
Due within one to two years	32,777	
Total	$ 106,682	$ 47,856

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

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

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Fair Value Accounting We adopted ASC 820 (formerly referred to as FASB Statement No. 157, *Fair Value Measurement*) effective January 1, 2008. ASC 820 establishes a valuation hierarchy for disclosure of the inputs to fair value measurement. This hierarchy prioritizes the inputs into three broad levels as follows:

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

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

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

The following table presents the fair value of our financial assets as of March 31, 2010 and December 31, 2009 using the ASC 820 input categories:

	March 31, 2010			December 31, 2009		
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)
Total cash, cash equivalents and available-for-sale securities:						
U.S. government and agency securities	$ 14,290	$	$ 14,290	$ 1,998	$	$ 1,998
Corporate debt securities	88,395	88,395		41,875	41,875	
Commercial paper	3,997		3,997	3,983		3,983
Money market funds	120,056	120,056		179,444	179,444	
Cash equivalents and available-for-sale securities	226,738	$ 208,451	$ 18,287	227,300	$ 221,319	$ 5,981
Cash	54,199			33,014		
Total cash, cash equivalents and available-for-sale securities	$ 280,937			$ 260,314		
Reported as:						
Cash and cash equivalents	$ 174,255			$ 212,458		
Short-term investments	73,905			47,856		
Long-term investments	32,777					
Total cash, cash equivalents and available-for-sale securities	$ 280,937			$ 260,314		

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

We classify items in Level 2 if the investments are valued using observable inputs to quoted market prices, benchmark yields, reported trades, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency.

We did not hold financial assets or liabilities which were recorded at fair value using inputs in the Level 3 category as of March 31, 2010 and December 31, 2009.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

3. INVENTORY

Inventory consisted of the following (in thousands):

	March 31, 2010	December 31, 2009
Raw materials	$ 2,401	$ 1,904
Finished goods	7,466	8,745
Inventory	$ 9,867	$ 10,649

4. PROPERTY AND EQUIPMENT Net

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

	March 31, 2010	December 31, 2009
Evaluation units	$ 9,259	$ 8,449
Computer equipment and software	9,102	8,827
Furniture and fixtures	1,166	1,191
Leasehold improvements and tooling	3,978	4,134
Total property and equipment	23,505	22,601
Less: accumulated depreciation and amortization	(16,842)	(16,214)
Property and equipment net	$ 6,663	$ 6,387

Depreciation expense was $1.4 million and $1.2 million during the three months ended March 31, 2010 and March 29, 2009, respectively.

5. INCOME (LOSS) PER SHARE

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

In November 2009, all of our outstanding convertible preferred stock converted into common stock in connection with our initial public offering. For periods that ended prior to such conversion, net income per share information is computed using the two-class method. The convertible preferred shares were entitled to receive annual non-cumulative dividends of $0.02, $0.05, $0.12, $0.12 and $0.30 per share for Series A, B, C, D, and E, respectively, payable prior and in preference to holders of common stock. After the payment of such dividends, convertible preferred shares were further entitled to receive a proportionate amount of any dividends paid on common stock on an if-converted basis. As a result of such dividend rights, the convertible preferred shares are considered to be participating securities. Under the two-class method of computing earnings per share, net income attributable to common stockholders is computed by an adjustment to subtract from net income the portion of current year earnings that the preferred shareholders would have been entitled to receive pursuant to their dividend rights had all of the year s earnings been distributed. No such adjustment to earnings is made during periods with a net loss, as the holders of the convertible preferred shares had no obligation to fund losses. Accordingly, in the first quarter of 2009, we did not apply the two-class method. Basic net income (loss) per share is computed by dividing net income attributable to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by using the weighted-average number of common shares outstanding, plus, for periods with net income attributable to common stock, the dilutive effects of stock options.

Net income per share information for the quarter ended March 29, 2009 gives effect to the repurchase of convertible preferred shares (Note 8). The excess of the fair value of the consideration paid for such preferred stock over the carrying value of the preferred stock represents a return to the preferred stockholders and is treated in a manner similar to the treatment of dividends paid to the holders of preferred stock in the computation of earnings per share. As a result, the premium paid is subtracted to derive net income attributable to common stockholders in determining earnings per share.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

A reconciliation of the numerator and denominator used in the calculation of basic and diluted net income (loss) per share follows:

	Three Months Ended March 31, 2010	Three Months Ended March 29, 2009
Numerator:		
Net income	$ 4,218	$ 3,774
Premium paid on repurchase of convertible preferred shares		(5,231)
Net income (loss) attributable to common stockholders-basic and diluted	$ 4,218	$ (1,457)
Denominator:		
Basic shares:		
Weighted-average common shares outstanding-basic	67,181	20,960
Diluted shares:		
Weighted-average common shares outstanding-basic	67,181	20,960
Effect of potentially dilutive securities:		
Employee stock options	7,610	
Warrants to purchase common stock	87	
Weighted-average shares used to compute diluted net income (loss) per share	74,878	20,960
Net income (loss) per share attributable to common stockholders:		
Basic	$ 0.06	$ (0.07)
Diluted	$ 0.06	$ (0.07)

The following outstanding options and convertible preferred stock were excluded from the computation of diluted net income (loss) per common share applicable to common stockholders for the periods presented as their effect would have been antidilutive (in thousands):

	Three Months Ended March 31, 2010	Three Months Ended March 29, 2009
Options to purchase common stock	723	8,822
Convertible preferred stock (on an as-converted to common stock basis)		39,004
Total	723	47,826

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

6. DEFERRED REVENUES

Deferred revenues consisted of the following (in thousands):

	March 31, 2010	December 31, 2009
Product	$ 4,679	$ 4,141
Services	177,553	168,314
Ratable products and services	29,305	29,475
Total deferred revenues	$ 211,537	$ 201,930
Reported As:		
Short-term	$ 145,140	$ 140,537
Long-term	66,397	61,393
Total deferred revenues	$ 211,537	$ 201,930

7. COMMITMENTS AND CONTINGENCIES

Leases and Minimum Royalties We lease our facilities under various noncancelable operating leases, which expire through 2014. Rent expense was $1.7 million and $1.4 million for the three months ended March 31, 2010 and March 29, 2009, respectively. Rent expense is recognized using the straight-line method over the term of the lease.

We entered into a Settlement and Patent License Agreement with Trend Micro in January 2006 (see Litigation section below). The aggregate future noncancelable minimum rental payments on operating leases and minimum royalties payable if we continued paying under the Trend Micro Settlement and License Agreement as of March 31, 2010 are as follows (in thousands):

	Rental Payment	Royalty
Fiscal Years:		
2010 (remainder)	$ 4,977	$ 3,000
2011	5,626	1,000
2012	3,757	1,000
2013	2,852	1,000
2014	1,352	500
Thereafter	787	500
Total	$ 19,351	$ 7,000

Contract Manufacturer Commitments Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of March 31, 2010, we had $19.1 million of open purchase orders with our independent contract manufacturers that may not be cancelable.

Litigation In May 2004, Trend Micro Incorporated filed a complaint against us alleging that we infringed a Trend Micro patent related to antivirus software. In January 2006, we settled the lawsuit with Trend Micro. Pursuant to the settlement and license agreement, we initially paid Trend Micro $15.0 million. The settlement and license agreement provides for additional quarterly royalty payments, not expected to exceed 1% of our total revenue each quarter, through 2015. In November 2008, we filed a complaint against Trend Micro in the United States District Court for the Northern District of California alleging, among other claims, that the patents that are the basis for the ongoing royalty payments are invalid and consequently that we have no contractual obligation to pay the royalties.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Trend Micro moved to dismiss the case, and, in June 2009, the court dismissed the case without prejudice on procedural grounds, and we appealed the dismissal in July 2009. Based on the dispute, we have ceased paying royalties under the settlement and license agreement. In August 2009, Trend Micro filed a complaint against us in the Superior Court of the State of California for Santa Clara County alleging breach of contract and seeking a declaratory judgment that we are obligated to make certain royalty payments to Trend Micro. In December 2009, we withdrew our appeal of the June 2009 dismissal by the United States District Court for the Northern District of California and filed a new complaint against Trend Micro in the United States District Court for the Northern District of California alleging, among other claims, that the patents that are the basis for the ongoing royalty payments are invalid and consequently that we have no contractual obligation to pay royalties. We have continued to accrue expense based on the quarterly royalties provided for in the settlement and license agreement. In February 2010, Trend Micro filed demurrers in the state Superior Court action regarding Fortinet s affirmative defenses that Fortinet has no obligation to pay royalties because the Trend Micro patents are invalid or unenforceable. In March 2010, Trend Micro filed a motion to dismiss our new complaint that we filed in the United States District Court for the Northern District of California. On May 3, 2010, the state court denied Trend Micro s demurrer in its entirety. On May 12, 2010, the United States District Court for the Northern District of California denied Trend Micro s motion to dismiss without prejudice and stayed the action before that court pending the conclusion of the state court action.

In January 2009, we filed a complaint against Palo Alto Networks, Inc., in the United States District Court for the Northern District of California alleging, among other claims, patent infringement. In September 2009, Palo Alto Networks filed a counterclaim against us alleging patent infringement. In May 2009, Enhanced Security Research, LLC (ESR) a non-practicing entity, filed a complaint in the United States District Court for the District of Delaware alleging patent infringement by us and other defendants. In August 2009, ESR filed a substantially similar complaint against us in the same court alleging infringement of the same patents. In September 2009, Deep Nines, Inc. filed, but did not serve us with, a complaint against us in the United States District Court for the Eastern District of Texas alleging that our products infringe certain of their patents. The Palo Alto Networks and ESR cases are currently at an early stage of the litigation process. The Deep Nines case has not yet been served.

In April 2010, an individual, a former stockholder of Fortinet, filed a class action lawsuit against us in the Superior Court of the State of California for the County of Los Angeles alleging violation of various California Corporate Code sections and related tort claims alleging misrepresentation and breach of fiduciary duty regarding the 2009 repurchase by Fortinet of shares of its stock while we were a privately-held company as discussed in Note 8 immediately below, Stockholders Equity Stock Repurchase .

In addition to the above matters, we are subject to other litigation in the course of business. Although no assurance may be given, we believe that we are not presently a party to any litigation the outcome of which will individually or in the aggregate be reasonably expected to have a material adverse effect on our business, operating results, cash flows, or financial condition.

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

8. STOCKHOLDERS EQUITY

Common Shares Reserved for Issuance At March 31, 2010, we had reserved shares of common stock for issuance as follows (in thousands):

Reserved under stock option plans	25,690
Warrants to purchase common stock	141

Total	25,831

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Stock Repurchase While we were a privately-held company, during the first six months of fiscal 2009, our board of directors approved a stock repurchase authorization. This repurchase authorization allowed us to repurchase up to $20.0 million of our convertible preferred and common stock at $4.25 per share through June 17, 2009. This repurchase authorization expressly excluded our board members and senior management. We repurchased 704,632 shares of common stock and 3,004,165 shares of convertible preferred stock for a total consideration of $15.7 million, out of which 416,177 shares of common stock and 1,476,000 shares of convertible preferred stock were repurchased in the first quarter of 2009 for total consideration of $8.0 million.

9. STOCK PLANS

2000 Stock Plan During 2000, we adopted the 2000 Stock Option Plan, which was amended and restated in April 2006 and further amended in March 2008 (the Amended and Restated 2000 Stock Plan). The Amended and Restated 2000 Stock Plan includes both incentive and non-statutory stock options. Under the Amended and Restated 2000 Stock Plan, we may grant options to purchase up to 21,500,000 shares of common stock to employees, directors and other service providers at prices not less than the fair market value at date of grant for incentive stock options and not less than 85% of fair market value for non-statutory options. Options granted to a person who, at the time of the grant, owns more than 10% of the voting power of all classes of stock shall be at no less than 110% of the fair market value and expire five years from the date of grant. All other options generally have a contractual term of 10 years. Options generally vest over four years.

2008 Stock Plan On January 28, 2008, our board of directors approved the 2008 Stock Plan (the 2008 Plan) and French Sub-Plan, which includes both incentive and non-statutory stock options. The maximum aggregate number of shares which may be subject to options and sold under the 2008 Plan and the French Sub-Plan is 5,000,000 shares, plus any shares that, as of the date of stockholder approval of the 2008 Plan, have been reserved but not issued under the 2000 Plan or shares subject to stock options or similar awards granted under the 2000 Plan that expire or otherwise terminate without having been exercised in full or that are forfeited to or repurchased by us.

Under the 2008 Plan and the French Sub-Plan, we may grant options to employees, directors and other service providers. In the case of an incentive stock option granted to an employee, who at the time of grant, owns stock representing more than 10% of the total combined voting power of all classes of stock, the exercise price shall be no less than 110% of the fair market value per share on the date of grant and expire five years from the date of grant, and options granted to any other employee, the per share exercise price shall be no less than 100% of the fair market value per share on the date of grant. In the case of a nonstatutory stock option and options granted to other service providers, the per share exercise price shall be no less than 100% of the fair market value per share on the date of grant.

2009 Equity Incentive Plan On November 17, 2009, our board of directors approved the 2009 Equity Incentive Plan (the 2009 Plan) and French Sub-Plan, which includes awards of stock options, stock appreciation rights, restricted stock, restricted stock units, and performance units or performance shares. The maximum aggregate number of shares that may be issued under the 2009 Plan is 9,000,000 shares, plus any shares subject to stock options or similar awards granted under the 2008 Stock Plan and the Amended and Restated 2000 Stock Plan that expire or otherwise terminate without having been exercised in full and shares issued pursuant to awards granted under the 2008 Stock Plan and the Amended and Restated 2000 Stock Plan that are forfeited to or repurchased by the Company, with the maximum number of shares to be added to the 2009 Plan pursuant to such terminations, forfeitures and repurchases not to exceed 21,000,000 shares. The shares may be authorized, but unissued or reacquired common stock. The number of shares available for issuance under the 2009 Plan will be increased on the first day of each fiscal year beginning with the 2011 fiscal year, in an amount equal to the lesser of (i) 7,000,000 shares, (ii) five percent (5%) of the outstanding shares on the last day of the immediately preceding fiscal year, or (iii) such number of shares determined by the board of directors.

Under the 2009 Plan and the French Sub-Plan, we may grant awards to employees, directors and other service providers. In the case of an incentive stock option granted to an employee who, at the time of the grant, owns stock representing more than 10% of the voting power of all classes of stock, the exercise price shall be no less than 110% of the fair market value per share on the date of grant and expire five years from the date of grant, and options granted to any other employee, the per share exercise price shall be no less than 100% of the fair market value per share on the date of grant. In the case of a non statutory stock option and options granted to other service providers, the per share exercise price shall be no less than 100% of the fair market value per share on the date of grant. Options granted to individuals owning less than 10% of the total combined voting power of all classes of stock generally have a contractual term of seven years and options generally vest over four years.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Stock-based compensation under ASC 718 Effective January 1, 2006, we adopted ASC 718, which requires compensation costs related to share-based transactions, including employee stock options, to be recognized in the financial statements based on fair value. Under ASC 718, the fair value of each option award is estimated on the grant date using the Black-Scholes option pricing model. We determined weighted-average valuation assumptions as follows:

Valuation method We estimate the fair value of stock options granted using the Black-Scholes valuation model.

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

Expected Volatility The computation of expected volatility for the periods presented is based on the historical and implied stock volatility of comparable companies from a representative peer group selected based on industry and market capitalization data as we did not have sufficient trading history to calculate it directly.

Fair Value of Common Stock The fair value of the shares of common stock that underlie the stock options we have granted has historically been determined by our board of directors. Because there has been no public market for our common stock, prior to our initial public offering in November 2009, our board has determined the fair value of our common stock at the time of grant of the option by considering a number of objective and subjective factors, our sales of preferred stock to unrelated third parties, our operating and financial performance, the lack of liquidity of our capital stock and trends in the broader network security and computer networking market.

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

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

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

	Three Months Ended	
	March 31, 2010	**March 29, 2009**
Dividend rate		
Risk-free interest rate	2.4%	1.3%
Expected term in years	4.6	4.6
Volatility	40.5%	51.8%

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

	Three Months Ended	
	March 31, 2010	**March 29, 2009**
Cost of product revenue	$ 24	$ 24
Cost of services revenue	208	124

Research and development	554	378
Sales and marketing	866	644
General and administrative	496	380
	$ 2,148	$ 1,550

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

		Options Outstanding			
	Shares Available For Grant	Number Of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Balance December 31, 2009	9,049	17,205			
Granted	(1,306)	1,306	$ 16.86		
Forfeited	190	(190)	8.41		
Exercised (aggregate intrinsic value of $8,948)		(565)	2.45		
Balance March 31, 2010	7,933	17,756			
Options vested and expected to vest March 31, 2010		17,311	$ 5.86	5.15	$ 202,970
Options exercisable March 31, 2010		10,985	$ 3.81	4.73	$ 151,245

At March 31, 2010, total compensation cost related to unvested stock-based awards granted to employees under our stock plans but not yet recognized was $22.5 million, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of 2.66 years. Future option grants will increase the amount of compensation expense to be recorded in these periods.

The total fair value of awards vested under our stock plans was $3.3 million and $0.8 million for the three months ended March 31, 2010 and March 29, 2009, respectively. The weighted-average fair value of options granted during the first quarter of 2010 was $6.28 per share.

Non-employees During the quarter ended March 31, 2010, we issued options to purchase 9,400 of common stock, at an exercise price of $16.86 per share, to non-employees in exchange for services. No options were granted to nonemployees in exchange for services during the quarter ended March 29, 2009. These options vest over periods of up to 48 months, and in accordance with ASC 505-50 (formerly referred to as Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services*), we accounted for these options as variable awards. The options were valued using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Three Months Ended	
	March 31, 2010	March 29, 2009
Dividend rate		
Risk-free interest rate	2.4%	1.3%
Expected term in years	5.1 - 6.8	6.1 - 7.5
Volatility	40.5%	51.8%

10. INCOME TAXES

The effective tax rate was 37.3% for the three months ended March 31, 2010, compared with an effective tax rate of 14.9% for the three months ended March 29, 2009. The provision for income taxes for March 31, 2010 is comprised of foreign income taxes, U.S. federal and state taxes, and withholding tax. The provision for income taxes for March 29, 2009 is comprised primarily of foreign income taxes, U.S. federal alternative minimum tax and state income taxes, and withholding tax.

As of March 31, 2010 and December 31, 2009, unrecognized tax benefits determined in accordance with authoritative guidance on accounting for uncertainty in income taxes, approximated $3.4 million for both periods. There were no significant changes in the unrecognized tax benefits for this period. The total amount of unrecognized tax benefits, if recognized, would favorably affect the effective tax rate.

It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. For the three months ended March 31, 2010, interest and penalties related to unrecognized tax benefits were immaterial. We do not expect any material unrecognized tax benefits to expire within the next twelve months.

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FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

11. EMPLOYEE BENEFIT PLAN

We have established a 401(k) tax-deferred savings plan (the 401(k) Plan) which permits participants to make contributions by salary deduction pursuant to Section 401(k) of the Internal Revenue Code. We are responsible for administrative costs of the 401(k) Plan and have made no contributions to the 401(k) Plan since inception.

12. CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

During the three months ended March 29, 2009, we paid compensation of $44,000 to two employees who are directly related to a former board member. This individual ceased being a board member as of October 2009.

In February 2008, we entered into a 23-month non-cancelable facility lease agreement with an entity affiliated with one of our board members. Under the terms of the agreement, in 2008, we paid approximately $284,000 for tenant improvements and $316,000 for a refundable deposit. For the quarter ended March 29, 2009 we paid $249,000 for office rent and operating expenses. The lease expired on December 31, 2009.

13. SEGMENT INFORMATION

ASC 280 (formerly referred to as SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information)* establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Our chief operating decision maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. We have one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, we are considered to be in a single reportable segment and operating unit structure.

FORTINET, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

	Three Months Ended	
Revenue	**March 31, 2010**	**March 29, 2009**
Americas	$ 23,817	$ 19,135
Europe, Middle East and Africa (EMEA)	27,074	20,782
Asia Pacific and Japan (APAC)	18,904	14,277
Total revenue	$ 69,795	$ 54,194

	Three Months Ended	
Interest Income	**March 31, 2010**	**March 29, 2009**
Americas	$ 263	$ 705
EMEA	4	8
APAC	1	1
Total interest income	$ 268	$ 714

Property and Equipment	**March 31, 2010**	**December 31, 2009**
Americas	$ 5,291	$ 4,988
EMEA	523	504
APAC	849	895
Total property and equipment net	$ 6,663	$ 6,387

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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 of 1933 and Section 21E of the Securities Exchange Act of 1934.These statements include, among other things, statements concerning our expectations:

- *regarding the significance of stock compensation as an expense;*
- *that our service revenues may become a larger portion of our total revenue and may increase as we renew existing services contracts and expand our customer base;*
- *regarding the percentage of our revenue attributable to ratable product and services revenue;*
- *regarding our royalty payments to Trend Micro;*
- *regarding trends in our costs of revenues, services gross margin and overall gross margin;*
- *regarding increases in our operating expenses;*
- *regarding our investment in our support infrastructure; and*
- *regarding the hiring of new employees;*
- *regarding the sufficiency of our existing cash and cash equivalents to meet our cash needs for at least the next 12 months; and*
- *regarding the impact of inflation;*

as well as other statements regarding our future operations, financial condition and prospects and business strategies. These forward-looking statements are subject to certain risks and uncertainties that could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q and, in particular, the risks discussed under the heading Risk Factors included elsewhere in this Quarterly Report on Form 10-Q and in our other Securities and Exchange Commission filings, including our Annual Report on Form 10-K for the year ended December 31, 2009, which was filed on March 5, 2010. 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 are a leading provider of network security appliances and the market leader in UTM network security solutions. We provide broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and government entities worldwide. As of March 31, 2010, we had shipped over 550,000 appliances to more than 5,000 channel partners and to more than 90,000 end-customers worldwide, including a majority of the 2009 Fortune Global 100.

Our core UTM product line of FortiGate appliances ships with a set of security and networking capabilities, including firewall, VPN, antivirus, intrusion prevention, Web filtering, antispam and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-30, designed for small businesses and branch offices, to the FortiGate-5000 series for large enterprises and service providers. On an annual basis for each of the last three fiscal years, sales of FortiGate products have generally been balanced across entry-level (FortiGate-30 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately one-third of FortiGate sales. For the first quarter of 2010 the percentage of our FortiGate related billings from the high-end category was 27% versus 21% for the first quarter of 2009, while the mid-range category decreased from 38% to 33% over the same period, and entry-level remained flat. Our UTM solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to the antivirus, intrusion prevention, Web filtering and antispam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web-based traffic and databases, and employee computers or handheld devices. During the current quarter, we extended and enhanced our FortiGate, FortiWeb, FortiMail, and FortiManager appliance families, and also introduced a new family of FortiAP secure access point appliances that address the demand for secure mobility in the enterprise.

We are a global, geographically diversified business, with more than 60% of our total revenue generated outside of the Americas region. For the first quarter of 2010, $23.8 million, or 34%, of our total revenue was generated from the Americas, representing an increase of 24% over the first quarter of 2009. EMEA generated $27.1 million, or 39%, of our total revenue during the current quarter, representing an increase of 30% over the same period of the prior year. APAC generated $18.9 million or 27% of our total revenue during the current quarter, representing an increase of 32% compared to the same period of the prior year. We sell globally in U.S. dollars, while our international expenses are denominated in local currencies.

Total revenue was $69.8 million for the first quarter of 2010, an increase of 29% compared to the first quarter of 2009. Product revenue was $27.1 million, an increase of 40% compared to the first quarter of 2009. Services revenue was $38.6 million, an increase of 22% compared to the first quarter of 2009. Services revenue provides a source of recurring revenue for us, representing about 55% and 58% of total revenue for the first quarter of 2010 and 2009, respectively, and is important to our future revenue and profitability. Ratable product and services revenue was $4.1 million, an increase of 23% compared to the first quarter of 2009.

Our Business Model

Our sales strategy is based on a distribution model whereby we primarily sell our products and services directly to distributors who sell to resellers and service providers, who, in turn, sell to our end-customers. In certain cases, we sell directly to government-focused resellers, large service providers and major systems integrators, who have significant purchasing power and unique customer deployment requirements. Typically, FortiGuard security subscription services and FortiCare technical support services are purchased along with our appliances. We invoice at the time of our sale for the total price of the products and subscription and support services, and the invoice generally becomes payable within 30 to 90 days. We generally recognize product revenue up-front but defer revenue for the sale of new and renewal subscription and support services contracts. We recognize the related services revenue over the service period, which is typically one year from the date the end-customer registers for these services (the date on which the services can first be used by the customer). As a result, our sales of new and renewal services increase our deferred revenue balance, which contributes significantly to our positive cash flow from operations.

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Key Metrics

We monitor the key financial metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. Our total deferred revenue increased by $9.6 million from $201.9 million at December 31, 2009 to $211.5 million at March 31, 2010. Revenue recognized plus the change in deferred revenue from the beginning to the end of the period is a useful metric that management identifies as billings. Billings for services drive deferred revenue, which is an important indicator of the health and visibility of our business, and has historically represented a majority of the quarterly revenue that we recognize. We also ended the first quarter of 2010 with $280.9 million in cash, cash equivalents and investments and have had positive cash flow from operations every fiscal year since 2005. We discuss revenue, gross margin, and the components of operating income and margin below under Components of Operating Results, and we discuss our cash, cash equivalents, and investments under Liquidity and Capital Resources. Deferred revenue and cash flow from operations are discussed immediately below the table.

	For The Three Months Ended Or As Of	
	March 31, 2010	March 29, 2009
	(dollars in thousands)	
Revenue	$ 69,795	$ 54,194
Gross margin	72.2%	73.0%
Operating income(1)	$ 6,704	$ 3,229
Operating margin	9.6%	6.0%
Total deferred revenue	$ 211,537	$ 177,611
Increase in total deferred revenue(2)	9,607	5,994
Cash, cash equivalents and investments	280,937	128,916
Cash flow from operations	21,816	15,571
Free cash flow(3)	20,802	12,946

(1) Includes stock-based compensation expense	$ 2,148	$ 1,550

(2) The increase in total deferred revenue is the change from the beginning of the period to the end of the period.

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

Deferred revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. The majority of our deferred revenue balance consists of the unamortized portion of services revenue from subscription and support service contracts. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods. We also assess the increase in our deferred revenue balance plus revenue we recognized in a particular period as a measure of our sales activity for that period.

Cash flow from operations. We monitor cash flow from operations as a measure of our overall business performance. Our cash flow from operations is driven in large part by advance payments for both new and renewal contracts for subscription and support services. Monitoring cash flow from operations enables us to analyze our financial performance without the non-cash effects of certain items such as depreciation, amortization and stock-based compensation expenses, thereby allowing us to better understand and manage the cash needs of our business. Our cash flow from operations was $21.8 million in the first quarter of 2010 and $15.6 million in the first quarter of 2009. In the first quarter of 2010, free cash flow (a non-GAAP measure, described in the Non-GAAP Financial Measures below) was $20.8 million, compared to $12.9 million in the first quarter of 2009.

Non-GAAP Financial Measures

To supplement our condensed consolidated financial statements presented in accordance with U.S. GAAP, we consider certain financial measures that are not prepared in accordance with GAAP, including non-GAAP gross margin, non-GAAP income from operations and operating margin, non-GAAP operating expenses, non-GAAP net income and free cash flow. These non-GAAP measures are not based on any standardized methodology prescribed by GAAP and are not necessarily comparable to similar measures presented by other companies. Non-GAAP gross margin is gross margin as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense, which is a non-cash charge. Non-GAAP income from operations is operating income, as reported on our condensed consolidated statements of operations, excluding the impact of stock-based compensation expense. Non-GAAP operating margin is non-GAAP income from operations divided by revenue. Non-GAAP operating expenses exclude the impact of stock-based compensation expense. Non-GAAP net income is net income plus stock-based compensation expense, less the related tax effects. Free cash flow, an alternative non-GAAP measure of liquidity, is defined as net cash provided by operating activities less capital expenditures.

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We believe that these non-GAAP financial measures are appropriate to enhance an overall understanding of our past financial performance, as they help illustrate underlying trends in our business that could otherwise be masked by the effect of the expenses that we exclude in these non-GAAP financial measures. Furthermore, we use many of these measures to establish budgets and operational goals for managing our business and evaluating our performance. We believe that the expenses that we exclude in these non-GAAP financial measures are not reflective of these underlying business trends or useful measures for determining our operational performance and overall business strategy. By excluding these expenses, we believe that our management and investors can better compare our recurring core business operating results over multiple periods.

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

The following tables reconcile GAAP gross margin, income from operations, operating margin, certain operating expenses and net income as reported on our condensed consolidated statements of operations to non-GAAP gross margin, non-GAAP income from operations, non-GAAP operating margin, certain non-GAAP operating expenses and non-GAAP net income for the first fiscal quarters of 2010 and 2009.

	Three Months Ended			
	March 31, 2010		March 29, 2009	
	Amount	% of Revenue	Amount	% of Revenue
	(dollars in thousands)			
Total revenue	$ 69,795		$ 54,194	