FORTINET INC
Form 10-Q
August 05, 2016

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

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
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 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

As of July 29, 2016, there were 172,687,823 shares of the registrant's common stock outstanding.

FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended June 30, 2016
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Part I

ITEM 1. Financial Statements

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

	June 30, 2016	December 31, 2015
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$596,380	$543,277
Short-term investments	388,388	348,074
Accounts receivable—net of reserves for sales returns and doubtful accounts of $10,215 and $6,228 at June 30, 2016 and December 31, 2015, respectively	254,379	259,563
Inventory	81,247	83,868
Prepaid expenses and other current assets	33,490	35,761
Total current assets	1,353,884	1,270,543
LONG-TERM INVESTMENTS	237,223	272,959
DEFERRED TAX ASSETS	180,782	119,216
PROPERTY AND EQUIPMENT—net	125,636	91,067
OTHER INTANGIBLE ASSETS—net	31,488	17,640
GOODWILL	14,235	4,692
OTHER ASSETS	16,930	14,393
TOTAL ASSETS	$1,960,178	$1,790,510
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$56,920	$61,500
Accrued liabilities	32,901	33,028
Accrued payroll and compensation	70,787	61,111
Income taxes payable	8,161	8,379
Deferred revenue	563,195	514,652
Total current liabilities	731,964	678,670
DEFERRED REVENUE	340,786	276,651
INCOME TAX LIABILITIES	66,304	60,624
OTHER LIABILITIES	16,498	19,188
Total liabilities	1,155,552	1,035,133
COMMITMENTS AND CONTINGENCIES (Note 10)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value—300,000 shares authorized; 172,436 and 171,399 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively	172	171
Additional paid-in capital	744,922	687,658
Accumulated other comprehensive income (loss)	724	(933)
Retained earnings	58,808	68,481
Total stockholders' equity	804,626	755,377
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,960,178	$1,790,510

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		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
REVENUE:				
Product	$136,641	$114,777	$261,213	$212,286
Service	174,750	125,008	334,754	240,385
Total revenue	311,391	239,785	595,967	452,671
COST OF REVENUE:				
Product	52,788	47,397	102,101	88,765
Service	31,715	22,101	60,046	44,335
Total cost of revenue	84,503	69,498	162,147	133,100
GROSS PROFIT:				
Product	83,853	67,380	159,112	123,521
Service	143,035	102,907	274,708	196,050
Total gross profit	226,888	170,287	433,820	319,571
OPERATING EXPENSES:				
Research and development	45,502	37,389	90,256	73,205
Sales and marketing	162,694	111,928	308,797	212,537
General and administrative	22,184	18,018	41,623	29,979
Restructuring charges	553	—	881	—
Total operating expenses	230,933	167,335	441,557	315,721
OPERATING INCOME (LOSS)	(4,045)	2,952	(7,737)	3,850
INTEREST INCOME	1,705	1,364	3,451	2,786
OTHER EXPENSE—net	(1,350)	(830)	(2,662)	(1,507)
INCOME (LOSS) BEFORE INCOME TAXES	(3,690)	3,486	(6,948)	5,129
PROVISION FOR (BENEFIT FROM) INCOME TAXES	(2,302)	2,694	(7,678)	2,777
NET INCOME (LOSS)	$(1,388)	$792	$730	$2,352
Net income (loss) per share (Note 8):				
Basic	$(0.01)	$—	$—	$0.01
Diluted	$(0.01)	$—	$—	$0.01
Weighted-average shares outstanding:				
Basic	172,075	169,930	171,910	169,009
Diluted	172,075	176,234	175,360	174,983

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Net income (loss)	$(1,388)	$ 792	$730	$ 2,352
Other comprehensive income (loss):				
Unrealized gains (losses) on investments	662	(822)	2,549	63
Tax provision (benefit)	232	(287)	892	23
Other comprehensive income (loss)—net of taxes	430	(535)	1,657	40
Comprehensive income (loss)	$(958)	$ 257	$2,387	$ 2,392

See notes to condensed consolidated financial statements.

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

	Six Months Ended	
	June 30, 2016	June 30, 2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$730	$2,352
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	21,841	13,382
Amortization of investment premiums	2,794	3,881
Stock-based compensation	59,249	40,525
Other non-cash items—net	1,192	1,891
Changes in operating assets and liabilities:		
Accounts receivable—net	2,022	9,523
Inventory	(8,019)	(7,917)
Deferred tax assets	(27,120)	(13,072)
Prepaid expenses and other current assets	2,442	(3,492)
Other assets	(2,409)	(513)
Accounts payable	(130)	(8,383)
Accrued liabilities	(6,426)	(228)
Accrued payroll and compensation	8,679	5,670
Other liabilities	(2,858)	(1,884)
Deferred revenue	111,082	97,156
Income taxes payable	5,463	10,033
Net cash provided by operating activities	168,532	148,924
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(230,855)	(229,479)
Sales of investments	7,366	22,472
Maturities of investments	219,131	240,625
Purchases of property and equipment	(44,399)	(15,688)
Payments made in connection with business acquisition, net of cash acquired	(20,660)	—
Net cash provided by (used in) investing activities	(69,417)	17,930
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	22,972	42,647
Taxes paid related to net share settlement of equity awards	(17,358)	(11,362)
Repurchase and retirement of common stock	(50,000)	—
Payments of debt assumed in connection with business acquisition	(1,626)	—
Net cash provided by (used in) financing activities	(46,012)	31,285
NET INCREASE IN CASH AND CASH EQUIVALENTS	53,103	198,139
CASH AND CASH EQUIVALENTS—Beginning of period	543,277	283,254
CASH AND CASH EQUIVALENTS—End of period	$596,380	$481,393
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes—net	$13,673	$10,077
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfers of evaluation units from inventory to property and equipment	$11,449	$8,923
Liability for purchase of property and equipment and asset retirement obligations	$7,617	$1,359
Liability incurred in connection with business acquisition	$1,513	$—

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 ("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, 2015, contained in our Annual Report on Form 10-K (the "Form 10-K") filed with the SEC on February 26, 2016. 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 and six months ended June 30, 2016 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, 2015 is derived from the audited consolidated financial statements for the year ended December 31, 2015.

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 and six months ended June 30, 2016, except for changes to our policy related to stock-based compensation expense. For more information, refer to the "Recently Adopted Accounting Standards."

Recently Adopted Accounting Standards

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09—Compensation—Stock Compensation—Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). The new guidance changes the accounting for certain aspects of stock-based payments to employees and requires excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity apart from other income tax cash flows. The standard also allows us to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made on an employee's behalf for withheld shares should be presented as a financing activity on our cash flows statement, and provides an accounting policy election to account for forfeitures as they occur. The new standard is effective for us beginning January 1, 2017, with early adoption permitted.

We elected to early adopt the new guidance in the second quarter of 2016. The primary impact of the adoption was the recognition of excess tax benefits in our provision for income taxes rather than paid-in capital, as well as the adjustment in stock-based compensation expense as a result of our change in forfeiture policy. The new guidance eliminates the requirement to delay the recognition of excess tax benefits until it reduces current taxes payable. We adopted this change on a modified retrospective basis, and recorded unrecognized excess tax benefits amounting to $32.4 million as a cumulative-effect adjustment, which increased retained earnings on January 1, 2016. The new guidance also requires us to record, subsequent to the adoption, excess tax benefits and tax deficiencies in the period these arise. As a result, our provision for income taxes decreased by $3.6 million during the first quarter of 2016 and $2.6 million during the second quarter of 2016.

Under the new guidance, we have elected to change our policy and have started to recognize forfeitures of awards as they occur. The change in forfeiture policy was adopted using a modified retrospective transition method. We recorded a cumulative-effect adjustment to decrease retained earnings by $0.8 million upon transition on January 1, 2016 and a retrospective decrease of stock-based compensation of $2.0 million during the first quarter of 2016.

The amendment to the minimum statutory withholding tax requirements was adopted on a modified retrospective basis. The adoption had no impact on the January 1, 2016 retained earnings. In addition, we adopted the presentation of taxes paid related to net share settlement of equity awards as a financing activity on the statement of cash flows on a retrospective basis. Our adoption had no impact to any of the periods presented in our consolidated cash flows statements since such cash flows have historically been presented as a financing activity.

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

The adoption of ASU 2016-09 impacted our previously reported quarterly results for 2016, as well as our weighted average shares outstanding—diluted, as follows (in thousands, except for earnings per share):

	Three Months Ended March 31, 2016	
	As Reported	As Adjusted
Statements of Operations:		
Stock-based compensation expense	$30,881	$28,901
Benefit from income taxes	$(1,809)	$(5,376)
Net income (loss)	$(3,429)	$2,118
Net income (loss) per share—Basic	$(0.02)	$0.01
Net income (loss) per share—Diluted	$(0.02)	$0.01
Weighted-average shares outstanding—Diluted	171,745	174,421

	March 31, 2016	
	As Reported	As Adjusted
Balance Sheets:		
Deferred tax assets	$131,696	$167,625
Additional paid-in capital	$718,849	$717,671
Retained earnings	$23,089	$60,196

In September 2015, the FASB issued ASU 2015-16—Business Combinations—Simplifying the Accounting for Measurement-Period Adjustments, which eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. Instead, acquirers must recognize measurement-period adjustments during the period in which they determine the amounts, including the effect on earnings of any amounts they would have recorded in previous periods if the accounting had been completed at the acquisition date. We adopted ASU 2015-16 on January 1, 2016. The adoption of ASU 2015-16 did not have any impact on our consolidated financial statements.

Recent Accounting Standards Not Yet Effective

In February 2016, the FASB issued ASU 2016-02—Leases, which amends lease accounting requirements to begin recording assets and liabilities arising from leases on the balance sheet. 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. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. We expect our assets and liabilities to increase as a result of the adoption of this standard. We are currently evaluating the full impact ASU 2016-02 will have on our consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01—Financial Instruments—Overall—Recognition and Measurement of Financial Assets and Financial Liabilities, which modifies how entities measure equity investments and present changes in the fair value of financial liabilities. Under the new guidance, entities will have to measure equity investments that do not result in consolidation and are not accounted under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicality exception. The practicality exception will apply to those equity investments that do not have a readily determinable fair value and do not qualify for the practical expedient to estimate fair value, and as such these investments may be measured at cost. ASU 2016-01 will be effective for us beginning on January 1, 2018. We do not expect the impact of ASU 2016-01 on our consolidated financial statements to be significant.

In July 2015, the FASB issued ASU 2015-11—Inventory—Simplifying the Measurement of Inventory, which changes the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. ASU 2015-11 applies to entities that measure inventory using a method other than last-in, first-out or the retail inventory method (e.g., first-in, first-out or average cost). ASU 2015-11 will be effective for us beginning on January 1, 2017. We do not expect the impact of ASU 2015-11 on our consolidated financial statements to be significant.

In May 2014, the FASB issued ASU 2014-09—Revenue from Contracts with Customers, which creates a single, joint revenue standard that is consistent across all industries and markets for companies that prepare their financial statements in accordance with GAAP. Under ASU 2014-09, an entity is required to recognize revenue upon the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to receive in exchange for those goods or services. In July 2015, the FASB decided to delay the effective date of the new revenue standard by one year. In March 2016, the FASB issued ASU 2016-08, which clarifies the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, which clarifies the implementation guidance on identifying performance obligations and licensing. In May 2016, the FASB issued ASU 2016-12—Revenue from Contracts with Customers—Narrow-scope Improvements and Practical Expedients, which amends the guidance on collectability, noncash consideration, presentation of sales tax and transition. These standards will be effective for us beginning on January 1, 2018, with the option to adopt earlier on January 1, 2017. We are currently evaluating the impact of these new standards on our consolidated financial statements.

2. FINANCIAL INSTRUMENTS AND FAIR VALUE

Our investments as of June 30, 2016 and December 31, 2015 were (in thousands):

	June 30, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	$415,008	$ 948	$ (78)	$415,878
Commercial paper	68,406	5	(3)	68,408
Municipal bonds	52,531	81	(1)	52,611
Certificates of deposit and term deposits [1]	19,823	—	—	19,823
U.S. government and agency securities	68,731	160	—	68,891
Total available-for-sale securities	$624,499	$ 1,194	$ (82)	$625,611

	December 31, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	$438,533	$ 30	$ (1,369)	$437,194
Commercial paper	66,263	3	(34)	66,232
Municipal bonds	61,050	12	(40)	61,022
Certificates of deposit and term deposits [1]	14,897	—	—	14,897
U.S. government and agency securities	41,727	3	(42)	41,688
Total available-for-sale securities	$622,470	$ 48	$ (1,485)	$621,033

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

The gross unrealized losses and the related fair values of our investments that have been in a continuous unrealized loss position as of June 30, 2016 and December 31, 2015 were (in thousands):

	June 30, 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	$77,153	$ (36)	$40,207	$ (42)	$117,360	$ (78)
Commercial paper	6,964	(3)	—	—	6,964	(3)
Municipal bonds	4,548	(1)	—	—	4,548	(1)
Total available-for-sale securities	$88,665	$ (40)	$40,207	$ (42)	$128,872	$ (82)

	December 31, 2015					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	$348,534	$ (1,187)	$42,033	$ (182)	$390,567	$ (1,369)
Commercial paper	31,977	(34)	—	—	31,977	(34)
Municipal bonds	41,677	(36)	1,008	(4)	42,685	(40)
U.S. government and agency securities	34,703	(42)	—	—	34,703	(42)
Total available-for-sale securities	$456,891	$ (1,299)	$43,041	$ (186)	$499,932	$ (1,485)

The contractual maturities of our investments as of June 30, 2016 and December 31, 2015 were (in thousands):

	June 30, 2016	December 31, 2015
Due within one year	$388,388	$ 348,074
Due within one to three years	237,223	272,959
Total	$625,611	$ 621,033

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 insignificant in the periods presented and are included in Other 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 June 30, 2016.

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.

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

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.

Fair Value of Financial Instruments

Assets Measured at Fair Value on a Recurring Basis

The fair values of our financial assets measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015 were (in thousands):

	June 30, 2016				December 31, 2015			
	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	$415,878	$—	$415,878	$ —	$437,194	$—	$437,194	$ —
Commercial paper	78,406	—	78,406	—	69,231	—	69,231	—
Municipal bonds	52,611	—	52,611	—	61,022	—	61,022	—
Certificates of deposit and term deposits	19,823	—	19,823	—	14,897	—	14,897	—
Money market funds	49,231	49,231	—	—	50,030	50,030	—	—
U.S. government and agency securities	68,891	58,869	10,022	—	41,688	25,693	15,995	—
Total	$684,840	$ 108,100	$576,740	$ —	$674,062	$ 75,723	$598,339	$ —
Reported as:								
Cash equivalents	$59,229				$53,029			
Short-term investments	388,388				348,074			

Long-term investments	237,223	272,959
Total	$684,840	$674,062

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the six months ended June 30, 2016.

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

3. INVENTORY

Our inventory as of June 30, 2016 and December 31, 2015 consisted of (in thousands):

	June 30, 2016	December 31, 2015
Raw materials	$17,042	$ 15,425
Finished goods	64,205	68,443
Inventory	$81,247	$ 83,868

Inventory includes finished goods held by distributors where revenue is recognized on a sell-through basis of $1.7 million and $1.1 million as of June 30, 2016 and December 31, 2015, respectively. Inventory also includes materials at contract manufacturers of $5.5 million and $4.9 million as of June 30, 2016 and December 31, 2015, respectively.

4. PROPERTY AND EQUIPMENT—net

Our property and equipment—net as of June 30, 2016 and December 31, 2015 consisted of (in thousands):

	June 30, 2016	December 31, 2015
Land	$31,251	$ 21,683
Building and building improvements	42,060	28,841
Evaluation units	18,299	15,784
Computer equipment and software	52,907	45,632
Furniture and fixtures	10,893	8,901
Construction-in-progress	13,681	8,106
Leasehold improvements	15,554	11,179
Total property and equipment	184,645	140,126
Less: accumulated depreciation	(59,009)	(49,059)
Property and equipment—net	$125,636	$ 91,067

Depreciation expense was $9.0 million and $6.8 million during the three months ended June 30, 2016 and June 30, 2015, respectively. Depreciation expense was $18.4 million and $12.8 million during the six months ended June 30, 2016 and June 30, 2015, respectively.

5. INVESTMENTS IN PRIVATELY-HELD COMPANIES

Our investments in the equity securities of three privately-held companies totaled $10.3 million as of June 30, 2016 and December 31, 2015. Each of these investments are accounted for as cost-basis investments, as we own less than 20% of the voting securities and do not have the ability to exercise significant influence over operating and financial policies of the respective entities. These investments are carried at historical cost and are recorded as Other assets on our condensed consolidated balance sheet and would be measured at fair value if indicators of impairment exist. As of June 30, 2016, no events have occurred that would adversely affect the carrying value of these investments.

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 were not required to be consolidated in our condensed consolidated financial statements.

6. BUSINESS COMBINATIONS

AccelOps, Inc.

On June 7, 2016, we completed our acquisition of AccelOps, Inc., ("AccelOps"), a provider of network security monitoring and analytics solutions for total cash consideration of $22.3 million, of which $20.7 million was paid as of June 30, 2016 and the remaining balance was recorded as a current liability in the consolidated balance sheet as of June 30, 2016. We believe this acquisition will extend the Fortinet Security Fabric (as defined below) by enhancing our network security visibility, security data analytics, and threat intelligence across multi-vendor solutions.

The acquisition of AccelOps is accounted as a business combination in accordance with the Accounting Standards Codification Topic 805 "Business Combinations" ("ASC 805") issued by the FASB. We use our best estimates and assumptions to assign fair value to the tangible and intangible assets acquired and liabilities assumed at the acquisition date. We included acquisition-related costs of $0.3 million in general and administrative expenses. The total purchase price was allocated to AccelOps' identifiable tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. The total purchase price was allocated using the information currently available. As a result, we may continue to adjust the estimated purchase price allocation as and when additional information is available. The acquisition also included a contingent obligation for up to $4.0 million in future earn out payments to certain stockholders of AccelOps, if specified future financial targets are met for the three and six months period ended June 30, 2016 and December 31, 2016. The financial target for the three months period ended June 30, 2016 was not met. As of June 30, 2016, no fair value was assigned to the contingent consideration based on the estimated probability of attainment of the remaining target. We will remeasure the contingent consideration periodically during the six-month contingency period for the remaining target, with changes in fair value to be recorded in our consolidated statements of operations.

Total preliminary allocation of the purchase price was (in thousands):

Cash and cash equivalents	$171
Accounts receivable	1,126
Prepaid expenses and other assets	430
Property and equipment	203
Deferred tax assets	2,977
Finite-lived intangible assets	15,800
Indefinite-lived intangible assets in process research and development	1,500
Goodwill	9,543
Total assets acquired	31,750
Deferred revenue	4,400
Accounts payable and accrued liabilities	3,311
Other liabilities	1,694
Total liabilities assumed	9,405
Total purchase price allocation	$22,345

Finite-lived intangible assets consist of developed technology, customer relationships, and other. AccelOps' technology provides a software solution to manage security, performance and compliance from a single platform. The acquired developed technologies include software patents, know-how, process and designs. The value of customer relationships is attributable to the generation of a consistent income source and the avoidance of costs associated with creating new customer relationships.

Indefinite-lived intangible assets consist of in-process research and development, which will begin to be amortized upon completion of development.

The estimated useful life and fair values of the acquired finite-lived intangible assets were as follows (in thousands, except for estimated useful life):

	Estimated Useful Life (in years)	Fair Values
Developed technologies	4	$11,600
Customer relationships	3	4,000
Other	2	200
Total		$15,800

The developed technologies and other are amortized on a straight-line basis. The amortization expense of developed technologies and other are recorded in cost of product revenue. The amortization expense of customer relationships is amortized on an accelerated basis and is recorded in sales and marketing expenses.

The goodwill of $9.5 million represents the amount of the purchase price in excess of the fair value of the net tangible liabilities assumed and intangible assets acquired, including AccelOps' assembled workforce. The goodwill recorded as part of the AccelOps acquisition is not deductible for U.S. federal income tax purposes. The financial results of this acquisition are considered immaterial for purposes of pro forma financial disclosures.

Meru Networks, Inc.

On July 8, 2015, we completed our acquisition of Meru Networks, Inc. ("Meru"), a provider of Wi-Fi networking products and services.

In connection with the acquisition, we paid $41.8 million, comprised of cash consideration of $40.9 million, withholding tax liability of $0.4 million and $0.5 million in estimated fair value associated with restricted stock units ("RSUs") of Meru that were converted for 53,401 shares of our common stock.

We accounted for this transaction as a business combination. In 2015, we included acquisition-related costs of $1.7 million in general and administrative expenses. The total purchase price was allocated to Meru's identifiable tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date.

Total allocation of the purchase price was as follows (in thousands):

Cash and cash equivalents	$	3,268
Accounts receivable	8,191	
Inventory	11,610	
Prepaid expenses and other assets	2,409	
Property and equipment	920	
Deferred tax assets	18,585	
Finite-lived intangible assets	19,600	
Goodwill	1,868	
	66,451	

Total assets acquired		
Deferred revenue	9,800	
Accounts payable and accrued liabilities	14,887	
Total liabilities assumed	24,687	
Total purchase price allocation	$	41,764

The goodwill of $1.9 million represents the premium we paid over the fair value of the net tangible liabilities assumed and identified intangible assets acquired, due primarily to Meru's assembled workforce. The goodwill recorded as part of the Meru acquisition is not deductible for U.S. federal income tax purposes.

Intangible assets consist primarily of customer relationships and developed technologies. Customer relationships represent Meru's installed base and the ability to sell existing, in-process and future versions of our products and services to its existing customers. Developed technologies represent the virtualized wireless local area network solutions offering centralized coordination and control of various access points on the network. This includes patented and unpatented technology, know-how, processes, designs and computer software. The estimated useful life and fair values of the acquired identifiable intangible assets were as follows (in thousands, except for estimated useful life):

	Estimated Useful Life (in years)	Fair Values
Customer relationships	5	$12,200
Developed technologies	4	7,200
Trade name	0.5	200
Total		$19,600

Customer relationships and trade name are amortized and the amortization expense is recorded in sales and marketing expenses in the condensed consolidated statement of operations. Developed technologies is amortized and the amortization expense is recorded in cost of product revenue in the condensed consolidated statement of operations.

7. GOODWILL AND OTHER INTANGIBLE ASSETS—net

Goodwill

Changes in the carrying amount of goodwill were (in thousands):

	Amount
Balance—December 31, 2015	$4,692
Addition due to business acquisition	9,543
Balance—June 30, 2016	$14,235

There were no impairments to goodwill during the three and six months ended June 30, 2016.

Other Intangible Assets—net

Other intangible assets—net as of June 30, 2016 and December 31, 2015 were (in thousands):

	June 30, 2016			
	Weighted-Average Useful Life (in Years)	Gross	Accumulated Amortization	Net
Other intangible assets—net:				
Finite-lived intangible assets:				
Customer relationships	4.5	$16,200	$ 3,257	$12,943
Developed technologies and other	3.8	23,184	6,139	17,045
		39,384	9,396	29,988
Indefinite-lived intangible assets:				
In-process research and development		1,500	—	1,500

Total other intangible assets—net	$40,884	$ 9,396	$31,488

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	December 31, 2015			
	Weighted-Average Useful Life (in Years)	Gross	Accumulated Amortization	Net
Other intangible assets—net:				
Customer relationships	5.0	$12,200	$ 1,220	$10,980
Developed technologies and other	3.6	11,384	4,724	6,660
Total other intangible assets—net		$23,584	$ 5,944	$17,640

Amortization expense was $2.3 million and $0.3 million during the three months ended June 30, 2016 and June 30, 2015, respectively. Amortization expense was $3.5 million and $0.5 million during the six months ended June 30, 2016 and June 30, 2015, respectively. The following table summarizes estimated future amortization expense of Other intangible assets—net with finite lives (in thousands):

	Amount
Years:	
2016 (remainder)	$6,032
2017	8,878
2018	7,281
2019	5,517
2020	2,280
Total	$29,988

8. NET INCOME (LOSS) PER SHARE

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

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

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Numerator:				
Net income (loss)	$(1,388)	$ 792	$730	$ 2,352
Denominator:				
Basic shares:				
Weighted-average common stock outstanding-basic	172,075	169,930	171,910	169,009
Diluted shares:				
Weighted-average common stock outstanding-basic	172,075	169,930	171,910	169,009
Effect of potentially dilutive securities:				
Stock options	—	3,720	1,796	3,779
RSUs (including PSUs)	—	2,521	1,580	2,131
ESPP	—	63	74	64
Weighted-average shares used to compute diluted net income per share	172,075	176,234	175,360	174,983
Net income (loss) per share:				
Basic	$(0.01)	$ —	$—	$ 0.01
Diluted	$(0.01)	$ —	$—	$ 0.01

The following potentially dilutive shares of common stock were excluded from the computation of diluted net income (loss) per share for the periods presented, as their effect would have been antidilutive (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Stock options	7,058	299	1,182	274
RSUs (including PSUs)	10,577	414	4,715	873
ESPP	554	—	141	84
	18,189	713	6,038	1,231

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9. RESTRUCTURING CHARGES

The following table provides a summary of restructuring activity as of June 30, 2016 (in thousands):

	Employee Severance and Other Benefits	Contract Terminations and Other Charges	Total
Balance as of December 31, 2015	$ 3,689	$ 229	$3,918
Costs incurred	837	44	881
Less cash payments	(2,757)	(171)	(2,928)
Less non-cash charges	(89)	—	(89)
Balance as of June 30, 2016	$ 1,680	$ 102	$1,782

2015 Meru Restructuring

In connection with the acquisition of Meru, we initiated planned cost reduction and restructuring activities to improve our cost structure and operational efficiencies starting in the third quarter of 2015. We estimate that we will incur approximately $8.0 million of restructuring charges, consisting of severance and other benefits, contract terminations and other charges. We did not incur any material restructuring charges during the three and six months ended June 30, 2016. To date, we have incurred $7.8 million of charges related to this restructuring. These charges are primarily related to severance payments to be paid in cash and are included in operating expense in the condensed consolidated statements of operations of the period when incurred.

Cash payments for the restructuring activities are expected to be paid through 2017, primarily relating to severance payments. The remaining restructuring reserve balance of $1.5 million is included in accrued liabilities on the condensed consolidated balance sheet as of June 30, 2016.

2016 AccelOps Restructuring

In connection with the acquisition of AccelOps, we initiated alignment activities in the second quarter of 2016. We estimate that we will incur approximately $0.7 million of restructuring charges, primarily consisting of severance and other benefits, all of which were incurred during the three and six months ended June 30, 2016, which are included in operating expense in the condensed consolidated statements of operations.

Cash payments for the restructuring activities are expected to be made in 2016, primarily relating to severance payments. The remaining restructuring reserve accrual of $0.2 million is included in accrued liabilities on the condensed consolidated balance sheet as of June 30, 2016.

10. COMMITMENTS AND CONTINGENCIES

Our future principal contractual obligations as of June 30, 2016 were (in thousands):

	Total	2016 (remainder)	2017	2018	2019	2020	Thereafter

Operating lease commitments	$75,975	$ 10,984	$17,146	$15,004	$12,595	$9,598	$ 10,648
Inventory purchase commitments	86,448	86,448	—	—	—	—	—
Other contractual commitments and open purchase orders	52,085	44,522	3,509	1,273	927	927	927
Total	$214,508	$ 141,954	$20,655	$16,277	$13,522	$10,525	$ 11,575

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Operating Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2026. 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 $4.6 million and $2.9 million during the three months ended June 30, 2016 and June 30, 2015, respectively. Rent expense was $8.5 million and $6.0 million during the six months ended June 30, 2016 and June 30, 2015, 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 June 30, 2016, we had $86.4 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 June 30, 2016, we had $52.1 million in other contractual commitments that may not be cancelable.

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

	Six Months Ended	
	June 30, 2016	June 30, 2015
Accrued warranty balance—beginning of the period	$3,144	$4,269
Warranty costs incurred	(1,481)	(2,059)
Provision for warranty for the period	718	2,294
Adjustment related to pre-existing warranties	(225)	171
Accrued warranty balance—end of the period	$2,156	$4,675

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 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. We have not recorded any significant accrual for loss contingencies associated with such legal proceedings; determined that a significant unfavorable outcome is probable or reasonably possible; or determined that the amount or range of any possible significant loss is reasonably estimable.

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 awards under such indemnification provisions.

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11. STOCKHOLDERS' EQUITY

Stock-Based Compensation Plans

We have stock-based compensation plans pursuant to which we have granted stock options and RSUs and PSUs. We also have an ESPP for all eligible employees. As of June 30, 2016, there were a total of 45,162,348 shares of common stock available for grant under our stock-based compensation plans.

Restricted Stock Units

The activity and related information for RSUs, including PSUs, was (in thousands, except per share amounts):

	Restricted Stock Units Outstanding	
	Number of Shares	Weighted-Average Grant Date Fair Value per Share
Balance—December 31, 2015	9,257	$ 32.97
Granted	3,698	25.92
Forfeited	(707)	32.24
Vested	(1,752)	27.87
Balance—June 30, 2016	10,496	$ 31.22

As of June 30, 2016, total compensation expense related to unvested RSUs, including PSUs, that were granted to employees and non-employees, but not yet recognized, was $279.3 million. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.94 years. We did not grant any PSUs during the three and six months ended June 30, 2016. The stock-based compensation expense related to PSU awards is not material.

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.

The number of shares and amount withheld for employee taxes were (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Shares withheld for taxes	247	124	590	345
Amount withheld for taxes	$8,051	$4,762	$17,358	$11,362

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Employee Stock Options

The weighted-average assumptions relating to our employee stock options were:

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Expected term in years	4.3	4.3	4.3	4.3
Volatility	39 %	38 %	39% - 43%	38% - 40%
Risk-free interest rate	1.2%	1.5 %	1.0% - 1.2%	1.5 %
Dividend rate	— %	— %	— %	— %

The stock option activity and related information was (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, 2015	6,968	$ 20.03		
Granted	1,298	$ 24.77		
Forfeited	(102)	$ 37.49		
Exercised	(1,263)	$ 8.18		
Balance—June 30, 2016	6,901	$ 22.83	3.33	65,715
Options exercisable—June 30, 2016	4,821	$ 20.30	2.09	$ 54,924

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 June 30, 2016, for all in-the-money options. As of June 30, 2016, total compensation expense related to unvested stock options granted to employees but not yet recognized was $18.0 million. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 3.2 years.

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

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Weighted-average fair value per share granted	$10.92	$12.75	$8.90	$11.54
Intrinsic value of options exercised	$6,829	$22,034	$26,253	$63,038
Fair value of options vested	$793	$2,718	$2,876	$6,510

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Employee Stock Purchase Plan

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

	Six Months Ended	
	June 30, 2016	June 30, 2015
Expected term in years	0.5	0.5
Volatility	48 %	28 %
Risk-free interest rate	0.4%	0.1 %
Dividend rate	— %	— %

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

	Six Months Ended	
	June 30, 2016	June 30, 2015
Weighted-average fair value per share granted	$7.19	$ 7.56
Shares issued under the ESPP	614	427
Weighted-average price per share issued	$20.49	$ 21.34

There were no shares granted or issued under the ESPP during the three month ended June 30, 2016 and June 30, 2015.

Stock-based Compensation Expense

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

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Cost of product revenue	$298	$210	$578	$350
Cost of service revenue	2,123	1,660	4,257	3,292
Research and development	7,458	5,541	14,601	10,698
Sales and marketing	16,990	11,271	32,805	20,578
General and administrative	3,478	3,078	7,008	5,764
Total stock-based compensation expense	$30,347	$21,760	$59,249	$40,682

The stock-based compensation expense by award type was (in thousands):

	Three Months Ended		Six Months Ended	

	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
RSUs	$26,799	$17,386	$51,902	$31,678
Stock options	1,592	3,017	3,546	6,472
ESPP	1,956	1,357	3,801	2,532
Total stock-based compensation expense	$30,347	$21,760	$59,249	$40,682

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

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Income tax benefit associated with stock-based compensation	$7,416	$4,266	$14,737	$7,643

Share Repurchase Program

In January 2016, our board of directors approved a new Share Repurchase Program (the "Program"), which authorizes the repurchase of up to $200.0 million of our outstanding common stock through December 31, 2017. Under the Program, share repurchases may be made by us from time to time in privately negotiated transactions or in open market transactions. The Program does not require us to purchase a minimum number of shares, and may be suspended, modified or discontinued at any time without prior notice. There were no shares repurchased under the Program during the three months ended June 30, 2016. During the six months ended June 30, 2016, we repurchased 2.0 million shares of common stock under the Program in open market transactions at an average price of $24.97 per share, for an aggregate purchase price of $50.0 million. As of June 30, 2016, $150.0 million remained available for future share repurchases under the Program.

12. INCOME TAXES

Our effective tax rate was 62% for the three months ended June 30, 2016, compared to an effective tax rate of 77% for the same period last year. The effective tax rate was 111% for the six months ended June 30, 2016, compared to an effective tax rate of 54% for the same period last year. The effective tax rate for the periods presented was comprised of U.S. federal and state taxes, foreign withholding taxes and foreign income taxes. The changes in the tax provision and effective tax rate were primarily due to the tax benefit from the adoption of the new accounting guidance relating to stock-based compensation and the tax benefit from the U.S. federal research and development credit (the "U.S. federal R&D credit"). The tax rate for the three and six months ended June 30, 2015 did not include a benefit from the U.S. federal R&D credit, as the credit had expired in December 2014. In December 2015, the U.S. federal R&D credit was made permanent and the tax benefit was reflected on the income tax provision for the three and six months ended June 30, 2016. There was a pretax loss for the three and six months ended June 30, 2016, as compared to having a pretax income for the same periods last year.

As of June 30, 2016 and December 31, 2015, unrecognized tax benefits were $63.7 million and $59.7 million, respectively. The total amount of $62.4 million in unrecognized tax benefits, if recognized, would favorably impact the effective tax rate. It is our policy to classify accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of June 30, 2016, we had accrued $7.9 million for estimated interest related to uncertain tax positions.

We file income tax returns in the U.S. federal jurisdiction, and various U.S. state and foreign jurisdictions. The statute of limitations is open for years that generated state net operating loss carryforwards and after 2009 for state jurisdictions. Additionally, we have foreign net operating losses that have an indefinite life. Generally, we are no longer subject to 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 tax authorities for tax years prior to 2012. We are currently under examination by U.S federal income tax authorities for the tax years 2012, 2013, and 2014. In addition, the tax authorities in France are examining the inter-company relationship between Fortinet Inc., Fortinet France and Fortinet Singapore. We are in the early stages of this inquiry and as of yet no official audit has been opened.

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13. 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 the 401(k) Plan and RRSP for the three months ended June 30, 2016 and June 30, 2015 were $1.2 million and $0.9 million, respectively. Our matching contributions to the 401(k) Plan and RRSP during the six months ended June 30, 2016 and June 30, 2015 were $2.2 million and $1.8 million, respectively.

14. 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		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Americas:				
United States	$80,811	$71,224	$156,369	$129,725
Canada	33,782	26,191	65,087	46,649
Other Americas	18,053	11,178	31,236	23,779
Total Americas	132,646	108,593	252,692	200,153
Europe, Middle East, and Africa ("EMEA")	114,453	83,404	219,944	159,068
Asia Pacific ("APAC")	64,292	47,788	123,331	93,450
Total revenue	$311,391	$239,785	$595,967	$452,671

Property and Equipment—net	June 30, 2016	December 31, 2015
Americas:		
United States	$90,457	$ 61,064
Other Americas	10,123	8,972
Total Americas	100,580	70,036
EMEA:		
France	14,841	13,201
Other EMEA	6,109	3,977

Total EMEA	20,950	17,178
APAC	4,106	3,853
Total property and equipment—net	$125,636	$ 91,067

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

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Exclusive Networks Group	20%	17 %	20%	17 %
Ingram Micro	10%	*	*	*

* Represents less than 10%

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

	June 30, 2016	December 31, 2015
Exclusive Networks Group	24 %	23 %
Fine Tec Computers	11 %	*

* Represents less than 10%

15. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The changes in accumulated balances of other comprehensive income or loss were (in thousands):

	June 30, 2016		
	Unrealized Gains/Losses on Investments	Tax benefit (provision) related to items of other comprehensive income or loss	Total
Beginning balance	$(1,437)	$ 504	$(933)
Other comprehensive income (loss) before reclassifications	2,552	(893)	1,659
Amounts reclassified from accumulated other comprehensive income (loss)	(3)	1	(2)
Net current-period other comprehensive income (loss)	2,549	(892)	1,657
Ending balance	$1,112	$ (388)	$724

The details of reclassification out of accumulated other comprehensive income (loss) were (in thousands):

Six Months Ended June 30, 2016

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss)	Affected Line Item in the Statement Where Net Income is Presented

Unrealized losses on investments	$	(3)	Other expense—net
Tax benefit related to items of other comprehensive loss		1	Provision for income taxes
Total reclassification for the period	$	(2)	

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16. FOREIGN CURRENCY DERIVATIVES

Our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency translation risk. However, a substantial portion of our operating expenses incurred outside the United States is denominated in foreign currencies and is subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Canadian dollar (“CAD”), Euro (“EUR”), Great British pound (“GBP”), and Chinese yen (“CNY”). To help protect against significant fluctuations in value and the volatility of future cash flows caused by changes in currency exchange rates, we engage in foreign currency risk management activities to hedge balance sheet items denominated in CAD. We do not use these contracts for speculative or trading purposes. All of the derivative instruments are with high quality financial institutions and we monitor the creditworthiness of these parties. These contracts typically have maturities between one and three months. Changes in the fair value of forward exchange contracts related to balance sheet accounts are insignificant and are included in Other expense—net in the condensed consolidated statement of operations. As of June 30, 2016, the fair value of the forward exchange contracts was not material.

Additionally, independent of any hedging activities, fluctuations in foreign currency exchange rates may cause us to recognize transaction gains and losses in our condensed consolidated statements of operations. Our hedging activities are intended to reduce, but not eliminate, the impact of currency exchange rate movements. As our hedging activities are relatively short-term in nature and are focused on the CAD, long-term material changes in the value of the U.S. dollar against other foreign currencies, such as the EUR, GBP and CNY could adversely impact our operating expenses in the future.

The notional amount of forward exchange contracts to hedge balance sheet accounts as of June 30, 2016 and December 31, 2015 were (in thousands):

	Buy/Sell	Notional
Balance Sheet Contracts:		
Currency—As of June 30, 2016		
CAD	Sell	$ 7,209
Currency—As of December 31, 2015		
CAD	Sell	$ 7,011

17. 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 related to matters that arose subsequent to the member joining our board of directors were $0.1 million and $0.9 million during the three months ended June 30, 2016 and June 30, 2015, respectively. No contingent fees were incurred during the three months ended June 30, 2016 and June 30, 2015. Expenses for legal services provided by the law firm related to matters that arose subsequent to the member joining our board of directors were $0.4 million and $2.8 million during the six months ended June 30, 2016 and June 30, 2015, respectively. Of such amounts, $0.2 million and $0.5 million were incurred under contingent fee arrangements during the six months ended June 30, 2016 and June 30, 2015, respectively. Amounts due and payable to the law firm were $0.3 million and $5.3 million as of June 30, 2016 and December 31, 2015, respectively.

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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 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 proportion of our revenue that consists of our product and service and other 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 functionality and value in our security subscription and support service offerings;
- growing our sales to enterprise, service provider and government organizations, and the impact of sales to these organizations on our long-term growth, expansion and operating results;
- 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 capital expenditures;
- competition in our markets;
- integration of acquired companies and technologies and expectations related to acquisitions;
- success of our recently implemented enterprise resource planning ("ERP") 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; and
- 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” in Part II, Item 1A of this Quarterly Report on Form 10-Q and those discussed in other documents we file with the SEC. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

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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 2015 Fortune 100. Our cybersecurity solutions are designed to provide broad, rapid protection against dynamic security threats while simplifying the IT infrastructure of our end-customers worldwide.

Our common operating system, centralized management and open application program interfaces allow many of the solutions in our portfolio to be combined to create an integrated security architecture (“Fortinet Security Fabric”) designed to address sophisticated threats and next-generation environments. The Fortinet Security Fabric connects our products, services and ecosystem partner solutions to help provide seamless protection at all points in the network, from endpoint to data center to cloud, regardless of whether deployed in physical, virtual or hybrid environments. Our Security Fabric delivers integrated scalability, access, awareness, security and openness both from the cloud and for the cloud. At the core of our Security Fabric is our FortiGate physical and virtual appliances, which ship with a set of broad security services, including firewall, virtual private network, application control, intrusion prevention, web filtering and advanced threat protection. These security services are enabled by our FortiGuard Labs, which provides extensive threat research and a global cloud network to deliver protection services to each FortiGate appliance. FortiGate also has extensive networking capabilities such as switching, routing, native internet protocol version 6 and different modes of deployment. FortiManager provides central management and FortiAnalyzer provides reporting and analytics.

Enterprise customers select the form factor 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 or a distributed firewall solutions at branch sites. Small businesses 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 or distributed enterprises, FortiGate-200 to -900 series for mid-sized enterprises, to the FortiGate-1000 to -6000 series for large enterprises and service providers. Our network security platform also includes our FortiGuard security subscription services, to which end-customers can subscribe in order to obtain access to dynamic updates to application control, anti-virus, intrusion prevention, web filtering, and anti-spam functionality. End-customers can also choose to purchase FortiCare technical support services for our products. End-customers also often use FortiManager and FortiAnalyzer products in conjunction with a FortiGate deployment to provide centralized management and analysis and reporting capabilities.

We complement our core FortiGate product line with other appliances and software licenses that offer additional protection from security threats to other critical areas of the enterprise, such as our secure wireless and access solutions, advanced threat protection, secure email gateway, web application firewalls, application delivery controllers, database security, distributed denial of service protection, and endpoint security for employee computers and mobile devices. Sales of these complementary products have grown in recent quarters.

Financial Highlights

- We recorded total revenue of $311.4 million and $596.0 million during the three and six months ended June 30, 2016, respectively, an increase of 30% and 32%, respectively, compared to the same periods last year. Product revenue was $136.6 million and $261.2 million during the three and six months ended June 30, 2016, an increase of 19% and 23% compared to the same periods last year. Service revenue was $174.8 million and $334.8 million during the three and six months ended June 30, 2016, an increase of 40% and 39% compared to the same periods last year.

- Cash, cash equivalents and investments were $1.22 billion as of June 30, 2016, an increase of $57.7 million, or 5%, from December 31, 2015.

- Deferred revenue was \$904.0 million as of June 30, 2016, an increase of \$112.7 million, or 14%, from December 31, 2015.

- We generated cash flows from operating activities of \$168.5 million during the six months ended June 30, 2016, an increase of \$19.6 million, or 13%, compared to the same period last year.

- In June 2016, we acquired AccelOps, a provider of network security monitoring and analytics solutions, for a total cash consideration of \$22.3 million.

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Revenue grew during the three and six months ended June 30, 2016 compared to the same periods last year, as our Security Fabric put us in a strong competitive position in a robust security market. Our strategy to invest in sales and marketing has enabled us to gain more enterprise customers today than we have had in the past. Large enterprises represent significant opportunity for cross-sell and upsell, as they tend to purchase more products and services over time. During the three months ended June 30, 2016, our revenue growth was driven by greater sales of our FortiGate and FortiGuard offerings, as we continued to see diversity of FortiGate product sales across all segments. Our high-end FortiGate products (FortiGate-1000 to -6000 series) accounted for 36% of billings. Our mid-range products (FortiGate-200 to -900 series) accounted for 28% of billings, and our entry-level products (FortiGate-20 to -100 series) accounted for 36% of billings. Service revenue also increased as we continue to add to and charge more for functionality and value in our FortiGuard security subscription, FortiCare technical support and other offerings.

During the three and six months ended June 30, 2016, operating expenses increased by 38% and 40%, respectively, as compared to the same period last year. The increase was primarily driven by our accelerated pace of hiring and investments made to expand our sales coverage, grow our marketing capabilities, develop new products and scale our customer support. We also continue to invest in research and development to strengthen our technology leadership position. We believe that continued product innovation has strengthened our technology and resulted in market share gains. In addition, we incurred expenses from business design and reengineering related to the implementation of an ERP system. Headcount increased by 37% to 4,562 employees and contractors as of June 30, 2016, up from 3,336 as of June 30, 2015.

Business Model

Our sales strategy is based on a distribution model whereby we primarily sell our products 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 government-focused resellers, large service providers and major systems integrators, which have significant purchasing power and unique customer deployment requirements. Typically, FortiGuard security subscription services and FortiCare technical support services are purchased along with our physical and virtual appliances, most frequently as part of a bundle offering that includes hardware and services. We invoice at the time of our sale for the total price of the products and subscription and technical support services for what has been delivered, and the invoice is generally payable within 30 to 90 days. We generally recognize product revenue up-front and defer revenue for the sale of new, and renewal of existing, FortiGuard security subscription and FortiCare technical support services contracts. We recognize the related service revenue over the service period, which is typically one to three years, although it 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 contributes significantly to our increase in gross margin, as well as our positive cash flow from operations.

Key Metrics

We monitor a number of financial and operating 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, cash, cash equivalents and investments, net cash provided by operating activities, and free cash flow. 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

	June 30, 2016	June 30, 2015
	(in thousands)	
Revenue	$311,391	$239,785
Deferred revenue	$903,981	$657,561
Billings (Non-GAAP)	$373,784	$297,175
Cash, cash equivalents and investments	$1,221,991	$1,148,371
Net cash provided by operating activities	$67,941	$84,305
Free cash flow (Non-GAAP)	$53,498	$73,544

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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 and the mix of short-term and long-term deferred revenue because it represents a significant portion, and the timing, of revenue to be recognized in future periods.

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. Management accounts for these limitations by providing specific information regarding GAAP revenue and evaluating billings together with GAAP revenue.

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	
	June 30, 2016	June 30, 2015
	(in thousands)	
Billings:		
Revenue	$311,391	$239,785
Add increase in deferred revenue	66,793	57,390
Less deferred revenue balance acquired in business acquisition	(4,400)	—
Total billings (Non-GAAP)	$373,784	$297,175

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 consider 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 the acquisition of property and equipment, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, repurchasing outstanding common stock and strengthening the balance sheet. Analysis of free cash flow facilitates management's comparison of our operating results to those of our peer companies. A limitation of using free cash flow rather than the GAAP measure of net cash provided by operating activities as a means for evaluating liquidity 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." 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	
	June 30, 2016	June 30, 2015

	(in thousands)	
Free Cash Flow:		
Net cash provided by operating activities	$67,941	$84,305
Less purchases of property and equipment	(14,443)	(10,761)
Free cash flow (Non-GAAP)	$53,498	$73,544

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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. Our estimates include those related to revenue recognition, stock-based compensation expense, valuation of inventory, warranty liabilities, investments, business combinations, restructuring charges, goodwill and other long-lived assets, and accounting for income taxes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

Except for the change in certain policies around stock-based compensation as a result of the early adoption of ASU 2016-09, there have been no material changes to our critical accounting policies and estimates as of and for the three and six months ended June 30, 2016, as compared to the critical accounting policies and estimates described in the Form 10-K. 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 a discussion relating to our change in certain accounting policies related to stock-based compensation.

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 June 30, 2016 and 2015

Revenue

	Three Months Ended June 30, 2016			June 30, 2015					
	Amount	% of Revenue		Amount	% of Revenue		Change	% Change	
	(in thousands, except percentages)								
Revenue:									
Product	$136,641	44	%	$114,777	48	%	$21,864	19	%
Service	174,750	56		125,008	52		49,742	40	
Total revenue	$311,391	100	%	$239,785	100	%	$71,606	30	%
Revenue by geography:									
Americas	$132,646	43	%	$108,593	45	%	$24,053	22	%
EMEA	114,453	36		83,404	35		31,049	37	
APAC	64,292	21		47,788	20		16,504	35	
Total revenue	$311,391	100	%	$239,785	100	%	$71,606	30	%

Total revenue increased by $71.6 million, or 30%, during the three months ended June 30, 2016 compared to the same period last year. On a geographic basis, revenue continued to be diversified globally. All three regions experienced revenue growth compared to the same period last year, with EMEA contributing to the largest portion of our revenue growth on both an absolute dollar and a percentage basis. Product revenue increased by $21.9 million, or 19%, during the three months ended June 30, 2016 compared to the same period last year. The increase in product revenue was primarily driven by greater sales of our FortiGate product family, as well as growth in other product lines. Service revenue increased by $49.7 million, or 40%, during the three months ended June 30, 2016 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. Service revenue also increased as we continue to add to and charge more for functionality and value in our FortiGuard security subscription, FortiCare technical support and other offerings.

Cost of revenue and gross margin

	Three Months Ended June 30, 2016		June 30, 2015		Change		% Change	
	(in thousands, except percentages)							
Cost of revenue:								
Product	$52,788		$47,397		$5,391		11	%
Service	31,715		22,101		9,614		44	
Total cost of revenue	$84,503		$69,498		$15,005		22	%
Gross margin (%):								
Product	61.4	%	58.7	%	2.7	%		
Service	81.9		82.3		(0.4	)		
Total gross margin	72.9	%	71.0	%	1.9	%		

Total gross margin increased by 1.9 percentage points during the three months ended June 30, 2016 compared to the same period last year, primarily driven by an increase in product gross margin. Product gross margin increased by 2.7 percentage points during the three months ended June 30, 2016 compared to the same period last year. Product gross margin was positively impacted by lower warranty expense, as well as higher sales of software products such as certain of our virtualized security solutions.

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Service gross margin decreased by 0.4 percentage points during the three months ended June 30, 2016 as compared to the same period last year. Cost of service revenue increased by $9.6 million primarily due to a $5.8 million increase in personnel costs related to headcount increases. In addition, cost of service revenue increased due to an increase in product replacement costs related to our extended support service offerings.

Operating expenses

	Three Months Ended								
	June 30, 2016			June 30, 2015			Change	% Change	
	Amount	% of Revenue		Amount	% of Revenue				
	(in thousands, except percentages)								
Operating expenses:									
Research and development	$45,502	15	%	$37,389	16	%	$8,113	22	%
Sales and marketing	162,694	52		111,928	47		50,766	45	
General and administrative	22,184	7		18,018	8		4,166	23	
Restructuring charges	553	—		—	—		553	*	
Total operating expenses	$230,933	74	%	$167,335	70	%	$63,598	38	%

* not meaningful

Research and development

Research and development expense increased by $8.1 million, or 22%, during the three months ended June 30, 2016 compared to the same period last year, primarily due to an increase of $6.1 million in personnel costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. Depreciation and other occupancy-related costs increased by $1.5 million. 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 2016.

Sales and marketing

Sales and marketing expense increased by $50.8 million, or 45%, during the three months ended June 30, 2016 compared to the same period last year, primarily due to an increase of $40.1 million in personnel costs as we continued to increase our sales and marketing headcount. Marketing-related expenses increased by $2.8 million as we invested in marketing to drive broader market awareness, create a global marketing engine, build broad market lead generation, nurture programs and accelerate pipeline. In addition, we incurred increases in travel and entertainment expenses of $3.1 million and depreciation expense and occupancy-related costs of $2.1 million. We intend to continue to make investments in our sales resources and infrastructure and marketing strategy, which are critical to support growth, but at a slower pace. As such, we expect sales and marketing expense as a percentage of total revenue to slightly decrease during the remainder of 2016.

General and administrative

General and administrative expense increased by $4.2 million, or 23%, during the three months ended June 30, 2016 compared to the same period last year. During the three months ended June 30, 2016, we expensed an additional $4.9 million relating to business process design and reengineering in preparation of implementing a new ERP system compared to the same period last year. In addition, personnel costs increased by $2.8 million due to increase in headcount in order to support our expanding business. The increase in expense was partially offset by lower professional fees, such as legal fees, of $1.8 million and other costs of $1.2 million. As a percentage of total revenue, we expect general and administrative expense to remain at a relatively comparable level during the remainder of 2016.

Restructuring charges

Restructuring charges of $0.6 million during the three months ended June 30, 2016 primarily relate to our restructuring activities related to the acquisition of AccelOps. See Note 9 to the condensed consolidated financial statements for additional details, including types of expenses incurred and the timing of future expenses and cash payments. See also the

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"Liquidity and Capital Resources" section of this Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Interest income and other expense—net

	Three Months Ended June 30, 2016	June 30, 2015	Change	% Change
	(in thousands, except percentages)			
Interest income	$1,705	$1,364	$341	25 %
Other expense—net	(1,350)	(830)	(520)	63

Interest income increased during the three months ended June 30, 2016 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 expense—net during the three months ended June 30, 2016 as compared to the same period last year was the result of higher foreign currency exchange losses. Other expense—net consisted primarily of foreign exchange and related hedging gains and losses.

Provision for (benefit from) income taxes

	Three Months Ended June 30, 2016	June 30, 2015	Change	% Change
	(in thousands, except percentages)			
Provision for (benefit from) income taxes	$(2,302)	$2,694	$(4,996)	(185)%
Effective tax rate (%)	62 %	77 %	(15)%	*

* not meaningful

Our effective tax rate was 62% for the three months ended June 30, 2016, as compared to an effective tax rate of 77% for the same period last year. The effective tax rate for the periods presented was comprised of U.S. federal and state taxes, and foreign withholding and income taxes. The changes in the tax provision and effective tax rate were primarily due to the tax benefit from adoption of the new accounting guidance relating to stock-based compensation and the tax benefit from the U.S. federal R&D credit. The tax rate for the three months ended June 30, 2015 did not include a benefit from the U.S. federal R&D credit as the credit had expired in December 2014. In December 2015, the U.S. federal R&D credit was made permanent and the tax benefit was reflected on the income tax provision for the three months ended June 30, 2016.

Within the next twelve 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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Six Months Ended June 30, 2016 and June 30, 2015

Revenue

	Six Months Ended June 30, 2016			June 30, 2015					
	Amount	% of Revenue		Amount	% of Revenue		Change	% Change	
	(in thousands, except percentages)								
Revenue:									
Product	$261,213	44	%	$212,286	47	%	$48,927	23	%
Service	334,754	56		240,385	53		94,369	39	
Total revenue	$595,967	100	%	$452,671	100	%	$143,296	32	%
Revenue by geography:									
Americas	$252,692	42	%	$200,153	44	%	$52,539	26	%
EMEA	219,944	37		159,068	35		60,876	38	
APAC	123,331	21		93,450	21		29,881	32	
Total revenue	$595,967	100	%	$452,671	100	%	$143,296	32	%

Total revenue increased by $143.3 million, or 32%, during the six months ended June 30, 2016 compared to the same period last year. All three regions experienced revenue growth compared to the same period last year, with EMEA contributing the largest portion of our revenue growth on both an absolute dollar and a percentage basis. Product revenue increased by $48.9 million, or 23%, during the six months ended June 30, 2016 compared to the same period last year. The increase in product revenue was primarily driven by greater sales in our FortiGate product family, as well as growth in other product lines.

Service revenue increased by $94.4 million, or 39%, during the six months ended June 30, 2016 compared to the same period last year 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, particularly our large enterprise customers, as well as the renewals of similar contracts sold in earlier periods. Service revenue also increased as we continue to add to and charge more for functionality and value in our FortiGuard security subscription, FortiCare technical support and other offerings.

Cost of revenue and gross margin

	Six Months Ended June 30, 2016	June 30, 2015	Change	% Change
	(in thousands, except percentages)			
Cost of revenue:				
Product	$102,101	$		