FORTINET INC
Form 10-Q
August 07, 2018

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, 2018
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, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

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

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

Exchange Act. o

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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 31, 2018, there were 169,136,958 shares of the registrant’s common stock outstanding.

FORTINET, INC.
QUARTERLY REPORT ON FORM 10-Q
For the Quarter Ended June 30, 2018
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Part I

ITEM 1. Financial Statements
FORTINET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited, in millions, except per share amounts)

	June 30, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$972.1	$ 811.0
Short-term investments	461.6	440.3
Accounts receivable—Net	333.6	348.2
Inventory	78.2	77.3
Prepaid expenses and other current assets	39.3	40.0
Total current assets	1,884.8	1,716.8
LONG-TERM INVESTMENTS	65.3	98.0
PROPERTY AND EQUIPMENT—NET	256.0	245.4
DEFERRED CONTRACT COSTS	160.6	—
DEFERRED TAX ASSETS	141.9	146.9
OTHER INTANGIBLE ASSETS—NET	21.4	16.3
GOODWILL	25.1	14.6
OTHER ASSETS	20.6	19.9
TOTAL ASSETS	$2,575.7	$ 2,257.9
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$63.7	$ 70.0
Accrued liabilities	59.0	50.0
Accrued payroll and compensation	91.3	92.0
Income taxes payable	21.7	21.4
Deferred revenue	849.5	793.8
Total current liabilities	1,085.2	1,027.2
DEFERRED REVENUE	621.3	542.5
INCOME TAX LIABILITIES	76.8	90.2
OTHER LIABILITIES	12.2	8.6
Total liabilities	1,795.5	1,668.5
COMMITMENTS AND CONTINGENCIES (Note 10)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value—300 shares authorized; 169.0 and 167.9 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	0.2	0.2
Additional paid-in capital	996.1	909.6
Accumulated other comprehensive loss	(1.4)	(0.8)
Accumulated deficit	(214.7)	(319.6)
Total stockholders' equity	780.2	589.4
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$2,575.7	$ 2,257.9

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
REVENUE:				
Product	$166.3	$142.7	$309.1	$277.9
Service	275.0	220.8	531.2	426.1
Total revenue	441.3	363.5	840.3	704.0
COST OF REVENUE:				
Product	73.9	60.8	132.1	116.1
Service	39.2	34.9	78.2	70.1
Total cost of revenue	113.1	95.7	210.3	186.2
GROSS PROFIT:				
Product	92.4	81.9	177.0	161.8
Service	235.8	185.9	453.0	356.0
Total gross profit	328.2	267.8	630.0	517.8
OPERATING EXPENSES:				
Research and development	61.2	51.2	120.3	102.4
Sales and marketing	192.8	166.3	378.1	336.7
General and administrative	23.5	21.9	48.5	44.5
Restructuring charges	—	(0.1)	—	0.3
Total operating expenses	277.5	239.3	546.9	483.9
OPERATING INCOME	50.7	28.5	83.1	33.9
INTEREST INCOME	5.8	3.2	10.3	5.6
OTHER INCOME (EXPENSE)—NET	(5.0)	1.2	(5.2)	1.5
INCOME BEFORE INCOME TAXES	51.5	32.9	88.2	41.0
PROVISION FOR (BENEFIT FROM) INCOME TAXES	2.2	9.9	(2.7)	7.3
NET INCOME	$49.3	$23.0	$90.9	$33.7
Net income per share (Note 9):				
Basic	$0.29	$0.13	$0.54	$0.19
Diluted	$0.28	$0.13	$0.53	$0.19
Weighted-average shares outstanding:				
Basic	168.6	175.7	168.1	175.1
Diluted	173.5	179.7	172.6	179.0

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Net income	$49.3	$ 23.0	$90.9	$ 33.7
Other comprehensive income (loss):				
Change in unrealized gains (losses) on investments	0.7	(0.1)	(0.5)	0.3
Tax provision (benefit) related to change in unrealized gains (losses) on investments	0.1	(0.1)	0.1	0.1
Other comprehensive income (loss)	0.6	—	(0.6)	0.2
Comprehensive income	$49.9	$ 23.0	$90.3	$ 33.9

See notes to condensed consolidated financial statements.

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

	Six Months Ended	
	June 30, 2018	June 30, 2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$90.9	$33.7
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation	77.1	68.4
Amortization of deferred contract costs	43.2	—
Depreciation and amortization	26.8	27.5
Other non-cash items—net	0.4	1.7
Amortization of investment premiums	0.2	1.4
Changes in operating assets and liabilities:		
Accounts receivable—net	28.9	37.9
Inventory	(10.8)	9.8
Prepaid expenses and other current assets	0.9	(3.2)
Deferred contract costs	(66.7)	—
Deferred tax assets	(13.3)	(24.4)
Other assets	(0.7)	0.7
Accounts payable	(9.1)	(19.9)
Accrued liabilities	(4.7)	1.8
Accrued payroll and compensation	(2.0)	1.6
Other liabilities	(2.2)	(2.7)
Deferred revenue	136.3	125.4
Income taxes payable	(13.2)	14.8
Net cash provided by operating activities	282.0	274.5
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(262.3)	(270.5)
Sales of investments	28.7	10.0
Maturities of investments	244.3	247.2
Purchases of property and equipment	(23.2)	(99.9)
Payments made in connection with business combination, net of cash acquired	(6.0)	—
Net cash used in investing activities	(18.5)	(113.2)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repurchase and retirement of common stock	(117.1)	(33.1)
Proceeds from issuance of common stock	56.7	41.8
Taxes paid related to net share settlement of equity awards	(32.5)	(25.9)
Payments of debt assumed in connection with business combination	(9.5)	—
Net cash used in financing activities	(102.4)	(17.2)
NET INCREASE IN CASH AND CASH EQUIVALENTS	161.1	144.1
CASH AND CASH EQUIVALENTS—Beginning of period	811.0	709.0
CASH AND CASH EQUIVALENTS—End of period	$972.1	$853.1
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfers of evaluation units from inventory to property and equipment	$10.5	$11.1
Liability for purchase of property and equipment and asset retirement obligations	$9.3	$22.2

See notes to condensed consolidated financial statements.

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FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation—The unaudited condensed consolidated financial statements of Fortinet, Inc. and its wholly owned subsidiaries (collectively, “we,” “us” or “our”) have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information, as well as the instructions to Form 10-Q pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2017, contained in our Annual Report on Form 10-K filed with the SEC on February 26, 2018 (the “Form 10-K”). 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, 2018 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, 2017 is derived from the audited consolidated financial statements for the year ended December 31, 2017.

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, 2018, except for the accounting policies for revenue recognition, trade receivables and deferred contract costs that were updated as a result of adopting Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers (Topic 606) (“Topic 606”). For more information, refer to the “Recently Adopted Accounting Standards” and Note 2.

Recently Adopted Accounting Standards

Financial Instruments – Recognition and Measurement

In January 2016, the Financial Accounting Standard Board (“FASB”) issued ASU 2016-01—Financial Instruments—Overall: Recognition and Measurement of Financial Assets and Financial Liabilities, which requires most equity investments to be measured at fair value, with subsequent changes in fair value recognized in net income. A practicality exception applies to those equity investments that do not have a readily determinable fair value. These investments may be measured at cost, adjusted for changes in observable prices minus impairment. ASU 2016-01 was effective prospectively for us beginning on January 1, 2018 for our equity investments, which were previously accounted for under the cost-method. We adopted ASU 2016-01 on January 1, 2018. There was no material impact on our condensed consolidated financial statements as of the adoption date.

Revenue Recognition

In May 2014, the FASB issued ASU 2014-09—Revenue from Contracts with Customers (Topic 606), which supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, and requires entities to recognize revenue when control of the promised goods or services is transferred to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. We adopted ASU 2014-09 and its related amendments (collectively known as Topic 606) as of January 1, 2018 using the modified retrospective transition method. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods.

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

We recorded a net reduction to our accumulated deficit as of January 1, 2018 of $117.3 million due to the cumulative impact of adopting Topic 606. The primary impact of adopting Topic 606 relates to the deferral of our incremental contract costs, which are comprised of sales commissions. Prior to January 1, 2018, we expensed all sales commissions upfront. Beginning on January 1, 2018, we continue to expense sales commissions related to product sales upfront, but capitalize and then amortize certain sales commissions on service contracts over the applicable amortization period. The capitalized sales commissions for initial service contracts are deferred and then amortized as expense on a straight-line basis over the period of benefit which we have determined to be five years. Sales commissions for renewal contracts are deferred and then amortized on a straight line basis over the contractual period of the underlying contracts. The deferral of sales commissions generated a deferred tax liability of $23.8 million, of which $18.0 million was recorded against deferred tax assets and the remaining $5.8 million was recorded in other long-term liabilities on our consolidated balance sheet. The impact on deferred revenue as of January 1, 2018 was $4.1 million, which primarily relates to certain changes in revenue recognition on software license sales and the acceleration of revenue from U.S.-based channel partners which were previously deferred until the product was sold through. Beginning on January 1, 2018, our sales returns reserve is now included on the balance sheet in accrued liabilities and no longer as a reduction to our accounts receivable. See Note 2 for further details.

The cumulative effects of the changes made to our January 1, 2018 consolidated balance sheet for the adoption of Topic 606 were as follows (in millions):

	Balance at December 31, 2017	Adjustments due to Topic 606	Balance at January 1, 2018
Assets:			
Accounts receivable, net	$348.2	$ 13.6	$361.8
Inventory	$77.3	$ (0.1)	$77.2
Deferred tax assets	$146.9	$ (18.0)	$128.9
Deferred contract costs	$—	$ 137.1	$137.1
Liabilities:			
Accrued liabilities	$50.0	$ 13.6	$63.6
Deferred revenue, current	$793.8	$ 0.3	$794.1
Deferred revenue, non-current	$542.5	$ (4.4)	$538.1
Other liabilities, non-current	$8.6	$ 5.8	$14.4
Stockholders' equity:			
Accumulated deficit	$(319.6)	$ 117.3	$(202.3)

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

Recent Accounting Standards Not Yet Effective

Leases

In February 2016, the FASB issued ASU 2016-02—Leases, which requires the recognition of right-of-use assets and lease liabilities on the consolidated balance sheet for substantially all leases. ASU 2016-02 includes a number of optional practical expedients that entities may elect to apply. ASU 2016-02 will also require significant additional disclosures about the amount, timing and uncertainty of cash flows from leases. In July 2018, the FASB issued ASU 2018-10—Codification Improvements to Topic 842, Leases, and ASU 2018-11 Leases (Topic 842) Targeted Improvements, which address questions about how to apply certain aspects of ASC 2016-02. The clarifications address the rate implicit in the lease, impairment of the net investment in the lease, lessee reassessment of lease classification, lessor reassessment of lease term and purchase options and variable payments that depend on an index or rate, and provide an alternative transition approach that allows companies to initially apply the new leases standard by recognizing a cumulative-effect adjustment on adoption date. ASC 2016-02 will be effective for us beginning on January 1, 2019, using a modified retrospective approach. Based on our current lease portfolio, we currently estimate the value of leased assets and liabilities that may be recognized on the consolidated balance sheet to be at least $45.0 million. We are continuing to evaluate the impact of ASU 2016-02 and our estimate is subject to change. We do not believe that ASC 2016-02 will have a material impact on our consolidated statements of operations and cash flows. We expect to expand our disclosures in the notes to consolidated financial statements to include more details on our leases, significant judgments and lease-related amounts recognized in the consolidated financial statements.

Stock Compensation

In June 2018, the FASB issued ASU 2018-07—Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting, which simplifies the accounting for share-based payments to nonemployees by aligning it with the accounting for share-based payments to employees subject to certain exceptions. ASC 2018-07 expands the scope of Accounting Standards Codification Topic 718, Compensation-Stock Compensation (“ASC 718”) to include share-based payments granted to nonemployees in exchange for goods or services used or consumed in an entity’s own operations and supersedes the guidance in ASC 505-50 by moving it to ASC 718. This amendment is effective for us beginning January 1, 2019. Early adoption is permitted, but no earlier than an entity’s adoption date of ASC 606. We are currently evaluating the impact of this new standards on our consolidated financial statements.

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2. REVENUE RECOGNITION

Revenue recognition

On January 1, 2018 we adopted Topic 606 using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported under Topic 605. The details of significant changes and quantitative impact of the changes are discussed below.

We derive the majority of our revenue from sales of our products, FortiGuard security subscription and FortiCare technical support services, and other services. Beginning in 2018, revenues are recognized when control of these goods or services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those goods or services. Prior to 2018, revenue was recognized under Topic 605 when all of the following criteria were met: (i) persuasive evidence of an arrangement existed, (ii) delivery has occurred or services have been rendered, (iii) sales price was fixed or determinable and (iv) collectability was reasonably assured.

Under Topic 606, we determine revenue recognition through the following steps:

- identification of the contract, or contracts, with the customer,
- identification of the performance obligations in the contract, including evaluation of performance obligations as to being distinct goods or services in a contract,
- determination of the transaction price,
- allocation of the transaction price to the performance obligations in the contract, and
- recognition of revenue when, or as, we satisfy a performance obligation.

Product revenue primarily consists of sales of hardware and software licenses of our FortiGate and Fabric products. We derive a substantial majority of product sales from our FortiGate products. Our FortiGate products include a broad set of built-in security and networking features and functionalities including firewall, SD-WAN, data leak prevention, VPN, switch and wireless controller and WAN acceleration, among others.

We previously recognized product revenue for sales to distributors that had no general right of return and direct sales to end-customers upon shipment, based on general revenue recognition accounting guidance once all other revenue recognition criteria were met. Certain distributors are granted stock rotation rights, limited rights of return or rebates for sales of our products. The arrangement fee for this group of distributors was not fixed or determinable when products were shipped and revenue was therefore deferred and recognized upon sell-through. For sales that included end-customer acceptance criteria, revenue was recognized upon acceptance. Under Topic 606, we recognize product revenue upon shipment when control of the promised goods is transferred to the customer. We recognize revenue from time-based software licenses upon electronic transfer of the license key to the customer. Previously, time-based software licenses were recognized over the license term.

We generally provide a 1-year warranty on hardware products and a 90-day warranty on software that provides assurance that our hardware or software products conform to published specifications. Such assurance-type warranties are not deemed to be separate performance obligations from the hardware or software product and costs associated with providing the warranties are accrued in accordance with ASC 460-10.

Service revenue relates to sales of our FortiGuard security subscription, FortiCare technical support services, and other services. Our FortiGuard security subscription services provide access to our application control, intrusion prevention, anti-botnet and mobile, anti-spam, web filtering, cloud sandbox and virus outbreak protection, industry security, security rating service and threat intelligent service functionality. Our FortiCare support services include rights to unspecified software upgrades, maintenance releases and patches, telephone and internet access to technical support personnel. Our typical subscription and contractual support term is one to three years, and to a lesser extent, five years. Our revenue recognition for service arrangements did not change under Topic 606. We continue to recognize revenue from these services ratably over the contractual service period because of continuous transfer of control to the customer over the maintenance period. Revenue related to subsequent renewals of these services are recognized over the support term of the renewal agreement. We also generate a small portion of our revenue from other services consisting of professional services, training and software-as-a-service (“SaaS”) which is either hosted or cloud-based services. We recognize revenue from professional and training services as the services are provided. We recognize revenue from SaaS as the subscription service is delivered over the term, which is typically one year, or on a monthly usage basis. To date, SaaS revenue has not represented a significant percentage of our total revenue.

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

Our sales contracts typically contain multiple deliverables, such as hardware, software license, security subscription, technical support services and other services, which are generally capable of being distinct and accounted for as separate performance obligations. We evaluated the criteria to be distinct under Topic 606 and concluded that the hardware and software license were distinct and distinct in context of the contract from the security subscription and technical support services, as the customer can benefit from the hardware and license without the services and the services are separately identifiable within the contract. We allocate the transaction price to each performance obligation based on relative standalone selling price. We determine standalone selling price based on the historical pricing and discounting practices for those services when sold separately. We determine standalone selling price for a product or service by considering multiple historical factors including, but not limited to, cost of products, gross margin objectives, pricing practices, geographies and the term of the service contract that fall within a reasonably range as a percentage of list price. Revenue is reported net of sales tax.

Under Topic 605, revenue from contracts that contain our products and services are allocated to each unit of accounting based on an estimated selling price using vendor-specific objective evidence (“VSOE”) of selling price, if it existed, or third-party evidence (“TPE”) of selling price. If neither VSOE nor TPE of selling price existed for a deliverable, we used our best estimate of selling price for that deliverable. For multiple-element arrangements where software deliverables were included, revenue was allocated to the non-software deliverables and to the software deliverables as a group using the relative estimated selling prices of each of the deliverables in the arrangement based on the estimated selling price hierarchy. The amount allocated to the software deliverables was then allocated to each software deliverable using the residual method when VSOE of fair value existed. If evidence of VSOE of fair value of one or more undelivered elements did not exist, all software allocated revenue was deferred and recognized when delivery of those elements occurred or when fair value was established. When the undelivered element for which we did not have VSOE of fair value was support, revenue for the entire arrangement was recognized ratably over the support period. The same residual method and VSOE of fair value principles applied for our multiple element arrangements that contained only software elements.

In certain circumstances, our contracts include provisions for sales rebates and other customer incentive programs. Additionally, in limited circumstances, we may permit end-customers, distributors and resellers to return our products, subject to varying limitations, for a refund within a reasonably short period from the date of purchase. These amounts are accounted for as variable consideration that can decrease the transaction price. We estimate variable consideration at the most likely amounts to which we expect our customers to be entitled. We include estimated amounts in the transaction price to the extent that it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. Our estimate for sales return reserve was $12.5 million as of June 30, 2018 and is included in current liabilities in our condensed consolidated balance sheet. Under Topic 605, a sales return reserve of $13.6 million was presented as a reduction to accounts receivable as of December 31, 2017.

We generally invoice at the time of our sale for the total price of the products and security and technical support and other services, and the invoice is payable within 30 to 90 days. We also invoice certain software licenses and services on a monthly basis. Amounts billed and due from our customers are classified as receivables on the balance sheet and do not bear interest. We record deferred revenue when cash payments are received or due in advance of our performance.

During the three and six months ended June 30, 2018, we recognized $203.3 million and $442.3 million, respectively, in revenue that was included in the deferred revenue balance as of December 31, 2017.

Shipping and handling fees charged to our customers are recognized as product revenue in the period shipped and the related costs for providing these services are recorded as a cost of sale. Shipping and handling fees recognized as product revenue were not significant during the three and six months ended June 30, 2018 and 2017.

Disaggregation of Revenue

The following table presents our revenue disaggregated by major product and service lines (in millions):

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017 (1)	June 30, 2018	June 30, 2017(1)
Product	$166.3	$142.7	$309.1	$277.9
Service:				
Security subscription	147.1	122.0	283.8	235.5
Technical support	116.4	90.1	226.0	171.2
Professional services and training	11.5	8.7	21.4	19.4
Total service revenue	275.0	220.8	531.2	426.1
Total revenue	$441.3	$363.5	$840.3	$704.0

(1) As noted above, prior period amounts have not been adjusted under the modified retrospective method.

Transaction Price Allocated to the Remaining Performance Obligations

As of June 30, 2018, we had $1.47 billion in remaining performance obligations, which is substantially comprised of deferred security subscription and technical support services not yet delivered. We expect to recognize revenue on approximately 80% of these remaining performance obligations over the next one to two years, with the remaining balance to be recognized in three to five years.

Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount. Trade accounts receivable is reduced by allowance for doubtful accounts which is determined based on our assessment of the collectability of customer accounts. The allowance for doubtful accounts was $0.7 million and $0.9 million as of June 30, 2018 and December 31, 2017, respectively. As of December 31, 2017, accounts receivable was also reduced by sales return reserve of $13.6 million which we reclassified to accrued liabilities account as of January 1, 2018 in accordance with the adoption of Topic 606.

Contract Assets

Contract assets represent amounts that have been recognized as revenue but for which we did not have the unconditional right to invoice the customer. Contract assets were insignificant as of June 30, 2018 and January 1, 2018.

Deferred Contract Costs

Sales commissions earned by our sales force are considered incremental and recoverable costs of obtaining a contract with a customer. Sales commissions for the sale of products are recognized at the time of sale. Sales commissions for initial service contracts are deferred and then amortized as an expense on a straight-line basis over the period of benefit which we have determined to be five years. We determined the period of benefit taking into consideration our customer contracts, our technology and other factors. Sales commissions for renewal contracts are deferred and then amortized on a straight line basis over the contractual period of the underlying contracts which ranges from one to three years and, to a lesser extent, five years. The amortization of deferred contract costs is included in sales and marketing expense in our condensed consolidated statement of operations. Amortization of deferred contract costs during the three and six months ended June 30, 2018 was $22.4 million and $43.2 million, respectively. No impairment loss was recognized during the three months ended June 30, 2018.

Practical Expedient

We elected to use the contract modification practical expedient. This practical expedient allows for all contract modifications before January 1, 2018 to be aggregated and evaluated at adoption date.

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

Impact on Condensed Consolidated Financial Statements

The following tables summarize the impact of adopting Topic 606 on our condensed consolidated financial statements as of and for the three and six months ended June 30, 2018 (in millions). These tables do not represent the full condensed consolidated financial statements as they only reflect the accounts impacted by the adoption of Topic 606.

Condensed Consolidated Balance Sheet

	As of June 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Assets:			
Accounts receivable	$333.6	$321.1	$ 12.5
Inventory	$78.2	$79.6	$ (1.4)
Deferred contract costs	$160.6	$—	$ 160.6
Deferred tax assets	$141.9	$167.8	$ (25.9)
Liabilities:			
Accrued liabilities	$59.0	$44.7	$ 14.3
Deferred revenue, current	$849.5	$865.9	$ (16.4)
Deferred revenue, non-current	$621.3	$622.5	$ (1.2)
Other liabilities, non-current	$12.2	$6.4	$ 5.8
Stockholders' Equity			
Accumulated deficit	$(214.7)	$(358.0)	$ 143.3

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

Condensed Consolidated Statement of Operations

	Three Months Ended June 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
REVENUE:			
Product	$166.3	$ 162.1	$ 4.2
Service	275.0	274.0	1.0
Total revenue	441.3	436.1	5.2
COSTS OF REVENUE:			
Product	73.9	74.1	(0.2)
GROSS PROFIT:			
Product	92.4	88.0	4.4
Service	235.8	234.8	1.0
Total gross profit	328.2	322.8	5.4
OPERATING EXPENSES:			
Sales and marketing expenses	192.8	204.6	(11.8)
OPERATING INCOME	50.7	33.5	17.2
INCOME BEFORE INCOME TAXES	51.5	34.3	17.2
PROVISION FOR (BENEFIT FROM) INCOME TAXES	2.2	(1.8)	4.0
NET INCOME	$49.3	$ 36.1	$ 13.2
Net income per share:			
Basic	$0.29	$ 0.21	$ 0.08
Diluted	$0.28	$ 0.21	$ 0.08

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

	Six Months Ended June 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
REVENUE:			
Product	$309.1	$ 299.2	$ 9.9
Service	531.2	529.5	1.7
Total revenue	840.3	828.7	11.6
COST OF REVENUE:			
Product	132.1	130.8	1.3
GROSS PROFIT:			
Product	177.0	168.4	8.6
Service	453.0	451.3	1.7
Total gross profit	630.0	619.7	10.3
OPERATING EXPENSES			
Sales and marketing expenses	378.1	401.6	(23.5)
OPERATING INCOME	83.1	49.3	33.8
INCOME BEFORE INCOME TAXES	88.2	54.4	33.8
BENEFIT FROM INCOME TAXES	(2.7)	(10.5)	7.8
NET INCOME	$90.9	$ 64.9	$ 26.0
Net income per share:			
Basic	$0.54	$ 0.39	$ 0.15
Diluted	$0.53	$ 0.38	$ 0.15

Condensed Consolidated Statement of Cash Flows

	Six Months Ended June 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Cash flows from operating activities:			
Net income	$90.9	$ 64.9	$ 26.0
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of deferred contract costs	43.2	—	43.2
Changes in operating assets and liabilities:			
Inventory	(10.8)	(12.2)	1.4
Deferred contract costs	(66.7)	—	(66.7)

Deferred tax assets	(13.3)	(21.1)	7.8
Accrued liabilities	(4.7)	(5.4)	0.7
Deferred revenue	136.3	148.7	(12.4)
Net cash provided by operating activities	$ 282.0	$ 282.0	$ —

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

3. FINANCIAL INSTRUMENTS AND FAIR VALUE

The following tables summarize our investments (in millions):

	June 30, 2018			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	$338.7	$ —	$ (1.8)	$336.9
Certificates of deposit and term deposits [1]	100.2	—	—	100.2
Commercial paper	66.8	—	—	66.8
U.S. government and agency securities	23.0	—	—	23.0
Total available-for-sale securities	$528.7	$ —	$ (1.8)	$526.9

	December 31, 2017			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	$391.0	$ —	$ (1.2)	$389.8
Commercial paper	74.2	—	—	74.2
Certificates of deposit and term deposits [1]	45.9	—	—	45.9
U.S. government and agency securities	28.5	—	(0.1)	28.4
Total available-for-sale securities	$539.6	$ —	$ (1.3)	$538.3

(1) The majority of our certificates of deposit and term deposits are foreign deposits.

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

	June 30, 2018					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	$258.2	$ (1.1)	$61.1	$ (0.7)	$319.3	$ (1.8)
Commercial paper	59.0	—	—	—	59.0	—
Certificates of deposit and term deposits	48.6	—	—	—	48.6	—
U.S. government and agency securities	10.4	—	8.5	—	18.9	—
Total available-for-sale securities	$376.2	$ (1.1)	$69.6	$ (0.7)	$445.8	$ (1.8)

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

	December 31, 2017					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	$317.4	$ (0.9)	$58.2	$ (0.3)	$375.6	$ (1.2)
Certificates of deposit and term deposits	37.2	—	—	—	37.2	—
Commercial paper	29.0	—	—	—	29.0	—
U.S. government and agency securities	17.0	—	11.4	(0.1)	28.4	(0.1)
Total available-for-sale securities	$400.7	$ (0.9)	$69.6	$ (0.4)	$470.3	$ (1.3)

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

	June 30, 2018	December 31, 2017
Due within one year	$ 461.6	$ 440.3
Due within one to three years	65.3	98.0
Total	$ 526.9	$ 538.3

Available-for-sale securities are reported at fair value, with unrealized gains and losses and the related tax impact included as a separate component of stockholders' equity and in comprehensive income. Realized losses on available-for-sale securities were insignificant in the periods presented and are included in other income (expense)—net in our condensed consolidated statements of operations. We use the specific identification method to determine the cost basis of investments sold.

The unrealized losses on our available-for-sale securities were caused by fluctuations in market value and interest rates as a result of the economic environment. As the decline in market value are attributable to changes in market conditions and not credit quality, and because we have concluded currently that we neither intend to sell nor is it more likely than not that we will be required to sell these investments prior to a recovery of par value, we do not consider these investments to be other-than temporarily impaired as of June 30, 2018.

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

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

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

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

We measure the fair value of money market funds and certain U.S. government and agency securities using quoted prices in active markets for identical assets. The fair value of all other financial instruments was based on quoted prices for similar assets in active markets, or on 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 following tables present the fair value of our financial assets measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017 (in millions):

	June 30, 2018				December 31, 2017			
	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	$341.2	$ —	$ 341.2	$ —	$411.1	$ —	$ 411.1	$ —
Certificates of deposit and term deposits	173.9	—	173.9	—	132.1	—	132.1	—
Money market funds	116.3	116.3	—	—	195.6	195.6	—	—
Commercial paper	104.4	—	104.4	—	128.9	—	128.9	—
U.S. government and agency securities	23.0	19.5	3.5	—	28.4	24.9	3.5	—
Total	$758.8	$ 135.8	$ 623.0	$ —	$896.1	$ 220.5	$ 675.6	$ —
Reported as:								
Cash equivalents	$231.9				$357.8			
Short-term investments	461.6				440.3			
Long-term investments	65.3				98.0			
Total	$758.8				$896.1			

There were no transfers between Level 1 and Level 2 of the fair value hierarchy during the six months ended June 30, 2018 and year ended December 31, 2017.

4. INVENTORY

Inventory consisted of the following (in millions):

	June 30, 2018	December 31, 2017
Raw materials	$ 13.7	$ 13.0
Finished goods	64.5	64.3
Inventory	$ 78.2	$ 77.3

Inventory includes materials at contract manufacturers of $1.9 million and $2.6 million as of June 30, 2018 and December 31, 2017, respectively. Inventory also includes finished goods held by distributors where revenue is recognized on a sell-through basis of $0.1 million as of December 31, 2017.

5. PROPERTY AND EQUIPMENT—Net

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

	June 30, 2018	December 31, 2017
Building and building improvements	$136.1	$ 133.2
Computer equipment and software	90.5	79.9
Land	71.9	65.6
Leasehold improvements	21.9	20.8
Evaluation units	19.5	20.1
Furniture and fixtures	15.9	14.7
Construction-in-progress	7.7	6.3
Total property and equipment	363.5	340.6
Less: accumulated depreciation	(107.5)	(95.2)
Property and equipment—net	$256.0	$ 245.4

Depreciation expense was $11.8 million during the three months ended June 30, 2018 and June 30, 2017. Depreciation expense was $23.1 million and $23.0 million during the six months ended June 30, 2018 and June 30, 2017, respectively.

6. INVESTMENTS IN PRIVATELY HELD COMPANIES

Our investments in the equity securities of privately held companies totaled $12.1 million as of June 30, 2018 and December 31, 2017. These investments, which were previously accounted for at cost, are now accounted for at cost, adjusted for changes in observable prices minus impairment. We own less than 20% of the voting securities in each of these investments and do not have the ability to exercise significant influence over operating and financial policies of the respective entities. These investments are carried at historical cost and are recorded as other assets on our condensed consolidated balance sheets and would be measured at fair value if indicators of impairment existed. As of June 30, 2018, no events have occurred that would adversely affect the carrying value of these investments.

As of June 30, 2018, 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 VIEs are not required to be consolidated in our condensed consolidated financial statements.

7. BUSINESS COMBINATION

Bradford Networks, Inc.

On June 4, 2018, we acquired all outstanding shares of Bradford Networks, Inc. (“Bradford”), a leading provider of network security products and services. We believe that this acquisition will extend the Fortinet Security Fabric to include network access control and provide for the assessment and response related to devices accessing the network, including Internet of Things devices.

Under the business combination method of accounting, the total preliminary purchase price was allocated to Bradford's net tangible and intangible assets based upon their estimated fair values as of June 4, 2018. The preliminary purchase price for Bradford was $6.8 million, of which $10.5 million was allocated to goodwill that was non-deductible for tax purposes, $8.8 million was allocated to identifiable intangible assets offset by $12.5 million of net liabilities assumed. The fair values assigned to assets acquired and liabilities assumed are based on management's best estimates and assumptions as of the reporting date and are considered preliminary pending finalization of our valuation analysis.

We may pay an additional $2.0 million in cash consideration as an earn-out that is subject in full to satisfaction of certain performance conditions. As of June 30, 2018, no fair value was assigned to the contingent consideration based on the estimated probability of attainment of the target.

Pro forma information has not been presented for these acquisitions as the impact to our Condensed Consolidated Financial Statements was not material.

8. GOODWILL AND OTHER INTANGIBLE ASSETS—Net

Goodwill

Changes in the carrying value of goodwill were (in millions):

	Amount
Balance—December 31, 2017	$ 14.6
Addition due to business combination	10.5
Balance—June 30, 2018	$ 25.1

There were no impairments to goodwill during the three and six months ended June 30, 2018.

Other Intangible Assets—net

The following tables present other intangible assets—net as of June 30, 2018 and December 31, 2017 (in millions, except years):

	June 30, 2018			
	Weighted-Average Useful Life (in Years)	Gross	Accumulated Amortization	Net
Other intangible assets—net:				
Finite-lived intangible assets:				
Developed technologies and other	3.8	$32.2	$ 16.4	$15.8
Customer relationships	4.5	16.7	11.1	5.6
Total other intangible assets—net		$48.9	$ 27.5	$21.4

	December 31, 2017			
	Weighted-Average Useful Life (in Years)	Gross	Accumulated Amortization	Net
Other intangible assets—net:				
Finite-lived intangible assets:				
Developed technologies and other	3.8	$24.0	$ 13.7	$10.3
Customer relationships	4.7	14.5	10.1	4.4
		38.5	23.8	14.7
Indefinite-lived intangible assets:				
In-process research and development		1.6	—	1.6
Total other intangible assets—net		$40.1	$ 23.8	$16.3

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The in-process research and development intangible asset of $1.6 million was completed in the first quarter of 2018. Upon completion, the cost was transferred to developed technology and is amortized over the estimated useful life of four years.

Amortization expense was $1.8 million and $2.2 million during the three months ended June 30, 2018 and June 30, 2017, respectively. Amortization expense was $3.6 million and $4.5 million during the six months ended June 30, 2018 and June 30, 2017, respectively.

The following table summarizes estimated future amortization expense of finite-lived intangible assets—net (in millions):

	Amount
Years:	
2018	$ 5.1
2019	8.4
2020	4.8
2021 and thereafter	3.1
Total	$ 21.4

9. NET INCOME PER SHARE

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

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

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Numerator:				
Net income	$49.3	$ 23.0	$90.9	$ 33.7
Denominator:				
Basic shares:				
Weighted-average common stock outstanding-basic	168.6	175.7	168.1	175.1
Diluted shares:				
Weighted-average common stock outstanding-basic	168.6	175.7	168.1	175.1
Effect of potentially dilutive securities:				
RSUs	3.4	2.4	3.1	2.3
Stock options	1.4	1.5	1.3	1.5
ESPP	0.1	0.1	0.1	0.1
Weighted-average shares used to compute diluted net income per share	173.5	179.7	172.6	179.0
Net income per share:				
Basic	$0.29	$ 0.13	$0.54	$ 0.19
Diluted	$0.28	$ 0.13	$0.53	$ 0.19

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
RSUs	0.3	1.2	0.7	1.8
Stock options	0.7	1.1	0.6	1.1
ESPP	—	—	0.1	0.1
Total	1.0	2.3	1.4	3.0

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

10. COMMITMENTS AND CONTINGENCIES

The following table summarizes our future principal contractual obligations as of June 30, 2018 (in millions):

	Total	2018	2019	2020	2021	2022	Thereafter
Operating lease commitments	$53.2	$8.9	$14.5	$11.2	$7.2	$4.3	$ 7.1
Inventory purchase commitments	104.9	100.7	—	4.2	—	—	—
Total	$158.1	$109.6	$14.5	$15.4	$7.2	$4.3	$ 7.1

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 $3.9 million during the three months ended June 30, 2018 and June 30, 2017, respectively. Rent expense was $8.7 million and $8.4 million during the six months ended June 30, 2018 and June 30, 2017, 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, 2018, we had $104.9 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, 2018, we had $9.5 million in other contractual commitments having a remaining term in excess of one year that may not be cancelable.

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 there can be no assurances and the outcome of these matters is currently not determinable. 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. As required under ASC 450, Contingencies, issued by the FASB, we accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss.

As previously disclosed, in October 2016, we received a letter from the United States Attorney's Office for the Northern District of California requesting information relating to our compliance with the Trade Agreements Act. We have been fully cooperating with this ongoing inquiry and have periodically met and spoken with the United States Attorney's Office in connection with this matter. We are currently in settlement discussions with the United States

Attorney’s Office.

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

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, 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, although from time to time there are indemnification claims asserted against us and currently there are pending indemnification claims, there have been no material awards under such indemnification provisions.

11. STOCKHOLDERS' EQUITY

Stock-Based Compensation Plans

We have stock-based compensation plans pursuant to which we have granted RSUs and stock options. We also have an ESPP for eligible employees. As of June 30, 2018, there were a total of 55.1 million shares of common stock available for grant under our stock-based compensation plans.

Restricted Stock Units

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

	Restricted Stock Units Outstanding	
	Number of Shares	Weighted-Average Grant Date Fair Value per Share
Balance—December 31, 2017	8.5	$ 34.79
Granted	3.2	50.97
Forfeited	(0.6)	37.21
Vested	(2.2)	34.21
Balance—June 30, 2018	8.9	$ 40.90

As of June 30, 2018, total compensation expense related to unvested RSUs granted to employees and non-employees under the 2009 Plan, but not yet recognized, was $326.2 million. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.41 years.

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

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

	Six Months Ended	
	June 30, 2018	June 30, 2017
Shares withheld for taxes	0.7	0.7
Amount withheld for taxes	$32.5	$ 25.9

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

Employee Stock Options

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Expected term in years	4.4	4.4	4.4	4.4
Volatility	31.1%	34.2 %	31.7%	36.3 %
Risk-free interest rate	2.9 %	1.9 %	2.6 %	1.9 %
Dividend rate	— %	— %	— %	— %

The following table summarizes the stock option activity and related information for the periods presented below (in millions, 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, 2017	4.3	$ 27.50		
Granted	0.7	49.70		
Forfeited	(0.1)	31.97		
Exercised	(1.5)	24.33		
Balance—June 30, 2018	3.4	$ 33.42		
Options vested and expected to vest—June 30, 2018	3.4	$ 33.42	4.15	$ 100.1
Options exercisable—June 30, 2018	1.8	$ 27.92	2.72	$ 62.4

The aggregate intrinsic value represents the difference between the exercise price of stock options and the quoted market price of our common stock on June 30, 2018, for all in-the-money stock options. As of June 30, 2018, total compensation expense related to unvested stock options granted to employees but not yet recognized was $19.3 million. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 2.8 years.

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Weighted-average fair value per share granted	$17.86	$ 12.18	$15.21	$ 12.22
Intrinsic value of options exercised	15.9	9.0	39.5	26.9
Fair value of options vested	1.5	1.7	4.2	5.1

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Employee Stock Purchase Plan

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

	Six Months Ended	
	June 30, 2018	June 30, 2017
Expected term in years	0.5	0.5
Volatility	27.0 %	33.4 %
Risk-free interest rate	1.8 %	0.7 %
Dividend rate	— %	— %

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

	Six Months Ended	
	June 30, 2018	June 30, 2017
Weighted-average fair value per share granted	$ 11.27	$ 9.28
Shares issued under the ESPP	0.7	0.6
Weighted-average price per share issued	$ 31.29	$ 27.97

There were no shares granted or issued under the ESPP during the three month ended June 30, 2018 and June 30, 2017.

Stock-based Compensation Expense

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Cost of product revenue	$ 0.4	$ 0.4	$ 0.8	$ 0.7
Cost of service revenue	2.7	2.5	5.2	4.8
Research and development	9.2	8.3	17.6	16.1
Sales and marketing	23.6	19.7	44.5	38.8
General and administrative	4.7	4.2	9.0	8.0
Total stock-based compensation expense	$ 40.6	$ 35.1	$ 77.1	$ 68.4

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

	Three Months Ended	Six Months Ended

	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
RSUs	$35.9	$ 30.9	$67.9	$ 59.9
Stock options	2.3	1.9	4.3	3.8
ESPP	2.4	2.3	4.9	4.7
Total stock-based compensation expense	$40.6	$ 35.1	$77.1	$ 68.4

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

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

	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Income tax benefit associated with stock-based compensation	$6.1	$ 7.7	$12.1	$ 14.4

Share Repurchase Program

In January 2016, our board of directors approved a Share Repurchase Program (the “Repurchase Program”), which authorized the repurchase of up to $200.0 million of our outstanding common stock through December 31, 2017. In 2016 and 2017, our board of directors approved the increases in the aggregate authorized repurchase amount under the Repurchase Program by $100.0 million and $700.0 million, respectively, to a total of $1.0 billion. Under the Repurchase Program, share repurchases may be made by us from time to time in privately negotiated transactions or in open market transactions. The Repurchase Program does not require us to purchase a minimum number of shares, and may be suspended, modified or discontinued at any time without prior notice.

During the three months ended June 30, 2018, we repurchased 27,245 shares of common stock under the Repurchase Program in open market transactions at an average price of $56.78 per share, for an aggregate purchase price of $1.5 million. As of June 30, 2018, $325.8 million remained available for future share repurchases under the Repurchase Program. See Note 16—Subsequent Event for additional disclosure related to the Repurchase Program.

12. INCOME TAXES

Our effective tax rate was 4% for the three months ended June 30, 2018, compared to an effective tax rate of 30% for the same period last year. Our effective tax rate was a benefit of 3% for the six months ended June 30, 2018, compared to an effective tax rate of 18% for the same period last year, with the primary difference being the change in the federal corporate income tax rate to 21% in 2018 from 35% in the prior year, the release of reserve for uncertain tax positions including interest due to a statute of limitation expiring and the completion of the Internal Revenue Service (“IRS”) audit. The effective tax rates for the periods presented are comprised of U.S. federal and state taxes, withholding taxes and foreign taxes, excess tax benefits from stock-based compensation and release of a reserve for uncertain tax positions. The tax rates for the three months ended June 30, 2018 and June 30, 2017 were impacted by U.S. federal and state taxes, withholding taxes and foreign taxes of $17.2 million and $14.4 million, respectively, which were offset by a tax provision benefit of $4.9 million and $4.1 million, respectively, for stock-based compensation. The tax rate for the three months ended June 30, 2018 was also impacted by release of a reserve for uncertain tax positions including interest of $10.1 million. The tax rate for the six months ended June 30, 2018 and June 30, 2017 were impacted by withholding taxes and foreign taxes of $25.7 million and $17.3 million, respectively, which were offset by a tax benefit of $10.5 million and $9.6 million, respectively, for stock-based compensation. The tax rate for the six months ended June 30, 2018 was also impacted by release of reserve for uncertain tax positions including interest of $18.0 million. Our effective tax rates fluctuate based on the amount of pre-tax income or loss. The impact of discrete items, such as excess tax benefits from stock-based compensation, on our effective tax rate is greater when our pre-tax income is lower.

As of June 30, 2018 and December 31, 2017, unrecognized tax benefits were $61.2 million and $72.5 million, respectively. The amount of $59.8 million in unrecognized tax benefits, if recognized, would favorably affect our effective tax rate. It is our policy to include accrued interest and penalties related to uncertain tax benefits in income tax expense. As of June 30, 2018 and December 31, 2017, accrued interest and penalties were $11.1 million and $13.5 million, respectively. It is reasonably possible that our gross unrecognized tax benefits will decrease by up to $7.9 million in the next 12 months, primarily due to the lapse of the statute of limitations. These adjustments, if recognized, would positively impact our effective tax rate, and would be recognized as additional tax benefits.

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

We file income tax returns in the U.S. federal jurisdiction and in various U.S. state and foreign jurisdictions. Generally, we are no longer subject to U.S. state and non-U.S. income tax examinations by tax authorities for tax years prior to 2008. We are no longer subject to examination by U.S federal income tax authorities for tax years prior to 2015. We have closed the Internal Revenue Service audit for tax years 2012, 2013 and 2014. In March 2018, we received a refund of $6.8 million for a carry-back claim approved in this audit. The tax authorities in France are examining the intercompany relationship between Fortinet, Inc., Fortinet France and Fortinet Singapore. In May 2017, we received a notice from the French tax authorities that an audit was officially opened for tax years from 2007 to 2015. In April 2018, the tax authorities in Israel initiated a tax audit for tax years from 2008 to 2014.

On July 24, 2018, the U.S. Court of Appeals for the Ninth Circuit overturned the U.S. Tax Court's unanimous 2015 decision in Altera v. Commissioner, holding that the IRS did not violate the rulemaking procedures required by the Administrative Procedures Act. In Altera, the taxpayer challenged IRS regulations that required participants in qualified cost sharing arrangements to share stock-based compensation costs. The Tax Court had invalidated those regulations, in part because the Treasury Department failed to adequately consider significant taxpayer comments when adopting them. The Ninth Court decision reverses the Tax Court's decision on this issue, holding that the Treasury Department's rule was not arbitrary and capricious because the Treasury Department provided a sufficient basis for its decision making. We are in the process of evaluating the impact of this court decision which occurred subsequent to the quarter end.

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 our 401(k) Plan and the RRSP for the three months ended June 30, 2018 and June 30, 2017 were $1.5 million and $1.3 million, respectively. Our matching contributions to our 401(k) Plan and the RRSP for the six months ended June 30, 2018 and June 30, 2017 were $3.0 million and $2.6 million, respectively.

14. SEGMENT 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 millions):

	Three Months Ended	Six Months Ended
Revenue		

	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Americas:				
United States	$ 144.6	$ 126.4	$ 278.5	$ 242.4
Latin America (“LATAM”)	28.7	22.0	55.2	40.2
Canada	16.0	12.3	31.4	24.5
Total Americas	189.3	160.7	365.1	307.1
Europe, Middle East and Africa (“EMEA”)	164.4	129.8	308.9	255.8
Asia Pacific (“APAC”)	87.6	73.0	166.3	141.1
Total revenue	$ 441.3	$ 363.5	$ 840.3	$ 704.0

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

Property and Equipment—net	June 30, 2018	December 31, 2017
Americas:		
United States	$ 122.9	$ 115.6
Canada	106.1	103.8
LATAM	0.5	0.3
Total Americas	229.5	219.7
EMEA:		
France	12.8	11.9
Other EMEA	4.7	5.8
Total EMEA	17.5	17.7
APAC	9.0	8.0
Total property and equipment—net	$ 256.0	$ 245.4

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, 2018 [1]	June 30, 2017	June 30, 2018 [1]	June 30, 2017
Exclusive Networks Group	29 %	20 %	29 %	20 %
Ingram Micro	10 %	10 %	*	*
Fine Tec Computers	*	12 %	*	12 %

* Represents less than 10%
[1] Due to the acquisition by Exclusive Networks Group of the U.S. division of Fine Tec Computers ("Fine Tec U.S.") in July 2017, Fine Tec U.S.'s revenue and accounts receivable have been combined with Exclusive Networks Group.

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

	June 30, 2018	December 31, 2017
Exclusive Networks Group	32 %	35 %

15. ACCUMULATED OTHER COMPREHENSIVE LOSS

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

June 30, 2018
Total

	Unrealized Losses on Investments	Tax provision related to unrealized gains or losses on investments	
Beginning balance	$(1.3)	$ 0.5	$(0.8)
Other comprehensive loss before reclassifications	(0.5)	(0.1)	(0.6)
Amounts reclassified from accumulated other comprehensive loss	—	—	—
Net current-period other comprehensive loss	(0.5)	(0.1)	(0.6)
Ending balance	$(1.8)	$ 0.4	$(1.4)

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

16. SUBSEQUENT EVENT

Share Repurchase

In July 2018, our board of directors approved a $500.0 million increase in the authorized stock repurchase under the Repurchase Program and extended the term of the Repurchase Program to December 31, 2019, bringing the aggregate amount authorized to be repurchased to $1.5 billion of our outstanding common stock through December 31, 2019.

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

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

- continued growth and market share gains;
- variability in sales in certain product categories from year to year and between quarters;
- expected impact of sales of certain products and services;
- the impact of macro-economic and geopolitical factors on our international sales;
- the proportion of our revenue that consists of our product and service revenue, and the mix of billings between products and services, and the duration of service contracts;
- the impact of our product innovation strategy;
- drivers of long-term growth and operating leverage, such as increased sales productivity, functionality and value in our standalone and bundled subscription service offerings;
- growing our sales to businesses, service providers and government organizations, the impact of sales to these organizations on our long-term growth, expansion and operating results, and the effectiveness of our internal sales organization;
- trends in revenue, cost 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 total 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;
- the impact of the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act");
- expectations regarding spending related to real estate and other capital expenditures and to the impact on free cash flows;
- competition in our markets;
- our intentions regarding share repurchases and the repatriation of cash, cash equivalents and investments held by our international subsidiaries and the sufficiency of our existing cash, cash equivalents and investments to meet our cash needs for at least the next 12 months;

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

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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.

Business Overview

Fortinet is a global leader in cybersecurity solutions to a wide variety of businesses, such as enterprises, data centers and distributed offices. Our cybersecurity solutions are designed to provide broad, integrated and automated protection against dynamic and sophisticated security threats, while simplifying the information technology and security infrastructure of our end-customers.

We have four focus areas for our business.

- Network Security - We derive a majority of product sales from our FortiGate network security appliances. Our FortiGate network security appliances include a broad set of built-in security and networking features and functionalities including firewall, SD-WAN, data leak prevention, VPN, switch and wireless controller, and WAN acceleration, among others. Our network security appliances include our FortiOS operating system, which provides the foundation for FortiGate security functions and FortiSPU, which is designed to enhance the security processing capabilities. Our customers may also purchase FortiGuard subscription services to access threat intelligence updates. We provide standard technical support across all our products through our FortiCare support services.

- Fortinet Security Fabric - The Fortinet Security Fabric, which is one of the fastest growing areas of our business, provides enterprise organizations with unified security across the entire digital attack surface, including network core, endpoints, applications, data centers, access and private and public cloud. It enables disparate security devices to work together as an integrated and collaborative whole.

- Cloud Security - We help customers secure their cloud environments in part by offering security through our virtual firewall software in public cloud environments. In addition, our FortiCASB extends the core capabilities of our security fabric architecture to provide businesses the same level of cybersecurity and threat intelligence in cloud environments as they receive on their physical networks. We experienced significant billings growth in on-demand cloud consumption and bring-your-own-license (“BYOL”), although not yet significant when compared to the rest of our business. The Fortinet cloud security is available across all major cloud providers, including Microsoft Azure, Amazon Web Services, Google Cloud, Oracle Cloud and IBM Cloud. We believe this area provides opportunity for growth.

- Internet of Things and Operational Technology (“OT”) - IoT and OT are new opportunities for us to grow our business. IoT and OT have created an environment where data move freely between devices across locations, network environments, remote offices, mobile workers and public cloud environments, making the data difficult to consistently track and secure. We are increasing our focus on OT to help protect the physical processes and things used in critical infrastructures, industrial and building automation.

Financial Highlights

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We recorded total revenue of $441.3 million and $840.3 million in the three and six months ended June 30, 2018, an increase of 21% and 19%, respectively, compared to $363.5 million and $704.0 million in the same periods last year. Product revenue was $166.3 million and $309.1 million in the three and six months ended June 30, 2018, an increase of 17% and 11%, respectively, compared to $142.7 million and $277.9 million in the same periods last year. Service revenue was $275.0 million and $531.2 million, respectively, in the three and six months ended June 30, 2018, an increase of 25% for both periods, compared to $220.8 million and $426.1 million in the same period last year.

- We generated operating income of $50.7 million and $83.1 million in the three and six months ended June 30, 2018, an increase of 78% and 145%, respectively, compared to $28.5 million and $33.9 million in the same periods last year.

- Cash, cash equivalents and investments were $1.50 billion as of June 30, 2018, an increase of $149.7 million, or 11%, from December 31, 2017.

- Deferred revenue was $1.47 billion as of June 30, 2018, an increase of $134.5 million, or 10%, from December 31, 2017.

- We generated cash flows from operating activities of $282.0 million in the six months ended June 30, 2018, an increase of $7.5 million, or 3%, compared to the same periods last year.

- During the six months ended June 30, 2018, we repurchased 2.5 million shares of common stock under the Repurchase Program for an aggregate purchase price of $117.1 million.

During the three and six months ended June 30, 2018, our revenue growth was driven by both product and service revenue. Product revenue grew 17% and 11% in the three and six months ended June 30, 2018, respectively. On a geographic basis, revenue continues to be diversified globally, which remains a key strength of our business. FortiGate unit shipments increased year-over-year. Sales of non-FortiGate products, such as the Fortinet Security Fabric and cloud products, also grew significantly. Service revenue growth of 25% in the three and six months ended June 30, 2018 was driven by the strength of our FortiCare technical support growing 29% and 32%, respectively, and FortiGuard security subscription revenue growing 21% and 20%, respectively.

The percentage of our FortiGate-related billings from entry-level products increased from 32% in the three months ended June 30, 2017 to 34% in the three months ended June 30, 2018. The percentage of our FortiGate-related billings from mid-range products increased from 29% in the three months ended June 30, 2017 to 31% in the three months ended June 30, 2018. The percentage of our FortiGate-related billings from high-end products decreased to 35% in the three months ended June 30, 2018 from 39% in the same period last year. We continue to see our enterprise customers purchasing a fairly balanced mix of products across these product groups.

During the three and six months ended June 30, 2018, operating expenses as a percentage of revenue decreased by 3 percentage points and 4 percentage points, respectively, compared to the same period last year. The decrease was primarily driven by a reduction in sales and marketing expenses as a percentage of revenue, as a result of the adoption of Topic 606 for deferred contract costs, which reduced our commissions expense in absolute dollars and as a percentage of total revenue. Our sales and marketing expenses included a benefit of $11.8 million and $23.5 million in the three and six months ended June 30, 2018, respectively, from the adoption of Topic 606 related to deferred contract costs. Under Topic 606, we capitalized certain commissions on service contracts and amortize the amount over a certain period. Prior to the adoption of Topic 606, we expensed the commission related to these service contracts upfront. Excluding this benefit, sales and marketing expense as a percentage of revenue would have increased 1 percentage point in the three months ended June 30, 2018 and would have been comparable in the six months ended June 30, 2018. Refer to Note 1 and Note 2 in our notes to the condensed consolidated financial statement for more information. Headcount increased by 4% to 5,462 employees and contractors as of June 30, 2018, up from 5,275 as of March 31, 2018.

Business Model

Our sales strategy is based on a distribution model whereby we primarily sell our hardware products, software and services directly to distributors which sell to resellers and service providers, which, in turn, sell to our end-customers. In certain cases, we sell directly to large service providers and major systems integrators. We also offer our products across all major cloud providers, and have recognized on demand revenue and BYOL revenue from Microsoft Azure, Amazon Web Services, Oracle Cloud, Google Cloud and IBM Cloud. In a BYOL arrangement, a customer purchases a perpetual license from us and deploys the software in a cloud provider’s environment. While the revenue from such sales are still relatively insignificant, they have increased significantly in recent periods on a percentage basis.

Typically, our customers purchase our hardware products and software licenses as well as our FortiGuard security subscription and FortiCare technical support services. We generally invoice at the time of our sale for the total price of the products and security and technical support services. The invoice is payable within 30 to 90 days. We also invoice certain licenses and services on a monthly basis.

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

Key Metrics

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

	Three Months Ended Or As Of	
	June 30, 2018	June 30, 2017
Revenue	$441.3	$363.5
Deferred revenue	$1,470.8	$1,161.5
Billings (non-GAAP)	$513.4	$426.9
Cash, cash equivalents and investments	$1,499.0	$1,464.9
Net cash provided by operating activities	$142.2	$144.8
Free cash flow (non-GAAP)	$130.6	$58.4

Deferred revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue. The majority of our deferred revenue balance consists of the unrecognized portion of service revenue from FortiGuard security subscription and FortiCare technical support service contracts, which is recognized as revenue ratably over the contractual service period. We monitor our deferred revenue balance, growth and the mix of short-term and long-term deferred revenue because it represents a significant portion of revenue and free cash flow to be recognized in future periods. Deferred revenue was $1.47 billion as of June 30, 2018, an increase of $134.5 million, or 10%, from December 31, 2017.

Billings (non-GAAP). We define billings as revenue recognized in accordance with generally accepted accounting principles in the United States ("GAAP") plus the change in deferred revenue from the beginning to the end of the period and adjustments to the deferred revenue balance due to adoption of the new revenue recognition standard 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 current and 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. Total billings were $513.4 million for the three months ended June 30, 2018, an increase of 20% compared to $426.9 million in the same period last year.

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

	Three Months Ended	
	June 30, 2018	June 30, 2017
Billings:		
Revenue	$441.3	$363.5
Add: Change in deferred revenue	74.4	63.4
Less: Deferred revenue balance acquired in business combination	(2.3)	—
Total billings (non-GAAP)	$513.4	$426.9

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Free cash flow (non-GAAP). We define free cash flow as net cash provided by operating activities minus capital expenditures such as purchases of real estate and other property and equipment. We believe free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after capital expenditures, can be used for strategic opportunities, including repurchasing outstanding common stock, investing in our business, making strategic acquisitions and strengthening the balance sheet. A limitation of using free cash flow rather than the GAAP measure of net cash provided by operating activities is that free cash flow does not represent the total increase or decrease in the cash, cash equivalents and investments balance for the period because it excludes cash provided by or used for other investing and financing activities. Management accounts for this limitation by providing information about our capital expenditures and other investing and financing activities on the face of the cash flow statement and under "—Liquidity and Capital Resources" and by presenting cash flows from investing and financing activities in our reconciliation of free cash flows. In addition, it is important to note that other companies, including companies in our industry, may not use free cash flow, may calculate free cash flow in a different manner than we do or may use other financial measures to evaluate their performance, all of which could reduce the usefulness of free cash flows as a comparative measure. A reconciliation of free cash flow to net cash provided by operating activities, the most directly comparable financial measure calculated and presented in accordance with GAAP, is provided below (in millions):

	Three Months Ended	
	June 30, 2018	June 30, 2017
Free Cash Flow:		
Net cash provided by operating activities	$142.2	$144.8
Less: Purchases of property and equipment	(11.6)	(86.4)
Free cash flow (non-GAAP)	$130.6	$58.4
Net cash provided by (used in) investing activities	$7.0	$(81.9)
Net cash used in financing activities	$(12.8)	$(33.0)

Critical Accounting Policies and Estimates

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

We adopted Topic 606 on January 1, 2018 using the modified retrospective method. Refer to Note 2 in the notes to our condensed consolidated financial statements included in this Quarterly Report on Form 10-Q for a discussion of the impact. Other than the adoption of Topic 606, there were no material changes to our critical accounting policies and estimates as of and for the three and six months ended June 30, 2018, as compared to the critical accounting policies and estimates described in the Form 10-K.

Recent Accounting Pronouncements

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

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Results of Operations

Three Months Ended June 30, 2018 and June 30, 2017

Revenue

	Three Months Ended					
	June 30, 2018 [1]		June 30, 2017			
	Amount	% of Revenue	Amount	% of Revenue	Change	% Change
	(in millions, except percentages)					
Revenue:						
Product	$166.3	38 %	$142.7	39 %	$ 23.6	17 %
Service	275.0	62	220.8	61	54.2	25
Total revenue	$441.3	100 %	$363.5	100 %	$ 77.8	21 %
Revenue by geography:						
Americas	$189.3	43 %	$160.7	44 %	$ 28.6	18 %
EMEA	164.4	37	129.8	36	34.6	27
APAC	87.6	20	73.0	20	14.6	20
Total revenue	$441.3	100 %	$363.5	100 %	$ 77.8	21 %

[1] Revenue during the three months ended June 30, 2018 under Topic 606 (As Reported) and 605 (Balances Without Adoption of Topic 606) were as follows (in millions):

	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Revenue:			
Product	$ 166.3	$ 162.1	$ 4.2
Service	275.0	274.0	1.0
Total revenue	$ 441.3	$ 436.1	$ 5.2
Revenue by geography:			
Americas	$ 189.3	$ 185.2	$ 4.1
EMEA	164.4	163.2	1.2
APAC	87.6	87.7	(0.1)
Total revenue	$ 441.3	$ 436.1	$ 5.2

Total revenue increased by $77.8 million, or 21%, during the three months ended June 30, 2018 compared to the same period last year. We continued to experience diversification of revenue globally. Revenue from all our regions grew, with the EMEA contributing the largest portion of our revenue growth both on an absolute dollar and on a percentage basis. Product revenue increased by $23.6 million, or 17%, during the three months ended June 30, 2018 compared to the same period last year. Product revenue during the three months ended June 30, 2018 included a $4.2 million benefit from the adoption of Topic 606, which primarily relates to the change in accounting treatment under Topic 606 for some of our software products where revenue from these arrangements can now be recognized immediately instead of ratably over the contracted service term. FortiGate unit shipments increased year-over-year. Sales of non-FortiGate products also increased significantly. Fortinet Security Fabric and cloud products were the fastest growing products compared to the remainder of our business. Service revenue increased by $54.2 million, or 25%, during the three months ended June 30, 2018 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.

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Cost of revenue and gross margin

	Three Months Ended June 30, 2018 [1]	June 30, 2017	Change	% Change
	(in millions, except percentages)			
Cost of revenue:				
Product	$73.9	$60.8	$13.1	22 %
Service	39.2	34.9	4.3	12
Total cost of revenue	$113.1	$95.7	$17.4	18 %
Gross margin (%):				
Product	55.6 %	57.4 %	(1.8)%	
Service	85.7	84.2	1.5	
Total gross margin	74.4 %	73.7 %	0.7 %	

[1] Cost of revenue and gross margin during the three months ended June 30, 2018 under Topic 606 (As Reported) and 605 (Balances Without Adoption of Topic 606) were as follows (in millions, except percentages):

	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Cost of revenue:			
Product	$73.9	$74.1	$ (0.2)
Service	39.2	39.2	—
Total cost of revenue	$113.1	$113.3	$ (0.2)
Gross margin (%):			
Product	55.6 %	54.3 %	1.3 %
Service	85.7	85.7 %	— %
Total gross margin	74.4 %	74.0 %	0.4 %

Total gross margin increased by 0.7 percentage points during the three months ended June 30, 2018 compared to the same period last year, driven by higher margin on service revenue. Service gross margin increased by 1.5 percentage points during the three months ended June 30, 2018 compared to the same period last year, due to the strength of our FortiCare technical support and FortiGuard security subscription revenue growing 29% and 21%, respectively, during the three months ended June 30, 2018 compared to the same period last year, which outpaced the increase in the related personnel costs and headcount growth, resulting in a higher margin. Cost of service revenue was comprised primarily of personnel costs. Product gross margin decreased by 1.8 percentage point during the three months ended June 30, 2018 compared to the same period last year, primarily due to a shift in product mix, product transition and contract term. The decrease was partially offset by increased revenue in higher margin software licenses. Total cost of product revenue was comprised primarily of direct and indirect cost of products sold, inventory reserves and other charges.

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Operating expenses

	Three Months Ended					
	June 30, 2018 [(1)]		June 30, 2017		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
	(in millions, except percentages)					
Operating expenses:						
Research and development	$61.2	14%	$51.2	14 %	$ 10.0	20 %
Sales and marketing	192.8	44	166.3	46	26.5	16
General and administrative	23.5	5	21.9	6	1.6	7
Restructuring charges	—	—	(0.1)	—	0.1	(100)
Total operating expenses	$277.5	63%	$239.3	66 %	$ 38.2	16 %

[(1)] Operating expenses during the three months ended June 30, 2018 under Topic 606 (As Reported) and 605 (Balances Without Adoption of Topic 606) were as follows (in millions):

	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Operating expenses:			
Research and development	$ 61.2	$ 61.2	$ —
Sales and marketing expenses	192.8	204.6	(11.8)
General and administrative	23.5	23.5	—
Total operating expenses	$ 277.5	$ 289.3	$ (11.8)

Research and development

Research and development expense increased by $10.0 million, or 20%, during the three months ended June 30, 2018 compared to the same period last year, primarily due to an increase of $6.9 million in personnel-related costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, product development expenses, such as third-party testing, prototypes and supplies, increased by $2.5 million and depreciation and other occupancy-related costs increased by $0.7 million. We intend to continue to invest in our research and development organization, and expect research and development expense to increase in absolute dollars during the remainder of 2018.

Sales and marketing

Sales and marketing expense increased by $26.5 million, or 16%, during the three months ended June 30, 2018 compared to the same period last year, primarily due to an increase of $18.3 million in personnel-related costs as sales and marketing headcount increased in order to drive market share gains globally. These increases in personnel costs included a benefit of $11.8 million from the adoption of the new accounting standard related to deferred contract costs. Under this new standard, we capitalized certain commissions on service contracts and amortize the amount over a certain period. Prior to the adoption of this new standard, we expensed the commission related to these service contracts. Our sales and marketing expense would have increased by $38.3 million or 23% under the prior accounting standard. Refer to Note 2 in our notes to the condensed consolidated financial statement for more information. Marketing-related expense increased by $2.2 million. In addition, travel and entertainment expense increased by $2.1

million and depreciation expense and other occupancy-related expense increased by $2.0 million. As a percentage of total revenue, sales and marketing expense decreased primarily due to the benefit from the new accounting standard on deferred contract costs. Excluding this benefit, sales and marketing expense as a percentage of revenue would have been 47% of total revenue. We intend to continue to make investments in our sales resources and infrastructure and marketing strategy, which are critical to support growth, and expect sales and marketing expense to increase in absolute dollars during the remainder of 2018.

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General and administrative

General and administrative expense increased by $1.6 million, or 7%, during the three months ended June 30, 2018 compared to the same period last year. Personnel costs increased by $2.7 million as we continued to increase headcount in order to support our expanding business. The increase in expense was partially offset by a decrease in depreciation and other occupancy-related costs of $1.9 million and decrease in professional fees of $0.5 million. We expect general and administrative expense to increase in absolute dollars during the remainder of 2018.

Operating income

We generated operating income of $50.7 million during the three months ended June 30, 2018, an increase of $22.2 million, or 78%, compared to $28.5 million in the same period last year. The improvement in operating income was primarily due to the benefit from the adoption of the new accounting standard. As a percentage of total revenue, sales and marketing expenses decreased to 44% in the three months ended June 30, 2018 from 46% in the same period last year. Excluding the benefit from the adoption of Topic 606, sales and marketing expense as a percentage of revenue would have been 47% of total revenue. The adoption of this new standard resulted in an improvement of 3.8 percentage points in our operating margin. In addition, the improvement in gross margin as well as the decrease in general and administrative expenses as a percentage of total revenue contributed to the improvement in operating margin.

Interest income and other income (expense)—net

	Three Months Ended			
	June 30, 2018	June 30, 2017	Change	% Change
	(in millions, except percentages)			
Interest income	$5.8	$ 3.2	$ 2.6	81 %
Other income (expense)—net	(5.0)	1.2	(6.2)	(517)

Interest income increased during the three months ended June 30, 2018 compared to the same period last year, primarily due to higher interest rates and 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 change in other income (expense)—net during the three months ended June 30, 2018 compared to the same period last year was primarily due to higher foreign currency exchange losses.

Provision for (benefit from) income taxes

	Three Months Ended			
	June 30, 2018 (1)	June 30, 2017	Change	% Change
	(in millions, except percentages)			
Provision for (benefit from) income taxes	$2.2	$ 9.9	$(7.7)	(78)%
Effective tax rate (%)	4 %	30 %	(26)%	—

[1] Provision for (benefit from) income taxes during the three months ended June 30, 2018 under Topic 606 (As Reported) and 605 (Balances Without Adoption of Topic 606) were as follows (in millions, except percentages):

	As Reported	Balances Without Adoption of Topic 606	Increase (Decrease)
Provision for (benefit from) income taxes	$ 2.2	$ (1.8)	$ 4.0
Effective tax rate (%)	4 %	(5)%	9 %

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Our effective tax rate was 4% for the three months ended June 30, 2018 compared to an effective tax rate of 30% for the same period last year, with the primary difference being the change in the federal tax rate to 21% in 2018 from 35% in the prior year, the release of a reserve on uncertain tax positions including interest due to a statute of limitation expiring and the completion of an IRS audit. The effective tax rate for the periods presented are comprised of U.S. federal and state taxes, withholding taxes, and foreign taxes of $17.2 million, which were offset by a tax provision benefit of $4.9 million for stock-based compensation. The tax rate for the three months ended June 30, 2018 was also impacted by release of a reserve on uncertain tax positions including interest of $10.1 million. The tax rate for the three months ended June 30, 2017 was comprised of U.S. federal and state taxes, withholding taxes and foreign taxes of $14.4 million which were offset by a tax provision benefit of $4.1 million for stock-based compensation.

In December 2017, the U.S. federal government enacted the 2017 Tax Act. Effective January 1, 2018, the 2017 Tax Act reduced the federal corporate income tax rate from 35% to 21% and created a territorial tax system with a one-time mandatory tax on foreign earnings of U.S. subsidiaries not previously subject to U.S. income tax. Under GAAP, changes in tax rates and tax law are accounted for in the period of enactment and deferred tax assets and liabilities are measured at the enacted tax rate.

The SEC staff has issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for the tax effects of the 2017 Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the 2017 Tax Act enactment date for companies to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the 2017 Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the 2017 Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provisions of the tax laws that were in effect immediately before the enactment of the 2017 Tax Act. At this time, our income tax reporting for these effects is provisional using reasonable estimates.

The 2017 Tax Act creates a new requirement that global intangible low-taxed income (“GILTI”) earned by controlled foreign corporations (“CFCs”) be included currently in the gross income of the CFCs’ U.S. shareholder. Because of the complexity of the new GILTI tax rules, we are continuing to evaluate this provision of the 2017 Tax Act and the application of ASC 740. Under GAAP, we are allowed to make an accounting policy choice of either (1) treating taxes due on U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the “period cost method”) or (2) factoring such amounts into a company’s measurement of its deferred taxes. Our selection of an accounting policy for the first quarter of 2018 with respect to the GILTI tax rules was to treat GILTI tax as a current-period expense under the period cost method.

The IRS issued Notice 2018-26 on April 2, 2018, which included allowing a deduction for foreign taxes during 2017 to be allocated to earning and profits calculated as of November 2, 2017. This deduction resulted in a decrease of our transition tax by $3.2 million. We also released unrecognized tax benefits in the first quarter of 2018, which had previously reduced our transition tax. This increased our transition tax by $2.7 million. The net tax provision benefit due to changes in the transition tax calculation was $0.5 million in the first quarter of 2018.

It is our policy is to include accrued interest and penalties related to uncertain tax benefits in income tax expense. As of June 30, 2018 and December 31, 2017, accrued interest and penalties were $11.1 million and $13.5 million, respectively. It is reasonably possible that our gross unrecognized tax benefits will decrease by up to $7.9 million in the next 12 months, primarily due to the lapse of the statute of limitations and audit settlement. These adjustments, if recognized, would positively impact our effective tax rate, and would be recognized as additional tax benefits.

On July 24, 2018, the U.S. Court of Appeals for the Ninth Circuit overturned the U.S. Tax Court's unanimous 2015 decision in Altera v. Commissioner, holding that the IRS did not violate the rulemaking procedures required by the Administrative Procedures Act. In Altera, the taxpayer challenged IRS regulations that required participants in qualified cost sharing arrangements to share stock-based compensation costs. The Tax Court had invalidated those regulations, in part because the Treasury Department failed to adequately consider significant taxpayer comments when adopting them. The Ninth Court decision reverses the Tax Court's decision on this issue, holding that the Treasury Department's rule was not arbitrary and capricious because the Treasury Department provided a sufficient basis for its decision making. We are in the process of evaluating the impact of this court decision which occurred subsequent to the quarter end.

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Six Months Ended June 30, 2018 and June 30, 2017

Revenue

	Six Months Ended								
	June 30, 2018 [1]			June 30, 2017					
	Amount	% of Revenue		Amount	% of Revenue		Change	% Change	
	(in millions, except percentages)								
Revenue:									
Product	$309.1	37	%	$277.9	39	%	$31.2	11	%
Service	531.2	63		426.1	61		105.1	25	
Total revenue	$840.3	100	%	$704.0	100	%	$136.3	19	%
Revenue by geography:									
Americas	$365.1	43	%	$307.1	44	%	$58.0	19	%
EMEA	308.9	37		255.8	36		53.1	21	
APAC	166.3	20		141.1	20		25.2	18	
Total revenue	$840.3	100	%	$704.0	100	%	$136.3	19	%

[1] Revenue during the six months ended June 30, 2018 under Topic 606 (As Reported) and Topic 605 (Balances Without Adoption of Topic 606) were as follows (in millions):

	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Revenue:			
Product	$ 309.1	$ 299.2	$ 9.9
Service	531.2	529.5	1.7
Total revenue	$ 840.3	$ 828.7	$ 11.6
Revenue by geography:			
Americas	$ 365.1	$ 354.3	$ 10.8
EMEA	308.9	307.1	1.8
APAC	166.3	167.3	(1.0)
Total revenue	$ 840.3	$ 828.7	$ 11.6

Total revenue increased by $136.3 million, or 19%, during the six months ended June 30, 2018 compared to the same period last year. We continued to experience diversification of revenue globally. Revenue from all our regions grew, with EMEA contributing the largest portion of our revenue growth on a percentage basis. Product revenue increased by $31.2 million, or 11%, during the six months ended June 30, 2018 compared to the same period last year. Sales of non-FortiGate products, such as the Fortinet Security Fabric and cloud products, were the fastest growing products compared to the remainder of our business. FortiGate unit shipments, including Fortinet Security Fabric, increased year-over-year. Product revenue in the six months ended June 30, 2018 included a $9.9 million benefit from the adoption of Topic 606, which primarily related to sell-through of our U.S. channel inventory and the change in accounting treatment under Topic 606 for some of our software products where revenue from these arrangements can now be recognized immediately instead of ratably over the contracted service term. Service revenue increased by $105.1 million, or 25%, during the six months ended June 30, 2018 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.

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Cost of revenue and gross margin

	Six Months Ended June 30, 2018 [1]	June 30, 2017	Change	% Change
	(in millions, except percentages)			
Cost of revenue:				
Product	$132.1	$116.1	$16.0	14 %
Service	78.2	70.1	8.1	12
Total cost of revenue	$210.3	$186.2	$24.1	13 %
Gross margin (%):				
Product	57.3 %	58.2 %	(0.9)%	
Service	85.3	83.5	1.8	
Total gross margin	75.0 %	73.6 %	1.4 %	

[1] Cost of revenue and gross margin during the six months ended June 30, 2018 under Topic 606 (As Reported) and 605 (Balances Without Adoption of Topic 606) were as follows (in millions, except percentages):

	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Cost of revenue:			
Product	$132.1	$130.8	$ 1.3
Service	78.2	78.2	—
Total cost of revenue	$210.3	$209.0	$ 1.3
Gross margin (%):			
Product	57.3 %	56.3 %	1.0 %
Service	85.3	85.2 %	0.1 %
Total gross margin	75.0 %	74.8 %	0.2 %

Total gross margin increased by 1.4 percentage points during the six months ended June 30, 2018 compared to the same period last year, driven by higher margin on service revenue. Service gross margin increased by 1.8 percentage points during the six months ended June 30, 2018 compared to the same period last year, due to the strength of our FortiCare technical support and FortiGuard security subscription revenue growing 32% and 20%, respectively, during the six months ended June 30, 2018 compared to the same period last year, which outpaced the increase in the related personnel costs and headcount growth, resulting in a higher margin. Cost of service revenue was comprised primarily of personnel costs. Product gross margin decreased by 0.9 percentage point during the six months ended June 30, 2018 compared to the same period last year, primarily due to increase in product mix, product transition and contract term. The decrease was partially offset by increased revenue in higher-margin software licenses. Total cost of product revenue was comprised primarily of direct and indirect cost of products sold, inventory reserves and other charges.

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Operating expenses

	Six Months Ended					
	June 30, 2018 [1]		June 30, 2017		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
	(in millions, except percentages)					
Operating expenses:						
Research and development	$120.3	14%	$102.4	15 %	$17.9	17 %
Sales and marketing	378.1	45	336.7	48	41.4	12
General and administrative	48.5	6	44.5	6	4.0	9
Restructuring charges	—	—	0.3	—	(0.3)	(100)
Total operating expenses	$546.9	65%	$483.9	69 %	$63.0	13 %

[1] Operating expenses during the six months ended June 30, 2018 under Topic 606 (As Reported) and Topic 605 (Balances Without Adoption of Topic 606) were as follows (in millions):

	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Operating expenses:			
Research and development	$ 120.3	$ 120.3	$ —
Sales and marketing expenses	378.1	401.6	(23.5)
General and administrative	48.5	48.5	—
Total operating expenses	$ 546.9	$ 570.4	$ (23.5)

Research and development

Research and development expense increased by $17.9 million, or 17%, during the six months ended June 30, 2018 compared to the same period last year, primarily due to an increase of $14.0 million in personnel-related costs as a result of increased headcount to support the development of new products and continued enhancements of our existing products. In addition, product development expenses, such as third-party testing, prototypes and supplies, increased by $2.6 million
and depreciation and other occupancy-related costs increased by $1.6 million.

Sales and marketing

Sales and marketing expense increased by $41.4 million, or 12%, during the six months ended June 30, 2018 compared to the same period last year, primarily due to an increase of $30.3 million in personnel-related costs as sales and marketing headcount increased in order to drive market share gains globally. These increases in personnel costs included a benefit of $23.5 million from the adoption of the new accounting standard related to deferred contract costs. Under this new standard, we capitalized certain commissions on service contracts and amortize the amount over a certain period. Prior to the adoption of this new standard, we expensed the commission related to these service contracts. Our sales and marketing expense would have increased by $64.9 million, or 19%, under the prior accounting standard. Refer to Note 2 in our notes to the condensed consolidated financial statement for more information. Travel and entertainment expense increased by $4.3 million. In addition, depreciation expense and other occupancy-related expense increased by $3.3 million and marketing-related expense increased by $3.1 million. As a percentage of total revenue, sales and marketing expense decreased primarily due to the benefit from the new accounting standard on deferred contract costs. Excluding this benefit, sales and marketing expense as a percentage of revenue would have been 48% of total revenue.

General and administrative

General and administrative expense increased by $4.0 million, or 9%, during the six months ended June 30, 2018 compared to the same period last year. Personnel costs increased by $6.2 million as we continued to increase headcount in order to support our expanding business. In addition, expense related to supplies and software licenses increased by $2.2 million. The increase in expense was partially offset by a decrease in depreciation and other occupancy-related costs of $3.4 million and a decrease in litigation settlement costs of $1.7 million.

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Operating income

We generated operating income of $83.1 million during the six months ended June 30, 2018, an increase of $49.2 million, or 145%, compared to $33.9 million in the same period last year. The improvement in operating income generated was primarily due to the benefit from the adoption of the new accounting standard. As a percentage of total revenue, sales and marketing expenses decreased to 45% in the six months ended June 30, 2018 from 48% in the same period last year. Excluding the benefit from the adoption of Topic 606, sales and marketing expense as a percentage of revenue would have been 48% of total revenue. The adoption of this new standard resulted in an improvement of 4.0 percentage points in our operating margin.

Interest income and other income (expense)—net

	Six Months Ended June 30, 2018	June 30, 2017	Change	% Change
	(in millions, except percentages)			
Interest income	$10.3	$ 5.6	$ 4.7	84 %
Other income (expense)—net	(5.2)	1.5	(6.7)	(447)

Interest income increased during the six months ended June 30, 2018 compared to the same period last year, primarily due to higher interest rates and 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 change in other income (expense)—net during the six months ended June 30, 2018 compared to the same period last year was primarily due to higher foreign currency exchange losses.

Provision for (benefit from) income taxes

	Six Months Ended June 30, 2018 [1]	June 30, 2017	Change	% Change
	(in millions, except percentages)			
Provision for (benefit from) income taxes	$(2.7)	$ 7.3	$(10.0)	(137)%
Effective tax rate (%)	(3)%	18 %	(21)%	—

[1] Provision for (benefit from) income taxes during the six months ended June 30, 2018 under Topic 606 (As Reported) and 605 (Balances Without Adoption of Topic 606) were as follows (in millions, except percentages):

	As Reported	Balances Without Adoption of Topic 606	Increase (Decrease)
Provision for (benefit from) income taxes	$ (2.7)	$(10.5)	$ 7.8
Effective tax rate (%)	(3)%	(19)%	16 %

Our effective tax rate was a benefit of 3% for the six months ended June 30, 2018 compared to an effective tax rate of 18% for the same period last year, with the primary difference being the change in the federal corporate income tax rate to 21% in 2018 from 35% in the prior year and release of reserve for uncertain tax positions, including interest due to a statute of limitation expiring and the IRS audit finalization. The effective tax rate for the periods presented are comprised of U.S. federal and state taxes, withholding taxes and foreign taxes of $25.7 million, which were offset by a tax benefit of $10.5 million for stock-based compensation. The tax rate for the six month ended June 30, 2018 was also impacted by release of reserve for uncertain tax positions including interest of $18.0 million. The tax rate for the six months ended June 30, 2017 was comprised of U.S. federal and state taxes, withholding taxes and foreign taxes of $17.3 million which were offset by a tax provision benefit of $9.6 million for stock-based compensation.

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Liquidity and Capital Resources

	As of	
	June 30, 2018	December 31, 2017
	(in millions)	
Cash and cash equivalents	$972.1	$ 811.0
Investments	526.9	538.3
Total cash, cash equivalents and investments	$1,499.0	$ 1,349.3
Working capital	$799.6	$ 689.6

	Six Months Ended	
	June 30, 2018	June 30, 2017
	(in millions)	
Net cash provided by operating activities	$282.0	$ 274.5
Net cash used in investing activities	(18.5)	(113.2)
Net cash used in financing activities	(102.4)	(17.2)
Net increase in cash and cash equivalents	$161.1	$ 144.1

Liquidity and capital resources may be impacted by our operating activities, as well as by our stock repurchases, real estate and other capital expenditures, proceeds associated with stock option exercises and issuances of common stock under the ESPP, payment of taxes in connection with the net settlement of equity awards and business acquisitions. In recent years, we have received significant capital resources as a result of increases in our deferred revenue and the proceeds from exercise of stock options and purchases under the ESPP. Additional increases in deferred revenue may depend on a number of factors including our billing growth rate, service contract renewal rates and length of initial and renewals service contracts. We expect proceeds from the issuance of stock options in future years to be impacted by the increased mix of restricted stock units granted versus stock options and also to vary based on our share price. As of June 30, 2018, $325.8 million remained available for future share repurchase under the Repurchase Program.

Construction on the new headquarters building is expected to start in the fourth quarter of 2018 and related spend will continue in 2019 and until project completion. We estimate 2018 spending for this project to be approximately $10.0 million to $20.0 million.

As of June 30, 2018, our cash, cash equivalents and investments of $1.50 billion were invested primarily in corporate debt securities, certificates of deposit and term deposits, money market funds, commercial paper and U.S. government and agency securities. It is our investment policy to invest excess cash in a manner that preserves capital, provides liquidity and maximizes return without significantly increasing risk. We do not enter into investments for trading or speculative purposes.

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As of June 30, 2018, $915.7 million of our cash and investments were held by our international subsidiaries. Under the 2017 Tax Act signed into law in December 2017, starting on January 1, 2018, we are no longer subject to federal income tax on earnings remitted from our foreign subsidiaries. We have analyzed our global working capital and cash requirements and the potential tax liabilities attributable to repatriation, and have determined that we will be repatriating certain unremitted foreign earnings which were previously deemed indefinitely reinvested. We expect to be able to repatriate an additional $150 million over the remainder of 2018. For those investments from which we were able to make a reasonable estimate of the tax effects of such repatriation, we have recorded a provisional estimate for withholding and state taxes. Most of our off-shore cash is located in Singapore. Corporate law in Singapore only allows dividends to be paid to the extent we have retained earnings in Singapore. In Singapore, our retained earnings are lower than our current cash balance. We believe that our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including our growth rate, the timing and amount of our planned share repurchases, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure access to adequate manufacturing capacity, the continuing market acceptance of our products and our investments in real estate through purchases or long-term leases. Historically, we have required capital principally to fund our working capital needs, share repurchases, capital expenditures, and acquisition activities. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all.

Operating Activities

Cash generated by operating activities is our primary source of liquidity. It is primarily comprised of net income, as adjusted for non-cash items, and changes in operating assets and liabilities, including deferred revenue. Non-cash adjustments consist primarily of stock-based compensation, amortization of deferred contract costs in connection with the adoption of Topic 606, depreciation of property and equipment, amortization of intangible assets and amortization of investment premiums.

Our operating activities during the six months ended June 30, 2018 provided $282.0 million in cash as a result of the continued growth of our business and our ability to successfully manage our working capital. Changes in operating assets and liabilities primarily resulted from an increase in sales of our FortiGuard security subscription and FortiCare technical support services to new and existing customers, as reflected by an increase in our deferred revenue. Our total deferred revenue balance grew 27% as of June 30, 2018 compared to the same period last year to $1.47 billion.

Our operating activities during the six months ended June 30, 2017 provided $274.5 million in cash as a result of the continued growth of our business and our ability to successfully manage our working capital. The increase in sales of our FortiGuard security subscription and FortiCare technical supports to new and existing customers was reflected in the increase in our deferred revenue.

Investing Activities

The changes in cash flows from investing activities primarily relate to timing of purchases, maturities and sales of investments, purchases of property and equipment and payments made in connection with a business combination. Historically, in making a lease versus purchase decision related to our larger facilities, we have considered various factors including financial metrics and the impact on our employees. In certain cases, we have elected to purchase the facility if we believe that purchasing rather than leasing is more in line with our long-term strategy. We expect to make similar decisions in the future.

During the six months ended June 30, 2018, cash used for investing activities was primarily due to the $23.2 million we spent on capital expenditures and $6.0 million used for the acquisition of Bradford, net of cash acquired. This was partially offset by an increase in cash of $10.7 million due to maturities and sales of our investments, net of purchases.

During the six months ended June 30, 2017, cash used in investing activities was primarily due to the $99.9 million we spent on capital expenditures, including the purchase of $84.8 million in real estate in Burnaby, Canada. Cash outflows due to purchases of investments, net of sales and maturities, were $13.3 million.

Financing Activities

The changes in cash flows from financing activities primarily relate to repurchase and retirement of common stock, proceeds from the issuance of common stock under our equity incentive plan and the ESPP, taxes paid related to net share settlement of equity awards and payments of debt assumed in a business combination.

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During the six months ended June 30, 2018, cash used for financing activities was $102.4 million, primarily due to $117.1 million used to repurchase our common stock and $9.5 million of payments of the debt assumed in business combination. This was partially offset by $24.2 million of proceeds from the issuance of common stock, net of tax withholding.

During the six months ended June 30, 2017, cash used in financing activities was $17.2 million, primarily due to $33.1 million used to repurchase our common stock. This was partially offset by $15.9 million of proceeds from the issuance of common stock, net of tax withholding.

Contractual Obligations and Commitments

There were no material changes outside the ordinary course of business during the six months ended June 30, 2018 to the contractual obligations and commitments disclosed in Management’s Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II, Item 7, of the Form 10-K. See Note 10 to the notes to the condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional information regarding contractual obligations and commitments.

Off-Balance Sheet Arrangements

As of June 30, 2018, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There were no material changes in our market risk during the six months ended June 30, 2018 compared to the disclosures in Part II, Item 7A of the Form 10-K.

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ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act as of June 30, 2018. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of June 30, 2018 to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

In January 2018, we implemented certain internal controls over financial reporting in connection with our adoption of ASC Topic 606, Revenue from Contracts with Customers. There were no other changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the six months ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II

ITEM 1. Legal Proceedings

We are subject to various claims, complaints and legal actions that arise from time to time in the normal course of business. We accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss. There can be no assurance that existing or future legal proceedings arising in the ordinary course of business or otherwise will not have a material adverse effect on our business, consolidated financial position, results of operations or cash flows.

As previously disclosed, in October 2016, we received a letter from the United States Attorney's Office for the Northern District of California requesting information relating to our compliance with the Trade Agreements Act. We have been fully cooperating with this ongoing inquiry and have periodically met and spoken with the United States Attorney's Office in connection with this matter. We are currently in settlement discussions with the United States Attorney's Office.

ITEM 1A. Risk Factors

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

Risks Related to Our Business

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

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

- our ability to attract and retain new end-customers or sell additional products and subscriptions to our existing end-customers;
- the level of demand for our products and services, which may render forecasts inaccurate;
- the timing of channel partner and end-customer orders, and our reliance on a concentration of shipments at the end of each quarter;
- the timing of shipments, which may depend on factors such as inventory levels, logistics, manufacturing or shipping delays, our ability to ship new products on schedule and our ability to accurately forecast inventory requirements;
- inventory management;
- the mix of products sold and the mix of revenue between products and services, as well as the degree to which products and services are bundled and sold together for a package price;

- the purchasing practices and budgeting cycles of our channel partners and end-customers;
- the effectiveness of our sales organization, generally or in a particular geographic region, the time it takes to hire sales personnel and the timing of hiring, and our ability to retain, sales personnel;
- sales execution risk related to effectively selling to all segments of the market, including enterprise, in addition to small- and medium-sized business and service providers, and to selling our broad security product and services portfolio;
- the seasonal buying patterns of our end-customers;

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

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

- our channel partners having insufficient financial resources to withstand changes and challenges in business conditions;

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- disruptions in our channel or termination of our relationship with important channel partners, including as a result of consolidation among distributors and resellers of security solutions;

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

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

- political, economic and social instability;

- general economic conditions, both in domestic and foreign markets;

- future accounting pronouncements or changes in our accounting policies, such as changes in the revenue recognition standards or accounting for leases, as well as the significant costs that may be incurred to adopt and comply with these new pronouncements;

- possible impairments or acceleration of depreciation of our existing real estate due to our current real estate holdings and future development plans; and

- legislative or regulatory changes, such as with respect to privacy, information and cybersecurity, exports, the environment and applicable accounting standards.

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

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

Our business depends on the overall demand for information technology and on the economic health of our current and prospective customers. In addition, the purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. Weak global economic conditions and spending environments, weak economic conditions in certain regions or a reduction in information technology spending regardless of macro-economic conditions could have adverse impacts on our business, financial condition and results of operations, including longer sales cycles, lower prices for our products and services, higher default rates among our channel partners, reduced unit sales and slower or declining growth.

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

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

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

Our FortiGuard security subscription and FortiCare technical support services revenue has historically accounted for a significant percentage of our total revenue. Revenue from the sale of new, or from the renewal of existing, FortiGuard security subscription and FortiCare technical support service contracts may decline and fluctuate as a result of a number of factors, including fluctuations in purchases of FortiGate appliances, changes in the sales mix between products and services, end-customers' level of satisfaction with our products and services, the prices of our products and services, the prices of products and services offered by our competitors, reductions in our customers' spending levels and the timing of revenue recognition with respect to these arrangements. If our sales of new, or renewals of existing, FortiGuard security subscription and FortiCare technical support service contracts decline, our revenue and revenue growth may decline and our business could suffer. In addition, in the event significant customers require payment terms for FortiGuard security subscription and FortiCare technical support services in arrears or for shorter periods of time than annually, such as monthly or quarterly, this may negatively impact our billings and revenue. Furthermore, we recognize FortiGuard security subscription and FortiCare technical support services revenue monthly over the term of the relevant service period, which is typically from one to three years, to a lesser extent, five years. As a result, much of the FortiGuard security subscription and FortiCare technical support services revenue we report each quarter is the recognition of deferred revenue from FortiGuard security subscription and FortiCare technical support services contracts entered into during previous quarters or years. Consequently, a decline in new or renewed FortiGuard security subscription and FortiCare technical support services contracts in any one quarter will not be fully reflected in revenue in that quarter but will negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in sales of new, or renewals of existing, FortiGuard security subscription and FortiCare technical support services is not reflected in full in our statements of operations until future periods. Our FortiGuard security subscription and FortiCare technical support services revenue also makes it difficult for us to rapidly increase our revenue through additional service sales in any period, as revenue from new and renewal support services contracts must be recognized over the applicable service period.

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

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

- economic or political instability in foreign markets;
- greater difficulty in enforcing contracts and accounts receivable collection, including longer collection periods;
- longer sales processes for larger deals, particularly during the summer months;
- changes in regulatory requirements;
- difficulties and costs of staffing and managing foreign operations;
- the uncertainty of protection for intellectual property rights in some countries;

- costs of compliance with foreign policies, laws and regulations and the risks and costs of non-compliance with such policies, laws and regulations;

- protectionist policies and penalties, and local laws, requirements, policies and perceptions that may adversely impact a U.S.-headquartered business's sales in certain countries outside of the United States;

- costs of complying with, and the risks and costs of non-compliance with, U.S. or other foreign laws and regulations for foreign operations, including the U.S. Foreign Corrupt Practices Act, the United Kingdom Bribery Act 2010, the General Data Protection Regulation (which became effective in May 2018), import and export control laws, tariffs and retaliatory measures, trade barriers and economic sanctions;

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- other regulatory or contractual limitations on our ability to sell our products in certain foreign markets, and the risks and costs of non-compliance;

- heightened risks of unfair or corrupt business practices in certain geographies and of improper or fraudulent sales or sales-related arrangements, such as sales "side agreements" to allow return rights, that could disrupt the sales team through terminations of employment or otherwise, and may adversely impact financial results as compared to those already reported or forecasted and result in restatements of financial statements and irregularities in financial statements;

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

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

- changes in foreign currency exchange rates;

- management communication and integration problems resulting from cultural differences and geographic dispersion; and

- changes in tax, employment and other laws.

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

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

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

- increased competition from competitors that traditionally target large and medium-sized businesses, service providers and government organizations and that may already have purchase commitments from those end-customers;

- increased purchasing power and leverage held by large end-customers in negotiating contractual arrangements;

- unanticipated changes in the capital resources or purchasing behavior of large end-customers, including changes in the volume and frequency of their purchases and changes in the mix of products and services and related payment terms;

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

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

- longer ramp-up periods for enterprise sales personnel as compared to other sales personnel.

Large and medium-sized businesses, service providers and government organizations often undertake a significant evaluation process that results in a lengthy sales cycle, in some cases longer than 12 months. Although we have a channel sales model, our sales representatives typically engage in direct interaction with end-customers, along with our distributors and resellers, in connection with sales to large and medium-sized end-customers. We may spend substantial time, effort and money in our sales efforts without being successful in producing any sales. In addition, product purchases by large and medium-sized businesses, service providers and government organizations are frequently subject to budget constraints, multiple approvals and unplanned administrative, processing and other delays. Furthermore, service providers represent our largest industry vertical and consolidation or continued changes in buying behavior by larger customers within this industry could negatively impact our business. Large and medium-sized businesses, service providers and government organizations typically have longer implementation cycles, require greater product functionality and scalability, expect a broader range of services, including design services, demand that vendors take on a larger share of risks, require acceptance provisions that can lead to a delay in revenue recognition and expect greater payment flexibility from vendors. In addition, large and medium-sized businesses, service providers and government organizations may require that our products and services be sold differently from how we offer our products and services, which could negatively impact our operating results. Our large business and service provider customers may also become more deliberate in their purchases as they plan their next-generation network security architecture, leading them to take more time in making purchasing decisions or to purchase based only on their immediate needs. All these factors can add further risk to business conducted with these customers. In addition, if sales expected from a large and medium-sized end-customer for a particular quarter are not realized in that quarter or at all, our business, operating results and financial condition could be materially and adversely affected.

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

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

Inventory management remains an area of focus as we balance the need to maintain inventory levels that are sufficient to ensure competitive lead times against the risk of inventory obsolescence because of rapidly changing technology and customer requirements, or excess inventory levels. If we ultimately determine that we have excess inventory, we may have to reduce our prices and write-down inventory, which in turn could result in lower gross margins. Alternatively, insufficient inventory levels may lead to shortages that result in delayed revenue or loss of sales opportunities altogether as potential end-customers turn to competitors' products that are readily available. For example, we have in the past experienced inventory shortages and excesses due to the variance in demand for certain products from forecasted amounts. In addition, for those channel partners that have rights of return, inventory held by such channel partners affects our results of operations. Our inventory management systems and related supply chain visibility tools may be inadequate to enable us to effectively manage inventory. If we are unable to effectively manage our inventory and that of our channel partners, our results of operations could be adversely affected.

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

Our future performance depends on the continued services and continuing contributions of our senior management to execute on our business plan and to identify and pursue new opportunities and product innovations. The loss of services of members of senior management, particularly Ken Xie, our Co-Founder, Chief Executive Officer and Chairman or Michael Xie, our Co-Founder, President and Chief Technology Officer, or of any of our senior sales leaders or functional area leaders, could significantly delay or prevent the achievement of our development and strategic objectives. In February 2018, we underwent a transition in senior management as Drew Del Matto resigned as our Chief Financial Officer and Keith Jensen was appointed as our Interim Chief Financial Officer. Mr. Jensen was appointed as our Chief Financial Officer effective May 2018. The loss of the services or the distraction of our senior management for any reason could adversely affect our business, financial condition and results of operations.

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

Our future success depends, in part, on our ability to continue to attract and retain highly skilled personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel, any failure to have in place and execute an effective succession plan for key executives, or delays in hiring required personnel, particularly in engineering, sales and marketing, may seriously harm our business, financial condition and results of operations. From time to time, we experience turnover in our management-level personnel. None of our key employees has an employment agreement for a specific term, and any of our employees may terminate their employment at any time. Our ability to continue to attract and retain highly skilled personnel will be critical to our future success. Competition for highly skilled personnel is frequently intense, especially for qualified employees in network security and especially in the locations where we have a substantial presence and need for highly skilled personnel, such as the San Francisco Bay Area and Vancouver, Canada. We may not be successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs. Also, to the extent we hire personnel from competitors, we may be subject to allegations that they have been improperly solicited or divulged proprietary or other confidential information. Changes in immigration laws, including changes to the rules regarding H1-B visas, may also harm our ability to attract personnel from other countries.

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

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

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

The sales prices for our products and services may decline for a variety of reasons, including competitive pricing pressures, discounts or promotional programs we offer, a change in our mix of products and services and anticipation of the introduction of new products and services. Competition continues to increase in the market segments in which we participate, and we expect competition to further increase in the future, thereby leading to increased pricing pressures. Larger competitors with more diverse product offerings may reduce the price of products and services that compete with ours in order to promote the sale of other products or services or may bundle them with other products or services. Additionally, although we price our products and services worldwide in U.S. dollars, currency fluctuations in certain countries and regions have in the past, and may in the future, negatively impact actual prices that partners and customers are willing to pay in those countries and regions. Furthermore, we anticipate that the sales prices and gross profits for our products or services will decrease over product life cycles. We cannot ensure that we will be successful in developing and introducing new offerings with enhanced functionality on a timely basis, or that our product and service offerings, if introduced, will enable us to maintain our prices, gross profits and operating margin at levels that will allow us to maintain profitability.

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

As a result of customer-buying patterns and the efforts of our sales force and channel partners to meet or exceed quarterly quotas, we have historically received a substantial portion of each quarter’s sales orders and generated a substantial portion of each quarter’s billings and revenue during the last two weeks of the quarter. If expected orders at the end of any quarter are delayed for any reason, including the failure of anticipated purchase orders to materialize, our logistics partners’ inability to ship products prior to quarter-end to fulfill purchase orders received near the end of the quarter, our failure to accurately forecast our inventory requirements and to appropriately manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, any delays in shipments due to trade compliance requirements, labor disputes or logistics changes at shipping ports or otherwise, our billings and revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

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

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

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

A significant portion of our sales is generated through a limited number of distributors, and substantially all of our revenue is generated through sales by our channel partners, including distributors and resellers. We depend on our channel partners to generate a significant portion of our sales opportunities and to manage our sales process. To the extent our channel partners are unsuccessful in selling our products, or we are unable to enter into arrangements with and retain a sufficient number of high-quality channel partners in each of the regions in which we sell products, or if we are unable to keep them motivated to sell our products, or they shift focus to other vendors and/or our competitors, our ability to sell our products and operating results will be harmed. The termination of our relationship with any significant channel partner may adversely impact our sales and operating results.

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We provide sales channel partners with specific programs to assist them in selling our products and incentivize them to sell our products, but there can be no assurance that these programs will be effective. In addition, our channel partners may be unsuccessful in marketing, selling and supporting our products and services and may purchase more inventory than they can sell. Our channel partners generally do not have minimum purchase requirements. Some of our channel partners may have insufficient financial resources to withstand changes and challenges in business conditions. In addition, if our channel partners' financial condition or operations weaken it could negatively impact their ability to sell our product and services. Our channel partners may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products, or may decide to cease selling our products and services altogether in favor of a competitor's products and services. They may also have incentives to promote our competitors' products to the detriment of our own, or they may cease selling our products altogether. We cannot ensure that we will retain these channel partners or that we will be able to secure additional or replacement partners or that existing channel partners will continue to perform. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results.

In addition, we may be impacted by consolidation of our existing channel partners. In such instances, we may experience changes to our overall business and operational relationships due to dealing with a larger combined entity, and our ability to maintain such relationships on favorable contractual terms may be more limited. We may also become increasingly dependent on a more limited number of channel partners, as consolidation increases the relative proportion of our business for which each channel partner is responsible, which may magnify the risks described in the preceding paragraphs. In July 2017, Exclusive Networks Group ("Exclusive"), which distributes our solutions to a large group of resellers and end-customers, acquired Fine Tec U.S. Since the acquisition of Fine Tec U.S., Exclusive's business with us has increased and may continue to increase in the future. The two channel partners together accounted for 32% of our total net accounts receivable as of June 30, 2018. During the three months ended June 30, 2018, Exclusive and Ingram Micro, Inc. ("Ingram Micro"), which distributed our solutions to a large group of resellers and end-customers, accounted for 29% and 10% of our total revenue, respectively. During the six months ended June 30, 2018, Exclusive accounted for 29% of our total revenue. During the three months ended June 30, 2017, Exclusive, Fine Tec Computers, and Ingram Micro accounted for 20%, 12%, and 10% of our total revenue, respectively. During the six months ended June 30, 2017, Exclusive and Fine Tec Computers accounted for 20% and 12% of our total revenue, respectively.

In addition, any new sales channel partner will require extensive training and may take several months or more to achieve productivity. Our channel partner sales structure could subject us to lawsuits, potential liability and reputational harm if, for example, any of our channel partners misrepresent the functionality of our products or services to end-customers or our channel partners violate laws or our corporate policies. We depend on our global channel partners to comply with applicable legal and regulatory requirements. To the extent that they fail to do so, that could have a material adverse effect on our business, operating results and financial condition. If we fail to optimize our channel partner model or fail to manage existing sales channels, our business will be seriously harmed.

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

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

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An actual, possible or perceived security breach or infection of the network of one of our end-customers, regardless of whether the breach is attributable to the failure of our products or services to prevent the security breach, could adversely affect the market's perception of our security products and services and, in some instances, subject us to potential liability that is not contractually limited. We may not be able to correct any security flaws or vulnerabilities promptly, or at all. Our products may also be misused by end-customers or third parties who obtain access to our products. For example, our products could be used to censor private access to certain information on the internet. Such use of our products for censorship could result in negative press coverage and negatively affect our reputation, even if we take reasonable measures to prevent any improper shipment of our products or if our products are provided by an unauthorized third party. Any actual, possible or perceived defects, errors or vulnerabilities in our products, or misuse of our products, could result in:

- the expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work around errors or defects or to address and eliminate vulnerabilities;
- the loss of existing or potential end-customers or channel partners;
- delayed or lost revenue;
- delay or failure to attain market acceptance;
- negative publicity and harm to our reputation; and
- litigation, regulatory inquiries or investigations that may be costly and harm our reputation and, in some instances, subject us to potential liability that is not contractually limited.

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

We rely heavily on information technology and accounting systems to help manage critical functions such as order processing, revenue recognition, financial forecasts, inventory and supply chain management and trade compliance reviews. In addition, we have been slow to adopt and implement certain automated functions, which could have a negative impact on our business. For example, a large part of our order processing relies on manual data entry of customer purchase orders received through email and, to a lesser extent, through electronic data interchange from our customers. Combined with the fact that we may receive a large amount of our orders in the last few weeks of any given quarter, an interruption in our email service or other systems could result in delayed order fulfillment and decreased billings and revenue for that quarter.

To manage any future growth effectively, we must continue to improve and expand our information technology and financial, operating and administrative systems and controls, and our business continuity and disaster recovery plans and processes, and continue to manage headcount, capital and processes in an efficient manner. We may not be able to successfully implement requisite improvements to these systems, controls and processes, such as system capacity, access and change management controls, in a timely or efficient manner. Our failure to improve our systems and processes, or their failure to operate in the intended manner, whether as a result of the significant growth of our business or otherwise, may result in our inability to manage the growth of our business and to accurately forecast our revenue, expenses and earnings, or to prevent certain losses. Moreover, the failure of our systems and processes could undermine our ability to provide accurate, timely and reliable reports on our financial and operating results and could impact the effectiveness of our internal control over financial reporting.

In addition, our systems, processes and controls may not prevent or detect all errors, omissions, malfeasance or fraud, such as corruption and improper “side agreements” that may impact revenue recognition. Our productivity and the quality of our products and services may also be adversely affected if we do not integrate and train our new employees quickly and effectively. Any future growth would add complexity to our organization and require effective coordination throughout our organization. Failure to ensure appropriate systems, processes and controls and to manage any future growth effectively could result in increased costs and harm our reputation and results of operations.

We have expanded our office real estate holdings to meet our projected growing need for office space. We purchased office buildings in Ottawa and Burnaby, Canada in 2017, and we have purchased various small buildings adjacent to our Sunnyvale headquarters as we expand our headquarters in Sunnyvale, California. These plans will require significant capital expenditure over the next several years and involve certain risks, including impairment charges and acceleration of depreciation, changes in future business strategy that may decrease the need for expansion (such as a decrease in headcount) and, risks related to construction. Future changes in growth or fluctuations in cash flow may also negatively impact our ability to pay for these projects or free cash flow. Additionally, inaccuracies in our projected capital expenditures could negatively impact our business, operating results and financial condition.

We may experience difficulties maintaining and expanding our ERP and CRM systems.

The maintenance of our ERP and CRM systems has required, and will continue to require, the investment of significant financial and human resources. In addition, we may choose to upgrade or expand the functionality of our ERP and CRM systems, leading to additional costs. We may also discover deficiencies in our design or maintenance of the ERP or CRM systems that could adversely affect our ability to process orders, ship products, provide services and customer support, send invoices and track payments, fulfill contractual obligations, accurately maintain books and records, provide accurate, timely and reliable reports on our financial and operating results, or otherwise operate our business. Additionally, if the system does not operate as intended, the effectiveness of our internal control over financial reporting could be adversely affected or our ability to assess it adequately could be delayed. Further, we recently implemented new systems to comply with the new revenue recognition standard and may further expand the scope of our ERP and CRM systems. Our operating results may be adversely affected if these upgrades or expansions are delayed or if the systems do not function as intended or are not sufficient to meet our revenue recognition accounting requirements.

If our estimates or judgments relating to our critical accounting policies are based on assumptions that change or prove to be incorrect, our operating results could fall below expectations of securities analysts and investors, resulting in a decline in our stock price.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, as provided in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Quarterly Report on Form 10-Q, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Additionally, in connection with adopting and implementing the new revenue accounting standard, management will make judgments and assumptions based on our interpretation of the new standard. The new revenue standard is principles based and interpretation of those principles may vary from company to company based on their unique circumstances. It is possible that interpretation, industry practice and guidance may evolve as we work toward implementing the new standard. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price. Significant assumptions and estimates used in preparing our consolidated financial statements include those related to revenue recognition and sales return reserves, stock-based compensation expense, valuation of inventory, investments, accounting for business combination, goodwill and other long-lived assets, restructuring, accounting for income taxes, and litigation and settlement costs.

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

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

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

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

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

Our proprietary SPU, which is the key to the performance of our appliances, is built by contract manufacturers including Faraday, MegaChips Corporation and Renesas. These contract manufacturers use foundries operated by UMC, TSMC or Renesas on a purchase-order basis, and these foundries do not guarantee their capacity and could delay orders or increase their pricing. Accordingly, the foundries are not obligated to continue to fulfill our supply requirements, and due to the long lead time that a new foundry would require, we could suffer temporary inventory shortages of our SPU as well as increased costs. In addition to our proprietary SPU, we also purchase off-the-shelf ASICs or integrated circuits from vendors for which we have experienced, and may continue to experience, long lead times. Our suppliers may also prioritize orders by other companies that order higher volumes or more profitable products. If any of these manufacturers materially delays its supply of ASICs or specific product models to us, or requires us to find an alternate supplier and we are not able to do so on a timely and reasonable basis, or if these foundries materially increase their prices for fabrication of our ASICs, our business would be harmed.

In addition, our reliance on third-party manufacturers and foundries limits our control over environmental regulatory requirements such as the hazardous substance content of our products and therefore our ability to ensure compliance with the Restriction of Hazardous Substances Directive (the “EU RoHS”) adopted in the European Union (the “EU”) and other similar laws. It also exposes us to the risk that certain minerals and metals, known as “conflict minerals,” that are contained in our products have originated in the Democratic Republic of the Congo or an adjoining country. As a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), the SEC adopted disclosure requirements for public companies whose products contain conflict minerals that are necessary to the functionality or production of such products. Under these rules, we are required to obtain sourcing data from suppliers, perform supply chain due diligence, and file annually with the SEC a specialized disclosure report on Form SD covering the prior calendar year. Although the SEC has provided guidance with respect to a portion of the conflict minerals filing requirements that somewhat reduced the reporting required, we have incurred and expect to incur additional costs to comply with the rules, including costs related to efforts to determine the origin, source and chain of custody of the conflict minerals used in our products and the adoption of conflict minerals-related governance policies, processes and controls. Moreover, the implementation of these compliance measures could adversely affect the sourcing, availability and pricing of materials used in the manufacture of our products to the extent that there may be only a limited number of suppliers that are able to meet our sourcing requirements, which would make it more difficult to obtain such materials in sufficient quantities or at competitive prices. We may also encounter customers who require that all of the components of our products be certified as conflict-free. If we are not able to meet customer requirements, such customers may choose to not purchase our products, which could impact our sales and the value of portions of our inventory.

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

We and our contract manufacturers currently purchase several key parts and components used in the manufacture of our products from limited sources of supply. We are therefore subject to the risk of shortages and long lead times in the supply of these components and the risk that component suppliers discontinue or modify components used in our products. We have in the past experienced, and are currently experiencing, shortages and long lead times for certain components. Certain of our limited source components for particular appliances and suppliers of those components include: specific types of CPUs from Intel, network chips from Broadcom, Marvell and Intel, and memory devices from Intel, ADATA, OCZ, Samsung and Western Digital. We also may face shortages in the supply of the capacitors and resistors that are used in the manufacturing of our products. The introduction by component suppliers of new versions of their products, particularly if not anticipated by us or our contract manufacturers, could require us to expend significant resources to incorporate these new components into our products. In addition, if these suppliers were to discontinue production of a necessary part or component, we would be required to expend significant resources and time in locating and integrating replacement parts or components from another vendor. Qualifying additional suppliers for limited source parts or components can be time-consuming and expensive.

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

- a potential inability to obtain an adequate supply of required parts or components when required;
- financial or other difficulties faced by our suppliers;
- infringement or misappropriation of our intellectual property;
- price increases;
- failure of a component to meet environmental or other regulatory requirements;
- failure to meet delivery obligations in a timely fashion; and
- failure in component quality.

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

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

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

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

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

For example, with respect to data privacy and protection, the General Data Protection Regulation (the "GDPR"), which became effective in May 2018 and superseded current EU data protection regulations. The GDPR imposes stringent data handling requirements on companies that receive or process personal data of residents of the EU, and non-compliance with the GDPR could result in significant penalties, including data protection audits and heavy fines. Compliance with, and the other burdens imposed by, the GDPR may limit our ability to operate or expand our business in Europe and could adversely impact our operating results, as could delays or shortcomings in the implementation of our GDPR compliance program. Additionally, other legal regimes throughout the world governed data handling, protection, and privacy. For example, in June 2018 California passed the California Consumer Privacy Act (the "CCPA"), which provides new data privacy rights for consumers and new operational requirements for companies, effective in 2020. Fines for noncompliance may be up to $7,500 per violation. The costs of compliance with, and other burdens imposed by, the GDPR and CCPA may limit the use and adoption of our products and services and could have an adverse impact on our business.

Selling our solutions to the U.S. government, whether directly or through channel partners, also subjects us to certain regulatory and contractual requirements. Failure to comply with these requirements by either us or our channel partners could subject us to investigations, fines, other penalties and damages, which could have an adverse effect on our business, operating results, financial condition and prospects. As an example, the U.S. Department of Justice (the "DOJ"), on its own behalf or on behalf of the General Services Administration (the "GSA"), as well as individuals, has in the past pursued claims against, reached financial settlements with or otherwise obtained damages from companies that sell electronic equipment and from IT vendors under the False Claims Act and other statutes related to pricing, discount practices and compliance with laws related to sales to the federal government, such as the Trade Agreements Act. The DOJ continues to actively pursue such claims. Violations of certain regulatory and contractual requirements could also result in us being suspended or debarred from future government contracting. Any of these outcomes could have an adverse effect on our revenue, operating results, financial condition and prospects. See Part II, Item 1 of this Quarterly Report on Form 10-Q for more information on our legal proceedings. These laws and regulations impose added costs on our business, and failure to comply with these or other applicable regulations and requirements, including non-compliance in the past, could lead to claims for damages from our channel partners, penalties, termination of contracts, loss of exclusive rights in our intellectual property and temporary suspension or permanent debarment from government contracting. Any such damages, penalties, disruptions or limitations in our ability to do business with the public sector could have an adverse effect on our business and operating results.

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

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

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Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of certain products to U.S. embargoed or sanctioned countries, governments and persons. Even though we take precautions to prevent our product from being shipped to U.S. sanctions targets, our products could be shipped to those targets by our channel partners, despite such precautions. Any such shipment could have negative consequences including government investigations and penalties and reputational harm. In addition, various countries regulate the import of certain encryption technology, including import permitting and licensing requirements, and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products globally or, in some cases, prevent the export or import of our products to certain countries, governments or persons altogether. Any change in export or import regulations, economic sanctions or related legislation, shift in the enforcement or scope of existing regulations, or change in the countries, governments, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, financial condition and results of operations.

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

Our business benefits from free trade agreements, such as the North American Free Trade Agreement ("NAFTA"), and we also rely on various U.S. corporate tax provisions related to international commerce, as we develop, market and sell our products and services globally. Efforts to withdraw from or materially modify NAFTA or other international trade agreements, or to change corporate tax policy related to international commerce, could adversely affect our financial condition and results of operations as could the continuing uncertainty regarding whether such actions will be taken.

Moreover, efforts to implement changes related to export or import regulations (including the imposition of new border taxes or tariffs on foreign imports), trade barriers, economic sanctions and other related policies could harm our results of operations. For example, in March 2018, the current administration imposed a 25% tariff on steel imports and a 10% tariff on aluminum imports and announced additional tariffs on goods imported from China specifically, as well as certain other countries. Other tariffs have since been imposed by the United States and more tariffs, including on electronic products, have been announced and could be effected in the coming months. Other countries have in turn imposed retaliatory tariffs on goods exported from the United States and both the United States and foreign countries have threatened to alter or leave current trade agreements. We do not expect these tariffs to have a significant effect on our raw material costs. However, if retaliatory trade measures taken by China or other countries in response to the tariffs cause the cost of our products to increase or disrupt our operations, we may be required to raise our prices, which may result in the loss of customers and harm to our reputation and operating performance.

Any modification in these areas, any shift in the enforcement or scope of existing regulations or any change in the countries, governments, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential end-customers with international operations and could result in increased costs. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, financial condition and results of operations.

If we fail to comply with environmental requirements, our business, financial condition, operating results and reputation could be adversely affected.

We are subject to various environmental laws and regulations, including laws governing the hazardous material content of our products, laws relating to our real property and future expansion plans and laws concerning the recycling of electrical and electronic equipment. The laws and regulations to which we are subject include the EU RoHS and the EU Waste Electrical and Electronic Equipment Directive (the “WEEE Directive”), as well as the implementing legislation of the EU member states. Similar laws and regulations have been passed or are pending in China, South Korea, Norway and Japan and may be enacted in other regions, including in the United States, and we are, or may in the future be, subject to these laws and regulations.

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The EU RoHS and the similar laws of other jurisdictions ban the use of certain hazardous materials such as lead, mercury, cadmium and certain plastic additives in the manufacture of electrical equipment, including our products. We have incurred costs to comply with these laws, including research and development costs, costs associated with assuring the supply of compliant components and costs associated with writing off noncompliant inventory. We expect to continue to incur costs related to environmental laws and regulations in the future. With respect to the EU RoHS, we and our competitors rely on exemptions for lead and other substances in network infrastructure equipment. It is possible this exemption will be revoked in the future. Additionally, although the RoHS exemptions have been extended, it is possible that some of these exemptions may expire in the future without being extended. If this exemption is revoked or expires without extension, if there are other changes to these laws (or their interpretation) or if new similar laws are passed in other jurisdictions, we may be required to reengineer our products to use components compatible with these regulations. This reengineering and component substitution could result in additional costs to us or disrupt our operations or logistics.

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

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

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

Sales to U.S. and foreign federal, state and local governmental agency end-customers have accounted for a portion of our revenue in past periods, and we may in the future increase sales to government organizations. Sales to government organizations are subject to a number of risks. Selling to government organizations can be highly competitive, expensive and time consuming, often requiring significant upfront time and expense, with long sales cycles and without any assurance of winning a sale.

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

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

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

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

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

If our internal enterprise IT networks, on which we conduct internal business and interface externally, or our operational networks, through which we connect to customer systems and provide services, are compromised, public perception of our products and services will be harmed, we may become subject to liability, and our business, operating results and stock price may be adversely impacted.

Our success depends on the market’s confidence in our ability to provide effective network security protection. Despite our efforts and processes to prevent breaches of our internal network system and website, we are still vulnerable to computer viruses, break-ins, phishing attacks, attempts to overload our servers with denial-of-service and other cyber-attacks and similar disruptions from unauthorized access to our internal network system or our website. Our security measures may also be breached due to employee error, malfeasance or otherwise, which may be more difficult to detect than outsider threats, and the existing programs and trainings we have in place to prevent such insider threats may not be effective or sufficient. Third parties may also attempt to fraudulently induce our employees to transfer funds or disclose information in order to gain access to our network and confidential information. We cannot guarantee that the measures we have taken to protect our network and website will provide absolute security. Moreover, because we provide network security products, we may be a more attractive target for attacks by computer hackers. Although we have not yet experienced significant damages from unauthorized access by a third party of our internal network or website, an actual or perceived breach of network security occurs in our internal systems or website could adversely affect the market perception of our products and services and investor confidence in our company. Any breach of our network system or website could impair our ability to operate our business, including our ability to provide FortiGuard security subscription and FortiCare technical support services to our end-customers, lead to interruptions or system slowdowns, cause loss of critical data or lead to the unauthorized disclosure or use of confidential, proprietary or sensitive information. We could also be subject to liability and litigation and reputational harm and our channel partners and end-customers may be harmed, lose confidence in us and decrease or cease using our products and services. Any breach of our internal network system or our website could have an adverse effect on our business, operating results and stock price.

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

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

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

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

- the mix of earnings in countries with differing statutory tax rates or withholding taxes;
- changes in the valuation of our deferred tax assets and liabilities;
- transfer pricing adjustments;
- an increase in non-deductible expenses for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development and impairment of goodwill;
- tax costs related to intercompany realignments;
- tax assessments resulting from income tax audits or any related tax interest or penalties that could significantly affect our provision for income taxes for the period in which the settlement takes place;
- a change in our decision to indefinitely reinvest foreign earnings;
- changes in accounting principles;
- court decisions, tax rulings and interpretations of tax laws, and regulations by international, federal or local governmental authorities; or
- changes in tax laws and regulations.

Significant judgment is required to determine the recognition and measurement attribute prescribed in the Financial Accounting Standards Board standard. In addition, the standard applies to all income tax positions, including the potential recovery of previously paid taxes, which, if settled unfavorably, could adversely impact our provision for income taxes or additional paid-in capital. Further, as a result of certain of our ongoing employment and capital investment actions and commitments, our income in certain foreign countries is subject to reduced tax rates. Our failure to meet these commitments could adversely impact our provision for income taxes.

We have open tax years that could be subject to the examination by the Internal Revenue Service (the “IRS”) and other tax authorities. Tax authorities in France are currently examining the inter-company relationship between Fortinet, Inc., Fortinet France and Fortinet Singapore. In May 2017, we received a notice from the French tax authorities that an audit was officially opened for tax years from 2007 to 2015. We regularly assess the likelihood of adverse outcomes resulting from such examinations to determine the adequacy of our provision for income taxes.

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Although we believe that our estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our consolidated financial statements and may materially affect our financial results in the period or periods for which such determination is made.

In December 2017, the U.S. federal government enacted the Tax Cuts and Jobs Act (the "2017 Tax Act"). The 2017 Tax Act significantly changed the existing U.S. corporate income tax laws by, among other things, lowering the corporate tax rate, implementing a territorial tax system and imposing a one-time deemed repatriation tax on cumulative undistributed foreign earnings, for which we have not previously recognized U.S. income taxes. Given the timing, scope and magnitude of the changes enacted by the 2017 Tax Act, along with ongoing implementation efforts, guidance and other developments from U.S. regulatory and standard-setting bodies, the completion of the accounting for certain tax items included in Note 11 to the consolidated financial statements that have been reported as provisional, or where no estimate of the impact was provided as a result of us not having the necessary information, may be subject to material change. Any significant changes to our future effective tax rate, including final resolution of provisional amounts relating to effects of the 2017 Tax Act, may result in a material adverse effect on our business, financial condition, results of operations or cash flows. We will continue to monitor and assess the impact of the 2017 Tax Act and the ongoing guidance and accounting interpretations issued in response to the 2017 Tax Act.

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

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

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

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

The Organisation for Economic Co-operation and Development (the "OECD") has been working on a Base Erosion and Profit Sharing Project, commonly known as BEPS. As part of this project, the OECD has issued and continues to issue guidelines and proposals that change various aspects of the existing framework under which our tax obligations are determined in many of the countries in which we do business. Due to our extensive international business activities, any changes in the taxation of such activities could increase our tax obligations in many countries and may increase our worldwide effective tax rate.

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

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

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

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

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

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

A significant natural disaster, such as an earthquake, fire, power outage, flood or other catastrophic event, could have a material adverse impact on our business, operating results and financial condition. Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity, and our research and development and data center in Burnaby, Canada, from which we deliver to customers our FortiGuard security subscription updates, is subject to the risk of flooding and is also in a region known for seismic activity. Any earthquake in the Bay Area or Burnaby or flooding in Burnaby could negatively impact our ability to provide products and services, such as FortiCare support and FortiGuard subscription services and could otherwise negatively impact our business. In addition, natural disasters could affect our manufacturing vendors, suppliers or logistics providers' ability to perform services, such as obtaining product components and manufacturing products, or assisting with shipments, on a timely basis, as well as our customers' ability to order from us and our employees' ability to perform their duties. In the event our or our service providers' information technology systems or manufacturing or logistics abilities are hindered by any of the events discussed above, shipments could be delayed, resulting in our missing financial targets, such as revenue and shipment targets, for a particular quarter. In addition, regional instability, civil unrest, labor disruptions, acts of terrorism and other geo-political unrest could cause disruptions in our business or the business of our manufacturers, logistics providers, partners or end-customers, or of the economy as a whole. Given our typical concentration of sales at the end of each quarter, any disruption in the business of our manufacturers, logistics providers, partners or end-customers that impacts sales at the end of our quarter could have a significant adverse impact on our quarterly results. To the extent that any of the above results in security risks to our customers, delays or cancellations of customer orders, the delay of the manufacture, deployment or shipment of our products, or interruption or downtime of our services, our business, financial condition and results of operations would be adversely affected.

Risks Related to Our Industry

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

The network security market is expected to continue to evolve rapidly. Moreover, many of our end-customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated techniques to gain access to and attack systems and networks. The technology in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, while minimizing the impact on network performance. Additionally, some of our new products and enhancements may require us to develop new hardware architectures and ASICs that involve complex, expensive and time consuming research and development processes. For example, we enter into development agreements with third parties. If our contract development projects are not successfully completed, or are not completed in a timely fashion, our product development could be delayed and our business generally could suffer. Costs for contract development can be substantial and our profitability may be harmed if we are unable to recover these costs. Although the market expects rapid introduction of new products or product enhancements to respond to new threats, the development of these products is difficult and the timetable for commercial release and availability is uncertain and there can be long time periods between releases and availability of new products. We have in the past and may in the future experience unanticipated delays in the availability of new products and services and fail to meet previously announced timetables for such availability. If we do not quickly respond to the rapidly changing and rigorous needs of our end-customers by developing and releasing and making available on a timely basis new products and services or enhancements that can respond adequately to new security threats, our competitive position and business prospects will be harmed.

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

Our uniform resource locator ("URL") database for our web filtering service may fail to keep pace with the rapid growth of URLs and may not categorize websites in accordance with our end-customers' expectations.

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

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

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

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

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

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

- inability to interoperate effectively with the networks or applications of our prospective end-customers;
- inability to protect against new types of attacks or techniques used by hackers;
- actual or perceived defects, vulnerabilities, errors or failures;
- negative publicity about their performance or effectiveness;
- introduction or anticipated introduction of competing products by our competitors;
- poor business conditions for our end-customers, causing them to delay IT purchases;

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- changes to the regulatory requirements around security; and

- reluctance of customers to purchase products incorporating open source software.

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

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

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

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

The market for network security products is intensely competitive and we expect competition to intensify in the future. Our competitors include companies such as Check Point, Cisco, F5 Networks, FireEye, Forcepoint, Imperva, Juniper, McAfee, Palo Alto Networks, Proofpoint, SonicWALL, Sophos, Symantec and Trend Micro.

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

- greater name recognition and longer operating histories;

- larger sales and marketing budgets and resources;

- broader distribution and established relationships with distribution partners and end-customers;

- access to larger customer bases;

- greater customer support resources;

- greater resources to make acquisitions;
- lower labor and development costs; and
- substantially greater financial, technical and other resources.

In addition, some of our larger competitors have substantially broader product offerings, and leverage their relationships based on other products or incorporate functionality into existing products in a manner that discourages customers from purchasing our products. These larger competitors often have broader product lines and market focus, and are in a better position to withstand any significant reduction in capital spending by end-customers in these markets. Therefore, these competitors will not be as susceptible to downturns in a particular market. Also, many of our smaller competitors that specialize in providing protection from a single type of network security threat are often able to deliver these specialized network security products to the market more quickly than we can. Some of our smaller competitors are using third-party chips designed to accelerate performance. Conditions in our markets could change rapidly and significantly as a result of technological advancements or continuing market consolidation. Our competitors and potential competitors may also be able to develop products or services that are equal or superior to ours, achieve greater market acceptance of their products and services, and increase sales by utilizing different distribution channels than we do. Our current and potential competitors may also offer point solutions, fabric and/or cloud security services that compete with some of the features present in our platform. They may also establish cooperative relationships among themselves or with third parties that may further enhance their resources. In addition, current or potential competitors may be acquired by third parties with greater available resources, and new competitors may arise pursuant to acquisitions of network security companies or divisions. As a result of such acquisitions, competition in our market may continue to increase and our current or potential competitors might be able to adapt more quickly to new technologies and customer needs, devote greater resources to the promotion or sale of their products and services, initiate or withstand substantial price competition, take advantage of acquisition or other opportunities more readily, or develop and expand their product and service offerings more quickly than we do. In addition, our competitors may bundle products and services competitive with ours with other products and services. Customers may accept these bundled products and services rather than separately purchasing our products and services. Due to budget constraints or economic downturns, organizations may be more willing to incrementally add solutions to their existing network security infrastructure from competitors than to replace it with our solutions. These competitive pressures in our market or our failure to compete effectively may result in price reductions, fewer customer orders, reduced revenue and gross margins and loss of market share.

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

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

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Risks Related to Intellectual Property

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

We rely primarily on patent, trademark, copyright and trade secrets laws and confidentiality procedures and contractual provisions to protect our technology. Valid patents may not issue from our pending applications, and the claims eventually allowed on any patents may not be sufficiently broad to protect our technology or products. Any issued patents may be challenged, invalidated or circumvented, and any rights granted under these patents may not actually provide adequate defensive protection or competitive advantages to us. Patent applications in the United States are typically not published until at least 18 months after filing, or, in some cases, not at all, and publications of discoveries in industry-related literature lag behind actual discoveries. We cannot be certain that we were the first to make the inventions claimed in our pending patent applications or that we were the first to file for patent protection. Additionally, the process of obtaining patent protection is expensive and time-consuming, and we may not be able to prosecute all necessary or desirable patent applications at a reasonable cost or in a timely manner. In addition, recent changes to the patent laws in the United States may bring into question the validity of certain software patents and may make it more difficult and costly to prosecute patent applications. As a result, we may not be able to obtain adequate patent protection or effectively enforce our issued patents.

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

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

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

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

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

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

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

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

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

We have several ongoing patent lawsuits, several non-practicing entity patent holding companies have sent us demand letters proposing that we license certain of their patents, and organizations have sent letters demanding that we provide indemnification for patent claims. One such patent lawsuit by a telecommunications company was filed in federal court in Delaware in July 2018. Given this and the proliferation of lawsuits in our industry and other similar industries by both non-practicing entities and operating entities, and recent non-practicing entity and operating entity patent litigation against other companies in the security space, we expect that we will be sued for patent infringement in the future, regardless of the merits of any such lawsuits. The cost to defend such lawsuits and any adverse result in such lawsuits could have a material adverse effect on our results of operations and financial condition.

We rely on the availability of third-party licenses.

Many of our products include software or other intellectual property licensed from third parties. It may be necessary in the future to renew licenses relating to various aspects of these products or to seek new licenses for existing or new products. Licensors may claim we owe them additional license fees for past and future use of their software and other intellectual property or that we cannot utilize such software or intellectual property in our products going forward. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms or for reasonable pricing, or the need to engage in litigation regarding these matters, could result in delays in product releases until equivalent technology can be identified, licensed or developed, if at all, and integrated into our products and may result in significant license fees and have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other intellectual property licensed from third parties on a nonexclusive basis could limit our ability to differentiate our products from those of our competitors.

We also rely on technologies licensed from third parties in order to operate functions of our business. If any of these third parties allege that we have not properly paid for such licenses or that we have improperly used the technologies under such licenses, we may need to pay additional fees or obtain new licenses, and such licenses may not be available on terms acceptable to us or at all or may be costly. In any such case, or if we were required to redesign our internal operations to function with new technologies, our business, results of operations and financial condition could be harmed.

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Risks Related to Ownership of our Common Stock

As a public company, we are subject to compliance initiatives that will require substantial time from our management and result in significantly increased costs that may adversely affect our operating results and financial condition.

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), Dodd-Frank and other rules implemented by the SEC and The Nasdaq Stock Market impose various requirements on public companies, including requiring changes in corporate governance practices. These requirements, as well as proposed corporate governance laws and regulations under consideration, may further increase our compliance costs. If compliance with these various legal and regulatory requirements diverts our management's attention from other business concerns, it could have a material adverse effect on our business, financial condition and results of operations. Sarbanes-Oxley requires, among other things, that we assess the effectiveness of our internal control over financial reporting annually, and of our disclosure controls and procedures quarterly. Although our most recent assessment, testing and evaluation resulted in our conclusion that, as of December 31, 2017, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in 2018 or future periods. We may incur additional expenses and commitment of management's time in connection with further evaluations, both of which could materially increase our operating expenses and accordingly reduce our operating results.

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

A change in accounting standards or practices, and varying interpretations of existing or new accounting pronouncements, such as changes to standards related to revenue recognition, equity investment valuation (which became effective for us beginning on January 1, 2018) and accounting for leases (which will become effective for us on January 1, 2019), as well as the significant costs incurred or that may be incurred to adopt and to comply with these new pronouncements, could have a significant effect on our reported financial results or the way we conduct our business. If we do not ensure that our systems and processes are aligned with the new standards, we could encounter difficulties generating quarterly and annual financial statements in a timely manner, which would have an adverse effect on our business, our ability to meet our reporting obligations and compliance with internal control requirements. We have adopted the new revenue recognition standard as of January 1, 2018. Refer to Note 1 and Note 2 in the notes to our condensed consolidated financial statements included in this Quarterly Report on Form 10-Q for additional information on the new standard and its potential impact on us.

The new revenue standard is principles based and interpretation of those principles may vary from company to company based on their unique circumstances. Management will make judgments and assumptions based on our interpretation of the new standard. It is possible that interpretation, industry practice and guidance may evolve as we work toward implementing the new revenue recognition standard. If our circumstances change or if actual circumstances differ from our assumptions, our operating result may be adversely affected and could fall below our publicly announced guidance or the expectations of securities analysts and investors, resulting in a decline in the market price of our common stock. Further, the new equity investment valuation standard, which requires most equity investments to be measured at fair value (with subsequent changes in fair value recognized in net income), may increase the volatility of our earnings.

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

The trading market for our common stock will depend in part on the research and reports that securities or industry analysts publish about us or our business. If we do not maintain adequate research coverage or if one or more of the analysts who cover us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price could decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price and trading volume to decline.

The trading price of our common stock may be volatile.

The market price of our common stock may be subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, news about us and our financial results, news about our competitors and their results, and other factors such as rumors or fluctuations in the valuation of companies perceived by investors to be comparable to us. For example, during the six months ended June 30, 2018, the closing price of our common stock ranged from $43.83 to $66.17 per share.

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

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

Share repurchases under our Repurchase Program (the “Repurchase Program”) could increase the volatility of the trading price of our common stock, could diminish our cash reserves, could occur at non-optimal prices and may not result in the most effective use of our capital.

In 2018, our board of directors approved the increase in the aggregate authorized repurchase amount under the Repurchase Program by $500.0 million, bringing the total authorization to $1.5 billion. Share repurchases under the Repurchase Program could affect the price of our common stock, increase stock price volatility and diminish our cash reserves. In addition, an announcement of the reduction, suspension or termination of our share repurchase program could result in a decrease in the trading price of our common stock. Moreover, despite analyses we perform in connection with repurchases under the Repurchase Program to determine the appropriate prices for repurchases of our stock, our stock price could decline, resulting in repurchases made at non-optimal prices. Our failure to repurchase our stock at optimal prices may be perceived by investors as an inefficient use of our cash and cash equivalents, which could result in litigation that may have an adverse effect on our business, operating results and financial condition. In addition, while our board of directors carefully considers various alternative uses of our cash and cash equivalents in determining whether to authorize stock repurchases, there can be no assurance that the decision by our board of directors to repurchase stock would result in in the most effective uses of our cash and cash equivalents, and there may be alternative uses of our cash and cash equivalents that would be more effective, such as investing in growing our business organically or through acquisitions.

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

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

- authorizing “blank check” preferred stock, which could be issued by the board without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;

- limiting the liability of, and providing indemnification to, our directors and officers;

- limiting the ability of our stockholders to call and bring business before special meetings;

- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;

- providing that certain litigation matters may only be brought against us in state or federal courts in the State of Delaware;

- controlling the procedures for the conduct and scheduling of board and stockholder meetings; and
- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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

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

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

However, these anti-takeover provisions will not have the effect of preventing activist stockholders from seeking to increase short-term stockholder value through actions such as nominating board candidates and requesting that we pursue strategic combinations or other transactions. These actions could disrupt our operations, be costly and time-consuming and divert the attention of our management and employees. In addition, perceived uncertainties as to our future direction as a result of activist stockholder actions could result in the loss of potential business opportunities, as well as other negative business consequences. Actions of an activist stockholder may also cause fluctuations in our stock price based on speculative market perceptions or other factors that do not necessarily reflect our business. Further, we may incur significant expenses in retaining professionals to advise and assist us on activist stockholder matters, including legal, financial, communications advisors and solicitation experts, which may negatively impact our future financial results.

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

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Share Repurchase Program

The following table provides information with respect to the shares of common stock we repurchased during the three months ended June 30, 2018 (in millions, except share and per share amounts):

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 - April 30, 2018	—	$ —	—	$ 327.3
May 1 - May 31, 2018	27,245	$ 56.78	27,245	$ 325.8
June 1 - June 30, 2018	—	$ —	—	$ 325.8

ITEM 6. Exhibits, Financial Statement Schedules

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

EXHIBIT INDEX

3.1* Amended and Restated Certificate of Incorporation

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

* Filed herewith.

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SIGNATURES

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

Date: August 6, 2018

FORTINET, INC.

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

FORTINET, INC.

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