

FORTINET INC  
Form S-1/A  
November 02, 2009  
Table of Contents

As filed with the Securities and Exchange Commission on November 2, 2009

Registration No. 333-161190

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## Amendment No. 5

to

## FORM S-1

## REGISTRATION STATEMENT

*UNDER*

*THE SECURITIES ACT OF 1933*

## Fortinet, Inc.

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

3577  
(Primary Standard Industrial  
Classification Code Number)

77-0560389  
(I.R.S. Employer  
Identification Number)

1090 Kifer Road  
Sunnyvale, California 94086

Edgar Filing: FORTINET INC - Form S-1/A

408-235-7700

(Address, including zip code, and telephone number, including area code, of Registrant's principal executive offices)

**John Whittle**

**Vice President and General Counsel**

**Fortinet, Inc.**

**1090 Kifer Road**

**Sunnyvale, California 94086**

**408-235-7700**

(Name, address, including zip code, and telephone number, including area code, of agent for service)

*Copies to:*

**Larry W. Sonsini**

**Alan F. Denenberg**

**Carmen Chang**

**Sarah K. Solum**

**John A. Fore**

**Davis Polk & Wardwell LLP**

**Scott Anthony**

**1600 El Camino Real**

**Wilson Sonsini Goodrich & Rosati, P.C.**

**Menlo Park, California 94025**

**650 Page Mill Road**

**650-752-2000**

**Palo Alto, California 94304**

**650-493-9300**

**Approximate date of commencement of proposed sale to the public:** As soon as practicable after this Registration Statement becomes effective.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act, check the following box. "

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

## Edgar Filing: FORTINET INC - Form S-1/A

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

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

**The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission acting pursuant to said Section 8(a) may determine.**

**Table of Contents**

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting offers to buy these securities in any state where the offer or sale is not permitted.

*PROSPECTUS (Subject to Completion)*

*Issued November 2, 2009*

*12,000,000 Shares*

*COMMON STOCK*

*Fortinet, Inc. is offering 5,781,683 shares of its common stock and the selling stockholders are offering 6,218,317 shares of common stock. We will not receive any proceeds from the sale of shares by the selling stockholders. This is our initial public offering and no public market exists for our shares. We anticipate that the initial public offering price will be between \$9.00 and \$11.00 per share.*

*We have applied to have our common stock listed on the Nasdaq Global Market under the symbol FTNT.*

*Investing in our common stock involves risks. See Risk Factors beginning on page 10.*

Edgar Filing: FORTINET INC - Form S-1/A

PRICE \$ A SHARE

	<i>Underwriting</i>			
	<i>Price to</i>	<i>Discounts and</i>	<i>Proceeds to</i>	<i>Proceeds to</i>
	<i>Public</i>	<i>Commissions</i>	<i>Fortinet</i>	<i>Selling Stockholders</i>
<i>Per share</i>	\$	\$	\$	\$
<i>Total</i>	\$	\$	\$	\$

We have granted the underwriters the right to purchase up to an additional 1,800,000 shares of common stock to cover over-allotments.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the shares of common stock to purchasers on \_\_\_\_\_, 2009.

MORGAN STANLEY

J.P. MORGAN

DEUTSCHE BANK SECURITIES

ROBERT W. BAIRD & CO.

RBC CAPITAL MARKETS

THINKEQUITY LLC

JMP SECURITIES

SIGNAL HILL

, 2009

**Table of Contents**

**Table of Contents**

**Table of Contents**



**Table of Contents****TABLE OF CONTENTS**

	<b>Page</b>
<u>Prospectus Summary</u>	1
<u>Risk Factors</u>	10
<u>Forward Looking Statements</u>	35
<u>Use of Proceeds</u>	36
<u>Dividend Policy</u>	36
<u>Capitalization</u>	37
<u>Dilution</u>	39
<u>Selected Consolidated Financial Data</u>	41
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	44
<u>Business</u>	75
<u>Management</u>	101
<u>Executive Compensation</u>	108
	<b>Page</b>
<u>Certain Relationships and Related Party Transactions</u>	129
<u>Principal and Selling Stockholders</u>	131
<u>Description of Capital Stock</u>	136
<u>Shares Eligible for Future Sale</u>	139
<u>Material United States Federal Income Tax Consequences to Non-U.S. Holders</u>	141
<u>Underwriters</u>	145
<u>Legal Matters</u>	150
<u>Experts</u>	150
<u>Where You Can Find Additional Information</u>	150
<u>Index to Consolidated Financial Statements</u>	F-1

You should rely only on the information contained in this prospectus and in any free writing prospectus. We, the underwriters and the selling stockholders have not authorized anyone to provide you with information different from that contained in this prospectus. We, the underwriters and the selling stockholders are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers and sales are permitted. The information in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or any sale of shares of our common stock.

**Until \_\_\_\_\_, 2009 (25 days after the commencement of this offering), all dealers that buy, sell or trade shares of our common stock, whether or not participating in this offering, may be required to deliver a prospectus. This delivery requirement is in addition to the obligation of dealers to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.**

For investors outside of the United States, neither we, the selling stockholders nor any of the underwriters have done anything that would permit this offering or possession or distribution of this prospectus in any jurisdiction where action for that purpose is required. Persons outside the United States who come into possession of this prospectus must inform themselves about, and observe any restrictions relating to, the offering of the shares of common stock and the distribution of this prospectus outside of the United States.

## Edgar Filing: FORTINET INC - Form S-1/A

Fortinet, FortiAnalyzer, FortiASIC, FortiClient, FortiGate, FortiGuard, FortiMail, FortiManager and FortiWiFi are trademarks of Fortinet, Inc. in the United States and other countries. This prospectus also includes other trademarks of Fortinet and trademarks of other persons.

**Table of Contents**

**PROSPECTUS SUMMARY**

*This summary highlights information contained elsewhere in this prospectus and does not contain all of the information you should consider in making your investment decision. Before deciding to invest in shares of our common stock, you should read this summary together with the more detailed information, including our consolidated financial statements and the related notes, elsewhere in this prospectus. You should carefully consider, among other things, the matters discussed in Risk Factors, our consolidated financial statements and related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, in each case included elsewhere in this prospectus.*

**FORTINET, INC.**

**Overview**

We have pioneered an innovative, high performance network security solution to the fundamental problems of an increasingly bandwidth-intensive network environment and a more sophisticated IT threat landscape. We are a leading provider of network security appliances and the market leader in Unified Threat Management, or UTM. Through our products and subscription services, we provide broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and government entities worldwide.

IT security and regulatory compliance have become increasingly complex for organizations, driving continued spending on solutions despite a cautious overall IT spending environment. The increasing sophistication of hackers and the rise of new Web applications have significantly multiplied the volume, intensity and diversity of security threats. Organizations have traditionally responded to security threats by deploying numerous standalone security point products within their network, such as gateway antivirus, firewall, intrusion prevention and Web filtering devices. This approach results in management complexity and a high total cost of ownership, leading to the need for a vendor that can integrate multiple security functions onto a single platform while maintaining high performance. Through our core focus on security innovation, we have built our UTM solution to address these problems. Our solution incorporates our proprietary application-specific integrated circuits, or ASICs, hardware architecture, operating system and set of associated security and networking functions to defend against multiple categories of IT security attacks without significantly impacting network performance, all while reducing point product complexity and cost.

We are the leading worldwide provider of UTM appliances, with a 15.4% share of the UTM appliance market for the second quarter of 2009, as determined by IDC.<sup>(1)</sup> IDC forecasts that the UTM market will grow from \$1.3 billion in 2007 to \$3.5 billion in 2012,<sup>(2)</sup> representing a compounded annual growth rate of 22.3%. Based on IDC data, the UTM market is the fastest growing segment within the network security market, which was \$6.8 billion in 2007.<sup>(2)</sup> As of September 30, 2009, we had shipped over 475,000 appliances to more than 5,000 channel partners and 75,000 end-customers worldwide, including a majority of the 2009 Fortune Global 100.

Our total revenue was \$123.5 million, \$155.4 million, and \$211.8 million for fiscal years 2006, 2007, and 2008, respectively, and was \$152.7 million and \$181.4 million for the first nine months of fiscal 2008 and 2009, respectively. Our business is geographically diversified, with 37% of our total revenue from the Americas, 37% from Europe, Middle East and Africa, or EMEA, and 26% from Asia Pacific countries, or APAC, for the first nine months of fiscal 2009. We have generated positive cash flow from operations since fiscal 2005, growing our cash

## Edgar Filing: FORTINET INC - Form S-1/A

- (1) IDC Worldwide Security Appliances Tracker, September 2009.
- (2) Worldwide Network Security 2008-2012 Forecast and 2007 Vendor Shares: Transitions Appliances Are More Than Meets the Eye, Doc #214246, October 2008.

## **Table of Contents**

flow from operations from \$3.4 million in fiscal 2005 to \$37.7 million in fiscal 2008 and to \$45.8 million for the first nine months of fiscal 2009. Subscription and support services, which represented approximately half of our total revenue for fiscal 2008 and the first nine months of fiscal 2009, are a significant source of recurring revenue.

### **Our Solution**

Our flagship UTM solution consists of our FortiGate appliance product line and our FortiGuard security subscription services, which together provide a broad array of security and networking functions, including firewall, virtual private network, or VPN, antivirus, intrusion prevention, Web filtering, antispy, and wide area network, or WAN, acceleration. Our FortiGate appliances, from the FortiGate-50 for small businesses and branch offices to the FortiGate-5000 series for large enterprises and service providers, are based on our proprietary technology platform. This platform includes our FortiASICs, which are specifically designed for accelerated processing of security and networking functions, and our FortiOS operating system, which provides the foundation for all of our security functions. Our FortiGuard security subscription services provide end-customers with access to dynamic updates to our antivirus, intrusion prevention, Web filtering and antispy functionality based on intelligence gathered by our dedicated FortiGuard Labs team. By combining multiple proprietary security and networking functions with our purpose-built FortiASIC and FortiOS, our FortiGate UTM solution delivers broad protection against dynamic security threats while reducing the operational burden and costs associated with managing multiple point products.

We complement our FortiGate product line with a family of FortiManager appliances, which enable end-customers to manage the system configuration and security functions of multiple FortiGate appliances from a centralized console, as well as FortiAnalyzer appliances, which enable collection, analysis and archiving of content and log data generated by our products. We also offer other appliances and software that protect our end-customers from security threats to other critical areas in the enterprise, such as messaging, Web-based traffic and databases, and employees' computers or handheld devices.

Key benefits of our solution include:

*Accelerated, high performance unified threat management.* We offer a high performance UTM solution based on our proprietary technology platform, comprised of our FortiASICs and FortiOS. Our FortiASICs are designed to accelerate the computationally intensive tasks required to secure networks in today's sophisticated threat environment while also delivering faster network performance than traditional network security solutions.

*High quality security functionality.* Our broad set of integrated, high quality security functions enables the most sophisticated and demanding end-customers to avoid the shortcomings of a traditionally fragmented security point product infrastructure. Organizations such as ICSA Labs and The NSS Group have certified the quality of our security functionality and our products have received Federal Information Processing Standard, or FIPS, Common Criteria EAL4+, and Network Equipment Building System, or NEBS, certifications, among others. The fact that many large organizations, including a majority of the 2009 Fortune Global 100, have deployed our solution is a testament to the quality of our offering.

*Lower total cost of ownership.* By consolidating security functionality, reducing network complexity, integrating high performance capabilities and centralizing management functions, our UTM solution is designed to lower our end-customers' total cost of ownership compared to multiple point products.

*Superior flexibility and ease of deployment.* Our UTM solution enables end-customers to activate additional security functions and subscription services on an on-demand basis as their security needs evolve.



## **Table of Contents**

*Dedicated, real-time security intelligence.* Through our subscription services, our FortiGuard Labs team of over 100 professionals is able to provide real time security intelligence 24 hours a day, seven days a week and 365 days a year by enabling rapid updates to our end-customers' security products and delivering the latest counter-measures to emerging network security threats.

*Broad, end-to-end security protection.* We offer a broad range of appliances and software to help end-customers defend against a myriad of security threats at many critical areas throughout the organization, including within the network through our UTM solution, but also in areas such as messaging, Web-based traffic and databases, and employees' computers or handheld devices, through our other offerings.

## **Our Strategy**

Key elements of our strategy include the following:

extend our UTM leadership through continued investment in research and development in our FortiASIC and FortiOS, and integration of other functions to expand the value proposition of UTM;

continue our security focus in the broader network security market and expand into additional security segments;

continue to increase our sales to new large enterprise, service provider and government customers;

further expand sales within our existing customer base by selling additional FortiGate appliances and complementary products and services;

continue to build and optimize our worldwide channel partner footprint; and

further enhance the security threat research capabilities that support our FortiGuard real-time security subscription services.

## **Selected Risk Factors**

Investing in our common stock involves risks. You should carefully read "Risk Factors" beginning on page 10 for an explanation of these risks before investing in our common stock. In particular, the following considerations, among others, may offset our competitive strengths or have a negative effect on our growth strategy, which could cause a decline in the price of our common stock and result in a loss of all or a portion of your investment:

we may not maintain profitability or continue growth;

our quarterly operating results are likely to vary and be unpredictable, which could cause our stock price to decline;

## Edgar Filing: FORTINET INC - Form S-1/A

reliance on a concentration of shipments at the end of the quarter could cause our revenue to fall below expectations of securities analysts and investors, resulting in a decline in our stock price;

insufficient inventory may result in lost sales opportunities or delayed revenue, while excess inventory may harm gross margins;

we rely on our channel partners to generate substantially all of our revenue, and a failure of partners to perform will harm our ability to grow;

the average sale prices of our products or services may decrease;

defects in our products or services could harm our reputation and results;

we face intense competition, especially from larger companies; and



**Table of Contents**

a significant deferral of revenue, for example, based on an inability to establish fair value for any products or services, could cause our revenue for any quarter to fall below expectations of securities analysts and investors, resulting in a decline in our stock price.

**Corporate Information**

We were incorporated as a Delaware corporation in November 2000. Our principal executive office is located at 1090 Kifer Road, Sunnyvale, California 94086. Our telephone number at that location is (408) 235-7700. Our website address is *www.fortinet.com*. We do not incorporate the information on or accessible through our website into this prospectus, and you should not consider any information on, or that can be accessed through, our website as part of this prospectus. Except where the context requires otherwise, in this prospectus the Company, Fortinet, we, us, and our refer to Fortinet, Inc. and, where appropriate, its subsidiaries.

**Table of Contents**

**THE OFFERING**

Shares of common stock offered by us	5,781,683 shares
Shares of common stock offered by the selling stockholders	6,218,317 shares
Total	12,000,000 shares
Shares of common stock to be outstanding after this offering	64,393,969 shares
Over-allotment option to be offered by us	1,800,000 shares

Use of proceeds

We expect our net proceeds from this offering will be approximately \$52.4 million based on an assumed initial public offering price of \$10.00 per share, which is the midpoint of the range reflected on the cover page of this prospectus, and after deducting underwriting discounts and commissions and estimated offering expenses payable by us and after giving effect to estimates of certain expenses that we expect to be reimbursed. We plan to use the net proceeds to us from this offering for working capital and other general corporate purposes. We will not receive any of the proceeds from the sale of shares of common stock by the selling stockholders. See Use of Proceeds.

Risk Factors

You should read the Risk Factors section of this prospectus for a discussion of factors to consider carefully before deciding to invest in shares of our common stock.

Proposed Nasdaq Global Market symbol FTNT

The number of shares of our common stock that will be outstanding after this offering is based on 58,612,286 shares outstanding at September 30, 2009, and excludes:

17,488,988 shares of common stock issuable upon the exercise of options outstanding as of September 30, 2009 (including 176,849 shares that we expect to be sold in this offering by certain selling stockholders upon the exercise of vested options immediately prior to the closing of this offering), at a weighted-average exercise price of \$4.88 per share;

300,025 shares of common stock issuable upon the exercise of options granted after September 30, 2009, at an exercise price of \$11.00 per share;

291,000 shares of common stock issuable upon the exercise of warrants outstanding as of September 30, 2009 (including 150,000 shares that we expect to be sold in this offering by a selling stockholder upon the exercise of a warrant immediately prior to the

## Edgar Filing: FORTINET INC - Form S-1/A

closing of this offering), at a weighted-average exercise price of \$7.07 per share; and

9,000,000 shares of common stock reserved for future issuance under our 2009 Equity Incentive Plan.

Unless otherwise indicated, all information in this prospectus assumes:

the automatic conversion of all outstanding shares of our convertible preferred stock into an aggregate of 37,475,835 shares of common stock upon the closing of this offering; and

no exercise by the underwriters of their right to purchase up to 1,800,000 shares of common stock from us to cover over-allotments.

**Table of Contents**

**SUMMARY CONSOLIDATED FINANCIAL DATA**

We present below our summary consolidated financial data. The summary consolidated statements of operations data for the fiscal years 2006, 2007 and 2008 have been derived from our audited consolidated financial statements included elsewhere in this prospectus. The summary consolidated statements of operations data for the first nine months of fiscal 2008 and 2009 and the summary consolidated balance sheet data as of September 30, 2009 have been derived from our unaudited consolidated financial statements included elsewhere in this prospectus. The unaudited consolidated financial statements include, in the opinion of management, all adjustments, consisting only of normal recurring adjustments, that management considers necessary for the fair presentation of the financial information set forth in those statements. The historical results presented below are not necessarily indicative of financial results to be achieved in future periods, and the results for the first nine months of fiscal 2009, are not necessarily indicative of results to be expected for the full year or for any other period. You should read this information together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our audited and unaudited consolidated financial statements and related notes, each included elsewhere in this prospectus.

The additional key metrics presented are used in addition to the financial measures reflected in the consolidated statements of operations and balance sheet data to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. We assess the increase in deferred revenue balance at the end of a period plus revenue we recognize in that period as a measure of our sales activity for that period. We monitor cash flow from operations as a measure of our overall business performance.

**Table of Contents**

	Fiscal Year <sup>(1)</sup>			Nine Months Ended	
	2006	2007	2008	September 28, 2008	September 30, 2009 <sup>(2)</sup>
(in thousands, except per share data)					
<b>Consolidated Statement of Operations Data:</b>					
Revenue					
Product	\$ 59,469	\$ 70,131	\$ 94,587	\$ 68,395	\$ 69,327
Services	39,590	74,152	105,292	75,394	101,758
Ratable product and services	24,407	11,083	11,912	8,936	10,318
Total revenue	123,466	155,366	211,791	152,725	181,403
Cost of revenue					
Product <sup>(3)</sup>	24,166	35,948	41,397	29,420	29,049
Services <sup>(3)</sup>	9,496	15,941	19,441	14,751	15,955
Ratable product and services	7,302	4,763	4,634	3,447	4,062
Total cost of revenues	40,964	56,652	65,472	47,618	49,066
Gross profit					
Product	35,303	34,183	53,190	38,975	40,278
Services	30,094	58,211	85,851	60,643	85,803
Ratable product and services	17,105	6,320	7,278	5,489	6,256
Total gross profit	82,502	98,714	146,319	105,107	132,337
Operating expenses					
Research and development <sup>(3)</sup>	21,446	27,588	37,035	28,186	31,207
Sales and marketing <sup>(3)</sup>	54,056	72,159	87,717	65,900	69,572
General and administrative <sup>(3)</sup>	12,997	20,544	16,640	12,367	13,678
Total operating expenses	88,499	120,291	141,392	106,453	114,457
Operating income (loss)	(5,997)	(21,577)	4,927	(1,346)	17,880
Interest income	2,376	3,507	2,614	1,872	1,677
Other income (expense), net	(503)	(1,991)	1,710	171	148
Income (loss) before income taxes	(4,124)	(20,061)	9,251	697	19,705
Provision for income taxes	1,220	1,781	1,888	1,277	3,466
Net income (loss)	(5,344)	(21,842)	7,363	(580)	16,239
Premium paid on repurchase of convertible preferred stock <sup>(4)</sup>					(9,266)
Net income (loss) attributable to common stockholders	\$ (5,344)	\$ (21,842)	\$ 7,363	\$ (580)	\$ 6,973
Net income (loss) per share attributable to common stockholders:					
Basic	\$ (0.28)	\$ (1.13)	\$ 0.37	\$ (0.03)	\$ 0.34
Diluted	\$ (0.28)	\$ (1.13)	\$ 0.11	\$ (0.03)	\$ 0.11
Weighted-average shares outstanding:					
Basic	18,861	19,276	20,017	19,802	20,788

Edgar Filing: FORTINET INC - Form S-1/A

Diluted	18,861	19,276	67,122	19,802	64,187
Pro-forma net income per share (unaudited):					
Basic			\$ 0.13		\$ 0.12
Diluted			\$ 0.11		\$ 0.11
Pro-forma weighted-average shares outstanding used in calculating net income per share (unaudited):					
Basic			57,493		58,264
Diluted			67,122		64,187

**Table of Contents**

- (1) Our fiscal years ended on December 31, 2006, December 30, 2007 and December 28, 2008.
- (2) We made the decision in the first quarter of 2009 to change our financial reporting periods from a fiscal to calendar basis. This change was implemented in the third quarter of 2009 upon completion of required system changes. Commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our third quarter of fiscal 2009 ended on September 30, 2009, and our fiscal 2009 will end on December 31, 2009. This change in period end had the effect of increasing the number of days in the nine month period ended September 30, 2009 by three days. Although a significant volume of shipments occurs during the final few days of each of our quarterly reporting periods, including during the quarter ended September 30, 2009, management believes that the three days added to the quarter ended September 30, 2009 from the effect of such conversion to a calendar quarter end did not materially impact our product revenue, as we manage our quarter-end sales cycle based on our financial reporting period end. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of the impact on our services revenue.
- (3) Includes stock-based compensation expense as follows:

	Fiscal Year			Nine Months Ended	
	2006	2007	2008 (in thousands)	September 28, 2008	September 30, 2009
Cost of product revenue	\$ 99	\$ 553	\$ 67	\$ 46	\$ 76
Cost of services revenue	52	416	400	283	465
Research and development	135	1,452	1,049	727	1,392
Sales and marketing	354	3,928	2,512	1,867	2,103
General and administrative	414	2,983	1,271	932	1,243
Total stock-based compensation	\$ 1,054	\$ 9,332	\$ 5,299	\$ 3,855	\$ 5,279

- (4) This amount relates to the repurchase of convertible preferred stock (see Note 10 to Notes to Consolidated Financial Statements) during the first nine months of fiscal 2009. The repurchase amount per share over the carrying value per share of the convertible preferred stock is considered similar to a dividend paid and thus the total amount is subtracted from net income to arrive at earnings available to common stockholders when deriving earnings per share.

	As of September 30, 2009		
	Actual	Pro Forma <sup>(1)</sup> (in thousands)	Pro Forma As Adjusted <sup>(2)</sup>
<b>Consolidated Balance Sheet Data:</b>			
Cash, cash equivalents and short-term investments	\$ 152,390	\$ 152,390	\$ 204,787
Working capital	45,522	45,522	97,919
Total assets	230,478	230,478	282,875
Current and long-term debt			
Deferred revenue, current and long-term	190,375	190,375	190,375
Convertible preferred stock	91,185		
Common stock including additional paid-in capital	18,570	109,755	162,152
Total stockholders' equity	3,888	3,888	56,285

- (1) The pro forma column in the summary consolidated balance sheet data above reflects the automatic conversion of all outstanding shares of our convertible preferred stock into common stock upon the closing of this offering.
- (2) The pro forma as adjusted column in the summary consolidated balance sheet data table above reflects:

the automatic conversion of all outstanding shares of our convertible preferred stock into common stock upon the closing of this offering; and

## Edgar Filing: FORTINET INC - Form S-1/A

our receipt of the estimated net proceeds from the sale of 5,781,683 shares of common stock offered by us in this offering, based on an assumed initial public offering price of \$10.00 per share, which is the midpoint of the range reflected on the cover page of this prospectus, and after deducting the underwriting discounts and commissions and estimated offering expenses payable by us and after giving effect to estimates of certain expenses that we expect to be reimbursed.



**Table of Contents**

	Fiscal Year or as of Fiscal Year End			Nine Months Ended or as of	
	2006	2007	2008	September 28, 2008	September 30, 2009 <sup>(3)</sup>
	(dollars in thousands)				
<b>Additional Key Metrics:</b>					
Revenue	\$ 123,466	\$ 155,366	\$ 211,791	\$ 152,725	\$ 181,403
Gross margin	66.8%	63.5%	69.1%	68.8%	73.0%
Operating income (loss) <sup>(1)</sup>	\$ (5,997)	\$ (21,577)	\$ 4,927	\$ (1,346)	\$ 17,880
Operating margin	(4.9)%	(13.9)%	2.3%	(0.9)%	9.9%
Total deferred revenue <sup>(2)</sup>	\$ 93,376	\$ 131,255	\$ 171,617	\$ 158,107	\$ 190,375
Increase in total deferred revenue	\$ 18,872	\$ 37,879	\$ 40,362	\$ 26,852	\$ 18,758
Cash, cash equivalents and short-term investments	\$ 64,041	\$ 90,161	\$ 124,190	\$ 108,570	\$ 152,390
Cash flow from operations	\$ 3,409	\$ 27,669	\$ 37,686	\$ 19,106	\$ 45,756

(1) Includes stock-based compensation expense: \$ 1,054      \$ 9,332      \$ 5,299      \$ 3,855      \$ 5,279

(2) Deferred revenue consists of amounts that have been invoiced but have not yet been recognized as revenue.

(3) We made the decision in the first quarter of 2009 to change our financial reporting periods from a fiscal to calendar basis. This change was implemented in the third quarter of 2009 upon completion of required system changes. Commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our third quarter of fiscal 2009 ended on September 30, 2009, and our fiscal 2009 will end on December 31, 2009. This change in period end had the effect of increasing the number of days in the nine month period ended September 30, 2009 by three days. Although a significant volume of shipments occurs during the final few days of each of our quarterly reporting periods, including during the quarter ended September 30, 2009, management believes that the three days added to the quarter ended September 30, 2009 from the effect of such conversion to a calendar quarter end did not materially impact our product revenue, as we manage our quarter-end sales cycle based on our financial reporting period end. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of the impact on our services revenue.

**Table of Contents**

**RISK FACTORS**

*Investing in our common stock involves a high degree of risk. You should carefully consider the following risks and all other information contained in this prospectus, including our 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, and you may lose some or all of your investment.*

**Risks Related to Our Business**

*We have a history of losses and may not maintain profitability, and our revenue growth may not continue.*

We have incurred net losses in most fiscal years since our inception, including net losses of \$59.0 million in fiscal 2004, \$14.2 million in fiscal 2005, \$5.3 million in fiscal 2006 and \$21.8 million in fiscal 2007. As a result, we had an accumulated deficit of \$103.9 million at September 30, 2009. Although we were profitable in fiscal 2008, we may not be able to sustain profitability in future periods if we fail to increase revenue or deferred revenue, manage our cost structure, or are subject to unanticipated liabilities. Revenue growth may slow or revenue may decline for a number of possible reasons, including slowing demand for our products or services, increasing competition, a decrease in the growth of our overall market, or if we fail for any reason to continue to capitalize on growth opportunities. Any failure by us to maintain profitability and continue our revenue growth could cause the price of our common stock to materially decline.

*Our quarterly operating results are likely to vary significantly and be unpredictable, which could cause the trading price of our stock to decline.*

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, including:

the level of demand for our products and services, and the timing of channel partner and end-customer orders;

the timing of shipments, which may depend on many factors such as inventory and logistics and our ability to ship new products on schedule and accurately forecast inventory requirements;

the mix of products sold, the mix of revenue between products and services and the degree to which products and services are bundled and sold together for a package price;

the budgeting cycles and purchasing practices of our channel partners and end-customers;

## Edgar Filing: FORTINET INC - Form S-1/A

seasonal buying patterns of our end-customers;

the timing of revenue recognition for our sales, which may be affected by both the mix of sales by our sell-in versus our sell-through channel partners, and by the extent to which we bring on new distributors;

the accuracy and timing of point of sale reporting by our sell-through distributors, which impacts our ability to recognize revenue;

the level of perceived threats to network security, which may fluctuate from period to period;

changes in end-customer, distributor or reseller requirements or market needs;

changes in the growth rate of the network security or UTM markets;

the timing and success of new product and service introductions by us or our competitors or any other change in the competitive landscape of our industry, including consolidation among our competitors or end-customers;

**Table of Contents**

deferral of orders from end-customers in anticipation of new products or product enhancements announced by us or our competitors;

decisions by potential end-customers to purchase network security solutions from larger, more established security vendors or from their primary network equipment vendors;

price competition;

changes in customer renewal rates for our services;

insolvency or credit difficulties confronting our customers, affecting their ability to purchase or pay for our products and services;

insolvency or credit difficulties confronting our key suppliers, which could disrupt our supply chain;

general economic conditions, both domestically and in our foreign markets;

future accounting pronouncements or changes in our accounting policies; and

increases or decreases in our expenses caused by fluctuations in foreign currency exchange rates, since a significant portion of our expenses are incurred and paid in currencies other than U.S. dollars.

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 operating results. This variability and unpredictability could result in our failing to meet our revenue or operating results expectations or those 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 and based on forecasted revenue trends. Accordingly, in the event of revenue shortfalls, we are generally unable to mitigate the negative impact on margins in the short term.

***Reliance on a concentration of shipments at the end of the quarter could cause our revenue to fall below expected levels, resulting in a decline in our stock price.***

As a result of customer-buying patterns and the efforts of our sales force and channel partners to meet or exceed quarterly quotas, historically we have received a substantial portion of a quarter's sales orders and generated a substantial portion of a quarter's revenue during the last two weeks or last days of the quarter. If expected revenue at the end of any quarter is delayed for any reason, including the failure of anticipated purchase orders to materialize, our or 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 manage inventory properly in a way to meet demand, or our inability to release new products on schedule, our revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

***We rely significantly on revenue from subscription and support services which may decline, and, because we recognize revenue from subscriptions and support services over the term of the relevant service period, downturns or upturns in sales are not immediately reflected in full in our operating results.***

Our services revenue accounted for 32.1% of our total revenue for fiscal 2006, 47.7% of our total revenue for fiscal 2007, 49.7% of our total revenue for fiscal 2008 and 56.1% of our total revenue for the first nine months of fiscal 2009. Sales of new or renewal subscription and services contracts may decline or fluctuate as a result of a number of factors, including 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 or reductions in our customers' spending levels. If our sales of new or renewal subscription and services contracts decline, our revenue and revenue growth may decline and our business will suffer. In addition we recognize subscription and service revenue monthly over the term of the relevant service period, which is typically one year but has been as long as five years. As a result, much of the revenue we report each quarter is the recognition of deferred revenue from subscription and services contracts entered into during previous quarters. Consequently, a decline in new or

## **Table of Contents**

renewed subscription or service 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 new or renewed sales of our subscriptions or services are not reflected in full in our results of operations until future periods. Our subscription and service 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 service contracts must be recognized over the applicable service period.

***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.***

Our channel partners may increase orders during periods of product shortages, cancel orders if their inventory is too high, return product or take advantage of price protection (if any), or delay orders in anticipation of new products. They 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. Management of our inventory is further complicated by the significant number of different products that we sell and the fact that we sell models that must meet regulatory requirements, such as the European Union's Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive, or the EU RoHS.

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. 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. 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. For example, in the third and fourth quarters of fiscal 2007 we had excess inventory, resulting in significant inventory write-offs. 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. If we are unable to effectively manage our inventory and that of our distribution partners, our results of operations could 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.***

Substantially all of our revenue is generated through sales by our channel partners, which include distributors and resellers. We depend upon our channel partners to generate sales opportunities and manage the 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, and keep them motivated to sell our products, our ability to sell our products and operating results will be harmed.

We provide sales channel partners with specific programs to assist them in selling 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. Our channel partners generally do not have minimum purchase requirements. They may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products. They may have incentives to promote our competitors' products to the detriment of our own. They may cease selling our products altogether. We cannot assure you that we will retain these channel partners or that we will be able to secure additional or replacement partners. The loss of one or more of our significant channel partners or the failure to obtain and ship a number of large orders each quarter through them could harm our operating results. During fiscal 2007, 2008 and the first nine months of fiscal 2009, Alternative Technology, Inc., a subsidiary of Arrow Electronics, Inc., was our most significant channel partner, accounting for 12% of our total revenue in each of the periods. Any new sales channel partner will require extensive

training and may take several months or more to achieve productivity. Our

## **Table of Contents**

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. If we fail to manage existing sales channels, our business will be seriously harmed.

*If we are not successful in continuing to execute our strategy to increase our sales to larger end-customers, our results of operations may suffer.*

An important part of our growth strategy is to increase sales of our products to large enterprises, service providers and government entities. Sales to enterprises, service providers and government entities involve risks that may not be present (or that are present to a lesser extent) with sales to small-to-mid-sized entities. These risks include:

increased competition from larger competitors, such as Cisco Systems, Inc., Check Point Software Technologies Ltd., McAfee, Inc. and Juniper Networks, Inc., that traditionally target enterprises, service providers and government entities 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 with us;

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

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

Large enterprises, service providers and government entities often undertake a significant evaluation process that results in a lengthy sales cycle, in some cases over twelve months. Although we have a channel sales model, our sales representatives typically engage in direct interaction with our distributors and resellers in connection with sales to larger end-customers. Due to the lengthy nature, the size and scope, and stringent requirements of these evaluations, we typically provide evaluation products to these customers. We may spend substantial time, effort and money in our sales efforts without being successful in producing any sales. If we are unsuccessful in converting these evaluations into sales, we may experience an increased inventory of used products and potential increased write-offs. In addition, product purchases by enterprises, service providers and government entities are frequently subject to budget constraints, multiple approvals, and unplanned administrative, processing and other delays. Finally, enterprise, service providers and government entities typically have longer implementation cycles; require greater product functionality and scalability and a broader range of services, including design services; demand that vendors take on a larger share of risks; sometimes require acceptance provisions that can lead to a delay in revenue recognition; and expect greater payment flexibility from vendors. All these factors can add further risk to business conducted with these customers. If sales expected from a large 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.

*The average sales prices of our products may decrease, which may reduce our gross profits.*

The average sales prices for our products may decline for a variety of reasons, including competitive pricing pressures, discounts we offer, a change in our mix of products, anticipation of the introduction of new products or promotional programs. 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 that compete with ours in order to promote



## Edgar Filing: FORTINET INC - Form S-1/A

the sale of other products or may bundle them with other products. Furthermore, we anticipate that the average sales prices and gross profits for our products will decrease over product life cycles. We cannot assure you that we will be successful in developing and introducing new offerings with enhanced functionality on a timely basis, or that our product offerings, if introduced, will enable us to maintain our prices and gross profits at levels that will allow us to maintain profitability.

## **Table of Contents**

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

Because our products and services are complex, they may contain defects or errors that are not detected until after their commercial release and deployment by our customers. Further, these defects or vulnerabilities may cause our products or services to be vulnerable to electronic break-ins. 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 subscription updates or our FortiGate appliances could result in a failure of our FortiGuard services to effectively update end-customers' FortiGate appliances and thereby leave customers vulnerable to attacks. Furthermore, our solutions may also fail to detect or prevent viruses, worms or similar threats due to a number of reasons such as the evolving nature of such threats and the continual emergence of new threats that we may fail to add to our FortiGuard databases in time to protect our end-customers' networks. Our FortiGuard or FortiCare data centers and networks may also experience technical failures and downtime, and may fail to distribute appropriate updates, or fail to meet the increased requirements of a growing 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.

An actual 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. 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 defects, errors or vulnerabilities in our products, or misuse of our products, could result in:

expenditure of significant financial and product development resources in efforts to analyze, correct, eliminate or work-around errors or defects or to address and eliminate vulnerabilities;

loss of existing or potential end-customers or channel partners;

delayed or lost revenue;

delay or failure to attain market acceptance;

negative publicity, which will harm our reputation; and

litigation, regulatory inquiries or investigations that may be costly and harm our reputation.

*Our business and operations have experienced rapid growth, and if we do not appropriately manage any future growth, or are unable to improve our systems and processes, our operating results will be negatively affected.*

We have a high volume business that has grown over the last several years. We rely heavily on information technology systems to help manage critical functions such as order processing, revenue recognition, financial forecasts and inventory and supply chain management. However, we

## Edgar Filing: FORTINET INC - Form S-1/A

have been slow to adopt and implement certain automated functions, like Electronic Data Interchange, which could have a negative impact on our business. For example, a large part of our order processing relies on the manual processing of emails from our customers. Combined with the fact the we may receive a majority of our orders in the last few weeks of any given quarter, a significant interruption in our email service could result in delayed order fulfillment and decreased revenue for that quarter. To manage any future growth effectively, we must continue to improve and expand our information technology and financial infrastructure, operating and administrative systems and controls, and continue to manage headcount, capital and processes in an efficient manner. We may not be able to

## **Table of Contents**

successfully implement improvements to these systems and processes in a timely or efficient manner. In addition, our systems and processes may not prevent or detect all errors, omissions or fraud. Our failure to improve our systems and processes, or their failure to operate in the intended manner, 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. Our productivity and the quality of our products and services may 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 among our organization. Failure to manage any future growth effectively could result in increased costs and harm our results of operations.

*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 prospectus, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our operating results may be adversely affected if our assumptions change or if actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors, resulting in a decline in our stock price. Significant assumptions and estimates used in preparing our consolidated financial statements include those related to revenue recognition, stock-based compensation, valuation of inventory, warranty liabilities and accounting for income taxes.

*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. As of September 30, 2009, we estimated that approximately \$2.8 million of our products in our distributors' inventory were subject to price protection. 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.

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

Our future success depends, in part, on our ability to continue to attract and retain highly skilled personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel, or delays in hiring required personnel, particularly in engineering and sales, may seriously harm our business, financial condition and results of operations. We have experienced 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 in the locations where we have a substantial presence and need for highly-skilled personnel: the San Francisco Bay Area, Vancouver, Canada and Beijing, China. A large portion of our employee base is substantially vested in significant stock option grants, and the ability to exercise those grants and sell their stock in a public market after the closing of this offering may result in a larger than normal turn-over rate. We may not be successful in



## **Table of Contents**

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.

*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 senior management, particularly Ken Xie, our Co-founder, President and Chief Executive Officer, Michael Xie, our Co-founder, Vice President of Engineering and Chief Technical Officer, and Ken Goldman, our Vice President and Chief Financial Officer, could significantly delay or prevent the achievement of our development and strategic objectives. In addition, key personnel may be distracted by activities unrelated to our business. The loss of the services, or distraction, of our senior management for any reason could adversely affect our business, financial condition and results of operations.

*If we are unable to establish fair value for any undelivered element of a customer order, revenue relating to the entire order will be deferred and recognized over future periods. A delay in the recognition of revenue for a significant portion of our sales in a particular quarter may cause our stock price to decline.*

In the course of our selling efforts, we typically enter into arrangements that require us to deliver a combination of products and services. We refer to each individual product or service as an element of the overall arrangement. These arrangements typically require us to deliver particular elements in a future period. As we discuss further in Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates Revenue Recognition, if we are unable to determine the fair value of any undelivered elements, we are required by generally accepted accounting principles, or GAAP, to defer revenue from the entire arrangement rather than just the undelivered elements. If we are required to defer revenue from the entire arrangement for a significant portion of our product sales, our revenue for that quarter could fall below our expectations or those of securities analysts and investors, resulting in a decline in our stock price.

*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. We believe the current global economic downturn may have adversely affected our total revenue in the first nine months of fiscal 2009. Continued weak global economic conditions, or a reduction in information technology spending even if economic conditions improve, could adversely impact our business, financial condition and results of operations in a number of ways, including longer sales cycles, lower prices for our products and services, higher default rates among our distributors, reduced unit sales and lower or no growth.

*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.*

We outsource the manufacturing of our security appliance products to a variety of contract manufacturing partners and original design manufacturing partners.

Our reliance on our third-party manufacturers reduces our control over the manufacturing process, exposing us to risks, including reduced control over quality assurance, product costs and product supply. 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

---

**Table of Contents**

manufacturers experience delays, disruptions, capacity constraints or quality control problems in their manufacturing operations, or fail to meet our future requirements for timely delivery, our ability to ship products to our customers could be impaired and our business would be seriously harmed.

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

Our proprietary FortiASIC, which is the key to the performance of our appliances, is fabricated by contract manufacturers in foundries operated by UMC and Taiwan Semiconductor Manufacturing Corporation, or TSMC. Faraday (using UMC's foundry) and K-Micro (using TSMC's foundry) manufacture our ASICs on a purchase order basis, and these foundries do not guarantee any capacity and could reject orders from either Faraday or K-Micro or try to increase pricing. Accordingly, the foundries are not obligated to continue to fulfill our supply requirements, and due to the long lead time that a new foundry would require, we could suffer temporary or long term inventory shortages of our FortiASIC as well as increased costs. Our suppliers may also prioritize orders by other companies that order higher volumes of products. If any of these suppliers 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 or specific product models, 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 EU RoHS and other similar laws. See [Table of Contents](#) If we fail to comply with environmental requirements, our business, financial condition, operating results and reputation could be adversely affected for information on the effects of the failure to comply with these laws.

***Because some of the key components in our products come from limited sources of supply, we are susceptible to supply shortages or supply changes, which could disrupt or delay our scheduled product deliveries to our customers and may result in the loss of sales and customers.***

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 in supply of these components and the risk that component suppliers discontinue or modify components used in our products. We have faced component shortages in the past. Certain of our limited source components for particular appliances and suppliers of those components include: specific types of central processing units from Intel Corporation, Advanced Micro Devices, Inc., RMI Corporation and VIA Technologies, Inc. and network chips from Broadcom Corporation, Marvell Technology Group Ltd. and Intel. 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.



**Table of Contents**

Our manufacturing partners have experienced increasing lead times for the purchase of components incorporated into our products. 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 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.

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

Our sales contracts are primarily denominated in U.S. dollars and therefore substantially all of our revenue is not subject to foreign currency risk. However, a strengthening of the U.S. dollar could increase the real cost of our products to our customers outside of the United States, which could adversely affect our financial condition and results of operations. In addition, the majority of our operating expenses are incurred outside the United States, are denominated in foreign currency and are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro and Canadian dollar. Although we have begun to hedge currency exposures relating to certain balance sheet accounts, we do not currently hedge currency exposures relating to operating expenses incurred outside of the United States, but we may do so in the future. If our attempts to hedge against these risks are not successful, our financial condition and results of operations could be adversely affected.

*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.*

## Edgar Filing: FORTINET INC - Form S-1/A

We market and sell our products throughout the world and have established sales offices in many parts of the world. 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, accounts receivable collection and longer collection periods;

changes in regulatory requirements;

difficulties and costs of staffing and managing foreign operations;

the uncertainty of protection for intellectual property rights in some countries;

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

costs of complying with U.S. laws and regulations for foreign operations, including the Foreign Corrupt Practices Act, import and export control laws, tariffs, trade barriers, economic sanctions and

## **Table of Contents**

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 arrangements that may impact financial results and result in restatements of financial statements and irregularities in financial statements;

the potential for political unrest, terrorism, hostilities or war;

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

multiple and possibly overlapping tax structures.

Product and service sales 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 from time to time. Failure to comply with these regulations could result in adverse affects 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 delays in revenue recognition, financial reporting misstatements, fines, penalties, or the prohibition of the importation or exportation of our products and services and could have a material adverse effect on our business and results of operations.

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

Certain of our products are subject to U.S. export controls and may be exported outside the U.S. only with the required export license or through an export license exception, because we incorporate encryption technology into our products. If we were to fail to comply with U.S. export licensing, U.S. Customs regulations, U.S. economic sanctions and other 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, we may also be adversely affected, through reputational harm and penalties. Obtaining the necessary export license for a particular sale may be time-consuming, and may result in the delay or loss of sales opportunities.

Furthermore, U.S. export control laws and economic sanctions prohibit the shipment of certain products to U.S. embargoed or sanctioned countries, governments and persons. Even though we take precautions to prevent our product from being shipped to U.S. sanctions targets, our products could be shipped to those targets by our channel partners, despite such precautions. Any such shipment could have negative consequences including government investigations and penalties and in reputational harm. In addition, various countries regulate the import of certain encryption technology, including import permitting/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.



## **Table of Contents**

*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 and laws relating to the recycling of electrical and electronic equipment. The laws and regulations to which we are subject include the European Union, or EU, RoHS and the EU Waste Electrical and Electronic Equipment (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.

The EU RoHS and the similar laws of other jurisdictions ban the use of certain hazardous materials such as lead, mercury and cadmium in the manufacture of electrical equipment, including our products. We have incurred costs to comply with these laws, including research and development costs, costs associated with assuring the supply of compliant components and costs associated with writing off noncompliant inventory. We expect to incur more of these costs in the future. With respect to the EU RoHS, we and our competitors rely on an exemption for lead in network infrastructure equipment. It is possible this exemption will be revoked in the near future. If revoked, 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 similar laws could result in reduced sales of our products, substantial product inventory write-offs, reputational damage, penalties and other sanctions.

*A portion of our revenue is generated by sales to government entities, 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 entities. Sales into government entities are subject to a number of risks. Selling to government entities can be highly competitive, expensive and time consuming, often requiring significant upfront time and expense without any assurance that we will win a sale. Government demand and payment for our products and services may be impacted by public sector budgetary cycles and funding authorizations, with funding reductions or delays adversely affecting public sector demand for our products. Most of our sales to government entities have been made indirectly through our distribution channel. Government entities 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 governmental entity, the financial health of the distributor could be substantially harmed, which could negatively affect our future sales to such distributor. Governments routinely investigate and audit government contractors' administrative processes, and, any unfavorable audit could result in the government refusing to continue buying our products and services, a reduction of revenue, fines or civil or criminal liability if the audit uncovers improper or illegal activities. Any such penalties could adversely impact our results of operations in a material way. Finally, for purchases by the U.S. government, the 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.



## **Table of Contents**

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

Our antivirus and our intrusion prevention services may falsely detect viruses or other threats that do not actually exist. This risk is heightened by the inclusion of a heuristics feature in our products, which attempts to identify viruses and other threats not based on any known signatures but based on characteristics or anomalies that may indicate that a particular item is a threat. When our end-customers enable the heuristics feature in our products, the risk of falsely identifying viruses and other threats significantly increases. These false positives, while typical in the industry, may impair the perceived reliability of our products and may therefore adversely impact market acceptance of our products. Also, our antispam and antispyware 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 antispam 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. Any such false identification of important files or applications could result in negative publicity, loss of end-customers and sales, increased costs to remedy any problem, and costly litigation.

***If our internal network system is compromised by computer hackers, public perception of our products and services will be harmed.***

We will not succeed unless the marketplace is confident that we provide effective network security protection. Because we provide network security products, we may be a more attractive target for attacks by computer hackers. Although we have not experienced significant damages from unauthorized access by a third-party of our internal network, if an actual or perceived breach of network security occurs in our internal systems it could adversely affect the market perception of our products and services. In addition, such a security breach could impair our ability to operate our business, including our ability to provide subscription and support services to our end-customers. If this happens, our revenue could decline and our business could suffer.

***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, to resolve any issues relating to our products. If we or our channel partners 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 enterprise, service provider and government entity end-customers require higher levels of support than smaller end-customers. If we fail to meet the requirements of the larger end-customers, it may be more difficult to execute on our strategy to increase our penetration with larger end-customers. 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.

***Changes in our provision for income taxes or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.***

## Edgar Filing: FORTINET INC - Form S-1/A

Our provision for income taxes is subject to volatility and could be adversely affected by:

our earnings being lower than anticipated in countries that have lower tax rates and higher than anticipated in countries that have higher tax rates;

changes in the valuation of our deferred tax assets and liabilities;



---

**Table of Contents**

expiration of or lapses in the research and development tax credit laws;

transfer pricing adjustments including the effect of acquisitions on our intercompany research and development cost sharing arrangement and legal structure;

tax effects of nondeductible compensation;

tax costs related to intercompany realignments;

changes in accounting principles; or

changes in tax laws and regulations including possible changes in the United States to the taxation of earnings of our foreign subsidiaries, and the deductibility of expenses attributable to foreign income, or the foreign tax credit rules.

Significant judgment is required to determine the recognition and measurement attribute prescribed in Accounting Standards Codification (ASC) 740-25 (formerly referred to as Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 ). In addition, ASC 740-25 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 countries is subject to reduced tax rates and in some cases is wholly exempt from tax. Our failure to meet these commitments could adversely impact our provision for income taxes. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our results of operations.

***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 and subject to uncertainty 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 by jurisdiction is different than those estimated, 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.

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.

In addition, we may be subject to examination of our income tax returns by the Internal Revenue Service and other tax authorities. If tax authorities challenge the relative mix of U.S. and international income, our future

## **Table of Contents**

effective income tax rates could be adversely affected. While we regularly assess the likelihood of adverse outcomes from such examinations and the adequacy of our provision for income taxes, there can be no assurance that such provision is sufficient and that a determination by a tax authority will not have an adverse effect on our business, financial condition and results of operations.

*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 or technologies. If we identify an appropriate acquisition candidate, we may not be successful in negotiating the terms of the acquisition, financing the acquisition, or effectively integrating the acquired business, product or technology into our existing business and operations. We may have difficulty incorporating acquired technologies or products with our existing product lines and maintaining uniform standards, controls, procedures and policies. 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. In addition, any acquisitions we are able to complete may not be accretive to earnings and may not result in any synergies or other benefits we had expected to achieve, which could result in substantial write-offs. Further, completing a potential acquisition and integrating an acquired business, products or technologies will 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, can contain undetected errors or failures, especially when first introduced or when new versions are released. Product errors could affect the performance of our products, 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 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. 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 adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management's time and other resources.

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

A significant natural disaster, such as an earthquake, fire or a flood, or a significant power outage could have a material adverse impact on our business, operating results and financial condition. Our corporate



## **Table of Contents**

headquarters are located in the San Francisco Bay Area, a region known for seismic activity. In addition, natural disasters could affect our manufacturing vendors or logistics providers' ability to perform services such as manufacturing products on a timely basis and assisting with shipments on a timely basis. For example, our primary international logistics provider is located in Taiwan which is an area known for typhoons. 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 missing financial targets, such as revenue and shipment targets, for a particular quarter. In addition, acts of terrorism could cause disruptions in our business or the business of our manufacturers, logistics providers, partners, or end-customers or the economy as a whole. Given our typical concentration of sales at each quarter end, 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. All of the aforementioned risks may be augmented if the disaster recovery plans for us and our suppliers prove to be inadequate. To the extent that any of the above results in delays or cancellations of customer orders, or the delay in the manufacture, deployment or shipment of our products, our business, financial condition and results of operations would be adversely affected.

## **Risks Related to Our Industry**

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

The network security market is expected to continue to evolve rapidly. Moreover, many of our end-customers operate in markets characterized by rapidly changing technologies and business plans, which require them to add numerous network access points and adapt increasingly complex enterprise networks, incorporating a variety of hardware, software applications, operating systems and networking protocols. In addition, computer hackers and others who try to attack networks employ increasingly sophisticated techniques to gain access to and attack systems and networks. The technology in our products is especially complex because it needs to effectively identify and respond to new and increasingly sophisticated methods of attack, while minimizing the impact on network performance. Additionally, some of our new products and enhancements may require us to develop new hardware architectures and ASICs that involve complex, expensive and time consuming research and development processes. 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. For example, in the first quarter of fiscal 2009, we released a new model within our FortiGate product line and, after its initial release, we detected errors in the product that required us to redesign certain aspects of the product which delayed the availability of the product for one quarter and delayed our recognition of revenue from large orders that included such product until the following quarter when the product became available. 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.

*Our 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



## Table of Contents

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 will impair the market acceptance of our products, which in turn will 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 users' 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 will 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 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;

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;

defects, errors or failures;

## Edgar Filing: FORTINET INC - Form S-1/A

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;

easing of 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.



## **Table of Contents**

*Unless we develop better market awareness of our company and our products, our revenue may not continue to grow.*

We are a relatively new entrant in the network security market and we believe that we have not yet established sufficient market awareness of our participation in that market. Market awareness of our capabilities and products is essential to our continued growth and our success in all of our markets, particularly for the large enterprise, service provider and government entities markets. If our marketing programs are not successful in creating market awareness of our company and products, our business, financial condition and results of operations will be adversely affected, and we will not be able to achieve sustained growth.

*Demand for Unified Threat Management products may be limited by market perception that UTM products are inferior to network security solutions from multiple vendors.*

Sales of most of our products depend on increased demand for UTM products. If the UTM market fails to grow as we anticipate, our business will be seriously harmed. Target customers may view UTM all-in-one solutions as inferior to security solutions from multiple vendors because of, among other things, their perception that UTM products 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, UTM solutions create a single point of failure in their networks, which means that an error, vulnerability or failure of the UTM product may place the entire network at risk. In addition, the market perception that UTM solutions may be suitable only for small and medium sized businesses because UTM lacks the performance capabilities and functionality of other solutions may harm our sales to large enterprise, service provider, and government entity 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 the UTM market in general, demand for UTM 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 or another well known UTM vendor exposing a single point of failure could significantly increase these concerns and perceptions and may result limited growth and harm our business and results of operations.

*We face intense competition in our market, especially from larger, better-known companies, 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 networking companies such as Cisco Systems, Inc. and Juniper Networks, Inc., security vendors such as Check Point Software Technologies Ltd., McAfee, Inc., and SonicWALL, Inc., and other point solution security vendors.

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.

## **Table of Contents**

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 users from purchasing our products. These larger competitors often have broader product lines and market focus, are in a better position to withstand any significant reduction in capital spending by end-customers in these markets, and will therefore 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 current and potential competitors may also establish cooperative relationships among themselves or with third parties that may further enhance their resources. In addition, current or potential competitors may be acquired by third parties with greater available resources, such as Juniper's acquisition of NetScreen Technologies, Inc., McAfee's acquisition of Secure Computing Corporation and Check Point's acquisition of Nokia's security appliance business. As a result of such acquisitions, 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 Systems, Inc. and Juniper Networks, Inc. offer, and may continue to introduce, network security features that compete with our products, either in stand-alone security products or as additional features in their network infrastructure products. The inclusion of, or the announcement of an intent to include, functionality perceived to be similar to that offered by our security solutions in networking products that are already generally accepted as necessary components of network architecture may have an adverse effect on our ability to market and sell our products. Furthermore, even if the functionality offered by network infrastructure providers is more limited than our products, a significant number of customers may elect to accept such limited functionality in lieu of adding appliances from an additional vendor such as us. Many organizations have invested substantial personnel and financial resources to design and operate their networks and have established deep relationships with other providers of networking products, which may make them reluctant to add new components to their networks, particularly from other vendors such as us. In addition, an organization's existing vendors or new vendors with a broad product offering may be able to offer concessions that we are not able to match because we currently offer only network security products and have fewer resources than many of our competitors. If organizations are reluctant to add additional network infrastructure from new vendors or otherwise decide to work with their existing vendors, our business, financial condition and results of operations will be adversely affected.

## **Risks Related to Intellectual Property**

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

We rely primarily on patent, trademark, copyright and trade secrets laws, confidentiality procedures and contractual provisions to protect our technology. We purchased most of our issued U.S. patents and many of our pending U.S. patent applications from other entities. Valid patents may not issue from our pending applications,



---

**Table of Contents**

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 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. 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 assure you 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 (GPL), the GNU Lesser Public License (LGPL), the BSD License, the Apache License and others. 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 of the open source licenses, be required to release the source code of our proprietary software to the public. This could 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 United States 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 generally available, in source code form, our proprietary code, 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 could adversely affect our business, operating results and financial condition.

---

**Table of Contents**

***Claims by others that we infringe their proprietary technology could harm our business.***

Patent and other intellectual property disputes are common in the network security industry. Third parties have asserted and may in the future assert claims of infringement of intellectual property rights against us. They may also assert such claims against our end-customers or channel partners whom we typically 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, future litigation may involve patent holding companies 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.

We are currently involved in several patent disputes, have been involved in patent disputes in the past, and likely will be involved in additional disputes in the future. In May 2004, Trend Micro Incorporated filed a complaint against us alleging that we infringed a Trend Micro patent related to antivirus software. The International Trade Commission, or ITC, subsequently instituted an investigation which resulted in an exclusion order and a cease and desist order prohibiting us from selling a broad array of our products in the United States. In January 2006, we settled the lawsuit with Trend Micro, and subsequently the ITC terminated its action and rescinded the orders. Pursuant to the settlement and license agreement, we initially paid Trend Micro \$15.0 million, and the settlement and license agreement provides for additional quarterly royalty payments, not expected to exceed 1% of our total revenue each quarter, through 2015. In November 2008, we filed a complaint against Trend Micro in the United States District Court for the Northern District of California alleging, among other claims, that the patents that are the basis for the ongoing royalty payments are invalid and consequently that we have no contractual obligation to pay the royalties. Trend Micro moved to dismiss the case, and, in June 2009, the court dismissed the case without prejudice on procedural grounds, and we appealed the dismissal in July 2009. Based on the dispute, we have ceased paying royalties under the settlement and license agreement. On August 6, 2009, Trend Micro filed a complaint against us in the Superior Court of the State of California for Santa Clara County alleging breach of contract and seeking a declaratory judgment that we are obligated to make certain specified royalty payments to Trend Micro. In September 2009, we filed a cross-complaint for declaratory judgment that alleged, among other claims, that the Trend Micro patents at issue are invalid and unenforceable, and, in October 2009, Trend Micro filed demurrers to our cross-complaint. Because this dispute is at an early stage, it is not possible to predict the outcome. An adverse outcome in this dispute could result in accelerated royalty payments and additional damages.

In January 2009, we filed a complaint against Palo Alto Networks, Inc. in the United States District Court for the Northern District of California alleging, among other claims, patent infringement. On September 4, 2009, Palo Alto Networks filed a counterclaim against us alleging patent infringement. In May 2009, Enhanced Security Research, LLC, or ESR, a non-practicing entity, filed a complaint in the United States District Court for the District of Delaware alleging patent infringement by us and other defendants. On August 3, 2009, ESR filed a substantially similar complaint against us in the same court alleging infringement of the same patents. In September 2009, Deep Nines, Inc. filed a complaint against us in the United States District Court for the Eastern District of Texas alleging that our products infringe certain of their patents. The Palo Alto Networks, ESR and

## **Table of Contents**

Deep Nines cases are currently at an early stage of the litigation process. If we are unsuccessful in defending against any of Palo Alto Networks' s, ESR' s or Deep Nines' s 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. Several other non-operating patent holding companies have sent us letters proposing that we license certain of their patents, and, given this and the proliferation of lawsuits in our industry and other similar industries by non-practicing entities and operating entities, we expect that we will be sued for patent infringement in the future, regardless of the merits of any such lawsuits. The cost to defend such lawsuits and any adverse result in such lawsuits could have a material adverse effect on our results of operations and financial condition.

*We rely on the availability of third-party licenses.*

Many of our products include software or other intellectual property licensed from third parties. It may be necessary in the future to renew licenses relating to various aspects of these products or to seek new licenses for existing or new products. There can be no assurance that the necessary licenses would be available on acceptable terms, if at all. The inability to obtain certain licenses or other rights or to obtain such licenses or rights on favorable terms, or the need to engage in litigation regarding these matters, could result in delays in product releases until equivalent technology can be identified, licensed or developed, if at all, and integrated into our products and may have a material adverse effect on our business, operating results, and financial condition. Moreover, the inclusion in our products of software or other intellectual property licensed from third parties on a nonexclusive basis could limit our ability to differentiate our products from those of our competitors.

## **Risks Related to this Offering and Ownership of our Common Stock**

*As a result of becoming a public company, we will be obligated to develop and maintain proper and effective internal controls over financial reporting. We may not complete our analysis of our internal controls over financial reporting in a timely manner, or these internal controls may not be determined to be effective, which may adversely affect investor confidence in our company and, as a result, the value of our common stock.*

We will be required, pursuant to Section 404 of the Sarbanes-Oxley Act, to furnish a report by management on, among other things, the effectiveness of our internal control over financial reporting for the first fiscal year beginning after the effective date of this offering. This assessment will need to include disclosure of any material weaknesses identified by our management in our internal control over financial reporting, as well as a statement that our auditors have issued an attestation report on our management' s assessment of our internal controls.

We are in the very early stages of the costly and challenging process of compiling the system and processing documentation necessary to perform the evaluation needed to comply with Section 404. We may not be able to complete our evaluation, testing and any required remediation in a timely fashion. During the evaluation and testing process, if we identify one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that our internal controls are effective. We have in the past identified material weaknesses and significant deficiencies in our internal control over financial reporting, and although we believe we have remediated the material weaknesses, certain significant deficiencies remain and we cannot assure you that there will not be material weaknesses and additional significant deficiencies in our internal controls in the future. If we are unable to assert that our internal control over financial reporting is effective, or if our auditors are unable to express an opinion on the effectiveness of our internal controls, we could lose investor confidence in the accuracy and completeness of our financial reports, which would cause the price of our common stock to decline.

*If securities or industry analysts do not publish 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 establish and maintain adequate research coverage or if one or more of the analysts who covers us downgrades our stock or publishes inaccurate or



## **Table of Contents**

unfavorable research about our business, our stock price would likely 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.

*Our failure to timely file a registration statement under the Securities Exchange Act of 1934 may subject us to claims under federal securities laws.*

In January 2007 we determined that we were required under Section 12(g) of the Securities Exchange Act of 1934 to have filed a Form 10 by April 30, 2006 to register our common stock and options to acquire our common stock, because options to purchase our common stock were held by more than 500 holders. Upon such determination, we suspended all further grants and exercises of options that would otherwise have been based on Rule 701. In December 2007, Securities and Exchange Commission Rule 12h-1, which exempts issuers from the registration requirements of Section 12(g) with respect to compensatory stock options, provided that certain requirements relating to outstanding options are satisfied, became effective. In January 2008, after consulting with the staff of the Securities and Exchange Commission regarding our situation, we concluded that we could rely on the Rule 12h-1 exemption once we satisfied the requirements of the rule and that, while doing so would not remedy the past violation, reliance on Rule 12h-1 as the basis for not registering our common stock when required by Section 12(g) should not exacerbate the past violation. We amended our option plan and became entitled to rely, on a prospective basis, on the Rule 12h-1 exemption on January 28, 2008, after which we resumed ordinary course option grants and permitted option exercises. As a result of our failure to register our common stock and options to purchase our common stock when required by Section 12(g), we could be subject to administrative and/or civil actions by the Securities and Exchange Commission. If any such claim or action is asserted, we could incur significant expenses and divert management's attention in defending them.

*Because we may have issued stock options and shares of common stock in violation of federal and state securities laws, we may be required to offer to repurchase those securities and may incur other costs.*

As a result of our non-compliance with Section 12(g) of the Securities Exchange Act of 1934 as described above, during the period between May 1, 2006 and January 27, 2008, and possibly for prior periods, we may not have been entitled to rely on Rule 701 or other exemptions under the Securities Act of 1933 for grants of stock options to our employees, directors and consultants, or the issuance of shares of our common stock upon exercise of options granted during such periods. Therefore, the grant of such options and issuance of such shares may have violated U.S. federal and state securities laws, which would give the holders of such options or shares the right to require us to repurchase those securities. Although we believe that we were entitled to rely on Rule 701 and other exemptions and otherwise believe that the grant and exercise of options during such periods did not violate U.S. federal or state securities laws, federal and state regulators may disagree.

If it is determined that we offered or sold securities without properly registering them under federal or state law, or securing an exemption from registration or state qualification, regulators could impose monetary fines or other sanctions as provided under such laws. They could also require us to make a rescission offer, which is an offer to repurchase the shares and options issued without registration or an exemption from federal and state securities laws, to certain of our stockholders and optionholders. Federal and state regulators could also extend the requirement to make a rescission offer to cover options and shares issued in other periods. Even if we make a rescission offer, eligible participants might opt not to accept our offer. Because federal securities laws do not provide that a rescission offer will terminate a purchaser's right to rescind a sale of stock that was not registered or exempt from such registration requirements, we may be required to honor such rescission rights in future periods. In that case, we may continue to be liable under federal and state securities laws for up to an amount equal to the value of all options and common stock granted or issued without registration or an exemption therefrom plus any statutory interest we may be required to pay.

## **Table of Contents**

***We will incur increased costs and demands upon management as a result of efforts to comply with the laws and regulations affecting public companies which could adversely affect our operating results.***

As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company, including costs associated with public company reporting and corporate governance requirements. These requirements include compliance with the Sarbanes-Oxley Act as well as other rules implemented by the SEC, and the applicable stock exchange. The expenses incurred by public companies for reporting and corporate governance purposes are significant. We expect these rules and regulations to substantially increase our legal and financial compliance costs and to make some activities more time-consuming and costly. The increased costs associated with operating as a public company will decrease our net income or increase our net loss, and may require us to reduce costs in other areas of our business or increase the prices of our products or services. Additionally, if these requirements divert our management's attention from other business concerns, they could have a material adverse effect on our business, financial condition and results of operations.

***Our failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in new products could reduce our ability to compete and could harm our business.***

We expect that our existing cash and cash equivalents, together with our net proceeds from this offering, will be sufficient to meet our anticipated cash needs for at least the next twelve months. After that, we may need to raise additional funds, and we may not be able to obtain additional debt or equity financing on favorable terms, if at all. If we raise additional equity financing, our stockholders may experience significant dilution of their ownership interests and the per share value of our common stock could decline. Furthermore, if we engage in debt financing, the holders of debt would have priority over the holders of common stock and we may be required to accept terms that restrict our ability to incur additional indebtedness, and take other actions that would otherwise be in the interests of the stockholders and force us to maintain specified liquidity or other ratios, any of which could harm our business, operating results and financial condition. If we need additional capital and cannot raise it on acceptable terms, we may not be able to, among other things:

develop or enhance our products and services;

continue to expand our sales and marketing and research and development organizations;

acquire complementary technologies, products or businesses;

expand operations, in the United States or internationally;

hire, train and retain employees; or

respond to competitive pressures or unanticipated working capital requirements.

Our failure to do any of these things could seriously harm our business, financial condition and results of operations.

## Edgar Filing: FORTINET INC - Form S-1/A

*An active, liquid and orderly trading market for our common stock may not develop, the price of our stock may be volatile, and you could lose all or part of your investment.*

Prior to this offering, there has been no public market for shares of our common stock. The initial public offering price of our common stock will be determined through negotiation with the underwriters. This price will not necessarily reflect the price at which investors in the market will be willing to buy and sell our shares of common stock following this offering. In addition, the trading price of our common stock following this offering is likely to be highly volatile and could be subject to wide fluctuations in response to various factors, some of which are beyond our control, including those factors described above in . Our quarterly operating results are likely to vary significantly and be unpredictable, which could cause the trading price of our stock to decline.

## **Table of Contents**

In addition, the stock market in general, and the market for technology companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Broad market and industry factors may seriously affect the market price of companies' stock, including ours, regardless of actual operating performance. These fluctuations may be even more pronounced in the trading market for our stock shortly following this offering. In addition, in the past, following periods of volatility in the overall market and the market price of a particular company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

***Concentration of ownership among our existing executive officers, directors and their affiliates may prevent new investors from influencing significant corporate decisions.***

Upon completion of this offering, our executive officers, directors and their affiliates will beneficially own, in the aggregate, approximately 44.3% of our outstanding common stock. As a result, these stockholders will be able to exercise a significant level of control over all matters requiring stockholder approval, including the election of directors, amendment of our certificate of incorporation and approval of significant corporate transactions. This control could have the effect of delaying or preventing a change of control of our company or changes in management and will make the approval of certain transactions difficult or impossible without the support of these stockholders. See "Principal and Selling Stockholders" for additional detail about the shareholdings of these persons.

***Future sales of shares by existing stockholders could cause our stock price to decline.***

If our existing stockholders sell, or indicate an intention to sell, substantial amounts of our common stock in the public market after the lock-up and other legal restrictions on resale discussed in this prospectus lapse, the trading price of our common stock could decline. Based on shares of common stock outstanding as of September 30, 2009, upon completion of this offering, we will have outstanding a total of 64,393,969 shares of common stock. Of these shares, only the 12,000,000 shares of common stock sold in this offering by us and the selling stockholders will be freely tradable, without restriction, in the public market immediately following this offering. Morgan Stanley & Co. Incorporated and J.P. Morgan Securities Inc., however, may, in their sole discretion, permit our officers, directors and other stockholders who are subject to these lock-up agreements to sell shares prior to the expiration of the lock-up agreements.

We expect that the lock-up agreements pertaining to this offering will expire 180 days from the date of this prospectus (subject to extension upon the occurrence of specified events). After the lock-up agreements expire, up to an additional 52,720,818 shares of common stock will be eligible for sale in the public market, 27,755,544 of which shares are held by directors, executive officers and other affiliates and will be subject to volume limitations under Rule 144 under the Securities Act and various vesting agreements. In addition, shares of common stock that are either subject to outstanding options or reserved for future issuance under our employee benefit plans will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rule 144 and Rule 701 under the Securities Act. If these additional shares of common stock are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline.

***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 which 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:

creating a classified board of directors whose members serve staggered three-year terms;

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

**Table of Contents**

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;

controlling the procedures for the conduct and scheduling of board and stockholder meetings; and

providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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

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

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

***Purchasers in this offering will experience immediate and substantial dilution in the book value of their investment.***

The initial public offering price of our common stock is substantially higher than the net tangible book value per share of our outstanding common stock immediately after this offering. Therefore, if you purchase our common stock in this offering, you will incur immediate dilution of \$9.13 in the net tangible book value per share from the price you paid, based on an assumed public offering price of \$10.00 per share, which is the midpoint of the range reflected on the cover page of this prospectus. In addition, following this offering, purchasers in the offering will have contributed 37.7% of the total consideration paid by our stockholders to purchase shares of common stock, in exchange for acquiring approximately 9.0% of our total outstanding shares as of September 30, 2009 after giving effect to this offering. The exercise of outstanding stock options will result in further dilution. For a further description of the dilution that you will experience immediately after this offering, see Dilution.

***Our management will have broad discretion over the use of the proceeds we receive in this offering and might not apply the proceeds in ways that increase the value of your investment.***

Our management will have broad discretion over the use of our net proceeds from this offering, and you will be relying on the judgment of our management regarding the application of these proceeds. Our management might not apply our net proceeds in ways that ultimately increase the

## Edgar Filing: FORTINET INC - Form S-1/A

value of your investment. We expect to use the net proceeds from this offering for general corporate purposes, including working capital and capital expenditures, which may in the future include investments in, or acquisitions of, businesses, services or technologies that management deems to likely be complementary or synergistic. We might not be able to yield a significant return, if any, on any investment of these net proceeds.

**Table of Contents**

**FORWARD LOOKING STATEMENTS**

This prospectus includes forward looking statements. All statements other than statements of historical facts contained in this prospectus, including statements regarding our future results of operations and financial position, business strategy and plans and our objectives for future operations, are forward looking statements. The words believe, may, will, estimate, continue, anticipate, intend, expect and similar are intended to identify forward looking statements. We have based these forward looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy, short-term and long-term business operations and objectives, and financial needs. These forward looking statements are subject to a number of risks, uncertainties and assumptions, including those described in Risk Factors. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time-to-time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward looking statements we may make. In light of these risks, uncertainties and assumptions, the forward looking events and circumstances discussed in this prospectus may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward looking statements.

You should not rely upon forward looking statements as predictions of future events. Although we believe that the expectations reflected in the forward looking statements are reasonable, we cannot guarantee that the future results, levels of activity, performance or events and circumstances reflected in the forward looking statements will be achieved or occur. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward looking statements. We undertake no obligation to update publicly any forward looking statements for any reason after the date of this prospectus to conform these statements to actual results or to changes in our expectations.

You should read this prospectus and the documents that we reference in this prospectus and have filed with the SEC as exhibits to the registration statement of which this prospectus is a part with the understanding that our actual future results, levels of activity, performance and events and circumstances may be materially different from what we expect.



**Table of Contents**

**USE OF PROCEEDS**

We estimate that our net proceeds from the sale of the common stock offered by us will be approximately \$52.4 million, assuming an initial public offering price of \$10.00 per share, which is the midpoint of the range reflected on the cover page of this prospectus, and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us and after giving effect to estimates of certain expenses that we expect to be reimbursed. If the underwriters' option to purchase additional shares in this offering is exercised in full, we estimate that our net proceeds will be approximately \$69.1 million. We will not receive any proceeds from the sale of shares of common stock by the selling stockholders. A \$1.00 increase or decrease in the assumed initial public offering price of \$10.00 would increase or decrease the net proceeds we received from the offering by approximately \$5.5 million, assuming the number of shares offered by us remains the same and after deducting the estimated underwriting discounts and commissions as set forth on the cover page of this prospectus and estimated offering expenses payable by us, or approximately \$7.2 million if the underwriters' overallotment option is exercised in full, and after deducting underwriting discounts and commissions and estimated offering expenses payable by us.

We intend to use the net proceeds to us from this offering for working capital and other general corporate purposes, which may include sales and marketing expenditures, general and administrative expenditures, developing new products and funding capital expenditures. We also may use a portion of the net proceeds to acquire businesses, products, services or technologies we believe to be complementary. However, we do not have agreements or commitments for any specific acquisitions at this time. We will have broad discretion in the way we use the net proceeds. Pending use of the net proceeds as described above, we intend to invest the net proceeds in money market funds and investment grade debt securities.

By establishing a public market for our common stock, this offering is also intended to facilitate our future access to public markets.

**DIVIDEND POLICY**

We have never declared or paid cash dividends on our common or convertible preferred stock. We currently do not anticipate paying any cash dividends in the foreseeable future. Any future determination to declare cash dividends will be made at the discretion of our board of directors, subject to applicable laws and will depend on our financial condition, results of operations, capital requirements, general business conditions and other factors that our board of directors may deem relevant.

**Table of Contents****CAPITALIZATION**

The following table sets forth our cash, cash equivalents and short-term investments and capitalization as of September 30, 2009:

on an actual basis;

on a pro forma basis to give effect to the automatic conversion of all outstanding shares of our convertible preferred stock into 37,475,835 shares of common stock upon the closing of this offering; and

on a pro forma as adjusted basis to reflect: (i) the automatic conversion of all outstanding shares of our convertible preferred stock into 37,475,835 shares of common stock; (ii) our receipt of the estimated net proceeds from the sale of shares of common stock offered by us in this offering, based on an assumed initial public offering price of \$10.00 per share, which is the midpoint of the range reflected on the cover page of this prospectus, and after deducting underwriting discounts and commissions and estimated offering expenses payable by us and after giving effect to estimates of certain expenses that we expect to be reimbursed; and (iii) the amendment and restatement of our certificate of incorporation upon the closing of this offering.

The information below is illustrative only and our cash, cash equivalents and short-term investments and capitalization following the completion of this offering will be based on the actual initial public offering price and other terms of this offering determined at pricing. You should read this table together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this prospectus.

	As of September 30, 2009		
	Actual	Pro Forma	Pro Forma As Adjusted <sup>(1)</sup>
	(in thousands, except share and per share data)		
	(unaudited)		
Cash, cash equivalents and short-term investments	\$ 152,390	\$ 152,390	\$ 204,787
Current and long-term debt	\$	\$	\$
Convertible preferred stock, par value \$0.001 per share; 40,500,000 shares authorized (actual), 37,475,835 shares issued and outstanding (actual); 40,500,000 shares authorized (pro forma), no shares issued or outstanding (pro forma); and 10,000,000 shares authorized (pro forma as adjusted), no shares issued or outstanding (pro forma as adjusted)	91,185		
Common stock, par value \$0.001 per share; 82,000,000 shares authorized (actual), 21,841,083 shares issued and 21,136,451 shares outstanding (actual); 82,000,000 shares authorized (pro forma), 59,316,918 shares issued and 58,612,286 shares outstanding (pro forma); 300,000,000 shares authorized (pro forma as adjusted), 65,098,601 shares issued and 64,393,969 shares outstanding (pro forma as adjusted)	21	58	64
Additional paid-in capital	18,549	109,697	162,088
Treasury stock	(2,995)	(2,995)	(2,995)
Accumulated other comprehensive loss	1,040	1,040	1,040
Accumulated deficit	(103,912)	(103,912)	(103,912)

Edgar Filing: FORTINET INC - Form S-1/A

Total stockholders' equity	3,888	3,888	56,285
Total capitalization	\$ 3,888	\$ 3,888	\$ 56,285

**Table of Contents**

- (1) Each \$1.00 increase (decrease) in the assumed initial public offering price of \$10.00 per share would increase (decrease) the amount of pro forma as adjusted cash, cash equivalents and short-term investments, additional paid-in capital, total stockholders' equity, total capitalization and net proceeds we receive from this offering by approximately \$5.5 million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and estimated offering expenses that we must pay and after giving effect to estimates of certain expenses that we expect to be reimbursed.

The table above excludes the following shares:

17,488,988 shares of common stock issuable upon the exercise of stock options outstanding as of September 30, 2009 (including 176,849 shares that we expect to be sold in this offering by certain selling stockholders upon the exercise of vested options immediately prior to the closing of this offering), at a weighted-average exercise price of \$4.88 per share;

300,025 shares of common stock issuable upon the exercise of options granted after September 30, 2009, at an exercise price of \$11.00 per share;

291,000 shares of common stock issuable upon the exercise of warrants outstanding as of September 30, 2009 (including 150,000 shares that we expect to be sold in this offering by a selling stockholder upon the exercise of a warrant immediately prior to the closing of this offering), at a weighted-average exercise price of \$7.07 per share;

9,000,000 shares of common stock reserved for future issuance under our 2009 Equity Incentive Plan; and

1,800,000 shares of common stock if the underwriters' over-allotment option were exercised in full.

**Table of Contents****DILUTION**

If you invest in our common stock, your investment will be diluted immediately to the extent of the difference between the public offering price per share of our common stock and the pro forma net tangible book value per share of our common stock after this offering. Our pro forma net tangible book value as of September 30, 2009, was approximately \$3.5 million, or \$0.06 per share of common stock. Pro forma net tangible book value per share represents the amount of our total tangible assets, less our total liabilities, divided by the number of shares of common stock outstanding as of September 30, 2009, after giving effect to the automatic conversion of all outstanding shares of our convertible preferred stock immediately prior to the closing of this offering.

Net tangible book value dilution per share to new investors represents the difference between the amount per share paid by purchasers of shares of common stock in this offering and the pro forma net tangible book value per share of common stock immediately after the completion of this offering. After giving effect to our sale of shares of common stock in this offering at an assumed initial public offering price of \$10.00 per share, the midpoint of the range reflected on the cover of this prospectus, and after deducting the underwriting discounts and commissions and estimated offering expenses payable by us and after giving effect to estimates of certain expenses that we expect to be reimbursed, our pro forma as adjusted net tangible book value as of September 30, 2009 would have been \$55.9 million, or \$0.87 per share. This represents an immediate increase in net tangible book value of \$0.81 per share to existing stockholders and an immediate dilution in net tangible book value of \$9.13 per share to investors purchasing common stock in this offering, as illustrated in the following table:

Assumed initial public offering price per share	\$ 10.00
Pro forma net tangible book value per share as of September 30, 2009	\$ 0.06
Increase per share attributed to this offering	0.81
Pro forma as adjusted net tangible book value per share	0.87
Dilution per share to new investors	\$ 9.13

A \$1.00 increase (decrease) in the assumed initial public offering price of \$10.00 per share, which is the midpoint of the range listed on the cover page of this prospectus, would increase (decrease) our pro forma as adjusted net tangible book value per share by \$0.08 (\$0.09), assuming the number of shares offered by us remains the same as set forth on the cover page of this prospectus and after deducting the estimated underwriting discounts and commissions and estimated offering expenses that we must pay.

If the underwriters exercise their option to purchase additional shares of our common stock in full, the pro forma as adjusted net tangible book value per share would be \$1.10 per share, the increase in pro forma net tangible book value per share to existing stockholders would be \$1.04 per share and the dilution per share to new investors purchasing shares in this offering would be \$8.90 per share.

The following table presents, on a pro forma basis as of September 30, 2009, after giving effect to the sale of 5,781,683 shares of common stock and the automatic conversion of all preferred stock into common stock upon the closing of this offering, the differences between the existing stockholders and the purchasers of shares in this offering (based on an assumed initial public offering price of \$10.00 per share, which is the midpoint of the range reflected on the cover page of this prospectus) with respect to the number of shares purchased from us, the total consideration paid and the average price paid per share:

Edgar Filing: FORTINET INC - Form S-1/A

	Shares Purchased		Total Consideration		Average Price Per Share
	Number	Percent	Amount	Percent	
			(In thousands other than percentages and per share data)		
Existing stockholders	58,612	91.0%	\$ 95,449	62.3%	\$ 1.63
New public investors	5,782	9.0	57,817	37.7	10.00
<b>Total</b>	<b>64,394</b>	<b>100.0%</b>	<b>\$ 153,266</b>	<b>100.0%</b>	<b>\$ 2.38</b>

**Table of Contents**

A \$1.00 increase or decrease in the assumed initial public offering price of \$10.00 per share, which is the midpoint of the range listed on the cover page of this prospectus, would increase or decrease, respectively, total consideration paid by new investors by \$5.8 million assuming the number of shares offered by us, as set forth on the cover of this prospectus, remains the same, and without deducting the estimated underwriting discounts and commissions and estimated offering expenses payable by us.

The foregoing calculations are based on 58,612,286 shares of our common stock outstanding as of September 30, 2009 and exclude:

17,488,988 shares of common stock issuable upon the exercise of options outstanding as of September 30, 2009 (including 176,849 shares that we expect to be sold in this offering by certain selling stockholders upon the exercise of vested options immediately prior to the closing of this offering), at a weighted-average exercise price of \$4.88 per share;

300,025 shares of common stock issuable upon the exercise of options granted after September 30, 2009, at an exercise price of \$11.00 per share;

291,000 shares of common stock issuable upon the exercise of warrants outstanding as of September 30, 2009 (including 150,000 shares that we expect to be sold in this offering by a selling stockholder upon the exercise of a warrant immediately prior to the closing of this offering), at a weighted-average exercise price of \$7.07 per share; and

9,000,000 shares of common stock reserved for issuance under our 2009 Equity Incentive Plan.

If all of these options and warrants were exercised, then our existing stockholders, including the holders of these options and warrants, would own 93.0% and our new investors would own 7.0% of the total number of shares of our common stock outstanding upon the closing of this offering. The net tangible book value per share after this offering would be \$1.78, causing dilution to new investors of \$8.22 per share.

Sales by the selling stockholders in this offering will cause the number of shares held by existing stockholders to be reduced to 52,393,969 shares or 81.4% of the total number of shares of our common stock outstanding after this offering. If the underwriters' overallotment option is exercised in full, the number of shares held by the existing stockholders after this offering would be reduced to 79.2% of the total number of shares of our common stock outstanding after this offering, and the number of newly issued shares held by new investors would increase to 7,581,683 or 11.5% of the total number of shares of our common stock outstanding after this offering.

To the extent that any outstanding options or warrants are exercised, new investors will experience further dilution.

**Table of Contents**

**SELECTED CONSOLIDATED FINANCIAL DATA**

The following selected consolidated financial data should be read in conjunction with the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and the related notes included in this prospectus. The selected consolidated financial data included in this section are not intended to replace the consolidated financial statements and the related notes included in this prospectus.

We made the decision in the first quarter of 2009 to change our financial reporting periods from a fiscal to calendar basis. This change was implemented in the third quarter of 2009 upon completion of required system changes. Accordingly, commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our third quarter of fiscal 2009 ended on September 30, 2009, and our fiscal 2009 year now ends on December 31, 2009. This transition had the effect of increasing the number of days in our quarter and nine months ended September 30, 2009 by three days. In 2005, we adopted a fiscal year that ends on the Sunday closest to December 31 of each year. Our 2004, 2005, 2006, 2007 and 2008 fiscal years ended on December 31, 2004, January 1, 2006, December 31, 2006, December 30, 2007 and December 28, 2008, respectively. Prior to the third quarter of fiscal 2009, our interim fiscal quarters ended on the Sunday closest to March 31, June 30 and September 30 of each year.

The consolidated statements of operations data for the fiscal years 2006, 2007 and 2008, and consolidated balance sheets data as of fiscal year end 2007 and 2008, were derived from our audited consolidated financial statements that are included elsewhere in this prospectus. The consolidated statements of operations data for fiscal years 2004 and 2005, and consolidated balance sheet data as of fiscal year end 2004, 2005 and 2006, were derived from our audited consolidated financial statements not included in this prospectus. The consolidated statements of operations data and balance sheet data as of and for the first nine months of fiscal 2008 and 2009 were derived from our unaudited consolidated financial statements that are included elsewhere in this prospectus. The unaudited consolidated financial statements include, in the opinion of management, all adjustments, consisting only of normal recurring adjustments, that management considers necessary for the fair presentation of the financial information set forth in those statements. The historical results presented below are not necessarily indicative of financial results to be achieved in future periods, and the results for the first nine months of fiscal 2009 are not necessarily indicative of results to be expected for the full year or for any other period.



**Table of Contents**

	Fiscal Year <sup>(1)</sup>				Nine Months Ended		
	2004	2005	2006	2007	2008	September 28, 2008	September 30, 2009 <sup>(2)</sup>
<b>Consolidated Statement of Operations Data:</b>							
Revenue							
Product	\$ 19,479	\$ 32,943	\$ 59,469	\$ 70,131	\$ 94,587	\$ 68,395	\$ 69,327
Services	8,537	25,469	39,590	74,152	105,292	75,394	101,758
Ratable product and services	10,717	21,403	24,407	11,083	11,912	8,936	10,318
Total revenue	38,733	79,815	123,466	155,366	211,791	152,725	181,403
Cost of revenue							
Product <sup>(3)</sup>	11,537	14,159	24,166	35,948	41,397	29,420	29,049
Services <sup>(3)</sup>	3,743	6,625	9,496	15,941	19,441	14,751	15,955
Ratable product and services	4,489	6,760	7,302	4,763	4,634	3,447	4,062
Total cost of revenue	19,769	27,544	40,964	56,652	65,472	47,618	49,066
Gross profit							
Product	7,942	18,784	35,303	34,183	53,190	38,975	40,278
Services	4,794	18,844	30,094	58,211	85,851	60,643	85,803
Ratable product and services	6,228	14,643	17,105	6,320	7,278	5,489	6,256
Total gross profit	18,964	52,271	82,502	98,714	146,319	105,107	132,337
Operating expenses							
Research and development <sup>(3)</sup>	14,542	17,398	21,446	27,588	37,035	28,186	31,207
Sales and marketing <sup>(3)</sup>	35,668	40,761	54,056	72,159	87,717	65,900	69,572
General and administrative <sup>(3)</sup>	7,603	13,481	12,997	20,544	16,640	12,367	13,678
Patent dispute settlement (recovery) <sup>(4)</sup>	20,000	(5,000)					
Total operating expenses	77,813	66,640	88,499	120,291	141,392	106,453	114,457
Operating income (loss)	(58,849)	(14,369)	(5,997)	(21,577)	4,927	(1,346)	17,880
Interest income	664	1,610	2,376	3,507	2,614	1,872	1,677
Other income (expense), net	(330)	(465)	(503)	(1,991)	1,710	171	148
Income (loss) before income taxes	(58,515)	(13,224)	(4,124)	(20,061)	9,251	697	19,705
Provision for income taxes	464	939	1,220	1,781	1,888	1,277	3,466
Net income (loss)	\$ (58,979)	\$ (14,163)	\$ (5,344)	\$ (21,842)	\$ 7,363	\$ (580)	\$ 16,239
Deemed dividend on convertible preferred stock <sup>(5)</sup>	(1,012)						(9,266)
Net income (loss) attributable to common stockholders	\$ (59,991)	\$ (14,163)	\$ (5,344)	\$ (21,842)	\$ 7,363	\$ (580)	\$ 6,973
Net income (loss) per share:							
Basic	\$ (3.62)	\$ (0.79)	\$ (0.28)	\$ (1.13)	\$ 0.37	\$ (0.03)	\$ 0.34
Diluted	\$ (3.62)	\$ (0.79)	\$ (0.28)	\$ (1.13)	\$ 0.11	\$ (0.03)	\$ 0.11
Weighted-average shares outstanding:							
Basic	16,594	18,029	18,861	19,276	20,017	19,802	20,788

## Edgar Filing: FORTINET INC - Form S-1/A

Diluted	16,594	18,029	18,861	19,276	67,122	19,802	64,187
Pro-forma net income per share attributable to common stockholders (unaudited):							
Basic					\$ 0.13		\$ 0.12
Diluted					\$ 0.11		\$ 0.11
Pro-forma weighted-average shares outstanding used in calculating net income per share (unaudited):							
Basic					57,493		58,264
Diluted					67,122		64,187

- (1) Our fiscal years ended on December 31, 2004, January 1, 2006, December 31, 2006, December 30, 2007 and December 28, 2008.
- (2) We made the decision in the first quarter of 2009 to change our financial reporting periods from a fiscal to calendar basis. This change was implemented in the third quarter of 2009 upon completion of required system changes. Commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our third quarter of fiscal 2009 ended on September 30, 2009, and our fiscal 2009 will end on December 31, 2009. This change in period end had the effect of increasing the number of days in the nine month period ended September 30, 2009 by three days. Although a significant volume of shipments occurs during the final few days of each of our quarterly reporting periods, including during the quarter ended September 30, 2009, management believes that the three days added to the quarter ended September 30, 2009 from the effect of such conversion to a calendar quarter end did not materially impact our product revenue, as we manage our quarter-end sales cycle based on our financial reporting period end. See

**Table of Contents**

Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of the impact on our services revenue.

(3) Includes stock-based compensation expense as follows:

	Fiscal Year					Nine Months Ended	
	2004	2005	2006	2007	2008	September 28, 2008	September 30, 2009
	(in thousands)						
Cost of product revenue	\$	\$	\$ 99	\$ 553	\$ 67	\$ 46	\$ 76
Cost of services revenue			52	416	400	283	465
Research and development	6	4	135	1,452	1,049	727	1,392
Sales and marketing	17	115	354	3,928	2,512	1,867	2,103
General and administrative	83	113	414	2,983	1,271	932	1,243
Total stock-based compensation	\$ 106	\$ 232	\$ 1,054	\$ 9,332	\$ 5,299	\$ 3,855	\$ 5,279

(4) See Business Legal Proceedings.

(5) This amount relates to the repurchase of convertible preferred stock (see Note 10 to Notes to Consolidated Financial Statements) during the first nine months of fiscal 2009. The repurchase amount per share over the carrying value per share of the convertible preferred stock is considered similar to a dividend paid and thus the total amount is subtracted from net income to arrive at earnings available to common stockholders when deriving earnings per share. In 2004, we extended the expiration date of certain warrants to purchase Series E convertible preferred stock. The incremental fair value of the warrants related to the extension is treated as a dividend and combined with net loss to arrive at net loss attributable to common stockholders.

	As of Fiscal Year End					As of	
	2004	2005	2006	2007	2008	September 28, 2008	September 30, 2009
	(in thousands)						
<b>Consolidated Balance Sheet Data:</b>							
Cash, cash equivalents and short-term investments	\$ 49,596	\$ 60,926	\$ 64,041	\$ 90,161	\$ 124,190	\$ 108,570	\$ 152,390
Working capital	7,515	8,069	12,399	12,862	34,723	19,273	45,522
Total assets	80,233	102,383	109,311	145,192	199,105	177,497	230,478
Deferred revenue, current and long-term	47,520	74,504	93,376	131,255	171,617	158,107	190,375
Current and long-term debt							
Convertible preferred stock	83,757	94,368	94,368	94,368	94,368	94,368	91,185
Common stock including additional paid-in capital	1,160	1,937	4,087	13,438	20,854	19,243	18,570
Total stockholders' equity (deficit)	452	(4,023)	(7,217)	(18,925)	(5,229)	(14,176)	3,888

---

**Table of Contents**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS**

*You should read the following discussion and analysis of our financial condition and results of operations together with the consolidated financial statements and related notes that are included elsewhere in this prospectus. This discussion contains forward looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward looking statements as a result of various factors, including those set forth under "Risk Factors" or in other parts of this prospectus.*

**Business Overview**

We are a leading provider of network security appliances and the market leader in UTM network security solutions. We provide broad, integrated and high performance protection against dynamic security threats while simplifying the IT security infrastructure for enterprises, service providers and government entities worldwide. We lead the UTM appliance market with a 15.4% share for the second quarter of 2009, as determined by IDC.<sup>(1)</sup> Based on IDC data, the UTM market is the fastest growing segment within the network security market, which was \$6.8 billion in 2007.<sup>(2)</sup> Customer demand for our solutions has enabled us to consistently achieve strong growth every year since first shipping product in 2002. As of September 30, 2009, we had shipped over 475,000 appliances to more than 5,000 channel partners and 75,000 end-customers worldwide, including a majority of the 2009 Fortune Global 100.

Our core UTM product line of FortiGate appliances ships with a set of security and networking capabilities, including firewall, VPN, antivirus, intrusion prevention, Web filtering, antispam and WAN acceleration functionality. We derive a substantial majority of product sales from our FortiGate appliances, which range from the FortiGate-30 designed for small businesses and branch offices to the FortiGate-5000 series for large enterprises and service providers. Sales of FortiGate products have generally been balanced across entry-level (FortiGate-30 to -100 series), mid-range (FortiGate-200 to -800 series) and high-end (FortiGate-1000 to -5000 series) models with each product category representing approximately a third of FortiGate sales for each of the last three fiscal years. Our UTM solution also includes our FortiGuard security subscription services, which end-customers can subscribe to in order to obtain access to dynamic updates to the antivirus, intrusion prevention, Web filtering and antispam functionality included in our appliances. End-customers can also choose to purchase FortiCare technical support services for our products. We complement our core FortiGate product line with other appliances and software that offer additional protection from security threats to other critical areas of the enterprise, such as messaging, Web-based traffic and databases, and employee computers or handheld devices.

Our total revenue has increased from \$38.7 million in fiscal 2004 to \$211.8 million in fiscal 2008 and was \$181.4 million for the first nine months of fiscal 2009. We ended the first nine months of fiscal 2009 with \$152.4 million in cash, cash equivalents and short-term investments and have had positive cash flow from operations every fiscal year since 2005. We achieved profitability in the third quarter of fiscal 2008 and have remained profitable each quarter since.

**Our Business Model**

Our sales strategy is based on a distribution model whereby we primarily sell our products and services directly to distributors who sell to resellers and service providers, who, in turn, sell to our end-customers. In certain cases, we sell directly to government-focused resellers, very large service providers and major systems integrator partners who have large purchasing power and unique customer deployment requirements. Typically, FortiGuard security subscription services and FortiCare technical support services are purchased along with our

Edgar Filing: FORTINET INC - Form S-1/A

- (1) IDC Worldwide Security Appliances Tracker, September 2009.
- (2) Worldwide Network Security 2008-2012 Forecast and 2007 Vendor Shares: Transitions Appliances Are More Than Meets the Eye, Doc #214246, October 2008.

**Table of Contents**

appliances. We invoice at the time of our sale for the total price of the products and subscription and support services, and the invoice generally becomes payable within thirty to sixty days. We generally recognize product revenue up-front but defer revenue based on the sale of new and renewal subscription and support services contracts and recognize related services revenue over the service period, which is typically one year from the date of registration by the end-customer. As a result, our sales of new and renewal services increase our deferred revenue balance, which contributes significantly to our positive cash flow from operations. As discussed below, we view deferred revenue and cash flow from operations as key financial metrics. As of September 30, 2009, our deferred revenue balance was \$190.4 million and our cash flow from operations for the first nine months of fiscal 2009 was \$45.8 million. Services revenue provides a source of recurring revenue for us, representing 49.7% of total revenue for fiscal year 2008 and 56.1% of total revenue for the first nine months of fiscal 2009, and is important to our future revenue and profitability.

We are a global, geographically diversified business, with more than 60% of our total revenue generated outside of the Americas region since fiscal 2006. For the first nine months of fiscal 2009, 37% of our total revenue was generated from the Americas, 37% from EMEA, and 26% from APAC. We sell globally in U.S. dollars, while our international expenses are denominated in local currencies.

**Key Metrics**

We monitor the key financial metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies. We discuss revenue, gross margin, and the components of operating income and margin below under **Components of Operating Results** and we discuss our cash, cash equivalents and short-term investments under **Liquidity and Capital Resources**. Deferred revenue and cash flow from operations are discussed immediately below the table.

	Fiscal Year or as of Fiscal Year End			Nine Months Ended or as of	
	2006	2007	2008	September 28, 2008	September 30, 2009 <sup>(2)</sup>
	(dollars in thousands)				
Revenue	\$ 123,466	\$ 155,366	\$ 211,791	\$ 152,725	\$ 181,403
Gross margin	66.8%	63.5%	69.1%	68.8%	73.0%
Operating income (loss) <sup>(1)</sup>	\$ (5,997)	\$ (21,577)	\$ 4,927	\$ (1,346)	\$ 17,880
Operating margin	(4.9)%	(13.9)%	2.3%	(0.9)%	9.9%
Total deferred revenue	\$ 93,376	\$ 131,255	\$ 171,617	\$ 158,107	\$ 190,375
Increase in total deferred revenue	18,872	37,879	40,362	26,852	18,758
Cash, cash equivalents and short-term investments	64,041	90,161	124,190	108,570	152,390
Cash flow from operations	3,409	27,669	37,686	19,106	45,756

(1) Includes stock-based compensation expense: \$ 1,054      \$ 9,332      \$ 5,299      \$ 3,855      \$ 5,279

(2) We made the decision in the first quarter of 2009 to change our financial reporting periods from a fiscal to calendar basis. This change was implemented in the third quarter of 2009 upon completion of required system changes. Commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our third quarter of fiscal 2009 ended on September 30, 2009, and our fiscal 2009 will end on December 31, 2009. This change in period end had the effect of increasing the number of days in the nine month period ended September 30, 2009 by three days. Although a significant volume of shipments occurs during the final few days of each of our quarterly reporting periods, including during the quarter ended September 30, 2009, management believes that the three days added to the quarter ended September 30, 2009 from the effect of such conversion to a calendar quarter end did not materially impact our product revenue, as we manage our quarter-end sales cycle based on our financial reporting period end.

## Edgar Filing: FORTINET INC - Form S-1/A

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

---

## **Table of Contents**

*Cash flow from operations.* We monitor cash flow from operations as a measure of our overall business performance. Our cash flow from operations is driven in large part by advance payments for both new and renewal contracts for subscription and support services. Monitoring cash flow from operations enables us to analyze our financial performance without the non-cash effects of certain items such as depreciation, amortization and stock-based compensation expenses, thereby allowing us to better understand and manage the cash needs of our business. Our cash flow from operations was \$3.4 million in each of fiscal 2005 and 2006, \$27.7 million in fiscal 2007 and \$37.7 million in fiscal 2008. For the first nine months of fiscal 2009, our cash flow from operations was \$45.8 million.

## **Components of Operating Results**

### ***Revenue***

We derive our revenue from sales of our products and subscription and support services. We recognize our revenue in accordance with the guidance in ASC 985-605-25 (formerly referred to as Statement of Position, or SOP 97-2, *Software Revenue Recognition* and SOP 98-9, Modification of SOP 97-2, *Software Revenue Recognition, With Respect to Certain Transactions*) which is discussed in further detail in **Critical Accounting Policies and Estimates Revenue Recognition** below. According to ASC 985-605-25, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collection is probable.

Our total revenue is comprised of the following:

*Product revenue.* Product revenue is generated from sales of our appliances and software. The substantial majority of our product revenue has been generated by our FortiGate line of appliances and we do not expect this to change in the foreseeable future. Product revenue also includes revenue derived from sales of FortiManager, FortiAnalyzer, FortiMail, FortiDB, FortiWeb and FortiScan appliances, and our FortiClient and virtual domain, or VDOM, software. We generally recognize revenue for products sold to distributors through the sell-in method upon shipment to the distributor and, for sell-through distributors, upon sale to their end-customer. As a percentage of total revenue, we expect our product revenue may vary from quarter-to-quarter based on seasonal and cyclical factors discussed below under **Quarterly Results of Operations** but generally may remain at comparable levels or decline modestly, as services revenue becomes a larger portion of our business as we renew existing services contracts and expand our customer base.

*Services revenue.* Services revenue is generated primarily from FortiGuard security subscription services related to antivirus, intrusion prevention, Web filtering and antispam updates and FortiCare technical support services for software updates, maintenance releases and patches, Internet access to technical content, telephone and Internet access to technical support personnel and hardware support. We recognize revenue from subscription and support services over the service performance period. Our typical contractual support and subscription term is one year from the date of registration. We also generate a small portion of our revenue from professional services and training services and we recognize this revenue upon completion of the project. As a percentage of total revenue, we expect our services revenue may remain at comparable levels or increase as we renew existing services contracts and expand our customer base.

*Ratable product and services revenue.* Ratable product and services revenue is generated from sales of our products and services in cases where the fair value of the services being provided cannot be segregated from the value of the entire sale. In these cases, the value of the entire sale is deferred and recognized ratably over the life of the service performance period. See **Critical Accounting Policies and Estimates Revenue Recognition**. In fiscal 2008 and for the first nine months of fiscal 2009, ratable product and service revenue represented approximately six percent of total revenue and we do not expect this percentage to change significantly in the near future.





---

## **Table of Contents**

### ***Cost of revenue***

Our total cost of revenue is comprised of the following:

*Cost of product revenue.* A substantial majority of the cost of product revenue consists of third-party manufacturing costs. Our cost of product revenue also includes product testing costs, write-offs for excess and obsolete inventory, royalty payments, amortization and any impairment of acquired intangible assets, warranty costs, shipping and allocated facilities costs, stock-based compensation costs, and personnel costs associated with logistics and quality control. Personnel costs include cash-based personnel costs such as salaries, benefits and bonuses. Royalty payments reflect payments we have made to Trend Micro since 2006, which Trend Micro claims are owed through 2015, as discussed in Business Legal Proceedings. For fiscal 2008 and the first nine months of fiscal 2009, this royalty represented approximately 1% of total revenue and, if such payments were made in accordance with the terms of the 2006 settlement agreement with Trend Micro, we would not expect this to increase substantially in the foreseeable future. In the fourth quarter of fiscal 2009, we expect to incur a non-cash charge of approximately \$0.4 million based on an assumed offering price of \$10.00, which is the midpoint of the range reflected on the cover of this prospectus. The charge will relate to certain warrants issued in connection with acquisitions of technology assets. See Note 6 to the consolidated financial statements.

*Cost of services revenue.* Cost of services revenue is primarily comprised of cash-based personnel costs associated with our FortiGuard Labs team and our technical support, professional services and training teams, as well as depreciation, supplies, data center, data communications, facility-related costs and stock-based compensation costs. We expect our cost of services revenue will increase as we continue to invest in subscription and support services to meet the needs of our growing customer base.

*Cost of ratable product and services revenue.* Cost of ratable product and services revenue is comprised primarily of deferred product costs and an allocation of services-related costs.

*Gross profit.* Gross profit as a percentage of revenue, or gross margin, has been and will continue to be affected by a variety of factors, including the average sales price of our products, any excess inventory write-offs, manufacturing costs, the mix of products sold and the mix of revenue between products and services. We believe our overall gross margin for the near term may decline modestly or be relatively flat compared to that achieved in the first nine months of fiscal 2009 as we do not anticipate in the near term any significant change in the factors positively influencing gross margin.

Services revenue has increased as a percentage of total revenue since inception and this trend has had a positive effect on our total gross margin given the higher services gross margins compared to product gross margins. Our services gross margins have been increasing, but we do not expect these margins to increase substantially in the future as we continue to invest in our support infrastructure.

*Operating expenses.* Our operating expenses consist of research and development, sales and marketing and general and administrative expenses. Personnel costs are the most significant component of operating expenses and consist of cash-based personnel costs such as salaries, benefits, bonuses and, with regard to the sales and marketing expense, sales commissions. They also include non-cash stock-based compensation. We expect personnel costs to continue to increase in absolute dollars as we hire new employees.

*Research and development.* Research and development expense consists primarily of cash-based personnel costs. Additional research and development expenses include ASIC and system prototypes and certification-related expenses, depreciation of capital equipment, facility-related expenses and stock-based compensation expenses. The majority of our research and development is focused on both software development and the ongoing development of our hardware platform. We record all research and

## Edgar Filing: FORTINET INC - Form S-1/A

development expenses as incurred, except for capital equipment which is depreciated over time. Our development teams are primarily located in Canada, China, and California. We expect our spending for research and development to increase in absolute dollars but intend for research and development expenses to remain comparable to recent periods as a percentage of total revenue.

*Sales and marketing.* Sales and marketing expense is the largest component of our operating expenses and primarily consists of cash-based personnel costs. Additional sales and marketing expenses include stock-based compensation, promotional and other marketing expenses, travel, depreciation of capital

## Table of Contents

equipment and facility-related expenses. We intend to hire additional personnel focused on sales and marketing and expand our sales and marketing efforts worldwide in order to add new customers and increase penetration within our existing customer base. Accordingly, we expect sales and marketing expenses to increase in absolute dollars and to continue to be our largest operating expense.

*General and administrative.* General and administrative expenses consist of cash-based personnel costs as well as professional fees, stock-based compensation, depreciation of capital equipment and software, and facility-related expenses. General and administrative personnel include our executive, finance, human resources, information technology and legal organizations. Our professional fees principally consist of outside legal, auditing, accounting, information technology and other consulting costs. We expect that general and administrative expense will increase in absolute dollars as we hire additional personnel, make improvements to our information technology infrastructure and incur significant additional costs for the compliance requirements of operating as a public company, including the costs associated with SEC reporting, Sarbanes-Oxley Act compliance and insurance.

*Interest income.* Interest income consists of income earned on our cash, cash equivalents and investments. We have historically invested our cash in money-market funds and other short-term, investment-grade investments.

*Other income (expense), net.* Other income (expense), net consists primarily of foreign exchange gains and losses. Foreign exchange gains and losses relate to transactions denominated in currencies other than the functional currency of the associated entity.

*Provision for income taxes.* We are subject to tax in the United States as well as other tax jurisdictions or countries in which we conduct business. Earnings from our non-U.S. activities are subject to local country income tax and may be subject to current U.S. income tax.

Our effective tax rates differ from the statutory rate primarily due to the valuation allowance on our deferred taxes, state taxes, foreign taxes, research and development tax credits and nondeductible compensation. For periods subsequent to the date on which we fully reverse our deferred tax asset valuation allowance, we expect that our effective tax rate will approximate the U.S. federal statutory tax rates plus the impact of state taxes.

As of December 31, 2008, we had \$49.7 million of federal and \$33.4 million of state net operating loss carry-forwards available to reduce future taxable income. These net operating loss carry-forwards begin to expire in 2021 and 2012 for federal and state tax purposes, respectively. Our ability to use our net operating loss carry-forwards to offset any future taxable income could be subject to limitations attributable to equity transactions that would result in a change of ownership as defined by Section 382 of the Internal Revenue Code of 1986, as amended, or the Internal Revenue Code. In addition, the State of California has suspended the ability of companies to utilize net operating losses to offset 2008 and 2009 state taxable income which has resulted in a higher effective state tax rate.

At December 28, 2008, we had a total deferred tax asset of approximately \$42.3 million, primarily comprised of our accumulated net operating loss carryforwards. We have provided a valuation allowance of approximately \$42.2 million against our net deferred tax assets as we believe that sufficient uncertainty exists regarding the realizability of the deferred tax assets. Our net deferred tax assets consist primarily of net operating loss carry-forwards generated before we achieved profitability. Recognition of deferred tax assets is appropriate when realization of such assets is more likely than not. Based upon the weight of available evidence, which includes our historical operating performance and the recorded domestic cumulative net losses in all periods prior to fiscal 2008, we have provided a full valuation allowance against our U.S. deferred tax assets. We intend to maintain valuation allowances until sufficient evidence exists to support the reversal of the valuation allowances. Under certain conditions related to our future profitability and other business factors, we believe it is possible our results will yield sufficient positive evidence to support the conclusion that it is more likely than not that we will realize the tax benefit of our net operating losses. If that is the case, subject to review of other qualitative factors and uncertainties, we would expect to begin reversing some or all of the remaining deferred tax asset valuation allowance as a credit to stockholders' equity for the portion of the net operating loss valuation allowance



## **Table of Contents**

associated with stock option transactions, and the remainder would be reversed into income as a reduction of tax expense. For the periods following the recognition of this tax benefit and to the extent we are profitable, we will record a tax provision for which the actual payment may be offset against our accumulated net operating loss carryforwards. However, our tax rate may significantly increase in future periods.

We make estimates and judgments about our future taxable income that are based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted. Any adjustment to the deferred tax asset valuation allowance would be recorded in the income statement of the periods that the adjustment is determined to be required.

Under current tax law, if cash and cash equivalents and investments held outside the United States are distributed to the United States in the form of dividends or otherwise, we may be subject to additional U.S. income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes.

## **Critical Accounting Policies and Estimates**

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

We believe that of our significant accounting policies, which are described in Note 1 to the financial statements included in this prospectus, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, we believe these are the most critical to fully understand and evaluate our financial condition and results of operations.

### ***Revenue Recognition***

We derive revenue from sales of products, including appliances and software, and services, including subscription, support and other services. Our appliances include operating system software that is integrated into the appliance hardware and is deemed essential to its functionality. As a result, we account for revenue in accordance with ASC 985-605-25-3 and all related interpretations. See [Recent Accounting Pronouncements](#) for a discussion of new revenue recognition standards that we will be required to adopt by fiscal 2011. We are still assessing the impact of the new standards and have not reflected in this prospectus any impact such standards may have on our consolidated financial statements.

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

## Edgar Filing: FORTINET INC - Form S-1/A

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

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

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

*Collectibility is probable.* We assess collectibility based primarily on creditworthiness as determined by credit checks and analysis, as well payment history. Payment terms generally range from thirty to sixty days from invoice date.

**Table of Contents**

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

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

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

We offer certain sales incentives to channel partners. Additionally, in limited circumstances we may permit end-customers, distributors and resellers to return our products, subject to varying limitations, for a refund within a reasonably short period from the date of purchase. We reduce revenue for estimates of sales returns and allowances. We estimate and record reserves for these sales incentives and sales returns based on our historical experience. In each accounting period, we must make judgments and estimates of sales incentives and potential future sales returns related to current period revenue. These estimates affect our net revenue line item on our consolidated statement of operations and affect our net accounts receivable, deferred revenue or accrued liabilities line items on our consolidated balance sheet. Historically, there have been no significant adjustments to these estimates related to prior periods.

At December 28, 2008, our allowance for sales returns was \$2.7 million compared to \$4.0 million at December 30, 2007. If our allowance for sales returns was to increase by 10%, or \$0.3 million, our net revenue would decrease by \$0.3 million for the year ended December 28, 2008.

**Stock-Based Compensation**

Our stock-based compensation expense is as follows:

	Fiscal Year			Nine Months Ended	
	2006	2007	2008	September 28, 2008	September 30, 2009
			(in thousands)		
Cost of product revenue	\$ 99	\$ 553	\$ 67	\$ 46	\$ 76
Cost of services revenue	52	416	400	283	465
Research and development	135	1,452	1,049	727	1,392



Edgar Filing: FORTINET INC - Form S-1/A

Sales and marketing	354	3,928	2,512	1,867	2,103
General and administrative	414	2,983	1,271	932	1,243
Total stock-based compensation	\$ 1,054	\$ 9,332	\$ 5,299	\$ 3,855	\$ 5,279

**Table of Contents**

*Employees.* Prior to January 2, 2006, we accounted for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board Opinion 25, or APB 25, *Accounting for Stock Issued to Employees* (now contained in ASC 718) and Financial Accounting Standards Board, or FASB, Interpretation 44, *Accounting for Certain Transactions Involving Stock Compensation - an interpretation of APB 25* (now contained in ASC 718). In addition, we had adopted the disclosure-only provisions of Statement of Financial Accounting Standard 123 (now contained in ASC 718). Effective January 2, 2006, we adopted SFAS 123R, *Share-Based Payments* (now contained in ASC 718), which revised SFAS 123 and superseded APB 25. For stock option grants made subsequent to January 2, 2006, we have accounted for such stock-based awards to employees in accordance with SFAS 123R, which requires compensation expense related to share-based transactions, including employee stock options, to be measured and recognized in the financial statements based on a determination of the fair value of the stock options. The grant date fair value is determined using the Black-Scholes-Merton ( Black-Scholes ) pricing model.

We adopted SFAS 123R (ASC 718) using the prospective method, in which non-public entities that previously applied SFAS 123 (ASC 718) using the minimum value method, whether for financial statement recognition or pro forma disclosure purposes, would continue to account for unvested stock options outstanding at the date of adoption of SFAS 123R (ASC 718) in the same manner as they had been accounted for prior to the adoption of SFAS 123R (ASC 718). We will continue to apply APB 25 (ASC 718) in future periods to stock options issued and outstanding at January 2, 2006.

For all employee stock options, we recognize expense over the requisite service period using the straight-line method.

The Black-Scholes pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable; characteristics not present in our option grants. Existing valuation models, including the Black-Scholes model, may not provide reliable measures of the fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon exercise. Stock options may expire or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements.

As of the end of fiscal years 2006, 2007 and 2008, there was approximately \$3.2 million, \$4.1 million and \$13.6 million, respectively, of unrecognized stock-based compensation expense related to non-vested stock option awards, net of estimated forfeitures, that we expect to be recognized over a weighted-average period of 1.72, 1.47 and 2.77 years, respectively.

For the period from January 2, 2006 through December 31, 2006 and for fiscal years 2007 and 2008, we calculated the fair value of options granted to employees using the Black-Scholes pricing model with the following assumptions:

	Fiscal Year		
	2006	2007 <sup>(1)</sup>	2008
Volatility	60 - 63%	49%	44 - 47%
Expected term, in years	6.0 - 6.1	6.1	4.5 - 4.6
Dividend yield			
Risk-free interest rate	4.3 - 5.1%	4.9%	2.3 - 3.3%

(1) There was only one grant date in fiscal 2007.

## Edgar Filing: FORTINET INC - Form S-1/A

*Nonemployees.* During the years ended December 31, 2006 and December 28, 2008, we issued to nonemployees in exchange for services, options to purchase 145,655 and 29,000 shares of common stock, respectively, at a range of exercise prices from \$1.95 to \$7.47 per share. No options were granted to nonemployees in exchange for services during the year ended December 30, 2007. These options vest over

**Table of Contents**

periods of up to 50 months, and in accordance with ASC 505-50 (formerly referred to as Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services*), we accounted for these options as variable awards. The options were valued using the Black-Scholes option pricing model with the following weighted-average assumptions (dollar amounts in thousands):

	2006	Fiscal Year 2007	2008
Volatility	60 - 63%	49 - 56%	44 - 51%
Expected term, in years	6.8 - 10.0	6.0 - 9.0	6.0 - 8.5
Dividend yield			
Risk-free interest rate	4.3 - 5.6%	4.3 - 4.9%	2.3 - 3.6%

The table below summarizes all stock option grants since the beginning of fiscal 2008 through the date of this prospectus:

Grant Date	Number of Options Granted	Common Stock Fair Value Per Share at Grant Date	Exercise Price
February 7, 2008	3,536,644	\$ 6.92	\$ 7.47
April 23, 2008	2,229,510	6.19	7.47
July 31, 2008	902,500	6.47	7.47
October 21, 2008	563,475	6.32	7.47
January 28, 2009	3,167,218	6.61	7.47
April 30, 2009	336,975	7.25	7.68
July 22, 2009	295,465	9.05	9.30
October 21, 2009	300,025	10.00	11.00

Based upon an assumed initial public offering price of \$10.00 per share, which is the midpoint of the range listed on the cover page of this prospectus, the aggregate intrinsic value of options outstanding as of September 30, 2009 was \$89.5 million, of which \$69.8 million related to vested options and \$19.7 million to unvested options.

In order to determine the fair value of our common stock underlying all option grants accounted for under ASC 718 or ASC 505-50, we have considered contemporaneous valuations of our common stock utilizing the discounted cash flow method and the comparable company method. As part of the comparable company method we analyzed a population of possible comparable companies and selected those technology companies that we considered to be the most comparable to us in terms of revenues, margins and growth. We weighted the discounted cash flow and comparable company methods equally as we determined that both methods were equally relevant in estimating the value of our common stock. In allocating the total equity value between preferred and common stock, we assumed that the preferred stock would convert to common stock. Additionally, each valuation utilizes the probability-weighted method and the option-pricing method for allocating the total equity value between preferred and common stock and each such method takes into account the likelihood of an initial public offering.

The significant input assumptions used in the valuation model are based on subjective future expectations combined with management judgment, including:

Assumptions utilized in the discounted cash flow method are:

our expected revenue, operating performance, cash flow and EBITDA for the current and future years, determined as of the valuation date based on our estimates;

a discount rate, which is applied to discretely forecasted future cash flows in order to calculate the present value of those cash flows; and

a terminal value multiple, which is applied to our last year of discretely forecasted EBITDA to calculate the residual value of our future cash flows.

---

**Table of Contents**

Assumptions utilized in the comparable company method are:

our expected revenue, operating performance, cash flow and EBITDA for the current and future years, determined as of the valuation date based on our estimates;

multiples of market value to trailing twelve months revenue, determined as of the valuation date, based on a group of comparable public companies we identified; and

multiples of market value to expected future revenue, determined as of the valuation date, based on the same group of comparable public companies.

Our board of directors has historically set the exercise price of stock options based on a price per share not less than the estimated fair market value of our common stock on the date of grant. Our board has taken into consideration numerous objective and subjective factors to determine the fair market value of our common stock on each grant date in order to be able to set exercise prices at or above the fair market value. Such factors included, but were not limited to, (i) valuations using the methodologies described above, (ii) our operating and financial performance, (iii) the lack of liquidity of our capital stock and the likelihood of achieving a liquidity event given then-current market conditions and trends in the broader security and networking markets and other similar technology stocks and, (iv) during the recent economic downturn, the benefits of preserving relative consistency of exercise prices during periods characterized by decreasing market values.

Significant factors contributing to the changes in common stock fair value at the date of each grant beginning in fiscal 2008 are as follows:

*Valuation at April 23, 2008* Our common stock fair value as of April 23, 2008 decreased to \$6.19 per share, or 11% from the prior valuation date, due to a decline in market value multiples for comparable public companies and a lower probability assigned to the possibility of going public. We utilized a market value to revenue multiple of 2.0 and assumed a 35% probability of an IPO, a 35% probability of a strategic sale and a 30% probability of no liquidity being available to shareholders.

*Valuation at July 31, 2008* Our common stock fair value as of July 31, 2008 increased to \$6.47 per share, or 5% from the prior valuation date, due to a higher probability assigned to the possibility of going public, partially offset by a decline in market value multiples for comparable public companies. We utilized a reduced market value to revenue multiple of 1.3 due to a reduction in the average market value to revenue multiples of the comparable companies used. We assumed a 50% probability of an IPO, a 25% probability of a strategic sale and a 25% probability of no liquidity being available to shareholders.

*Valuation at October 21, 2008* Our common stock fair value as of October 21, 2008 decreased to \$6.32 per share, or 2% from the prior valuation date. We utilized a market value to revenue multiple of 1.2 and continued to assume a 50% probability of an IPO, a 25% probability of a strategic sale and a 25% probability of no liquidity being available to shareholders.

*Valuation at January 28, 2009* Our common stock fair value as of January 28, 2009 increased to \$6.61 per share, or 5% from the prior valuation date, due to a slight increase in our forecasted operating results due to greater focus on achieving long-term profitability. We continued to utilize a market value to revenue multiple of 1.2 and a 50% probability of an IPO, 25% probability of a strategic sale and a 25% probability of no liquidity being available to shareholders.

*Valuation at April 30, 2009* Our common stock fair value as of April 30, 2009 increased to \$7.25 per share, or 10% from the prior valuation date, primarily due to an increase in market value multiples for comparable public companies. We utilized a higher market value to revenue multiple of 1.7 due to an increase in the average market value to revenue multiples of the comparable companies

## Edgar Filing: FORTINET INC - Form S-1/A

used. We continued to assume a 50% probability of an IPO, a 25% probability of a strategic sale and a 25% probability of no liquidity being available to shareholders.

*Valuation at July 22, 2009* Our common stock fair value as of July 22, 2009 increased to \$9.05 per share, or 25% from the prior valuation date, due to an increase in the terminal value multiple, an

---

**Table of Contents**

increase in market value to revenue multiples for comparable public companies and increased probability assigned to the possibility of going public, partially offset by a decrease in our forecasted operating results due to a reassessment of growth assumptions given current and forecasted economic conditions and recent operating results which were lower than originally forecasted. We utilized a higher market value to revenue multiple of 2.8 due to an increase in the average market value to revenue multiples of the comparable companies used. We assumed a 65% probability of an IPO, a 10% probability of a strategic sale and a 25% probability of no liquidity being available to shareholders.

In all valuations above we applied a 10% discount for lack of marketability. In addition, the probability assigned to the likelihood of an IPO increased from 35% to 65% over the valuation periods presented due to: (1) our overall growth, (2) improvement in our operating profitability, and (3) changes in management's overall assessment of the likelihood of a successful initial public offering given our performance and the state of the public equity markets. Other than the factors discussed above, there were no significant changes to input assumptions or changes in valuation methodologies.

For the options to purchase 300,025 shares of common stock that we granted on October 21, 2009, our common stock fair value increased to \$10.00 per share, or approximately 10%, from the prior valuation date. Our three managing underwriters provided us with an estimated valuation range of \$9 to \$11 per share for our initial public offering assuming an offering in the fourth quarter of 2009. We considered the valuation range proposed by the underwriters relative to our financial results and the current economic conditions. After considering the estimated valuation range and these other factors, we concluded that the midpoint of the range provided by our managing underwriters, \$10.00 per share, is a reasonable estimate of the fair value of our common stock.

The assumptions around fair value that we have made represent our management's best estimate, but they are highly subjective and inherently uncertain. If management had made different assumptions, our calculation of the options' fair value and the resulting stock-based compensation expense could differ, perhaps materially, from the amounts recognized in our financial statements. For example, if we increased the assumption regarding our stock's volatility for options granted during 2008 by 10%, our stock-based compensation expense would increase by \$0.7 million, net of expected forfeitures. Likewise, if we increased our assumption of the expected lives of options granted during 2008 by one year, our stock-based compensation expense would increase by \$0.4 million, net of expected forfeitures. These notional increased expense amounts would be amortized over the options' four year vesting period.

In addition to the assumptions used to calculate the fair value of our options, we are required to estimate the expected forfeiture rate of all stock-based awards and only recognize expense for those awards we expect to vest. Accordingly, the stock-based compensation expense recognized in our consolidated statement of operations for the year ended December 28, 2008 has been reduced for estimated forfeitures. If we were to change our estimate of forfeiture rates, the amount of stock-based compensation expense could differ, perhaps materially, from the amount recognized in our financial statements. For example, if we had decreased our estimate of expected forfeitures by 50%, our stock-based compensation expense for the year ended December 28, 2008, net of expected forfeitures, would have increased by \$77,000. This decrease in our estimate of expected forfeitures would increase the amount of expense for all unvested awards that have not yet been recognized by \$1.8 million, amortized over a weighted-average period of 2.77 years.

In January 2007, our board of directors extended the exercise period of vested stock options to April 30, 2008 for certain terminated employees. This extension was a modification under ASC 718, resulting in incremental expense. In accordance with ASC 718 and ASC 815-40 (formerly referred to as EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*), we classified the options as liability awards at the time of modification as the option exercises would likely require the issuance of shares to be registered. Accordingly, at the end of each quarter in the year ended December 30, 2007, we determined the fair value of these options utilizing the Black-Scholes valuation model and changes in fair value of the options are included in stock-based compensation. During the year ended December 30, 2007, we recorded \$7.6 million of stock-based compensation expense related to the modification.



## **Table of Contents**

In connection with the SEC's adoption of Rule 12h-1 in December 2007, the liability awards were reclassified into equity as we determined that we were no longer required to register the issuance of shares to settle the awards. As a result of the reclassification, \$6.1 million was reclassified from current liabilities to additional paid-in-capital.

### ***Valuation of Inventory***

Inventory is recorded at the lower of cost (using the first-in, first-out method) or market, after we give appropriate consideration to obsolescence and inventory in excess of anticipated future demand. In assessing the ultimate recoverability of inventory, we are required to make estimates regarding future customer demand, the timing of new product introductions, economic trends and market conditions. If the actual product demand is significantly lower than forecasted, we could be required to record additional inventory write-downs which would be charged to cost of product revenue. Any write-downs could have an adverse impact on our gross margins and profitability. During fiscal 2007, we wrote-off \$6.3 million of excess inventory, of which \$6.0 million was written-off in the second half of fiscal 2007.

### ***Warranty Liabilities***

We generally provide a one-year warranty on hardware products and a 90-day warranty on software. A provision for estimated future costs related to warranty activities is charged to cost of product revenue based upon historical product failure rates and historical costs incurred in correcting product failures. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than expected, our gross margin could be adversely affected.

### ***Accounting for Income Taxes***

We record income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in our financial statements or tax returns. In estimating future tax consequences, generally all expected future events other than enactments or changes in the tax law or rates are considered. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized.

We operate in various tax jurisdictions and are subject to audit by various tax authorities. We provide for tax contingencies whenever it is deemed probable that a tax asset has been impaired or a tax liability has been incurred for events such as tax claims or changes in tax laws. Tax contingencies are based upon their technical merits, relevant tax law and the specific facts and circumstances as of each reporting period. Changes in facts and circumstances could result in material changes to the amounts recorded for such tax contingencies.

On January 1, 2007, we adopted ASC 740 (formerly referred to as Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48)), which defines the confidence level that a tax position must meet in order to be recognized in the financial statements. ASC 740 requires that the tax effects of a position be recognized only if it is more likely than not to be sustained based solely on its technical merits as of the reporting date. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments and which may not accurately anticipate actual outcomes.

## Edgar Filing: FORTINET INC - Form S-1/A

With the adoption of ASC 740, companies are required to adjust their financial statements to reflect only those tax positions that are more likely than not to be sustained. Any necessary adjustment would be recorded directly to retained earnings and reported as a change in accounting principle as of the date of adoption. ASC 740 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The adoption of ASC 740 did not have a material impact on our consolidated financial statements.

As part of the process of preparing our consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions in which we operate. We estimate actual current tax exposure together with

**Table of Contents**

assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets, which are included in our consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in our consolidated statements of operations become deductible expenses under applicable income tax laws, or loss or credit carryforwards are utilized.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Due to the uncertainty surrounding our ability to realize such deferred tax assets, a full valuation allowance has been established, except with respect to deferred tax assets related to certain foreign operations.

We make estimates and judgments about our future taxable income that are based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted. Any adjustment to the deferred tax asset valuation allowance would be recorded in the income statement for the periods in which the adjustment is determined to be required.

**Results of Operations**

The following tables set forth our results of operations for the periods presented and as a percentage of our total revenue for those periods. The period-to-period comparison of financial results is not necessarily indicative of financial results to be achieved in future periods, and the results for the first nine months of fiscal 2009 are not necessarily indicative of results to be expected for the full year or for any other period.

	2006	Fiscal Year <sup>(1)</sup> 2007	2008 (in thousands)	Nine Months Ended September 28, 2008	September 30, 2009 <sup>(2)</sup>
<b>Consolidated Statement of Operations Data:</b>					
Revenue					
Product	\$ 59,469	\$ 70,131	\$ 94,587	\$ 68,395	\$ 69,327
Services	39,590	74,152	105,292	75,394	101,758
Ratable product and services	24,407	11,083	11,912	8,936	10,318
Total revenue	123,466	155,366	211,791	152,725	181,403
Cost of revenue					
Product	24,166	35,948	41,397	29,420	29,049
Services	9,496	15,941	19,441	14,751	15,955
Ratable product and services	7,302	4,763	4,634	3,447	4,062
Total cost of revenues	40,964	56,652	65,472	47,618	49,066
Gross profit					
Product	35,303	34,183	53,190	38,975	40,278
Services	30,094	58,211	85,851	60,643	85,803
Ratable product and services	17,105	6,320	7,278	5,489	6,256
Total gross profit	82,502	98,714	146,319	105,107	132,337

Edgar Filing: FORTINET INC - Form S-1/A

Operating expenses					
Research and development	21,446	27,588	37,035	28,186	31,207
Sales and marketing	54,056	72,159	87,717	65,900	69,572
General and administrative	12,997	20,544	16,640	12,367	13,678
Total operating expenses	88,499	120,291	141,392	106,453	114,457
Operating income (loss)	(5,997)	(21,577)	4,927	(1,346)	17,880
Interest income	2,376	3,507	2,614	1,872	1,677
Other income (expense), net	(503)	(1,991)	1,710	171	148
Income (loss) before income taxes	(4,124)	(20,061)	9,251	697	19,705
Provision for income taxes	1,220	1,781	1,888	1,277	3,466
Net income (loss)	\$ (5,344)	\$ (21,842)	\$ 7,363	\$ (580)	\$ 16,239

**Table of Contents**

- (1) Our fiscal years ended on December 31, 2006, December 30, 2007 and December 28, 2008.
- (2) We made the decision in the first quarter of 2009 to change our financial reporting periods from a fiscal to calendar basis. This change was implemented in the third quarter of 2009 upon completion of required system changes. Commencing in the third quarter of fiscal 2009, we began operating and reporting financial results on a calendar quarter and year basis. Our third quarter of fiscal 2009 ended on September 30, 2009, and our fiscal 2009 will end on December 31, 2009. This change in period end had the effect of increasing the number of days in the nine month period ended September 30, 2009 by three days. Although a significant volume of shipments occurs during the final few days of each of our quarterly reporting periods, including during the quarter ended September 30, 2009, management believes that the three days added to the quarter ended September 30, 2009 from the effect of such conversion to a calendar quarter end did not materially impact our product revenue, as we manage our quarter-end sales cycle based on our financial reporting period end.

	Fiscal Year			Nine Months Ended	
	2006	2007	2008	September 28, 2008	September 30, 2009
	(as % of revenue)				
Revenue					
Product	48.2%	45.1%	44.7%	44.8%	38.2%
Services	32.1%	47.7%	49.7%	49.4%	56.1%
Ratable product and services	19.7%	7.2%	5.6%	5.8%	5.7%
Total revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Total cost of revenue	33.2%	36.5%	30.9%	31.2%	27.0%
Total gross profit	66.8%	63.5%	69.1%	68.8%	73.0%
Operating expenses					
Research and development	17.4%	17.8%	17.5%	18.5%	17.2%
Sales and marketing	43.8%	46.4%	41.4%	43.1%	38.4%
General and administrative	10.5%	13.2%	7.9%	8.1%	7.5%
Total operating expenses	71.7%	77.4%	66.8%	69.7%	63.1%
Operating income (loss)	(4.9)%	(13.9)%	2.3%	(0.9)%	9.9%
Interest income	1.9%	2.3%	1.3%	1.2%	0.9%
Other income (expense), net	(0.4)%	(1.3)%	0.8%	0.1%	0.1%
Income (loss) before provision for income taxes	(3.4)%	(12.9)%	4.4%	0.4%	10.9%
Provision for income taxes	1.0%	1.2%	0.9%	0.8%	1.9%
Net income (loss)	(4.4)%	(14.1)%	3.5%	(0.4)%	9.0%

**First Nine Months of Fiscal 2009 and 2008****Revenue**

	September 28, 2008		September 30, 2009		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		

Edgar Filing: FORTINET INC - Form S-1/A

(dollars in thousands)

<b>Revenue</b>						
Product	\$ 68,395	44.8%	\$ 69,327	38.2%	\$ 932	1.4%
Services	75,394	49.4%	101,758	56.1%	26,364	35.0%
Ratable product and services	8,936	5.8%	10,318	5.7%	1,382	15.5%
<b>Total revenue</b>	<b>\$ 152,725</b>	<b>100.0%</b>	<b>\$ 181,403</b>	<b>100.0%</b>	<b>\$ 28,678</b>	<b>18.8%</b>
<i>Revenue by Geography</i>						
Americas	\$ 54,100	35.4%	\$ 67,817	37.4%	\$ 13,717	25.4%
EMEA	57,052	37.4%	67,239	37.1%	10,187	17.9%
APAC	41,573	27.2%	46,347	25.5%	4,774	11.5%
<b>Total revenue</b>	<b>\$ 152,725</b>	<b>100.0%</b>	<b>\$ 181,403</b>	<b>100.0%</b>	<b>\$ 28,678</b>	<b>18.8%</b>

**Table of Contents**

Total revenue increased \$28.7 million, or 18.8%, in the first nine months of fiscal 2009 compared to the same period in fiscal 2008, primarily due to growth in services revenue. The Americas region contributed the largest portion of this growth. Product revenue increased \$0.9 million, or 1.4%, in the first nine months of fiscal 2009 compared to the same period in fiscal 2008. The increase in product revenue was primarily driven by higher product sales volume in the first nine months of fiscal 2009 compared to 2008, predominantly in the Americas region, as we expanded our distributor base to include those that focus on high volume sales of entry-level products. While there were no material price changes between the periods, the shift in product mix towards our entry-level products had the effect of decreasing our average sales price. Although a significant volume of shipments occur towards the end of each of our quarterly reporting periods, including during the quarter ended September 30, 2009, management believes that the transition from a fiscal quarter ending on the Sunday closest to the calendar quarter end, to a calendar quarter end basis (which transition added three days to the nine months ended September 30, 2009), did not materially impact our product revenue as we manage our quarter end sales cycle based on our financial reporting period end. Services revenue increased \$26.4 million, or 35.0%, in the first nine months of fiscal 2009 compared to the same period in fiscal 2008 due to recognition of revenue from our growing deferred revenue balance consisting of subscription and support contracts sold to a larger customer base. The increase in services revenue also reflects additional services revenue amortization of approximately \$1.2 million due to our reporting period transition discussed above. The growth in ratable product and services revenue was due to a slight decrease in the weighted-average service period over which such revenue was recognized, due to a decrease in the average contractual term of support contracts for arrangements in which we recognized product and services revenue ratably over the performance period. We expect that the weighted-average service period over which ratable revenue is recognized will decrease over the remainder of fiscal 2009.

**Cost of revenue and gross margin**

	Nine Months Ended		Change	% Change
	September 28, 2008	September 30, 2009		
	(dollars in thousands)			
Cost of revenue				
Product	\$ 29,420	\$ 29,049	\$ (371)	(1.3)%
Services	14,751	15,955	1,204	8.2%
Ratable product and services	3,447	4,062	615	17.8%
<b>Total cost of revenue</b>	<b>\$ 47,618</b>	<b>\$ 49,066</b>	<b>\$ 1,448</b>	<b>3.0%</b>
Gross margin				
Product	57.0%	58.1%	1.1%	
Services	80.4%	84.3%	3.9%	
Ratable product and services	61.4%	60.6%	(0.8)%	
<b>Total gross margin</b>	<b>68.8%</b>	<b>73.0%</b>	<b>4.2%</b>	

Total gross margin increased 4.2 percentage points primarily due to higher mix of services revenue versus product revenue in the first nine months of fiscal 2009 compared to the same period in fiscal 2008. Product gross margin increased 1.1 percentage points in the first nine months of fiscal 2009 compared to the same period in fiscal 2008 primarily due to lower warranty-related return costs which resulted in a savings of \$2.5 million, partially offset by \$1.1 million related to the impairment and amortization of intangible assets in the first nine months of fiscal 2009. The 3.9 percentage point increase in services gross margin in the first nine months of fiscal 2009 was primarily due to growth in services revenue resulting from a larger customer base to leverage our support cost structure. Service cost increased by \$1.2 million primarily due to \$0.9 million of higher cash-based personnel costs related to headcount increases in our professional services and training teams and an increase of \$0.2 million in stock-based compensation. Ratable product and services gross margin was relatively unchanged in the period.

**Table of Contents***Operating Expenses*

	September 28, 2008		September 30, 2009		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
Nine Months Ended						
(dollars in thousands)						
Operating expenses						
Research and development	\$ 28,186	18.5%	\$ 31,207	17.2%	\$ 3,021	10.7%
Sales and marketing	65,900	43.1%	69,572	38.4%	3,672	5.6%
General and administrative	12,367	8.1%	13,678	7.5%	1,311	10.6%
<b>Total operating expenses</b>	<b>\$ 106,453</b>	<b>69.7%</b>	<b>\$ 114,457</b>	<b>63.1%</b>	<b>\$ 8,004</b>	<b>7.5%</b>
<i>Includes stock-based compensation of:</i>						
Research and development	\$ 727		\$ 1,392		\$ 665	
Sales and marketing	1,867		2,103		236	
General and administrative	932		1,243		311	
<b>Total</b>	<b>\$ 3,526</b>		<b>\$ 4,738</b>		<b>\$ 1,212</b>	

*Research and development expense*

Research and development expense increased \$3.0 million, or 10.7%, in the first nine months of fiscal 2009 from the same period in fiscal 2008 primarily due to an increase of \$2.2 million in cash-based personnel costs as we increased our headcount to support continued enhancements of our products. We also had an increase of \$0.7 million in stock-based compensation expense, an increase of \$0.2 million in depreciation expense and \$0.1 million of increased rent and occupancy-related expenses. These increases were partially offset by \$0.2 million in lower external test and certification costs.

*Sales and marketing expense*

For the first nine months of fiscal 2009, sales and marketing expense increased \$3.7 million, or 5.6%, primarily due to increased cash-based personnel costs of \$2.2 million based on increased headcount primarily in the U.S., a \$0.5 million increase in promotional and other marketing-related expenses, a \$0.3 million increase in rent and occupancy-related expenses, a \$0.2 million increase in travel, higher depreciation costs of \$0.2 million, and a \$0.2 million increase in stock-based compensation expense. These increases were partially offset by a \$0.3 million decrease in the use of outside services, including third-party outsourced marketing services. As a percentage of revenue, sales and marketing expenses decreased 4.7 percentage points as the productivity of our sales force improved.

*General and administrative expense*

For the first nine months of fiscal 2009, general and administrative expense increased \$1.3 million, or 10.6%, primarily due to a \$1.1 million increase in external legal and accounting-related services, a \$0.3 million increase in stock-based compensation and a \$0.3 million increase in



## Edgar Filing: FORTINET INC - Form S-1/A

rent and occupancy-related expenses. These increases were partially offset by a \$0.2 million decrease in travel expenses and a \$0.2 million decrease in supplies and other related expenses.

### *Interest income and other income (expense), net*

	Nine Months Ended		Change	% Change
	September 28, 2008	September 30, 2009		
	(dollars in thousands)			
Interest income	\$ 1,872	\$ 1,677	\$ (195)	(10.4)%
Other income (expense), net	171	148	(23)	*

\* not meaningful

**Table of Contents**

Despite higher balances of cash, cash equivalents and short-term investments during the first nine months of fiscal 2009, lower interest rates resulted in \$0.2 million of lower interest income than the same period in fiscal 2008. The increase in the first nine months of fiscal 2009 in other income (expense), net was due to an increase in foreign exchange gains primarily due to the strengthening of the U.S. dollar against the British pound and the Canadian dollar. The gain in the first nine months of fiscal 2008 was primarily due to the strengthening of the U.S. dollar against the Canadian dollar.

**Provision for income taxes**

	Nine Months Ended		Change	% Change
	September 28, 2008	September 30, 2009		
	(dollars in thousands)			
Provision for income taxes	\$ 1,277	\$ 3,466	\$ 2,189	171.4%
Effective tax rate	183.2%	17.6%	*	

\* not meaningful

The effective tax rate was 17.6% for the first nine months of fiscal 2009, compared with an effective tax rate of 183.2% for the first nine months of fiscal 2008. The provision for income taxes for the first nine months of fiscal 2009 is comprised of foreign income taxes, U.S. federal alternative minimum tax and state taxes. The provision for income taxes for the first nine months of fiscal 2008 is comprised primarily of foreign and state income taxes. The \$2.2 million increase in the provision for income taxes for the first nine months of fiscal 2009, compared with the first nine months of fiscal 2008, was attributable to an increase in U.S. alternative minimum tax, an increase in state taxes due to improved results during the first nine months of fiscal 2009, and an increase in foreign income tax expense, as tax expense for the nine months ended September 30, 2008 was reduced by realization of certain foreign tax credits.

**Fiscal Years 2008 and 2007****Revenue**

	Fiscal Year 2007		Fiscal Year 2008		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
	(dollars in thousands)					
Revenue						
Product	\$ 70,131	45.1%	\$ 94,587	44.7%	\$ 24,456	34.9%
Services	74,152	47.7%	105,292	49.7%	31,140	42.0%
Ratable product and services	11,083	7.2%	11,912	5.6%	829	7.5%
Total revenue	\$ 155,366	100.0%	\$ 211,791	100.0%	\$ 56,425	36.3%

**Revenue by Geography**

Americas	\$ 55,461	35.7%	\$ 75,367	35.6%	\$ 19,906	35.9%
EMEA	54,722	35.2%	79,755	37.7%	25,033	45.7%
APAC	45,183	29.1%	56,669	26.7%	11,486	25.4%

## Edgar Filing: FORTINET INC - Form S-1/A

Total revenue	\$ 155,366	100.0%	\$ 211,791	100.0%	\$ 56,425	36.3%
---------------	------------	--------	------------	--------	-----------	-------

Total revenue increased \$56.4 million, or 36.3%, in fiscal 2008 primarily as a result of growth in sales in the EMEA and Americas regions. Product revenue increased \$24.5 million, or 34.9%, in fiscal 2008 largely driven by increased sales of our higher-end products, consisting of our FortiGate-1000 to 5000 series, to large enterprises and service providers. While there were no material price changes between the periods, the shift in product mix towards our higher-end products had the effect of increasing our average sales price. In addition we experienced modest overall growth in sales volume. Services revenue increased \$31.1 million, or 42.0%, due to an increase in our installed customer base. The modest growth in ratable product and services revenue was due to the incremental amortization of new ratable product and services sales.

**Table of Contents***Cost of revenue and gross margin*

	Fiscal Year			% Change
	2007	2008	Change	
	(dollars in thousands)			
Cost of revenue				
Product	\$ 35,948	\$ 41,397	\$ 5,449	15.2%
Services	15,941	19,441	3,500	22.0%
Ratable product and services	4,763	4,634	(129)	(2.7)%
<b>Total cost of revenue</b>	<b>\$ 56,652</b>	<b>\$ 65,472</b>	<b>\$ 8,820</b>	<b>15.6%</b>
Gross margin				
Product	48.7%	56.2%	7.5%	
Services	78.5%	81.5%	3.0%	
Ratable product and services	57.0%	61.1%	4.1%	
<b>Total gross margin</b>	<b>63.5%</b>	<b>69.1%</b>	<b>5.6%</b>	

Total gross margin increased 5.6 percentage points in fiscal 2008 primarily due to improving product margins based on enhanced inventory management and a higher mix of services revenue. The 7.5 percentage point increase in product gross margin in fiscal 2008 was primarily due to a \$6.3 million excess inventory write-off taken in fiscal 2007 which reduced product gross margin by approximately nine percentage points in fiscal 2007. The 3.0 percentage point increase in services gross margin in fiscal 2008 was primarily due to higher revenue and a larger customer base which enabled us to leverage our support cost structure. Services cost increased \$3.5 million in fiscal 2008 primarily due to an increase of \$2.5 million in cash-based personnel costs resulting from increased headcount in our threat research centers and in our technical support centers in both the EMEA and Americas regions. Additional costs included a \$0.4 million increase in stock-based compensation expense and \$0.5 million of higher facility-related expenses to support the additional staffing requirements. Ratable gross margin increased in accordance with the respective product and services gross margin increases.

*Operating Expenses*

	2007		2008		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
	(dollars in thousands)					
Operating expenses						
Research and development	\$ 27,588	17.8%	\$ 37,035	17.5%	\$ 9,447	34.2%
Sales and marketing	72,159	46.4%	87,717	41.4%	15,558	21.6%
General and administrative	20,544	13.2%	16,640	7.9%	(3,904)	(19.0)%
<b>Total operating expenses</b>	<b>\$ 120,291</b>	<b>77.4%</b>	<b>\$ 141,392</b>	<b>66.8%</b>	<b>\$ 21,101</b>	<b>17.5%</b>

*Includes stock-based compensation of:*

Research and development	\$ 1,452	\$ 1,049	\$ (403)
Sales and marketing	3,928	2,512	(1,416)
General and administrative	2,983	1,271	(1,712)

Edgar Filing: FORTINET INC - Form S-1/A

Total	\$ 8,363	\$ 4,832	\$ (3,531)
-------	----------	----------	------------

The higher stock-based compensation expense in fiscal 2007 was primarily due to the remeasurement of the vested portion of certain option grants associated with extending the exercise period for employees that had terminated their employment with us. See Critical Accounting Policies and Estimates Stock-Based Compensation.

**Table of Contents***Research and development expense*

Research and development expense increased \$9.4 million, or 34.2%, in fiscal 2008 primarily due to an increase of \$8.1 million in cash-based personnel costs as a result of increased headcount, an increase of \$0.7 million in higher external test and certification costs and an increase of \$0.7 million for rent and occupancy-related expenses. These increases were partially offset by a \$0.4 million decrease in stock-based compensation expense.

*Sales and marketing expense*

Sales and marketing expense increased \$15.6 million, or 21.6%, in fiscal 2008 primarily due to increased cash-based personnel costs of \$12.2 million resulting from increased headcount in an effort to help drive our overall revenue growth. In fiscal 2008 we also had \$2.5 million in additional promotional and other marketing-related expenses, \$1.3 million of incremental rent and occupancy-related expenses and \$0.5 million from increased travel expenses. These increases were partially offset by a \$1.4 million decrease in stock-based compensation expense. As a result, sales and marketing expense as a percent of revenue decreased 5.0 percentage points in fiscal 2008.

*General and administrative expense*

The \$3.9 million decrease in general and administrative expense was primarily due to \$3.6 million in lower external accounting and legal services expenses in fiscal 2008 as compared to fiscal 2007 when we made investments in the automation of our financial processes. Cash-based personnel costs increased \$1.2 million as we incurred the full year costs from increased headcount in fiscal 2007 to support our growth and bad debt expense of \$0.2 million, offset by a decrease in stock-based compensation expense of \$1.7 million. As a result, general and administrative expense as a percent of revenue decreased 5.3 percentage points in fiscal 2008.

*Interest income and other income (expense), net*

	Fiscal Year			%
	2007	2008	Change	Change
	(dollars in thousands)			
Interest income	\$ 3,507	\$ 2,614	\$ (893)	(25.5)%
Other income (expense), net	(1,991)	1,710	3,701	*

\* not meaningful

The \$0.9 million decrease in interest income in fiscal 2008 was due to lower interest rates earned, despite higher balances of cash, cash equivalents and short-term investments. The gain in fiscal 2008 in other income (expense), net was the result of an increase in foreign exchange gains primarily due to the strengthening of the U.S. dollar against the Euro, British Pound and the Canadian dollar. The loss in fiscal 2007 was primarily due to the weakening of the U.S. dollar against the same three currencies.

*Provision for income taxes*

	Fiscal Year			
	2007	2008	Change	%
	(dollars in thousands)			Change
Provision for income taxes	\$ 1,781	\$ 1,888	\$ 107	6.0%
Effective tax rate	(8.9)%	20.4%	*	

\* not meaningful

**Table of Contents**

The effective tax rate was 20.4% for fiscal 2008, compared with an effective tax rate of negative 8.9% for fiscal 2007. The provision for income taxes for fiscal 2008 is comprised primarily of foreign income taxes and state taxes. We incurred tax expense despite a consolidated loss before income taxes for fiscal 2007 primarily due to foreign income taxes paid based on profits realized by our foreign subsidiaries. The increase in the provision for income taxes for fiscal 2008 compared to fiscal 2007 was attributable to an increase in state income taxes due to improved results in fiscal 2008, offset by a reduction in foreign income tax expense driven by the realization of certain foreign tax credits.

**Fiscal Years 2007 and 2006****Revenue**

	2006		2007		Change	% Change
	Amount	% of Revenue	Amount	% of Revenue		
			(dollars in thousands)			
Revenue						
Product	\$ 59,469	48.2%	\$ 70,131	45.1%	\$ 10,662	17.9%
Services	39,590	32.1%	74,152	47.7%	34,562	87.3%
Ratable product and services	24,407	19.7%	11,083	7.2%	(13,324)	(54.6)%
Total revenue	\$ 123,466	100.0%	\$ 155,366	100.0%	\$ 31,900	25.8%

**Revenue by Geography**

Americas	\$ 37,654	30.5%	\$ 55,461	35.7%	\$ 17,807	47.3%
EMEA	42,303	34.3%	54,722	35.2%	12,419	29.4%
APAC	43,509	35.2%	45,183	29.1%	1,674	3.8%
Total revenue	\$ 123,466	100.0%	\$ 155,366	100.0%	\$ 31,900	25.8%

Total revenue increased \$31.9 million, or 25.8%, in fiscal 2007 primarily driven by the Americas and EMEA regions. Product revenue increased \$10.7 million, or 17.9%, as we experienced increased volumes broadly across our FortiGate product line, with the majority of the growth in our entry-level and mid-range products below the FortiGate-1000. Product average sales prices and the product mix were relatively unchanged from period to period. Services revenue increased \$34.6 million, or 87.3%, due an increase in our installed customer base. The \$13.3 million decrease in ratable product and services revenues was due to the establishment of VSOE for a higher proportion of our sales transactions in fiscal 2006 and 2007 than in prior periods, resulting in a lower portion of our sales being recognized as ratable revenue.

**Cost of revenue and gross margin**

	Fiscal Year		Change	% Change
	2006	2007		
	(dollars in thousands)			
Cost of revenue				
Product	\$ 24,166	\$ 35,948	\$ 11,782	48.8%
Services	9,496	15,941	6,445	67.9%



Edgar Filing: FORTINET INC - Form S-1/A

Ratable product and services	7,302	4,763	(2,539)	(34.8)%
<b>Total cost of revenue</b>	<b>\$ 40,964</b>	<b>\$ 56,652</b>	<b>\$ 15,688</b>	<b>38.3%</b>
Gross margin				
Product	59.4%	48.7%	(10.7)%	
Services	76.0%	78.5%	2.5%	
Ratable product and services	70.1%	57.0%	(13.1)%	
Total gross margin	66.8%	63.5%	(3.3)%	

**Table of Contents**

Total gross margin decreased 3.3 percentage points from fiscal 2006 to fiscal 2007, primarily due to lower product gross margin associated with excess inventory write-offs. The 10.7 percentage point decrease in product gross margin was primarily attributable to a \$6.3 million excess inventory write-off taken in fiscal 2007, compared to a \$1.4 million write-off in fiscal 2006, resulting in a seven percentage point lower margin in fiscal 2007. Higher warranty-related return costs and freight costs also accounted for a total of four percentage point decrease in product gross margin in fiscal 2007 when compared to 2006. The 2.5 percentage point increase in services gross margin was primarily due to the growth in our services revenue exceeding the related costs of providing those services. Services cost increased \$6.4 million primarily due to \$3.6 million of higher cash-based personnel costs resulting from increased headcount. The increased headcount was widely distributed across all technical support centers worldwide and the threat research centers which are required to support our larger customer base. Additional costs included a \$1.5 million increase in general operating expenses such as depreciation, supplies and travel-related expenses and a \$0.2 million increase in facility-related expenses. In addition, stock-based compensation expense increased by \$0.4 million in fiscal 2007. The 13.1 percentage point reduction in ratable product and services gross margin was consistent with the decrease in product gross margins for the period.

**Operating expenses**

	Fiscal Year				Change	% Change
	2006	% of Revenue	2007	% of Revenue		
	Amount		Amount			
	(dollars in thousands)					
Operating expenses						
Research and development	\$ 21,446	17.4%	\$ 27,588	17.8%	\$ 6,142	28.6%
Sales and marketing	54,056	43.8%	72,159	46.4%	18,103	33.5%
General and administrative	12,997	10.5%	20,544	13.2%	7,547	58.1%
Total operating expenses	\$ 88,499	71.7%	\$ 120,291	77.4%	\$ 31,792	35.9%
<i>Includes stock-based compensation of:</i>						
Research and development	\$ 135		\$ 1,452		\$ 1,317	
Sales and marketing	354		3,928		3,574	
General and administrative	414		2,983		2,569	
Total	\$ 903		\$ 8,363		\$ 7,460	

The increase in stock-based compensation expense in 2007 was primarily due to the remeasurement of the vested portion of certain option grants associated with extending the exercise period for employees that had terminated their employment with us. See Critical Accounting Policies and Estimates Stock-Based Compensation.

**Research and development expense**

Research and development expense increased by \$6.1 million, or 28.6%, in fiscal 2007 primarily due to \$4.0 million in higher cash-based personnel costs as a result of increased headcount and a \$1.3 million increase in stock-based compensation expense. Higher depreciation expense of \$0.3 million, travel-related expenses of \$0.2 million, \$0.2 million of higher rent and occupancy-related expenses and \$0.2 million in higher expensed equipment and other supplies also contributed to the increase.

*Sales and marketing expense*

Sales and marketing expense increased \$18.1 million, or 33.5%, in fiscal 2007 due to increased cash-based personnel costs of \$11.2 million primarily resulting from increased headcount, particularly in the U.S. to expand

**Table of Contents**

our focus on large enterprise and service provider accounts. In addition to a \$3.6 million increase in stock-based compensation, we had an increase of \$1.2 million in travel-related expenses due to our expanded sales force, \$1.1 million of incremental promotional and other marketing expenses and a \$0.5 million increase in rent and occupancy-related expenses. Primarily as a result of increased cash-based and stock-based compensation expense, sales and marketing as a percent of revenue increased 2.6 percentage points in fiscal 2007.

*General and administrative expense*

General and administrative expense increased \$7.5 million, or 58.1%, in fiscal 2007 due to a \$2.9 million increase in cash-based personnel costs as a result of increased headcount, particularly in our accounting and finance functions to support our overall growth, a \$2.6 million increase in stock-based compensation and a \$2.0 million increase in external audit and accounting services as we invested in automation of financial processes. As a result, general and administrative expense as a percent of revenue increased 2.7 percentage points in fiscal 2007.

*Interest income and other income (expense), net*

	Fiscal Year		Change	% Change
	2006	2007		
	(dollars in thousands)			
Interest income	\$ 2,376	\$ 3,507	\$ 1,131	47.6%
Other income (expense), net	(503)	(1,991)	(1,488)	*

\* not meaningful

The \$1.1 million increase in interest income was due to interest earned on higher invested balances. The loss in fiscal 2007 in other income (expense), net was primarily due to the weakening of the U.S. dollar against the Euro, British Pound and the Canadian dollar. The loss in fiscal 2006 was primarily due to the weakening of the U.S. dollar against the Euro and British Pound.

*Provision for income taxes*

	Fiscal Year		Change	% Change
	2006	2007		
	(dollars in thousands)			
Provision for income taxes	\$ 1,220	\$ 1,781	\$ 561	46.0%
Effective tax rate	(29.6)%	(8.9)%	*	

\* not meaningful

The effective tax rate was negative 8.9% for fiscal 2007, compared with negative 29.6% for fiscal 2006. We incurred tax expense despite a consolidated loss before income taxes for fiscal 2007 and 2006 primarily due to foreign income taxes. The change in the provision for fiscal 2007 compared to fiscal 2006 was primarily attributable to increased profitability of our foreign operations.



**Table of Contents****Quarterly Results of Operations**

The following tables set forth selected unaudited quarterly statements of operations data for the last eleven fiscal quarters, as well as the percentage that each line item represents of total revenue. The information for each of these quarters has been prepared on the same basis as the audited annual financial statements included elsewhere in this prospectus and, in the opinion of management, includes all adjustments, which includes only normal recurring adjustments, necessary for the fair presentation of the results of operations for these periods. This data should be read in conjunction with our audited consolidated financial statements and related notes included elsewhere in this prospectus. These quarterly operating results are not necessarily indicative of our operating results for any future period.

	Apr 1, 2007	July 1, 2007	Sept 30, 2007	Dec 30, 2007	Three Months Ended			Dec 28, 2008	Mar 29, 2009	June 28, 2009	Sept 30, 2009 <sup>(1)</sup>
					Mar 30, 2008	June 29, 2008	Sept 28, 2008				
(in thousands)											
<b>Consolidated Statements of Operations Data:</b>											
Revenue											
Product	\$ 15,950	\$ 19,448	\$ 16,245	\$ 18,488	\$ 20,691	\$ 24,088	\$ 23,616	\$ 26,192	\$ 19,326	\$ 24,451	\$ 25,550
Services	15,195	16,902	19,551	22,504	22,312	25,455	27,627	29,898	31,573	33,473	36,712
Ratable product and services	3,456	2,461	2,538	2,628	2,761	3,004	3,171	2,976	3,295	3,421	3,602
Total revenue	34,601	38,811	38,334	43,620	45,764	52,547	54,414	59,066	54,194	61,345	65,864
Cost of revenue											
Product <sup>(2)</sup>	6,597	8,436	8,950	11,965	9,474	10,317	9,629	11,977	8,305	10,316	10,428
Services <sup>(2)</sup>	3,319	3,813	4,099	4,710	4,597	5,170	4,984	4,690	5,048	5,357	5,550
Ratable product and services	1,155	907	1,151	1,550	1,067	1,153	1,227	1,187	1,301	1,306	1,455
Total cost of revenue	11,071	13,156	14,200	18,225	15,138	16,640	15,840	17,854	14,654	16,979	17,433
Total gross profit	23,530	25,655	24,134	25,395	30,626	35,907	38,574	41,212	39,540	44,366	48,431
Operating expenses											
Research and development <sup>(2)</sup>	5,998	6,363	7,278	7,949	8,780	9,449	9,957	8,849	9,876	10,534	10,797
Sales and marketing <sup>(2)</sup>	15,967	17,776	17,677	20,739	21,556	22,910	21,434	21,817	21,763	24,341	23,468
General and administrative <sup>(2)</sup>	4,405	4,631	4,343	7,165	3,953	4,451	3,963	4,273	4,672	4,516	4,490
Total operating expenses	26,370	28,770	29,298	35,853	34,289	36,810	35,354	34,939	36,311	39,391	38,755
Operating income (loss)	(2,840)	(3,115)	(5,164)	(10,458)	(3,663)	(903)	3,220	6,273	3,229	4,975	9,676
Interest income	771	866	913	957	735	542	595	742	714	535	428
Other income (expense), net	(248)	(588)	(560)	(595)	(903)	199	875	1,539	494	(282)	(64)
Income (loss) before income taxes	(2,317)	(2,837)	(4,811)	(10,096)	(3,831)	(162)	4,690	8,554	4,437	5,228	10,040
Provision for income taxes	164	804	376	437	338	756	183	611	663	652	2,151
Net income (loss)	\$ (2,481)	\$ (3,641)	\$ (5,187)	\$ (10,533)	\$ (4,169)	\$ (918)	\$ 4,507	\$ 7,943	\$ 3,774	\$ 4,576	\$ 7,889

(1) Our transition to a calendar year and quarters beginning in the third quarter of fiscal 2009 had the effect of increasing the number of days in the nine months ended September 30, 2009 by three days relative to the nine months ended September 28, 2008.

## Edgar Filing: FORTINET INC - Form S-1/A

(2) Includes stock-based compensation expense as follows:

	Three Months Ended										
	Apr 1, 2007	July 1, 2007	Sept 30, 2007	Dec 30, 2007	Mar 30, 2008	June 29, 2008	Sept 28, 2008	Dec 28, 2008	Mar 29, 2009	June 28, 2009	Sept 30, 2009
	(in thousands)										
Cost of product revenue	\$ 181	\$ 147	\$ 175	\$ 48	\$ 9	\$ 18	\$ 19	\$ 21	\$ 24	\$ 27	\$ 25
Cost of services revenue	33	61	91	235	79	93	111	117	124	172	169
Research and development	268	308	640	235	162	266	299	322	378	498	516
Sales and marketing	1,262	1,055	914	697	559	661	647	645	644	692	767
General and administrative	316	321	386	1,959	253	322	357	339	380	404	459
<b>Total stock-based compensation</b>	<b>\$ 2,060</b>	<b>\$ 1,892</b>	<b>\$ 2,206</b>	<b>\$ 3,174</b>	<b>\$ 1,062</b>	<b>\$ 1,360</b>	<b>\$ 1,433</b>	<b>\$ 1,444</b>	<b>\$ 1,550</b>	<b>\$ 1,793</b>	<b>\$ 1,936</b>

**Table of Contents**

	Apr 1, 2007	July 1, 2007	Sept 30, 2007	Dec 30, 2007	Three Months Ended			Dec 28, 2008	Mar 29, 2009	June 28, 2009	Sept 30, 2009 <sup>(1)</sup>
					Mar 30, 2008	June 29, 2008	Sept 28, 2008				
	(as % of revenues)										
Revenue											
Product	46.1%	50.1%	42.4%	42.4%	45.2%	45.8%	43.4%	44.3%	35.7%	39.9%	38.8%
Services	43.9%	43.5%	51.0%	51.6%	48.8%	48.4%	50.8%	50.6%	58.3%	54.6%	55.7%
Ratable product and services	10.0%	6.4%	6.6%	6.0%	6.0%	5.8%					