FORTINET INC
Form 10-Q
November 07, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 001-34511

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o
		Emerging growth company	o

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

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

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As of October 31, 2018, there were 170,370,205 shares of the registrant’s common stock outstanding.

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

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

	September 30, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,169.3	$ 811.0
Short-term investments	464.9	440.3
Accounts receivable—Net	324.4	348.2
Inventory	80.8	77.3
Prepaid expenses and other current assets	38.7	40.0
Total current assets	2,078.1	1,716.8
LONG-TERM INVESTMENTS	38.6	98.0
PROPERTY AND EQUIPMENT—NET	265.4	245.4
DEFERRED CONTRACT COSTS	169.6	—
DEFERRED TAX ASSETS	147.8	146.9
OTHER INTANGIBLE ASSETS—NET	18.1	16.3
GOODWILL	25.7	14.6
OTHER ASSETS	20.2	19.9
TOTAL ASSETS	$ 2,763.5	$ 2,257.9
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 66.6	$ 70.0
Accrued liabilities	60.7	50.0
Accrued payroll and compensation	85.4	92.0
Income taxes payable	23.0	21.4
Deferred revenue	876.2	793.8
Total current liabilities	1,111.9	1,027.2
DEFERRED REVENUE	668.2	542.5
INCOME TAX LIABILITIES	80.7	90.2
OTHER LIABILITIES	11.1	8.6
Total liabilities	1,871.9	1,668.5
COMMITMENTS AND CONTINGENCIES (Note 10)		
STOCKHOLDERS' EQUITY:		
Common stock, $0.001 par value—300 shares authorized; 170.3 and 167.9 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	0.2	0.2
Additional paid-in capital	1,048.4	909.6
Accumulated other comprehensive loss	(1.0)	(0.8)
Accumulated deficit	(156.0)	(319.6)
Total stockholders' equity	891.6	589.4
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 2,763.5	$ 2,257.9

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
REVENUE:				
Product	$164.5	$ 137.1	$473.6	$ 415.1
Service	289.4	237.1	820.6	663.2
Total revenue	453.9	374.2	1,294.2	1,078.3
COST OF REVENUE:				
Product	72.0	58.1	204.1	174.2
Service	39.6	35.5	117.8	105.7
Total cost of revenue	111.6	93.6	321.9	279.9
GROSS PROFIT:				
Product	92.5	79.0	269.5	240.9
Service	249.8	201.6	702.8	557.5
Total gross profit	342.3	280.6	972.3	798.4
OPERATING EXPENSES:				
Research and development	58.7	53.5	179.0	155.9
Sales and marketing	198.3	172.4	576.4	509.1
General and administrative	22.5	21.0	71.0	65.5
Restructuring charges	—	—	—	0.3
Total operating expenses	279.5	246.9	826.4	730.8
OPERATING INCOME	62.8	33.7	145.9	67.6
INTEREST INCOME—NET	6.9	3.9	17.2	9.5
OTHER INCOME (EXPENSE)—NET	0.9	0.4	(4.3)	1.9
INCOME BEFORE INCOME TAXES	70.6	38.0	158.8	79.0
PROVISION FOR INCOME TAXES	11.9	11.3	9.2	18.6
NET INCOME	$58.7	$ 26.7	$149.6	$ 60.4
Net income per share (Note 9):				
Basic	$0.35	$ 0.15	$0.89	$ 0.34
Diluted	$0.33	$ 0.15	$0.86	$ 0.34
Weighted-average shares outstanding:				
Basic	169.8	175.5	168.7	175.3
Diluted	175.7	179.0	173.7	179.0

See notes to condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Net income	$ 58.7	$ 26.7	$ 149.6	$ 60.4
Other comprehensive income (loss):				
Change in unrealized gains (losses) on investments	0.5	0.2	(0.1)	0.5
Tax provision related to change in unrealized gains (losses) on investments	0.1	0.1	0.1	0.2
Other comprehensive income (loss)	0.4	0.1	(0.2)	0.3
Comprehensive income	$ 59.1	$ 26.8	$ 149.4	$ 60.7

See notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	September 30, 2018	September 30, 2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$149.6	$ 60.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation	120.3	102.7
Amortization of deferred contract costs	66.3	—
Depreciation and amortization	41.0	41.2
Other	(1.7)	3.2
Amortization of investment premiums	—	2.1
Changes in operating assets and liabilities:		
Accounts receivable—net	38.0	51.4
Inventory	(19.0)	17.7
Prepaid expenses and other current assets	1.8	(9.6)
Deferred contract costs	(98.8)	—
Deferred tax assets	(19.1)	(22.1)
Other assets	(3.3)	(0.4)
Accounts payable	(4.9)	(16.5)
Accrued liabilities	(2.0)	8.0
Accrued payroll and compensation	(8.6)	(3.5)
Other liabilities	(2.8)	(3.8)
Deferred revenue	209.9	184.4
Income taxes payable	(8.0)	21.7
Net cash provided by operating activities	458.7	436.9
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(405.2)	(359.6)
Sales of investments	39.6	10.0
Maturities of investments	405.6	329.1
Purchases of property and equipment	(41.4)	(121.6)
Payments made in connection with business combination, net of cash acquired	(6.0)	—
Net cash used in investing activities	(7.4)	(142.1)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repurchase and retirement of common stock	(117.1)	(124.0)
Proceeds from issuance of common stock	81.6	61.9
Taxes paid related to net share settlement of equity awards	(48.0)	(35.9)
Payments of debt assumed in connection with business combination	(9.5)	—
Net cash used in financing activities	(93.0)	(98.0)
NET INCREASE IN CASH AND CASH EQUIVALENTS	358.3	196.8
CASH AND CASH EQUIVALENTS—Beginning of period	811.0	709.0
CASH AND CASH EQUIVALENTS—End of period	$1,169.3	$ 905.8
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Transfers of evaluation units from inventory to property and equipment	$16.2	$ 16.3
Liability for purchase of property and equipment and asset retirement obligations	$6.7	$ 8.6

See notes to condensed consolidated financial statements.

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FORTINET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Preparation—The unaudited condensed consolidated financial statements of Fortinet, Inc. and its wholly owned subsidiaries (collectively, “we,” “us” or “our”) have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information, as well as the instructions to Form 10-Q pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements, and should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2017, contained in our Annual Report on Form 10-K filed with the SEC on February 26, 2018 (the “Form 10-K”). In the opinion of management, all adjustments, which includes normal recurring adjustments, considered necessary for a fair presentation have been included. All intercompany balances, transactions and cash flows have been eliminated. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the results for the full year or for any future periods. The condensed consolidated balance sheet as of December 31, 2017 is derived from the audited consolidated financial statements for the year ended December 31, 2017.

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

There have been no material changes to our significant accounting policies as of and for the three and nine months ended September 30, 2018, except for the accounting policies for revenue recognition, trade receivables and deferred contract costs that were updated as a result of adopting Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers (Topic 606) (“Topic 606”). For more information, refer to the “Recently Adopted Accounting Standards” and Note 2.

Recently Adopted Accounting Standards

Financial Instruments – Recognition and Measurement

In January 2016, the Financial Accounting Standard Board (“FASB”) issued ASU 2016-01—Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, with further clarifications made recently with the issuance of ASU 2018-03, which requires most equity investments to be measured at fair value, with subsequent changes in fair value recognized in net income. A practicality exception applies to those equity investments that do not have a readily determinable fair value. These investments may be measured at cost, adjusted for changes in observable prices minus impairment. ASU 2016-01 was effective prospectively for us beginning on January 1, 2018 for our equity investments, which were previously accounted for under the cost-method. We adopted ASU 2016-01 on January 1, 2018. There was no material impact on our condensed consolidated financial statements as of the adoption date.

Revenue Recognition

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

We recorded a net reduction to our accumulated deficit as of January 1, 2018 of $117.3 million due to the cumulative impact of adopting Topic 606. The primary impact of adopting Topic 606 relates to the deferral of our incremental contract costs, which are comprised of sales commissions. Prior to January 1, 2018, we expensed all sales commissions upfront. Beginning on January 1, 2018, we continue to expense sales commissions related to product sales upfront, but capitalize and then amortize certain sales commissions on service contracts over the applicable amortization period. The capitalized sales commissions for initial service contracts are deferred and then amortized as expense on a straight-line basis over the period of benefit which we have determined to be five years. Sales commissions for renewal contracts are deferred and then amortized on a straight line basis over the contractual period of the underlying contracts. The deferral of sales commissions generated a deferred tax liability of $23.8 million, of which $18.0 million was recorded against deferred tax assets and the remaining $5.8

million was recorded in other long-term liabilities on our condensed consolidated balance sheet. The impact on deferred revenue as of January 1, 2018 was $4.1 million, which primarily relates to certain changes in revenue recognition on software license sales and the acceleration of revenue from U.S.-based channel partners which were previously deferred until the product was sold through. Beginning on January 1, 2018, our sales returns reserve is now included on the balance sheet in accrued liabilities and no longer as a reduction to our accounts receivable. See Note 2 for further details.

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

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

Recent Accounting Standards Not Yet Effective

Leases

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

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Stock Compensation

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

Cloud Computing

In August 2018, the FASB issued ASU 2018-15—Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract, which requires a customer in a cloud computing arrangement that is a service contract to follow the internal-use software guidance in ASC Subtopic 350-40 to determine which implementation costs to capitalize as assets or expense as incurred. ASU 2018-15 is effective for us beginning January 1, 2020, and early adoption is permitted. We are currently evaluating the impact of ASU 2018-15 on our consolidated financial statements.

Fair Value Measurements

In August 2018, the FASB issued ASU 2018-13—Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement, which eliminates, adds and modifies certain disclosure requirements for fair value measurements in ASC 820—Fair Value Measurement as part of its disclosure framework project. ASU 2018-13 is effective for us beginning January 1, 2020. The amendments in ASU 2018-13 on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption. All other amendments in ASU 2018-13 should be applied retrospectively to all periods presented upon their effective date. Early adoption is permitted upon issuance of ASU 2018-13. An entity is permitted to early adopt any removed or modified disclosures upon issuance of ASU 2018-13 and delay adoption of the additional disclosures until their effective date. We are currently evaluating the impact of ASU 2018-13 on our consolidated financial statements.

Comprehensive Income

In February 2018, the FASB issued ASU 2018-02—Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which allows companies to reclassify stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017 (the “2017 Tax Act”), from accumulated other comprehensive income to retained earnings. ASU 2018-02 also requires certain new disclosures regardless of the election. ASU 2018-02 is effective for us beginning January 1, 2019, and early adoption is permitted. We are currently evaluating the impact of ASU 2018-02 on our consolidated financial statements.

Financial Instruments

In June 2016, the FASB issued ASU 2016-13—Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which requires a financial asset (or a group of financial assets) measured at an amortized cost basis to be presented at the net amount expected to be collected. The new approach to estimating credit losses (referred to as the current expected credit losses model) applies to most financial assets measured at amortized cost and certain other instruments, including trade and other receivables, loans and held-to-maturity debt securities. ASU 2016-13 is effective for us beginning on January 1, 2020, and early adoption is permitted. We are currently evaluating the impact of ASU 2016-13 on our consolidated financial statements.

2. REVENUE RECOGNITION

Revenue recognition

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

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

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

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

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

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

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

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

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

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

In certain circumstances, our contracts include provisions for sales rebates and other customer incentive programs. Additionally, in limited circumstances, we may permit end-customers, distributors and resellers to return our products, subject to varying limitations, for a refund within a reasonably short period from the date of purchase. These amounts are accounted for as variable consideration that can decrease the transaction price. We estimate variable consideration at the most likely amounts to which we expect our customers to be entitled. We include estimated amounts in the transaction price to the extent that it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. Our estimate for sales return reserve was $13.7 million as of September 30, 2018 and is included in current liabilities in our condensed consolidated balance sheet. Under Topic 605, a sales return reserve of $13.6 million was presented as a reduction to accounts receivable as of December 31, 2017.

We generally invoice at the time of our sale for the total price of the hardware, software licenses, security and technical support and other services, and the invoice is payable within 30 to 45 days. We also invoice certain services on a monthly basis. Amounts billed and due from our customers are classified as receivables on the balance sheet and do not bear interest. Our deferred revenue primarily consists of amounts that have been invoiced but have not been recognized as revenue as of period end.

During the three and nine months ended September 30, 2018, we recognized $173.0 million and $615.3 million, respectively, in revenue that was included in the deferred revenue balance as of December 31, 2017.

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

Disaggregation of Revenue

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017 [1]	September 30, 2018	September 30, 2017 [1]
Product	$164.5	$ 137.1	$473.6	$ 415.1
Service:				
Security subscription	157.0	130.8	440.7	366.3
Technical support	121.4	96.1	347.4	267.3
Professional services and training	11.0	10.2	32.5	29.6
Total service revenue	289.4	237.1	820.6	663.2
Total revenue	$453.9	$ 374.2	$1,294.2	$ 1,078.3

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

Transaction Price Allocated to the Remaining Performance Obligations

As of September 30, 2018, we had $1.54 billion in remaining performance obligations, which is substantially comprised of deferred security subscription and technical support services not yet delivered. We expect to recognize revenue on approximately 80% of these remaining performance obligations over the next one to two years, with the remaining balance to be recognized in three to five years.

Accounts Receivable

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

Contract Assets

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

Deferred Contract Costs

Sales commissions earned by our sales force are considered incremental and recoverable costs of obtaining a contract with a customer. Sales commissions for the sale of products and software licenses are recognized at the time of sale.

Sales commissions for initial service contracts are deferred and then amortized as an expense on a straight-line basis over the period of benefit which we have determined to be five years. We determined the period of benefit taking into consideration our customer contracts, our technology and other factors. Sales commissions for renewal contracts are deferred and then amortized on a straight line basis over the contractual period of the underlying contracts which ranges from one to three years and, to a lesser extent, five years. The amortization of deferred contract costs is included in sales and marketing expense in our condensed consolidated statement of operations. Amortization of deferred contract costs during the three and nine months ended September 30, 2018 was $23.2 million and $66.3 million, respectively. No impairment loss was recognized during the three and nine months ended September 30, 2018.

Practical Expedient

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Impact on Condensed Consolidated Financial Statements

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

Condensed Consolidated Balance Sheet

	As of September 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Assets:			
Accounts receivable	$324.4	$310.7	$ 13.7
Inventory	$80.8	$81.9	$ (1.1)
Deferred contract costs	$169.6	$—	$ 169.6
Deferred tax assets	$147.8	$175.6	$ (27.8)
Liabilities:			
Accrued liabilities	$60.7	$45.5	$ 15.2
Deferred revenue, current	$876.2	$896.6	$ (20.4)
Deferred revenue, non-current	$668.2	$667.0	$ 1.2
Other liabilities, non-current	$11.1	$5.2	$ 5.9
Stockholders' Equity			
Accumulated deficit	$(156.0)	$(308.5)	$ 152.5

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

Condensed Consolidated Statement of Operations

	Three Months Ended September 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
REVENUE:			
Product [1]	$164.5	$ 162.3	$ 2.2
Service	289.4	289.6	(0.2)
Total revenue	453.9	451.9	2.0
COSTS OF REVENUE:			
Product	72.0	72.3	(0.3)
GROSS PROFIT:			
Product	92.5	90.0	2.5
Service	249.8	250.0	(0.2)
Total gross profit	342.3	340.0	2.3
OPERATING EXPENSES:			
Sales and marketing expenses	198.3	207.3	(9.0)
OPERATING INCOME	62.8	51.5	11.3
INCOME BEFORE INCOME TAXES	70.6	59.3	11.3
PROVISION FOR INCOME TAXES	11.9	9.8	2.1
NET INCOME	$58.7	$ 49.5	$ 9.2
Net income per share:			
Basic	$0.35	$ 0.29	$ 0.05
Diluted	$0.33	$ 0.28	$ 0.05

[1] Product revenue during the three months ended September 30, 2018 included a $2.2 million benefit from the adoption of Topic 606, which primarily related to the change in accounting treatment under Topic 606 for some of our software products where revenue from these arrangements is now recognized upfront instead of ratably over the contracted service term.

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

	Nine Months Ended September 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
REVENUE:			
Product [1]	$473.6	$ 461.5	$ 12.1
Service	820.6	819.1	1.5
Total revenue	1,294.2	1,280.6	13.6
COST OF REVENUE:			
Product	204.1	203.1	1.0
GROSS PROFIT:			
Product	269.5	258.4	11.1
Service	702.8	701.3	1.5
Total gross profit	972.3	959.7	12.6
OPERATING EXPENSES			
Sales and marketing expenses	576.4	608.9	(32.5)
OPERATING INCOME	145.9	100.8	45.1
INCOME BEFORE INCOME TAXES	158.8	113.7	45.1
BENEFIT FROM INCOME TAXES	9.2	(0.7)	9.9
NET INCOME	$149.6	$ 114.4	$ 35.2
Net income per share:			
Basic	$0.89	$ 0.68	$ 0.21
Diluted	$0.86	$ 0.66	$ 0.20

[1] Product revenue during the nine months ended September 30, 2018 included a $12.1 million benefit from the adoption of Topic 606, which primarily related to the change in accounting treatment under Topic 606 for some of our software products where revenue from these arrangements is now recognized upfront instead of ratably over the contracted service term.

Condensed Consolidated Statement of Cash Flows

	Nine Months Ended September 30, 2018		
	As Reported	Balances Without Adoption of Topic 606	Effect of Change Increase (Decrease)
Cash flows from operating activities:			
Net income	$149.6	$ 114.4	$ 35.2
Adjustments to reconcile net income to net cash provided by operating activities:			

Amortization of deferred contract costs	66.3	—	66.3
Other	(1.7)	(1.6)	(0.1)
Changes in operating assets and liabilities:			
Inventory	(19.0)	(20.0)	1.0
Deferred contract costs	(98.8)	—	(98.8)
Deferred tax assets	(19.1)	(29.0)	9.9
Accrued liabilities	(2.0)	(3.5)	1.5
Deferred revenue	209.9	224.9	(15.0)
Net cash provided by operating activities	$458.7	$ 458.7	$ —

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

3. FINANCIAL INSTRUMENTS AND FAIR VALUE

The following tables summarize our investments (in millions):

	September 30, 2018			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate debt securities	$296.6	$ —	$ (1.2)	$295.4
Certificates of deposit and term deposits [1]	106.1	—	—	106.1
Commercial paper	72.5	—	(0.1)	72.4
U.S. government and agency securities	29.7	—	(0.1)	29.6
Total available-for-sale securities	$504.9	$ —	$ (1.4)	$503.5

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

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

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

	September 30, 2018					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	$163.1	$ (0.3)	$94.5	$ (0.9)	$257.6	$ (1.2)
Commercial paper	90.5	(0.1)	—	—	90.5	(0.1)
Certificates of deposit and term deposits	35.9	—	—	—	35.9	—
U.S. government and agency securities	26.2	—	3.5	(0.1)	29.7	(0.1)
Total available-for-sale securities	$315.7	$ (0.4)	$98.0	$ (1.0)	$413.7	$ (1.4)

	December 31, 2017					
	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate debt securities	$317.4	$ (0.9)	$58.2	$ (0.3)	$375.6	$ (1.2)
Certificates of deposit and term deposits	37.2	—	—	—	37.2	—

Commercial paper	29.0	—	—	—	29.0	—
U.S. government and agency securities	17.0	—	11.4	(0.1)	28.4	(0.1)
Total available-for-sale securities	$400.7	$ (0.9)	$69.6	$ (0.4)	$470.3	$ (1.3)

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

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

	September 30, 2018	December 31, 2017
Due within one year	$ 464.9	$ 440.3
Due within one to three years	38.6	98.0
Total	$ 503.5	$ 538.3

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

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

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

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

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

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

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

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

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

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

Fair Value of Financial Instruments

Assets Measured at Fair Value on a Recurring Basis

The following tables present the fair value of our financial assets measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017 (in millions):

	September 30, 2018				December 31, 2017			
	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Significant Other Unobservable Remaining Inputs (Level 3)	Aggregate Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Remaining Inputs (Level 2)	Significant Other Unobservable Remaining Inputs (Level 3)
Assets:								
Corporate debt securities	$295.4	$ —	$ 295.4	$ —	$411.1	$ —	$ 411.1	$ —
Certificates of deposit and term deposits	228.3	—	228.3	—	132.1	—	132.1	—
Money market funds	139.0	139.0	—	—	195.6	195.6	—	—
Commercial paper	121.0	—	121.0	—	128.9	—	128.9	—
U.S. government and agency securities	29.6	26.1	3.5	—	28.4	24.9	3.5	—
Total	$813.3	$ 165.1	$ 648.2	$ —	$896.1	$ 220.5	$ 675.6	$ —
Reported as:								
Cash equivalents	$309.8				$357.8			
Short-term investments	464.9				440.3			
Long-term investments	38.6				98.0			
Total	$813.3				$896.1			

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

4. INVENTORY

Inventory consisted of the following (in millions):

	September 30, 2018	December 31, 2017
Raw materials	$ 12.5	$ 13.0
Finished goods	68.3	64.3
Inventory	$ 80.8	$ 77.3

Inventory includes materials at contract manufacturers of $2.9 million and $2.6 million as of September 30, 2018 and December 31, 2017, respectively. Inventory also includes finished goods held by distributors where revenue is recognized on a sell-through basis of $0.1 million as of December 31, 2017.

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

5. PROPERTY AND EQUIPMENT—Net

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

	September 30, 2018	December 31, 2017
Building and building improvements	$ 138.6	$ 133.2
Computer equipment and software	95.0	79.9
Land	75.7	65.6
Leasehold improvements	21.9	20.8
Evaluation units	20.2	20.1
Furniture and fixtures	16.7	14.7
Construction-in-progress	11.5	6.3
Total property and equipment	379.6	340.6
Less: accumulated depreciation	(114.2)	(95.2)
Property and equipment—net	$ 265.4	$ 245.4

Depreciation expense was $11.8 million and $11.7 million during the three months ended September 30, 2018 and September 30, 2017, respectively. Depreciation expense was $34.9 million and $34.7 million during the nine months ended September 30, 2018 and September 30, 2017, respectively.

6. INVESTMENTS IN PRIVATELY HELD COMPANIES

Our investments in the equity securities of privately held companies totaled $9.1 million as of September 30, 2018 and $12.1 million as of December 31, 2017. These investments, which were previously accounted for at cost, are now accounted for at cost, adjusted for changes in observable prices minus impairment. We own less than 20% of the voting securities in each of these investments and do not have the ability to exercise significant influence over operating and financial policies of the respective entities. These investments are carried at historical cost and are recorded as other assets on our condensed consolidated balance sheets and would be measured at fair value if indicators of impairment existed. During the three months ended September 30, 2018, we sold equity securities of a privately held company for $5.2 million and recognized a gain of $2.2 million as other income in our condensed consolidated statements of operations. As of September 30, 2018, no other events have occurred that would adversely affect the carrying value of our remaining investments.

As of September 30, 2018, we determined that we had a variable interest in these privately held companies. However, we determined that we were not the primary beneficiary as we did not have the power to direct their activities that most significantly affect their economic performance. The variable interest entities are not required to be consolidated in our condensed consolidated financial statements.

7. BUSINESS COMBINATION

Bradford Networks, Inc.

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

Under the business combination method of accounting, the total purchase price was allocated to Bradford’s net tangible and intangible assets based upon their estimated fair values as of June 4, 2018. The purchase price allocation was preliminary and was based on management's best estimates and assumptions as of the reporting date. During the three months ended September 30, 2018, we subsequently decreased the intangible assets by $0.8 million with a corresponding change to goodwill of $0.6 million and deferred tax asset of $0.2 million. The preliminary purchase price for Bradford was $6.8 million, of which $11.1 million was allocated to goodwill that was non-deductible for tax purposes, and $8.0 million was allocated to identifiable intangible assets offset by $12.3 million of net liabilities assumed.

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

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

8. GOODWILL AND OTHER INTANGIBLE ASSETS—Net

Goodwill

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

	Amount
Balance—December 31, 2017	$ 14.6
Addition due to business combination	11.1
Balance—September 30, 2018	$ 25.7

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

Other Intangible Assets—net

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

	September 30, 2018			
	Weighted-Average Useful Life (in Years)	Gross	Accumulated Amortization	Net
Other intangible assets—net:				
Finite-lived intangible assets:				
Developed technologies and other	3.8	$31.4	$ 18.1	$13.3
Customer relationships	4.5	16.7	11.9	4.8
Total other intangible assets—net		$48.1	$ 30.0	$18.1

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

Total other intangible assets—net	$40.1	$ 23.8	$16.3

The in-process research and development intangible asset of $1.6 million was completed in the three months ended March 31, 2018. Upon completion, the cost was transferred to developed technology and is amortized over the estimated useful life of four years.

Amortization expense was $2.5 million and $2.0 million during the three months ended September 30, 2018 and September 30, 2017, respectively. Amortization expense was $6.1 million and $6.5 million during the nine months ended September 30, 2018 and September 30, 2017, respectively.
The following table summarizes estimated future amortization expense of finite-lived intangible assets—net (in millions):

	Amount
Years:	
2018	$ 2.5
2019	8.2
2020	4.6
2021 and thereafter	2.8
Total	$ 18.1

9. NET INCOME PER SHARE

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

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Numerator:				
Net income	$ 58.7	$ 26.7	$ 149.6	$ 60.4
Denominator:				
Basic shares:				
Weighted-average common stock outstanding-basic	169.8	175.5	168.7	175.3
Diluted shares:				
Weighted-average common stock outstanding-basic	169.8	175.5	168.7	175.3
Effect of potentially dilutive securities:				
RSUs	4.2	2.1	3.5	2.2
Stock options	1.6	1.3	1.4	1.4
ESPP	0.1	0.1	0.1	0.1
Weighted-average shares used to compute diluted net income per share	175.7	179.0	173.7	179.0
Net income per share:				
Basic	$ 0.35	$ 0.15	$ 0.89	$ 0.34
Diluted	$ 0.33	$ 0.15	$ 0.86	$ 0.34

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
RSUs	0.3	1.0	0.6	1.6
Stock options	—	1.1	0.4	1.1
ESPP	0.2	0.4	0.1	0.2
Total	0.5	2.5	1.1	2.9

10. COMMITMENTS AND CONTINGENCIES

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

	Total	2018	2019	2020	2021	2022	Thereafter
Operating lease commitments	$52.0	$4.1	$15.3	$11.6	$8.0	$5.0	$ 8.0
Inventory purchase commitments	174.0	111.1	58.7	4.2	—	—	—
Total	$226.0	$115.2	$74.0	$15.8	$8.0	$5.0	$ 8.0

Operating Leases—We lease certain facilities under various non-cancelable operating leases, which expire through 2026. Certain leases require us to pay variable costs such as taxes, maintenance, and insurance. The terms of certain operating leases also provide for renewal options and escalation clauses. Rent expense was $4.4 million and $4.1 million during the three months ended September 30, 2018 and September 30, 2017, respectively. Rent expense was $13.1 million and $12.5 million during the nine months ended September 30, 2018 and September 30, 2017, respectively. Rent expense is recognized using the straight-line method over the term of the lease.

Inventory Purchase Commitments—Our independent contract manufacturers procure components and build our products based on our forecasts. These forecasts are based on estimates of future demand for our products, which are in turn based on historical trends and an analysis from our sales and marketing organizations, adjusted for overall market conditions. In order to reduce manufacturing lead times and plan for adequate component supply, we may issue purchase orders to some of our independent contract manufacturers which may not be cancelable. As of September 30, 2018, we had $174.0 million of open purchase orders with our independent contract manufacturers that may not be cancelable.

Other Contractual Commitments and Open Purchase Orders—In addition to commitments with contract manufacturers, we have open purchase orders and contractual obligations in the ordinary course of business for which we have not received goods or services. As of September 30, 2018, we had $11.6 million in other contractual commitments having a remaining term in excess of one year that may not be cancelable.

Litigation—We are involved in disputes, litigation, and other legal actions. For lawsuits where we are the defendant, we are in the process of defending these litigation matters, and there can be no assurances and the outcome of these matters is currently not determinable. There are many uncertainties associated with any litigation and these actions or other third-party claims against us may cause us to incur costly litigation fees, including contingent legal fees with related parties, costs and substantial settlement charges, and possibly subject us to damages and other penalties. In addition, the resolution of any intellectual property litigation may require us to make royalty payments, which could adversely affect our gross margins in future periods. If any of those events were to occur, our business, financial condition, results of operations, and cash flows could be adversely affected. The actual liability in any such matters may be materially different from our estimates, if any, which could result in the need to adjust the liability and record additional expenses. As required under ASC 450, Contingencies, issued by the FASB, we accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss.

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

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

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

11. STOCKHOLDERS’ EQUITY

Stock-Based Compensation Plans

We have stock-based compensation plans pursuant to which we have granted RSUs and stock options. We also have an ESPP for eligible employees. As of September 30, 2018, there were a total of 54.5 million shares of common stock available for grant under our stock-based compensation plans.

Restricted Stock Units

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

	Restricted Stock Units Outstanding	
	Number of Shares	Weighted-Average Grant Date Fair Value per Share
Balance—December 31, 2017	7.5	$ 34.79
Granted	3.7	54.82
Forfeited	(0.7)	38.24
Vested	(3.1)	34.32
Balance—September 30, 2018	8.4	$ 44.48

As of September 30, 2018, total compensation expense related to unvested RSUs granted to employees and non-employees under the 2009 Plan, but not yet recognized, was $331.7 million. This expense is expected to be amortized on a straight-line basis over a weighted-average vesting period of 2.8 years.

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

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

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Shares withheld for taxes	0.2	0.3	0.9	1.0
Amount withheld for taxes	$ 15.5	$ 10.0	$ 48.0	$ 35.9

Employee Stock Options

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Expected term in years	4.4	4.4	4.4	4.4
Volatility	30.5 %	33.1 %	31.6 %	36.1 %
Risk-free interest rate	2.7 %	1.8 %	2.7 %	1.9 %
Dividend rate	— %	— %	— %	— %

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

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Balance—December 31, 2017	4.3	$ 27.50		
Granted	0.8	51.29		
Forfeited	(0.1)	31.90		
Exercised	(1.8)	24.74		
Balance—September 30, 2018	3.2	$ 34.69		
Options vested and expected to vest—September 30, 2018	3.2	$ 34.69	4.13	$ 183.4
Options exercisable—September 30, 2018	1.6	$ 28.42	2.75	$ 104.9

The aggregate intrinsic value represents the difference between the exercise price of stock options and the quoted market price of our common stock on September 30, 2018, for all in-the-money stock options. As of September 30, 2018, total compensation expense related to unvested stock options granted to employees but not yet recognized was $18.1 million. This expense is expected to be amortized on a straight-line basis over a weighted-average period of 2.7 years.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Weighted-average fair value per share granted	$22.75	$ 11.09	$15.67	$ 12.17
Intrinsic value of options exercised	14.1	3.4	53.6	30.3
Fair value of options vested	1.4	1.6	5.7	6.7

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Employee Stock Purchase Plan

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Expected term in years	0.5	0.5	0.5	0.5
Volatility	30.5 %	26.2 %	28.9 %	29.5 %
Risk-free interest rate	2.2 %	1.2 %	2.0 %	0.9 %
Dividend rate	— %	— %	— %	— %

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Weighted-average fair value per share granted	$18.28	$ 8.31	$14.14	$ 8.73
Shares issued under the ESPP	0.4	0.5	1.1	1.1
Weighted-average price per share issued	$41.89	$ 31.49	$35.32	$ 29.52

Stock-based Compensation Expense

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

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Cost of product revenue	$ 0.3	$ 0.3	$ 1.1	$ 1.0
Cost of service revenue	2.8	2.4	8.0	7.2
Research and development	9.3	8.0	26.9	24.1
Sales and marketing	26.0	19.6	70.5	58.4
General and administrative	4.8	4.0	13.8	