NETGEAR, INC
Form 10-Q
October 30, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the quarterly period ended September 27, 2015.
¨ 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: 000-50350
NETGEAR, Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	77-0419172 (IRS Employer Identification No.)
350 East Plumeria Drive, San Jose, California	95134
(Address of principal executive offices)	(Zip Code)

(408) 907-8000
(Registrant's telephone number including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer	x	Accelerated filer	¨
Non-Accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No x
The number of outstanding shares of the registrant's Common Stock, $0.001 par value, was 31,509,309 as of October 23, 2015.

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PART I: FINANCIAL INFORMATION
Item 1. Financial Statements
NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	September 27, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$202,429	$141,234
Short-term investments	61,419	115,895
Accounts receivable, net	274,173	275,689
Inventories	170,013	222,883
Deferred income taxes	29,430	29,039
Prepaid expenses and other current assets	31,019	38,225
Total current assets	768,483	822,965
Property and equipment, net	23,951	29,694
Intangibles, net	53,191	66,230
Goodwill	81,721	81,721
Other non-current assets	47,405	48,077
Total assets	$974,751	$1,048,687
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$98,171	$106,357
Accrued employee compensation	21,414	21,588
Other accrued liabilities	132,911	143,742
Deferred revenue	30,722	30,023
Income taxes payable	5,258	2,406
Total current liabilities	288,476	304,116
Non-current income taxes payable	14,402	15,252
Other non-current liabilities	10,412	7,754
Total liabilities	313,290	327,122
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock	32	35
Additional paid-in capital	474,875	454,144
Accumulated other comprehensive income (loss)	(43)	38
Retained earnings	186,597	267,348
Total stockholders' equity	661,461	721,565
Total liabilities and stockholders' equity	$974,751	$1,048,687

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Net revenue	$341,893	$353,338	$939,832	$1,040,333
Cost of revenue	245,566	251,005	677,569	742,889
Gross profit	96,327	102,333	262,263	297,444
Operating expenses:				
Research and development	21,572	23,337	63,126	67,994
Sales and marketing	35,923	39,283	107,538	117,373
General and administrative	11,803	11,726	33,192	34,995
Restructuring and other charges	1,016	1,360	6,384	2,190
Litigation reserves, net	—	69	(2,690)	254
Total operating expenses	70,314	75,775	207,550	222,806
Income from operations	26,013	26,558	54,713	74,638
Interest income	65	68	184	174
Other income (expense), net	(199)	2,246	(67)	1,911
Income before income taxes	25,879	28,872	54,830	76,723
Provision for income taxes	10,780	8,847	28,053	27,582
Net income	$15,099	$20,025	$26,777	$49,141
Net income per share:				
Basic	$0.47	$0.56	$0.80	$1.36
Diluted	$0.47	$0.55	$0.79	$1.34
Weighted average shares used to compute net income per share:				
Basic	31,979	35,643	33,473	36,133
Diluted	32,335	36,250	34,002	36,806

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Net income	$15,099	$20,025	$26,777	$49,141
Other comprehensive income (loss), before tax:				
Unrealized gain (loss) on derivative instruments	10	139	(102)	66
Unrealized gain on available-for-sale securities	6	2	34	25
Other comprehensive income (loss), before tax	16	141	(68)	91
Tax expense related to items of other comprehensive income	(2)	(1)	(13)	(10)
Other comprehensive income (loss), net of tax	14	140	(81)	81
Comprehensive income	$15,113	$20,165	$26,696	$49,222

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended	
	September 27, 2015	September 28, 2014
Cash flows from operating activities:		
Net income	$26,777	$49,141
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	27,336	26,398
Purchase premium amortization/discount accretion on investments, net	(73)	42
Non-cash stock-based compensation	12,517	15,226
Income tax impact associated with stock option exercises	(1,049)	(394)
Excess tax benefit from stock-based compensation	(252)	(340)
Deferred income taxes	(149)	(2,133)
Changes in assets and liabilities:		
Accounts receivable	1,516	(12,084)
Inventories	52,870	17,963
Prepaid expenses and other assets	7,332	(9,846)
Accounts payable	(7,696)	(22,439)
Accrued employee compensation	(174)	4,021
Other accrued liabilities	(4,405)	(9,196)
Deferred revenue	(899)	9,221
Income taxes payable	2,002	1,974
Net cash provided by operating activities	115,653	67,554
Cash flows from investing activities:		
Purchases of short-term investments	(50,301)	(105,076)
Proceeds from sales and maturities of short-term investments	105,142	109,669
Purchase of property and equipment	(11,142)	(13,421)
Payments made in connection with business acquisitions	—	(1,050)
Net cash provided by (used in) investing activities	43,699	(9,878)
Cash flows from financing activities:		
Purchase and retirement of common stock	(107,531)	(68,006)
Proceeds from exercise of stock options	6,137	6,039
Proceeds from issuance of common stock under employee stock purchase plan	2,985	2,762
Excess tax benefit from stock-based compensation	252	340
Net cash used in financing activities	(98,157)	(58,865)
Net increase (decrease) in cash and cash equivalents	61,195	(1,189)
Cash and cash equivalents, at beginning of period	141,234	143,009
Cash and cash equivalents, at end of period	$202,429	$141,820

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

NETGEAR, Inc. (“NETGEAR” or the “Company”) was incorporated in Delaware in January 1996. The Company is a global networking company that delivers innovative products to consumers, businesses and service providers. The Company's products are built on a variety of proven technologies such as wireless (WiFi and LTE), Ethernet and powerline, with a focus on reliability and ease-of-use. The product line consists of wired and wireless devices that enable networking, broadband access and network connectivity. These products are available in multiple configurations to address the needs of the end-users in each geographic region in which the Company's products are sold.
The accompanying unaudited condensed consolidated financial statements include the accounts of NETGEAR, Inc. and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated in consolidation. The balance sheet dated December 31, 2014 has been derived from audited financial statements at such date. Accordingly, these condensed consolidated financial statements do not include all of the information and footnotes typically found in the audited consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company’s financial position, results of operations, comprehensive income and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2014.
The Company’s fiscal year begins on January 1 of the year stated and ends on December 31 of the same year. The Company reports its interim results on a fiscal quarter basis rather than on a calendar quarter basis. Under the fiscal quarter basis, each of the first three fiscal quarters ends on the Sunday closest to the calendar quarter end, with the fourth quarter ending on December 31.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of net revenue and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three and nine months ended September 27, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015 or any future period.

Note 2. Summary of Significant Accounting Policies

The Company’s significant accounting policies are disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. The Company’s significant accounting policies have not materially changed during the nine months ended September 27, 2015.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customer" (Topic 606). The guidance in this update supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also specifies the accounting for some costs to obtain or fulfill a contract with a customer. An entity should apply the amendments in the update either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. On July 9, 2015, the FASB concluded to delay the effective date of the new revenue standard by one year. ASU 2014-09 is effective for the Company beginning in the first quarter fiscal 2018. Early adoption is permitted but may not occur earlier than January 1, 2017, the original effective date of the standard for the Company. The Company is in the process of evaluating the available transition methods and the impact of this standard on its financial position, results of operations or cash flows.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory" (Topic 330). Under the current guidance, inventory is measured at the lower of cost or market, with market value represented by replacement cost, net realizable value or net realizable value less a normal profit margin. Under the new guidance, inventory is required to be measured at the lower of cost or net realizable value. ASU 2015-11 should be applied on a prospective basis and is effective for the Company

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beginning in the first fiscal quarter of 2017. Early adoption is permitted. The Company does not expect the adoption of this guidance to have a material impact on its financial position, results of operations or cash flows.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 3. Balance Sheet Components

Available-for-sale short-term investments (in thousands)

	As of September 27, 2015				December 31, 2014			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. treasuries	$60,067	$26	$—	$60,093	$114,944	$6	$(15)	$114,935
Certificates of deposit	269	—	—	269	158	—	—	158
Total	$60,336	$26	$—	$60,362	$115,102	$6	$(15)	$115,093

The Company's short-term investments are primarily comprised of marketable securities that are classified as available-for-sale and consist of government securities with an original maturity or remaining maturity at the time of purchase of greater than three months and no more than 12 months. Accordingly, none of the available-for-sale securities have unrealized losses greater than 12 months.

Accounts receivable, net (in thousands)

	As of September 27, 2015	December 31, 2014
Gross accounts receivable	$291,345	$296,239
Allowance for doubtful accounts	(1,255)	(1,255)
Allowance for sales returns	(14,394)	(17,489)
Allowance for price protection	(1,523)	(1,806)
Total allowances	(17,172)	(20,550)
Total accounts receivable, net	$274,173	$275,689

Inventories (in thousands)

	As of September 27, 2015	December 31, 2014
Raw materials	$2,382	$3,625
Work in process	1	8
Finished goods	167,630	219,250
Total inventories	$170,013	$222,883

The Company records provisions for excess and obsolete inventory based on forecasts of future demand. While management believes the estimates and assumptions underlying its current forecasts are reasonable, there is risk that additional charges may be necessary if current forecasts are greater than actual demand.

NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Property and equipment, net (in thousands)

	As of September 27, 2015	December 31, 2014
Computer equipment	$10,399	$9,779
Furniture, fixtures and leasehold improvements	18,202	19,379
Software	30,140	29,294
Machinery and equipment	65,094	60,135
Total property and equipment, gross	123,835	118,587
Accumulated depreciation and amortization	(99,884)	(88,893)
Total property and equipment, net	$23,951	$29,694

Depreciation and amortization expense pertaining to property and equipment was $4.4 million and $13.8 million for the three and nine months ended September 27, 2015, respectively, and $4.6 million and $13.1 million for the three and nine months ended September 28, 2014, respectively.

Intangibles, net (in thousands)

	Gross	Accumulated Amortization	Net
September 27, 2015			
Technology	$61,099	$(46,275)	$14,824
Customer contracts and relationships	56,500	(21,519)	34,981
Other	10,545	(7,159)	3,386
Total intangibles, net	$128,144	$(74,953)	$53,191

	Gross	Accumulated Amortization	Net
December 31, 2014			
Technology	$61,099	$(39,341)	$21,758
Customer contracts and relationships	56,500	(16,205)	40,295
Other	10,545	(6,368)	4,177
Total intangibles, net	$128,144	$(61,914)	$66,230

Amortization of intangibles was $4.2 million and $13.0 million for the three and nine months ended September 27, 2015, respectively, and $4.5 million and $13.4 million for the three and nine months ended September 28, 2014, respectively.
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Estimated amortization expense related to intangibles for each of the next five years and thereafter is as follows (in thousands):

Year Ending December 31	Amount
2015 (remaining three months)	$4,244
2016	16,921
2017	11,386
2018	7,871
2019	6,028
Thereafter	6,741
Total estimated amortization expense	$53,191

Other non-current assets (in thousands)

	As of	
	September 27, 2015	December 31, 2014
Non-current deferred income taxes	$38,805	$38,696
Cost method investment	1,322	1,322
Other	7,278	8,059
Total other non-current assets	$47,405	$48,077

Other accrued liabilities (in thousands)

	As of	
	September 27, 2015	December 31, 2014
Sales and marketing programs	$52,130	$54,582
Warranty obligation	47,928	44,888
Freight	6,550	6,827
Other	26,303	37,445
Total other accrued liabilities	$132,911	$143,742

Note 4. Derivative Financial Instruments

The Company’s subsidiaries have had, and will continue to have material future cash flows, including revenue and expenses, which are denominated in currencies other than the Company’s functional currency. The Company and all its subsidiaries designate the U.S. dollar as the functional currency. Changes in exchange rates between the Company’s functional currency and other currencies in which the Company transacts business will cause fluctuations in cash flow expectations and cash flow realized or settled. Accordingly, the Company uses derivatives to mitigate its business exposure to foreign exchange risk. The Company enters into foreign currency forward contracts in Australian dollars, British pounds, Euros, and Japanese yen to manage the exposures to foreign exchange risk related to expected future cash flows on certain forecasted revenue, costs of revenue, operating expenses and existing assets and liabilities. The Company does not enter into derivatives transactions for trading or speculative purposes.

The Company’s foreign currency forward contracts do not contain any credit-risk-related contingent features. The Company is exposed to credit losses in the event of nonperformance by the counter-parties of its forward contracts. The Company enters into derivative contracts with high-quality financial institutions and limits the amount of credit exposure to any one counter-party. In addition, the derivative contracts typically mature in less than six months and the Company continuously evaluates the credit standing of its counter-party financial institutions. The counter-parties to these arrangements are large, highly rated financial institutions and the Company does not consider non-performance a material risk.

The Company may choose not to hedge certain foreign exchange exposures for a variety of reasons, including, but not limited to, materiality, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can be no

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign exchange rates. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments in accordance with the authoritative guidance for derivatives and hedging. The Company records all derivatives on the balance sheet at fair value. The effective portions of cash flow hedges are recorded in other comprehensive income ("OCI") until the hedged item is recognized in earnings. Derivatives that are not designated as hedging instruments and the ineffective portions of its designated hedges are adjusted to fair value through earnings in other income (expense), net in the unaudited condensed consolidated statement of operations.

The fair values of the Company's derivative instruments and the line items on the unaudited condensed consolidated balance sheets to which they were recorded as of September 27, 2015 and December 31, 2014 are summarized as follows (in thousands):

Derivative Assets	Balance Sheet Location	Fair Value at September 27, 2015	Balance Sheet Location	Fair Value at December 31, 2014
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	$505	Prepaid expenses and other current assets	$2,416
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	32	Prepaid expenses and other current assets	—
Total		$537		$2,416

Derivative Liabilities	Balance Sheet Location	Fair Value at September 27, 2015	Balance Sheet Location	Fair Value at December 31, 2014
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	$641	Other accrued liabilities	$409
Derivative liabilities designated as hedging instruments	Other accrued liabilities	37	Other accrued liabilities	38
Total		$678		$447

For details of the Company's fair value measurements, see Note 11, Fair Value Measurements.

Offsetting Derivative Assets and Liabilities

The Company has entered into master netting arrangements which allow net settlements under certain conditions. Although netting is permitted, it is currently the Company's policy and practice to record all derivative assets and liabilities on a gross basis in the unaudited condensed consolidated balance sheets.

The following tables set forth the offsetting of derivative assets as of September 27, 2015 and December 31, 2014 (in thousands):

As of September 27, 2015	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets	Net Amount

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	
Barclays	$73	$—	$73	$(73)	$—	$—
Wells Fargo	464	—	464	(283)	—	181
Total	$537	$—	$537	$(356)	$—	$181

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

As of December 31, 2014	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$319	$—	$319	$(16)	$—	$303
Wells Fargo	2,097	—	2,097	(431)	—	1,666
Total	$2,416	$—	$2,416	$(447)	$—	$1,969

The following tables set forth the offsetting of derivative liabilities as of September 27, 2015 and December 31, 2014 (in thousands):

As of September 27, 2015	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$372	$—	$372	$(73)	$—	$299
JP Morgan Chase	23	—	23	—	—	23
Wells Fargo	283	—	283	(283)	—	—
Total	$678	$—	$678	$(356)	$—	$322

As of December 31, 2014	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$16	$—	$16	$(16)	$—	$—
Wells Fargo	431	—	431	(431)	—	—
Total	$447	$—	$447	$(447)	$—	$—

Cash flow hedges

To help manage the exposure of operating margins to fluctuations in foreign currency exchange rates, the Company hedges a portion of its anticipated foreign currency revenue, costs of revenue and certain operating expenses. These hedges are designated at the inception of the hedge relationship as cash flow hedges under the authoritative guidance for derivatives and hedging. Effectiveness is tested at least quarterly both prospectively and retrospectively using regression analysis to ensure that the hedge relationship has been effective and is likely to remain effective in the future. The Company typically hedges portions of its anticipated foreign currency exposure for three to five months. The Company enters into about five forward contracts per quarter with an average size of approximately $7.0 million USD equivalent related to its cash flow hedging program.

The Company expects to reclassify to earnings all of the amounts recorded in OCI associated with its cash flow hedges over the next twelve months. OCI associated with cash flow hedges of foreign currency revenue is recognized as a component of net revenue in the same period as the related revenue is recognized. OCI associated with cash flow hedges of foreign currency costs of revenue and operating expenses are recognized as a component of cost of revenue and operating expense in the same period as the related costs of revenue and operating expenses are recognized.

Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur within the designated hedge period or if not recognized within 60 days following the end of the hedge period. Deferred gains and losses in OCI with such derivative instruments are reclassified immediately into earnings through other income and expense. Any subsequent changes in fair value of such derivative instruments also are reflected in current earnings

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

unless they are re-designated as hedges of other transactions. The Company did not recognize any material net gains or losses related to the loss of hedge designation as there were no discontinued cash flow hedges during the three and nine months ended September 27, 2015 and September 28, 2014.

The effects of the Company's derivative instruments on OCI and the unaudited condensed consolidated statement of operations for the three and nine months ended September 27, 2015 and September 28, 2014 are summarized as follows (in thousands):

	Three Months Ended September 27, 2015				
Derivatives Designated as Hedging Instruments	Gain (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$(416)	Net revenue	$(552)	Other income (expense), net	$ (9)
Foreign currency forward contracts	—	Cost of revenue	3	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	123	Other income (expense), net	—
Total	$(416)		$(426)		$ (9)

(a) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

	Nine Months Ended September 27, 2015				
Derivatives Designated as Hedging Instruments	Gain (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$(1,299)	Net revenue	$(1,474)	Other income (expense), net	$ (43)
Foreign currency forward contracts	—	Cost of revenue	7	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	270	Other income (expense), net	—
Total	$(1,299)		$(1,197)		$ (43)

(a) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Derivatives Designated as Hedging Instruments	Three Months Ended September 28, 2014 Gain (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$401	Net revenue	$320	Other income (expense), net	$ (41)
Foreign currency forward contracts	—	Cost of revenue	—	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(58)	Other income (expense), net	—
Total	$401		$262		$ (41)

(a) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

Derivatives Designated as Hedging Instruments	Nine Months Ended September 28, 2014 Gain (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$(170)	Net revenue	$(221)	Other income (expense), net	$ (107)
Foreign currency forward contracts	—	Cost of revenue	8	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(23)	Other income (expense), net	—
Total	$(170)		$(236)		$ (107)

(a) Refer to Note 8, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

Non-designated hedges

The Company enters into non-designated hedges under the authoritative guidance for derivatives and hedging to manage the exposure of non-functional currency monetary assets and liabilities held on its financial statements to fluctuations in foreign currency exchange rates, as well as to reduce volatility in other income and expense. The non-designated hedges are generally expected to offset the changes in value of its net non-functional currency asset and liability position resulting from foreign exchange rate fluctuations. Foreign currency denominated accounts receivable and payable are hedged with non-designated hedges when the related anticipated foreign revenue and expenses are recognized in the Company's financial statements. The Company also hedges certain non-functional currency monetary assets and liabilities that may not be incorporated into the cash flow hedge program. The Company adjusts its non-designated hedges monthly and enters into about 15 non-designated derivatives per quarter. The average size of its non-designated hedges is approximately $2.0 million USD equivalent and these hedges range from one to five months in duration.

The effects of the Company's non-designated hedged included in other income (expense), net in the unaudited condensed consolidated statements of operations for the three and nine months ended September 27, 2015 and September 28, 2014 are as follows (in thousands):

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Derivatives Not Designated as Hedging Instruments	Location of Gains (Losses) Recognized in Income on Derivative	Amount of Gains (Losses) Recognized in Income			
		Three Months Ended		Nine Months Ended	
		September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Foreign currency forward contracts	Other income (expense), net	$1,267	$3,567	$3,278	$1,629

Note 5. Net Income Per Share

Basic net income per share is computed by dividing the net income for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of shares of common stock and potentially dilutive common stock outstanding during the period. Potentially dilutive common shares include outstanding stock options and unvested restricted stock awards, which are reflected in diluted net income per share by application of the treasury stock method. Under the treasury stock method, the amount that the employee must pay for exercising stock options, the amount of stock-based compensation cost for future services that the Company has not yet recognized, and the estimated tax benefit that would be recorded in additional paid-in capital upon exercise are assumed to be used to repurchase shares.

Net income per share for the three and nine months ended September 27, 2015 and September 28, 2014 are as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Numerator:				
Net income	$15,099	$20,025	$26,777	$49,141
Denominator:				
Weighted average common shares - basic	31,979	35,643	33,473	36,133
Potentially dilutive common share equivalent	356	607	529	673
Weighted average common shares - dilutive	32,335	36,250	34,002	36,806
Basic net income per share	$0.47	$0.56	$0.80	$1.36
Diluted net income per share	$0.47	$0.55	$0.79	$1.34
Anti-dilutive employee stock-based awards, excluded	2,768	2,774	$2,486	$2,608

Note 6. Income Taxes

The income tax provision for the three and nine months ended September 27, 2015 was $10.8 million, or an effective tax rate of 41.7%, and $28.1 million, or an effective tax rate of 51.2%, respectively. The income tax provision for the three and nine months ended September 28, 2014 was $8.8 million, or an effective tax rate of 30.6%, and $27.6 million, or an effective tax rate of 36.0%, respectively. During the three and nine months ended September 27, 2015 and September 28, 2014, the Company incurred losses in a jurisdiction where no tax benefit could be recorded. As a result, the forecasted losses from this jurisdiction were excluded from the determination of tax expense for the respective periods. The increase in the effective tax rate for the three and nine month period ended September 27, 2015 compared to the same period in the prior year was primarily caused by an increase in losses incurred in a jurisdiction where no tax benefit could be recorded as well as a shift in the distribution of earnings to jurisdictions with relatively higher tax rates.

The Company files income tax returns in the U.S. federal jurisdiction as well as various state, local, and foreign jurisdictions. Due to the uncertain nature of ongoing tax audits, the Company has recorded its liability for uncertain tax positions as part of its long-term liability as payments cannot be anticipated over the next twelve months. The existing tax positions of the Company continue to generate an increase in the liability for uncertain tax positions. The liability for uncertain tax positions may be reduced for liabilities that are settled with taxing authorities or on which the statute of limitations could expire without assessment from tax authorities. The possible reduction in liabilities for uncertain tax positions resulting from the expiration of statutes of limitation in multiple jurisdictions in the next twelve months is approximately $0.7 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

Note 7. Commitments and Contingencies

Leases

The Company leases office space, cars and equipment under operating leases, some of which are non-cancelable, with various expiration dates through December 2026. The terms of some of the Company's office leases provide for rental payments on a graduated scale. The Company recognizes rent expense on a straight-line basis over the lease period, and has accrued for rent expense incurred but not paid.

Purchase Obligations

The Company has entered into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31 to 45 days prior to the expected shipment date. Orders are non-cancelable within 30 days prior to the expected shipment date. At September 27, 2015, the Company had approximately $158 million in non-cancelable purchase commitments with suppliers. The Company establishes a loss liability for all products it does not expect to sell for which it has committed purchases from suppliers. Such losses have not been material to date. From time to time the Company's suppliers procure unique complex components on the Company's behalf. If these components do not meet specified technical criteria or are defective, the Company should not be obligated to purchase the materials. However, disputes may arise as a result and significant resources may be spent resolving such disputes.

Warranty Obligation
Changes in the Company's warranty obligation, which is included in other accrued liabilities in the unaudited condensed consolidated balance sheets, are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Balance as of beginning of the period	$40,967	$41,934	$44,888	$48,754
Provision for warranty obligation made during the period	22,625	17,175	53,862	44,630
Settlements made during the period	(15,664)	(16,357)	(50,822)	(50,632)
Balance at end of period	$47,928	$42,752	$47,928	$42,752

Guarantees and Indemnifications

The Company, as permitted under Delaware law and in accordance with its Bylaws, indemnifies its officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a Director and Officer Insurance Policy that enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the fair value of each indemnification agreement is minimal. Accordingly, the

Company has no liabilities recorded for these agreements as of September 27, 2015.

In its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers for any expenses or liability resulting from claimed infringements by the Company's products of patents, trademarks or copyrights of third parties, subject to customary carve outs. The terms of these indemnification agreements are generally perpetual any time after execution date of the respective agreement. The maximum amount of potential future infringement indemnification is generally unlimited. The Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 27, 2015.

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Employment Agreements

The Company has signed various employment agreements with key executives pursuant to which, if their employment is terminated without cause, such employees are entitled to receive their base salary (and commission or bonus, as applicable) for 52 weeks (for the Chief Executive Officer), 39 weeks (for the Senior Vice President of Worldwide Operations and Support) and up to 26 weeks (for other key executives). Such employees will also continue to have stock options vest for up to a one-year period following such termination without cause. If a termination without cause or resignation for good reason occurs within one year of a change in control, such employees are entitled to full acceleration (for the Chief Executive Officer) and up to two years acceleration (for other key executives) of any unvested portion of his or her equity awards. The Company has no liabilities recorded for these agreements as of September 27, 2015.

Litigation and Other Legal Matters

The Company is involved in disputes, litigation, and other legal actions, including, but not limited to, the matters described below. In all cases, at each reporting period, the Company evaluates whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, the Company accrues for the amount, or if a range, the Company accrues the low end of the range, only if there is not a better estimate than any other amount within the range, as a component of legal expense within litigation reserves, net. The Company monitors developments in these legal matters that could affect the estimate the Company had previously accrued. In relation to such matters, the Company currently believes that there are no existing claims or proceedings that are likely to have a material adverse effect on its financial position within the next twelve months, or 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 the Company may cause the Company to incur costly litigation and/or substantial settlement charges. In addition, the resolution of any intellectual property litigation may require the Company to make royalty payments, which could have an adverse effect in future periods. If any of those events were to occur, the Company's 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 the Company's estimates, which could result in the need to adjust the liability and record additional expenses.

Ericsson v. NETGEAR, Inc.

On September 14, 2010, Ericsson Inc. and Telefonaktiebolaget LM Ericsson (collectively “Ericsson”) filed a patent infringement lawsuit against the Company and defendants D-Link Corporation, D-Link Systems, Inc., Acer, Inc., Acer America Corporation, and Gateway, Inc. in the U.S. District Court, Eastern District of Texas alleging that the defendants infringe certain Ericsson patents. The Company has been accused of infringing eight U.S. patents: 5,790,516 (the “'516 Patent”); 6,330,435 (the “'435 Patent”); 6,424,625 (the “'625 Patent”); 6,519,223 (the “'223 Patent”); 6,772,215 (the “'215 Patent”); 5,987,019 (the “'019 Patent”); 6,466,568 (the “'568 Patent”); and 5,771,468 (the “'468 Patent"). Ericsson generally alleges that the Company and the other defendants have infringed and continue to infringe the Ericsson patents through the defendants' IEEE 802.11-compliant products. In addition, Ericsson alleged that the Company infringed the claimed methods and apparatuses of the '468 Patent through the Company's PCMCIA routers. The Company filed its answer to the Ericsson complaint on December 17, 2010 where it asserted the affirmative defenses of noninfringement and invalidity of the asserted patents. On March 1, 2011, the defendants filed a motion to transfer venue to the District Court for the Northern District of California and their memorandum of law in support thereof. On March 21, 2011, Ericsson filed its opposition to the motion, and on April 1, 2011, defendants filed their reply to Ericsson's opposition to the motion to transfer. On June 8, 2011, Ericsson filed an amended complaint that added Dell, Toshiba and Belkin as defendants. At the status conference held on Jun 9, 2011, the Court set a Markman (claim construction) hearing for June 28, 2012 and trial for June 3, 2013. On June 14, 2011, Ericsson submitted its infringement contentions against the Company. On September 29, 2011, the Court denied the defendants' motion to transfer venue to the Northern District of California. In advance of the Markman hearing, the parties on March 9, 2012 exchanged proposed constructions of claim terms and on April 9, 2012 filed the Joint Claim Construction Statement with the District Court. On May 8, 2012, Ericsson submitted its opening Markman brief and on June 1, 2012 the defendants submitted their responsive Markman brief. Ericsson's Reply Markman brief was submitted June 15, 2012, and on June 28, 2012 the Markman hearing was held in the Eastern District of Texas. On June 21, 2012, Ericsson dismissed the '468 Patent ("Multi-purpose base station") with prejudice and gave the Company a covenant not to sue as to products in the marketplace now or in the past. On June 22, 2012, Intel filed its complaint in Intervention, meaning that Intel became an official defendant in the Ericsson case. The parties thereafter completed fact discovery and exchanged expert reports. During the exchange of the expert reports, Ericsson dropped the '516 Patent (the OFDM "pulse shaping" patent). In addition, Ericsson dropped the '223 Patent (packet discard patent) against all the defendants' products, except for those products that use Intel chips. Thus, Ericsson has now dropped the '468 Patent (wireless base station), the '516 Patent (OFDM pulse shaping), and the '223 Patent (packet discard patent) for all non-Intel products. The five remaining patents were all only asserted against 802.11-compliant products.

At a Court ordered mediation in Dallas on January 15, 2013, the parties did not come to an agreement to settle the litigation. On March 8, 2013, the parties received the Markman Order in response to the claim construction briefing and claim construction hearing.

A jury trial in the Ericsson case occurred in the Eastern District of Texas from June 3 through June 13, 2013. After hearing the evidence, the jury found no infringement of the '435 and '223 Patents, and the jury found infringement of claim 1 of the '625 Patent, claims 1 and 5 of the '568 Patent, and claims 1 and 2 of the '215 Patent. The jury also found that there was no willful infringement by any defendant. Additionally, the jury found no invalidity of the asserted claims of the '435 and '625 Patents. The jury assessed the following damages against the defendants: D-Link: $435,000; NETGEAR: $3,555,000; Acer/Gateway: $1,170,000; Dell: $1,920,000; Toshiba: $2,445,000; Belkin: $600,000. The damages awards equate to 15 cents per unit for each accused 802.11 device sold by each defendant. Thus, unless the defendants' various appeals are successful, the Company will likely have a 15 cent per unit obligation on its 802.11 devices until 2016 (when one infringed patent in suit expires), 10 cent per unit obligation from 2016 through 2018 (when a second infringed patent in suit expires), and a 5 cent per unit obligation from 2018 through 2020 (when the third and last infringed patent in suit expires).

The Company and other defendants submitted various post-trial motions and briefs to the Court for its consideration, including motions and briefs for judgment as a matter of law in favor of defendants on non-infringement and invalidity of the patents in suit and for a reduction in damages, and the defendants have also moved for a new trial. These motions were argued before the Court on July 16, 2013. On August 6, 2013, the Court issued its orders on the various JMOL's (“Judgment as a Matter of Law”) and other post-trial motions. The Court denied all the defendants’ motions and set the reasonable and nondiscriminatory (RAND) royalty rate for the infringed patents equivalent to the jury verdict of 15 cents per unit.

After negotiations, Ericsson and the Company agreed to the following as collateral while the appeal of the verdict, Court’s rulings, and the RAND royalty rate are pending. Ericsson will forego collecting the $3,555,000 verdict plus various fees (Prejudgment interest of $224,141; Post-judgment interest of $336 per day; Costs of $41,667) assigned to the Company pending appeal, so long as a Company representative declares and provides Ericsson with adequate quarterly assurances that the judgment can still be paid. For the ongoing royalties of 15 cents per 802.11n or 802.11ac device sold by the company that the jury and Court awarded, the Company will place the ongoing royalty amount into the Court’s registry (escrow account) and will give Ericsson a corresponding royalty report until the Company’s appeals of the jury verdict, the Court’s orders, and the RAND royalty rate are exhausted.

On December 16, 2013, the defendants submitted their appeal brief to the Federal Circuit. Ericsson filed its response brief on February 20, 2014, and the defendants filed their reply brief before on March 24, 2014. The oral arguments before the Federal Circuit took place on June 5, 2014.

On December 4, 2014, the Federal Circuit issued its opinion and order in the Company’s Ericsson appeal. The Federal Circuit vacated the entirety of the $3.6 million jury verdict against the Company and the ongoing 15 cent per unit royalty verdict, and also vacated the entirety of the verdict against the other defendants and their ongoing royalties, finding that the District Court hadn’t properly instructed the jury on royalty rates and Ericsson’s licensing promises. The Federal Circuit held that the lower court had failed to adequately instruct the jury about Ericsson’s actual commitments to license the infringed patents on reasonable and nondiscriminatory (“RAND”) terms. Further, the Federal Circuit stated that the lower court had neglected to inform the jury that a royalty for a patented technology must be removed from the value of the entire standard, and that a RAND royalty rate should be based on the invention’s value, rather than any added value from standardization. The jury’s damages awards were therefore completely vacated, and the case was remanded for further proceedings. As of the end of the fourth quarter of 2014, based on the Federal Circuit’s opinion and order, the Company made adjustments to decrease the accrual related to this case.

While the Federal Circuit found the district court had inadequate jury instructions, it held that there was enough evidence for the jury to find infringement of two claims of U.S. Patent Number 6,466,568 and two claims of U.S. Patent Number 6,772,215, but reversed the lower court’s decision not to grant a noninfringement judgment as a matter of law regarding the third patent, U.S. Patent Number 6,424,625, finding that no reasonable jury could find that the '625 Patent was infringed by the defendants.

Neither Ericsson nor the defendants appealed the Federal Circuit’s decision, and the Federal Circuit issued its mandate and sent the case back to the U.S. District Court in the Eastern District of Texas for a new damages trial. No proceedings have yet taken place in the U.S. District Court in the Eastern District of Texas following the Federal Circuit’s mandate.

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In September of 2013, Broadcom filed petitions in the USPTO at the Patent Trial and Appeal Board (PTAB) seeking inter partes review (“IPR”) of Ericsson’s three patents that the jury found were infringed by the Company and other defendants. On March 6, 2015, the PTAB invalidated all the claims of these three patents that were asserted against the Company and other defendants at trial -- claim 1 of the '625 Patent, claims 1 and 5 of the '568 Patent, and claims 1 and 2 of the '215 Patent -- ruling these claims were anticipated or obvious in light of prior art. The PTAB also rejected two motions to amend by Ericsson, which sought to substitute certain proposed claims in the '625 and '568 patents, should they be found unpatentable by the PTAB. This PTAB decision comes on top of the Federal Circuit decision (a) vacating the jury verdict after finding that the district court had not properly instructed the jury on royalty rates and Ericsson’s licensing promises, and (b) ruling that no reasonable jury could have found the ‘625 Patent infringed. Ericsson appealed the PTAB decision to the Federal Circuit and also requested that the PTAB reconsider its decision, but the PTAB denied Ericsson’s request for reconsideration. While Ericsson appeals the PTAB decision the present status of the case is that the Company does not infringe on any valid Ericsson patent, and accordingly the Company reversed the accruals related to this case in the first fiscal quarter of 2015.

Agenzia Entrate Provincial Revenue Office 1 of Milan v. NETGEAR International, Inc.

In November 2012, the Italian Tax Police began a comprehensive tax audit of NETGEAR International, Inc.’s Italian Branch. The scope of the audit initially was from 2004 through 2011 and was subsequently expanded to include 2012. The tax audit encompasses Corporate Income Tax (IRES), Regional Business Tax (IRAP) and Value-Added Tax (VAT). In December 2013, December 2014, and August 2015, an assessment was issued by Inland Revenue Agency, Provincial Head Office No. 1 of Milan-Auditing Department (Milan Tax Office) for the 2004 tax year, the 2005 through 2007 tax years, and the 2008 through 2010 tax years, respectively. All other years remain under audit. In May 2014, the Company filed with the Provincial Tax Court of Milan (Tax Court) a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2004 year. The hearing was held and decision was issued on November 7, 2014. The Tax Court found in favor of the Company and nullified the assessment by the Inland Revenue Agency for 2004. The Inland Revenue Agency appealed the decision of the Tax Court on June 12, 2015. The Company filed its counter appeal with respect to the 2004 year during September 2015. With respect to 2005 through 2007, the Company filed its briefs with the Tax Court in mid-February. In June, 2015, the Company filed with the Provincial Tax Court of Milan (Tax Court) a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2005 through 2007 tax years. The hearing was held and the Request for Suspension of payment was granted. With respect to 2008 through 2010, the Company filed its briefs with the Tax Court in October 2015. It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Via Vadis v. NETGEAR, Inc.

On August 22, 2014, the Company was sued by Via Vadis, LLC and AC Technologies, S.A. (“Via Vadis”), in the Western District of Texas. The complaint alleges that the Company’s ReadyNAS and Stora products “with built-in BitTorrent software" allegedly infringe three related patents of Via Vadis (U.S. Patent Nos. 7,904,680, RE40,521, and 8,656,125). Via Vadis filed similar complaints against Belkin, Buffalo, Blizzard, D-Link, and Amazon.

By referring to “built-in BitTorrent software,” the Company believes that the complaint is referring to the BitTorrent Sync application, which was released by BitTorrent Inc. in spring of 2014. At a high-level, the application allows file synchronization across multiple devices by storing the underlying files on multiple local devices, rather than on a centralized server. The Company’s ReadyNAS products do not include BitTorrent software when sold. The BitTorrent application is provided as one of a multitude of potential download options, but the software itself is not included on the Company’s devices when shipped. Therefore, the only viable allegation at this point is an indirect infringement allegation.

On November 10, 2014, the Company answered the complaint denying that it infringes the patents in suit and also asserting the affirmative defenses that the patents in suit are invalid and barred by the equitable doctrines of laches, waiver, and/or estoppel.

On February 5, 2015, the Court set the claim construction hearing for December 4, 2015 and allowed discovery for claim construction purposes to commence. On February 6, 2015, the Company filed its motion to transfer venue from the Western District of Texas to the Northern District of California with the Court; on February 13, 2015, Via Vadis filed its opposition to the Company's motion to transfer; and on February 20, 2015, the Company filed its reply brief on its motion to transfer. In early April 2015, the Company received the plaintiff's infringement contentions, and on June 12, 2015, the defendants served invalidity contentions. Discovery in the case was stayed until the Court issues its claim construction order. On July 30, 2015 the Court granted the Company's motion to transfer venue to the Northern District of California. In addition, the Company recently learned that Amazon and Blizzard filed petitions for the inter partes reviews ("IPRs") for the patents in suit. On October 15, 2015, the Company and

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Via Vadis came to an agreement in principle to petition the California Court to stay the case pending resolution of the IPR proceedings filed by Amazon and Blizzard. No Scheduling Order has been issued by the California Court.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Wetro Lan v. NETGEAR, Inc.

On January 30, 2015, the Company was sued by a non-practicing entity called Wetro Lan LLC (“Wetro Lan”) in United States District Court, Eastern District of Texas, Marshall Division. Wetro Lan alleges direct infringement by the Company of United States Patent No. 6,795,918 (the “'918 Patent”) entitled “Service Level Computer Security” based on the Company’s manufacture and selling of the “NETGEAR WGR614v9 Wireless Router and similarly situated NETGEAR, Inc. Wireless Routers.” On April 13, 2015 the Company answered the complaint. The Company denied that it infringed the patent and asserted several affirmative defenses (counterclaims), including noninfringement, invalidity, limitation of damages, laches, waiver, estoppel, and other equitable defenses, and on May 4, 2015 Wetro Lan answered the Company’s counterclaims.

On July 16, 2015, the Company filed with the Court a motion to transfer venue from the Eastern District of Texas to the Northern District of California. On August 17, 2015, Wetro Lan filed with the Court its opposition to the Company’s motion to transfer venue, and on August 24, 2015 the Company filed its Reply in Support of Transfer as filed. The Court has not yet ruled on the Company’s transfer motion. It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Frequency Systems LLC v NETGEAR, Inc.

On May 8, 2015, the Company was sued by a non-practicing entity named Frequency Systems LLC (“Frequency Systems”) in the United States District Court, Eastern District of Texas. Frequency Systems alleges direct or indirect infringement by the Company of a single patent, U.S. Pat. No. 8,417,205 (the “'205 Patent”), entitled “Antenna selection scheme for multiple antennae.” Frequency Systems alleges infringement generically by the Company’s “wireless routers and access points product families” without specifying any models.

Frequency Systems also simultaneously sued ADTRAN, TCL Communications, Amped Wireless, ASUS, Belkin, Buffalo, Cisco, D-Link, EnGenius Technologies, Extreme Networks, HP, HTC, Huawei, ATEN Technology, IOGear, Kyocera, LG, Linksys, Motorola Mobility, Novatel Wireless, Sharp, TP-Link, TRENDnet, Western Digital, ZTE, and ZyXEL.

The Company answered the complaint on July 23, 2015 asserting various defenses, including noninfrigement and invalidity of the patent in suit.

Recently, it appears that Frequency Systems granted RPX Corporation a license. This is significant because the Company’s products that use WiFi chipsets of licensed companies (i.e. companies that are RPX members) likely will be licensed. The licensed RPX members include Broadcom and QualComm-Atheros.

On September 24, 2015, Frequency Systems served preliminary infringement contentions. Frequency Systems alleges that the Company infringes claims 1, 2 and 4 of the '205 Patent by the sale of products that are compliant with the 802.11n wireless standard, and identifies the following Company models as exemplars: R8000, R7500, R7000, R6400, R6300, R6250, AC1450, R6220, R6200, R6100, R6050, WNDR4700, WNDR4720, WNDR4500, WNDR4300, WNDR3700, WNDR3400, WNR2500, JNR3210, WNR2020, R7900, R6700, D7800, D7000, D6400,

D6200, DGND4000, DGND3700, C7000, C6300, C3700, MBR1515, MBR1515A, MVBR1517, MVBR1210C, WNDAP660, EX7000, EX6200, EX6150, EX6100, X3920, EX3700, WN2500RP, WN3000RP, EX2700, A6210, LG2200D, LG6100D, WNDAP620, WND930, WNDAP360, WNDAP350, WN203, WN802T, and D2200D.

The Court held its initial scheduling conference on September 30, 2015. The Company’s invalidity contentions are due on November 25, 2015.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Verifire Network Solutions v NETGEAR, Inc.

On June 3, 2015, the Company was sued by a non-practicing entity named Verifire Network Solutions, LLC. (“Verifire”) in the United States District Court, Eastern District of Texas. Verifire alleges direct infringement by the Company of a single patent, US Patent No. 8,463,727 (the “'727 Patent”), entitled “Communication management system and communication management method,” and the complaint targets Netgear’s ProSAFE® business-class VPN Firewall and ProSECURE® UTM Firewall product families. Verifire recently has sued several other companies in the same Court on the same patent, including Fortinet, WatchGuard, Check Point, and Hewlett Packard.

The Company received an extension to answer the complaint and filed its Answer to the on August 26, 2015. On September 22, 2015, Verifire produced its preliminary infringement contentions. Verifire asserted that claims 1 and 3 of the '727 Patent cover all network security equipment, including firewalls such as the ProSAFE and ProSECURE lines manufactured by the Company.

Recently, many defendants settled, as RPX Corporation appears to have signed a settlement agreement with Verifire to settle out RPX members. The remaining defendants are: ADTRAN, Panda Distribution, Inc., and the Company. The Court held its initial scheduling conference on September 30, 2015. The Company’s invalidity contentions are due on November 25, 2015.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

Chrimar Systems, Inc. v NETGEAR, Inc.

On July 1, 2015, the Company was sued by a non-practicing entity named Chrimar Systems, Inc., doing business as CMS Technologies and Chrimar Holding Company, LLC (collectively, “CMS”), in the Eastern District of Texas for allegedly infringing four patents-U.S. Patent Nos. 8,155,012 (the “'012 Patent”), entitled “System and method for adapting a piece of terminal equipment”; 8,942,107 (the “'107 Patent”), entitled “Piece of ethernet terminal equipment”; 8,902,760 (the “'760 Patent”), entitled “Network system and optional tethers”; and 9,019,838 (the “'838 Patent”), entitled “Central piece of network equipment” (collectively “patents-in-suit”).

The patents-in-suit relate to using or embedding an electrical DC current or signal into an existing Ethernet communication link in order to transmit additional data about the devices on the communication link, and the specifications for the patents are identical. It appears that Chrimar has approximately 40 active cases in the Eastern District of Texas, as well as some cases in the Northern District of California on the patents-in-suit and the parent patent to the patents-in-suit.

The Company received an extension until September 15, 2015 to answer the complaint. The Company answered the complaint with a Motion to Dismiss Chrimar’s indirect infringement claims. Chrimar subsequently filed a response to the Company’s motion to dismiss and Chrimar’s First Amended Complaint. Chrimar responded to the Motion to Dismiss by dropping its induced infringement claims and providing supplemental allegations in support of its contributory infringement claims with respect to the '760 Patent. For the '012, '107 and '838 Patents, Chrimar now only alleges direct infringement. Chrimar originally asserted direct and indirect infringement for all four patents-in-suit.

Subsequently, on October 5, 2015, the Company filed a Motion to Dismiss the Direct Infringement Claims Relating to the '760 Patent. Chrimar filed its response to this motion to dismiss on October 15, 2015, and the Company filed its Reply on October 26, 2015.

It is too early to reasonably estimate any financial impact to the Company resulting from this litigation matter.

IP Indemnification Claims

In its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers (the “Indemnified Parties”) for any expenses or liability resulting from claimed infringements by the Company's products of patents, trademarks or copyrights of third parties that are asserted against the Indemnified Parties, subject to customary carve outs. The terms of these indemnification agreements are generally perpetual after execution of the agreement. The maximum amount of potential future indemnification is generally unlimited. From time to time, the Company receives requests for indemnity and may choose to assume the defense of such litigation asserted against the Indemnified Parties.

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Environmental Regulation

The Company is required to comply and is currently in compliance with the European Union ("EU") and other Directives on the Restrictions of the use of Certain Hazardous Substances in Electrical and Electronic Equipment (“RoHS”), Waste Electrical and Electronic Equipment ("WEEE") requirements, Energy Using Product (“EuP”) requirements, the REACH Regulation, Packaging Directive and the Battery Directive.

The Company is subject to various federal, state, local, and foreign environmental laws and regulations, including those governing the use, discharge, and disposal of hazardous substances in the ordinary course of our manufacturing process. The Company believes that its current manufacturing and other operations comply in all material respects with applicable environmental laws and regulations; however, it is possible that future environmental legislation may be enacted or current environmental legislation may be interpreted to create an environmental liability with respect to its facilities, operations, or products. See further discussion of the business risks associated with environmental legislation under the risk titled, "We are subject to, and must remain in compliance with, numerous laws and governmental regulations concerning the manufacturing, use, distribution and sale of our products, as well as any such future laws and regulations. Some of our customers also require that we comply with their own unique requirements relating to these matters. Any failure to comply with such laws, regulations and requirements, and any associated unanticipated costs, may adversely affect our business, financial condition and results of operations." within Item 1A Risk Factors of this Form 10-Q.

Note 8. Stockholders' Equity

Common Stock Repurchase Program

From time to time, the Company’s Board of Directors has authorized programs under which the Company may repurchase shares of its common stock, depending on market conditions, in the open market or through privately negotiated transactions. Under the authorizations, the timing and actual number of shares subject to repurchase are at the discretion of management and are contingent on a number of factors, such as levels of cash generation from operations, cash requirements for acquisitions and the price of the Company’s common stock. Repurchases made by the Company pursuant to Board-authorized programs during the nine months ended September 27, 2015 and September 28, 2014 are discussed below. As of September 27, 2015, 2.6 million shares remained authorized for repurchase under the repurchase program approved by the Board on July 21, 2015. There were no remaining shares authorized under any previously approved programs.
The Company repurchased, reported based on trade date, 3.4 million shares of common stock at a cost of $105.2 million during the nine months ended September 27, 2015. The Company repurchased, reported based on trade date, 2.1 million shares of common stock at a cost of $68.6 million under the repurchase authorization during the nine months ended September 28, 2014.
The Company repurchased, as reported based on trade date, approximately 77,000 shares of common stock at a cost of $2.4 million under a repurchase program to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving restricted stock units ("RSUs") during the nine months ended September 27, 2015. Similarly, during the nine months ended September 28, 2014, the Company repurchased approximately 50,000 shares of common stock at a cost of $1.6 million under the same program to help facilitate tax withholding for RSUs.
These shares were retired upon repurchase. The purchase price for the shares of the Company’s stock repurchased is reflected as a reduction to stockholders’ equity. The Company’s policy related to repurchases of its common stock is to charge the excess of cost over par value to retained earnings. All repurchases were made in compliance with Rule 10b-18 under the Securities Exchange Act of 1934, as amended.

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Accumulated Other Comprehensive Income, Net

The following table sets forth the changes in accumulated other comprehensive income ("AOCI") by component, net of tax, for the nine months ended September 27, 2015 (in thousands):

	Gains and losses on available for sale securities	Gains and losses on derivatives	Total
Beginning balance as of December 31, 2014	$(5)	$43	$38
Other comprehensive income (loss) before reclassifications	21	(1,299)	(1,278)
Amounts reclassified from accumulated other comprehensive income	—	1,197	1,197
Net current period other comprehensive income (loss)	21	(102)	(81)
Ending balance as of September 27, 2015	$16	$(59)	$(43)

The following tables provide details about significant amounts reclassified out of each component of AOCI for the three and nine months ended September 27, 2015 and September 28, 2014 (in thousands):

	Three Months Ended September 27, 2015		Nine Months Ended September 27, 2015	
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations
Gains and losses on cash flow hedge:				
Foreign currency forward contracts	$(552)	Net revenue	$(1,474)	Net revenue
Foreign currency forward contracts	3	Cost of revenue	7	Cost of revenue
Foreign currency forward contracts	123	Operating expenses	270	Operating expenses
	(426)	Total before tax	(1,197)	Total before tax
	—	Tax expense (1)	—	Tax expense (1)
	$(426)	Total, net of tax	$(1,197)	Total, net of tax

(1) Under our tax structure all hedging gains and losses from derivative contracts are ultimately borne by a legal entity in a jurisdiction with no income tax.

	Three Months Ended September 28, 2014		Nine Months Ended September 28, 2014	
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations
Gains and losses on cash flow hedge:				
Foreign currency forward contracts	$320	Net revenue	$(221)	Net revenue
Foreign currency forward contracts	—	Cost of revenue	8	Cost of revenue
Foreign currency forward contracts	(58)	Operating expenses	(23)	Operating expenses
	262	Total before tax	(236)	Total before tax
	—	Tax expense (1)	—	Tax expense (1)

$262	Total, net of tax	$(236)	Total, net of tax

(1) Under our tax structure all hedging gains and losses from derivative contracts are ultimately borne by a legal entity in a jurisdiction with no income tax.

Note 9. Employee Benefit Plans

The Company grants options and RSUs from the Amended and Restated 2006 Long-Term Incentive Plan, under which awards may be granted to all employees. Award vesting periods for this plan is generally four years. As of September 27, 2015, approximately 1.5 million shares from this plan were reserved for future grants.

Additionally, the Company sponsors an Employee Stock Purchase Plan (the “ESPP”), pursuant to which eligible employees may contribute up to 10% of base compensation, subject to certain income limits, to purchase shares of the Company’s common stock. Employees may purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date. As of September 27, 2015, approximately 0.1 million shares were reserved under the ESPP.

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Option Activity

Stock option activity during the nine months ended September 27, 2015 was as follows:

	Number of shares (in thousands)	Weighted Average Exercise Price Per Share (in dollars)
Outstanding at December 31, 2014	3,939	$30.58
Granted	296	31.34
Exercised	(262)	23.44
Cancelled	(128)	33.23
Expired	(246)	34.82
Outstanding at September 27, 2015	3,599	$30.78

RSU Activity

RSU activity during the nine months ended September 27, 2015 was as follows:

	Number of shares (in thousands)	Weighted Average Grant Date Fair Value Per Share (in dollars)
Outstanding at December 31, 2014	858	$30.68
RSUs granted	468	32.13
RSUs vested	(259)	31.04
RSUs cancelled	(108)	31.44
Outstanding at September 27, 2015	959	$31.59

Valuation and Expense Information

The fair value of each option award is estimated on the date of grant using a Black-Scholes-Merton option valuation model that uses the assumptions noted in the following table. The estimated expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk free interest rate is based on the implied yield currently available on U.S. Treasury securities with a remaining term commensurate with the estimated expected term. Expected volatility is based on historical volatility over the most recent period commensurate with the estimated expected term.

The table below sets forth the weighted average assumptions used to estimate the fair value of option grants during the three and nine months ended September 27, 2015 and September 28, 2014.

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Expected life (in years)	N/A	N/A	4.5	4.5
Risk-free interest rate	N/A	N/A	1.44%	1.44%
Expected volatility	N/A	N/A	39.3%	42.6%
Dividend yield	N/A	N/A	—	—

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following table sets forth the stock-based compensation expense resulting from stock options, RSUs and the ESPP included in the Company’s unaudited condensed consolidated statements of operations (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Cost of revenue	$358	$573	$1,190	$1,533
Research and development	877	1,255	2,495	3,878
Sales and marketing	1,173	1,409	3,838	4,759
General and administrative	1,703	1,925	4,994	5,056
Total stock-based compensation	$4,111	$5,162	$12,517	$15,226

As of September 27, 2015, $7.9 million of unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.53 years. Additionally, $21.0 million of unrecognized compensation cost related to unvested RSUs, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.66 years.

Note 10. Segment Information and Operations by Geographic Area

Operating segments are components of an enterprise about which separate financial information is available and is regularly evaluated by management, namely the Chief Operating Decision Maker (“CODM”) of an organization, in order to determine operating and resource allocation decisions. By this definition, the Company operates in three specific business units: retail, commercial, and service provider. The retail business unit consists of high performance, dependable and easy-to-use home networking, home security automation and storage products. The commercial business unit consists of business networking, storage and security solutions that bring enterprise class functionality down to the small and medium-sized business at an affordable price. The service provider business unit consists of made-to-order and retail proven, whole home networking hardware and software solutions as well as 4G LTE hotspots sold to service providers for sale to their subscribers. The Company believes this structure enables it to better focus its efforts on the Company's core customer segments and allows it to be more nimble and opportunistic as a company overall.

The Company's CEO began temporarily serving as interim general manager of the retail business unit in March 2014 and as interim general manager of the service provider business unit in February 2015, due to the previous general managers' departures from the Company. As of September 27, 2015, the CEO continued to serve as interim general manager of both business units and will do so until replacements for the positions are appointed.

The results of the reportable segments are derived directly from the Company’s management reporting system. The results are based on the Company’s method of internal reporting and are not necessarily in conformity with accounting principles generally accepted in the United States. Management measures the performance of each segment based on several metrics, including contribution income. Segment contribution income includes all product line segment revenues less the related cost of sales, research and development and sales and marketing costs. Contribution income is used, in part, to evaluate the performance of, and allocate resources to, each of the segments. Certain operating expenses are not allocated to segments because they are separately managed at the corporate level. These unallocated indirect costs include corporate costs, such as corporate research and development, corporate marketing expense and general and administrative costs, amortization of intangibles, stock-based compensation expense, restructuring and other charges, acquisition-related expense, losses on inventory commitments due to restructuring, litigation reserves, net, and interest and other income (expense), net. The Company does not evaluate operating segments using discrete asset information.

NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Financial information for each reportable segment and a reconciliation of segment contribution income to income before income taxes is as follows (in thousands, except percentage data):

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Net revenue:				
Retail	$164,081	$131,341	$416,847	$360,236
Commercial	65,187	71,974	200,935	226,284
Service provider	112,625	150,023	322,050	453,813
Total net revenue	341,893	353,338	939,832	1,040,333
Contribution income:				
Retail	$21,149	$21,813	$53,715	$51,222
Retail contribution margin	12.9 %	16.6 %	12.9 %	14.2 %
Commercial	13,700	15,112	42,507	51,781
Commercial contribution margin	21.0 %	21.0 %	21.2 %	22.9 %
Service Provider	14,819	14,164	27,472	42,918
Service Provider contribution margin	13.2 %	9.4 %	8.5 %	9.5 %
Total segment contribution income	49,668	51,089	123,694	145,921
Corporate and unallocated costs	(14,363)	(13,544)	(39,559)	(40,428)
Amortization of intangibles (1)	(4,165)	(4,396)	(12,804)	(13,177)
Stock-based compensation expense	(4,111)	(5,162)	(12,517)	(15,226)
Restructuring and other charges	(1,016)	(1,360)	(6,384)	(2,190)
Acquisition-related expense	—	—	—	(8)
Losses on inventory commitments due to restructuring	—	—	(407)	—
Litigation reserves, net	—	(69)	2,690	(254)
Interest income	65	68	184	174
Other income (expense), net	(199)	2,246	(67)	1,911
Income before income taxes	$25,879	$28,872	$54,830	$76,723

(1) Amount excludes amortization expense related to patents included in cost of revenue.

The Company conducts business across three geographic regions: Americas, Europe, Middle-East and Africa (“EMEA”) and Asia Pacific ("APAC"). Net revenue by geography comprises gross revenue less such items as end-user customer rebates and other sales incentives deemed to be a reduction of net revenue per the authoritative guidance for revenue recognition, sales returns and price protection. For reporting purposes revenue is attributed to each geographic region based on the location of the customer. The following table shows net revenue by geography for the periods indicated (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
United States (U.S.)	$213,913	$ 188,569	$552,787	$ 561,067
Americas (excluding U.S.)	5,823	5,335	13,194	15,150
United Kingdom (U.K.)	27,850	38,933	80,965	122,707
EMEA (excluding U.K.)	49,875	69,488	153,862	192,943
APAC	$44,432	$ 51,013	$139,024	$ 148,466
Total net revenue	$341,893	$ 353,338	$939,832	$ 1,040,333

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Property and equipment, net, by geographic location are as follows (in thousands):

	As of September 27, 2015	December 31, 2014
United States	$10,200	$12,453
Canada	3,982	4,375
EMEA	506	657
China	7,723	10,786
APAC (excluding China)	1,540	1,423
	$23,951	$29,694

Note 11. Fair Value Measurements (in thousands)
The following tables summarize assets and liabilities measured at fair value on a recurring basis as of September 27, 2015:

	As of September 27, 2015			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents—money-market funds	$45,904	$45,904	$—	$—
Available-for-sale securities—U.S. treasuries (1)	60,093	60,093	—	—
Available-for-sale securities—certificates of deposit (1)	269	269	—	—
Trading securities—mutual funds (1)	1,057	1,057	—	—
Foreign currency forward contracts (2)	537	—	537	—
Total assets measured at fair value	$107,860	$107,323	$537	$—

(1) Included in short-term investments on the Company's unaudited condensed consolidated balance sheet.
(2) Included in prepaid expenses and other current assets on the Company's unaudited condensed consolidated balance sheet.

	As of September 27, 2015			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Foreign currency forward contracts (3)	$678	$—	$678	$—
Total liabilities measured at fair value	$678	$—	$678	$—

(3) Included in other accrued liabilities on the Company's unaudited condensed consolidated balance sheet.

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of December 31, 2014:

	As of December 31, 2014			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents—money-market funds	$4,408	$4,408	$—	$—
Available-for-sale securities—U.S. treasuries (1)	114,935	114,935	—	—
Available-for-sale securities—certificates of deposit (1)	158	158	—	—
Trading securities—mutual funds (1)	802	802	—	—
Foreign currency forward contracts (2)	2,416	—	2,416	—
Total assets measured at fair value	$122,719	$120,303	$2,416	$—

(1) Included in short-term investments on the Company's unaudited condensed consolidated balance sheet.
(2) Included in prepaid expenses and other current assets on the Company's unaudited condensed consolidated balance sheet.

	As of December 31, 2014			
	Total	Quoted market prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Foreign currency forward contracts (3)	$447	$—	$447	$—
Total liabilities measured at fair value	$447	$—	$447	$—

(3) Included in other accrued liabilities on the Company's unaudited condensed consolidated balance sheet.
The Company's investments in cash equivalents and available-for-sale securities are classified within Level 1 of the fair value hierarchy because they are valued based on quoted market prices in active markets. The Company enters into foreign currency forward contracts with only those counterparties that have long-term credit ratings of A-/A3 or higher. The Company's foreign currency forward contracts are classified within Level 2 of the fair value hierarchy as they are valued using pricing models that take into account the contract terms as well as currency rates and counterparty credit rates. The Company verifies the reasonableness of these pricing models using observable market data for related inputs into such models. Additionally, the Company includes an adjustment for non-performance risk in the recognized measure of fair value of derivative instruments. At September 27, 2015 and December 31, 2014, the adjustment for non-performance risk did not have a material impact on the fair value of the Company's foreign currency forward contracts. The carrying value of non-financial assets and liabilities measured at fair value in the financial statements on a recurring basis, including accounts receivable and accounts payable, approximate fair value due to their short maturities.

Note 12. Shipping and Handling Fees and Costs

The Company includes shipping and handling fees billed to customers in net revenue. Shipping and handling costs associated with inbound freight are included in cost of revenue and ending inventory. Shipping and handling costs associated with outbound freight are included in sales and marketing expenses and totaled \$2.3 million and \$7.9 million for the three and nine months ended September 27, 2015, respectively, and \$2.7 million and \$7.7 million for the three and nine months ended September 28, 2014, respectively.

Note 13. Restructuring and Other Charges

The Company incurred restructuring and other charges of \$1.0 million and \$6.4 million during the three and nine months ended September 27, 2015, respectively. Restructuring and other charges recognized in the nine months ended September 27, 2015 are primarily related to contract and employee termination charges, as well as other activities attributable to the restructuring actions announced in February 2015. Restructuring and other charges incurred in the nine months ended September 28, 2014 were primarily attributable to charges recognized associated with the early termination of a lease agreement in Canada and one-time separation costs, primarily relating to the departure of the general manager of the retail business unit in the first quarter of 2014.

Accrued restructuring and other charges are classified within other accrued liabilities in the unaudited condensed consolidated balance sheets. Amounts attributable to employee termination and other charges are expected to be paid out by the end of the first fiscal quarter of 2016. Amounts attributable to lease contract termination charges will be paid over the remaining lease term until January 2022.

The following table provides a summary of the activity related to accrued restructuring and other charges for the nine months ended September 27, 2015 (in thousands):

	Accrued Restructuring and Other Charges at December 31, 2014	Additions (a)	Cash Payments	Accrued Restructuring and Other Charges at September 27, 2015
Restructuring				
Employee termination charges	$ 316	$4,689	$(4,610)	$ 395
Lease contract termination and other charges	—	1,243	$(592)	651
Total Restructuring and other charges	$ 316	$5,932	$(5,202)	$ 1,046

(a) Total restructuring and other charges recognized in the Company's unaudited condensed consolidated statement of operations for the nine months ended September 27, 2015 includes non-cash charges and adjustments, net of $0.5 million. These amounts have been excluded from the table above.

In the third quarter of 2015, the Company completed the steps necessary to reduce the cost structure of the service provider business unit and supporting functions to match the reduced revenue outlook and to concentrate resources on LTE and long-term and profitable accounts. Management does not expect to incur any material incremental charges associated with the restructuring actions announced in February 2015.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Forward-looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, the words “believes,” “anticipates,” “plans,” “expects,” “intends,” “could,” “may,” “will,” and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a discrepancy include, but are not limited to, those discussed in “Part II—Item 1A—Risk Factors” and “Liquidity and Capital Resources” below. All forward-looking statements in this document are based on information available to us as of the date hereof and we assume no obligation to update any such forward-looking statements. The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and the accompanying notes contained in this quarterly report. Unless expressly stated or the context otherwise requires, the terms “we,” “our,” “us” and “NETGEAR” refer to NETGEAR, Inc. and our subsidiaries.

Business and Executive Overview

We are a global networking company that delivers innovative products to consumers, businesses and service providers. Our products are built on a variety of proven technologies such as wireless (WiFi and LTE), Ethernet and powerline, with a focus on reliability and ease-of-use. Our product line consists of wired and wireless devices that enable networking, broadband access and network connectivity. These products are available in multiple configurations to address the needs of our end-users in each geographic region in which our products are sold.

We operate in three specific business segments: retail, commercial, and service provider. We believe this structure enables us to better focus our efforts on our core customer segments and allows us to be more nimble and opportunistic as a company overall. Our CEO began temporarily serving as interim general manager of the retail business unit in March 2014 and as interim general manager of the service provider business unit in February 2015 due to the previous general managers' departures from the

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Company. Our CEO will continue to serve as interim general manager of both business units until replacements are appointed. The retail business unit is focused on individual consumers and consists of high performance, dependable and easy-to-use home networking, home security automation and storage products. The commercial business unit is focused on small and medium-sized businesses and consists of business networking, storage and security solutions that bring enterprise class functionality at an affordable price. The service provider business unit is focused on the service provider market and consists of made-to-order and retail-proven whole home networking hardware and software solutions, as well as 4G LTE hotspots sold to service providers for sale to their subscribers. We conduct business across three geographic regions: Americas, Europe, Middle-East and Africa ("EMEA") and Asia Pacific ("APAC").

The retail, commercial business, and broadband service provider markets are intensely competitive and subject to rapid technological change. We believe that the principal competitive factors in the retail, commercial, and service provider markets for networking products include product breadth, size and scope of the sales channel, brand name, timeliness of new product introductions, product availability, performance, features, functionality and reliability, ease-of-installation, maintenance and use, and customer service and support. To remain competitive, we believe we must continue to aggressively invest resources in developing new products and enhancing our current products while continuing to expand our channels and maintaining customer satisfaction worldwide.

We sell our networking products through multiple sales channels worldwide, including traditional retailers, online retailers, wholesale distributors, direct market resellers ("DMRs"), value-added resellers ("VARs"), and broadband service providers. Our retail channel includes traditional retail locations domestically and internationally, such as Best Buy, Costco, Fry's Electronics, K-mart, Staples, Target, Wal-Mart, Argos (U.K.), Dixons (U.K.), PC World (U.K.), MediaMarkt (Germany, Austria), Dick Smith (Australia), JB HiFi (Australia), Elkjop (Norway) and Sunning and Guomei (China). Online retailers include Amazon.com, Newegg.com and Buy.com. Our DMRs include CDW Corporation, Insight Corporation and PC Connection in domestic markets and Misco throughout Europe. In addition, we also sell our products through broadband service providers, such as multiple system operators ("MSOs"), DSL, and other broadband technology operators domestically and internationally. Some of these retailers and broadband service providers purchase directly from us, while others are fulfilled through wholesale distributors around the world. A substantial portion of our net revenue to date has been derived from a limited number of wholesale distributors and retailers. We expect that these wholesale distributors and retailers will continue to contribute a significant percentage of our net revenue for the foreseeable future.

During the third quarter of 2015, we experienced a 3.2% decrease in net revenue compared to the third quarter of 2014, driven primarily by a reduction in service provider net revenue. The decrease was primarily attributable to a reduction in gross shipments driven, in part, by continued weakness in carrier spending in North America and Europe, combined with the negative effects of a high degree of variability in carrier customer ordering patterns, a characteristic inherent to the service provider business unit. As previously announced, during the first quarter of 2015 we began to execute on our plans to reduce the cost structure of the service provider business unit and supporting functions to better align with the reduced revenue outlook, and to concentrate resources on LTE and long term and profitable accounts. These efforts continued in the third quarter of 2015. Retail net revenue increased compared to the prior year period, due primarily to an increase in gross shipments of broadband gateways, home wireless and home security automation products, partially offset by a reduction in gross shipments of multimedia products. We continue to see strong demand for our retail products, including the Nighthawk series and recently introduced Arlo Smart Home cameras. Commercial net revenue decreased compared to the prior year period due primarily to a reduction in gross shipments of network storage, wireless products and switches driven by a difficult small business climate in Europe caused by weakening foreign currencies compared to the U.S. dollar and economic uncertainty surrounding the Greek economic crisis. On a geographic basis, net revenue increased in the Americas, offset by declines experienced in EMEA and APAC. The increase in the Americas was driven primarily by an increase in gross shipments of our broadband gateways, home security automation, home wireless products and switches, partially offset by a decrease in gross shipments of our mobile and multimedia products. The decline in EMEA was driven primarily by a reduction in gross shipments of broadband gateways, home wireless, network storage products and switches, partially offset by an increase in gross shipments of home security automation and mobile products. The decline in APAC was driven primarily by a reduction in gross shipments of mobile and home wireless products, partially offset by an increase in gross shipments of our broadband gateways and home security automation products.

Looking forward, we expect growth in our retail business unit mainly driven by continued introduction and wider adoption of our new 802.11ac technology, the accelerated penetration of home security automation products and successfully establishing our cable gateways in the retail market. We expect growth in our commercial business unit driven by sales of our 10Gig switches, PoE switches, storage and wireless products among small and medium-sized businesses and end users. Although service provider results remained relatively strong in 2014, we began to see softening in the fourth quarter of the year and continued to experience declines in the nine months ended September 27, 2015 due to continued weakness in capital expense spending by certain service providers in both North America and in Europe. In the third quarter of 2015 we completed the steps necessary to reduce the cost structure of the service provider business unit and supporting functions to match the reduced revenue outlook and to concentrate

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resources on LTE and long-term and profitable accounts. We remain focused on improving profitability, while investing in key strategic growth areas. The areas that we are targeting continue to be LTE, 802.11ac, home security automation and our switching category of products.

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Results of Operations

The following table sets forth the unaudited condensed consolidated statements of operations for the three and nine months ended September 27, 2015, with the comparable reporting period in the preceding year.

	Three Months Ended						Nine Months Ended					
	September 27, 2015			September 28, 2014			September 27, 2015			September 28, 2014		
	(In thousands, except percentage data)											
Net revenue	$341,893	100.0	%	$353,338	100.0	%	$939,832	100.0	%	$1,040,333	100.0	%
Cost of revenue	245,566	71.8	%	251,005	71.0	%	677,569	72.1	%	742,889	71.4	%
Gross profit	96,327	28.2	%	102,333	29.0	%	262,263	27.9	%	297,444	28.6	%
Operating expenses:												
Research and development	21,572	6.3	%	23,337	6.6	%	63,126	6.7	%	67,994	6.5	%
Sales and marketing	35,923	10.5	%	39,283	11.2	%	107,538	11.5	%	117,373	11.3	%
General and administrative	11,803	3.5	%	11,726	3.3	%	33,192	3.5	%	34,995	3.4	%
Restructuring and other charges	1,016	0.3	%	1,360	0.4	%	6,384	0.7	%	2,190	0.2	%
Litigation reserves, net	—	—	%	69	0.0	%	(2,690)	(0.3	)%	254	0.0	%
Total operating expenses	70,314	20.6	%	75,775	21.5	%	207,550	22.1	%	222,806	21.4	%
Income from operations	26,013	7.6	%	26,558	7.5	%	54,713	5.8	%	74,638	7.2	%
Interest income	65	0.1	%	68	0.1	%	184	0.0	%	174	0.0	%
Other income (expense), net	(199)	(0.1	)%	2,246	0.6	%	(67)	0.0	%	1,911	0.2	%
Income before income taxes	25,879	7.6	%	28,872	8.2	%	54,830	5.8	%	76,723	7.4	%
Provision for income taxes	10,780	3.2	%	8,847	2.5	%	28,053	3.0	%	27,582	2.7	%
Net income	$15,099	4.4	%	$20,025	5.7	%	$26,777	2.8	%	$49,141	4.7	%

Net Revenue by Geographic Segment

Our net revenue consists of gross product shipments, less allowances for estimated returns for stock rotation and warranty, price protection, end-user customer rebates and other sales incentives deemed to be a reduction of net revenue per the authoritative guidance for revenue recognition, and net changes in deferred revenue.

We conduct business across three geographic regions: Americas, EMEA and APAC. For reporting purposes revenue is attributed to each geographic region based upon the location of the customer.

	Three Months Ended					Nine Months Ended				
	September 27, 2015	% Change		September 28, 2014		September 27, 2015	% Change		September 28, 2014	
	(In thousands, except percentage data)									
Americas	$219,736	13.3	%	$193,904		$565,981	(1.8	)%	$576,217	
Percentage of net revenue	64.3 %			54.9	%	60.2 %			55.4	%
EMEA	$77,725	(28.3	)%	$108,421		$234,827	(25.6	)%	$315,650	
Percentage of net revenue	22.7 %			30.7	%	25.0 %			30.3	%
APAC	$44,432	(12.9	)%	$51,013		$139,024	(6.4	)%	$148,466	

Percentage of net revenue	13.0 %		14.4 %	14.8 %		14.3 %
Total net revenue	$341,893	(3.2)%	$353,338	$939,832	(9.7)%	$1,040,333

Americas

The increase in Americas net revenue for the three months ended September 27, 2015 compared to the prior year periods was driven primarily by an increase in gross shipments of our broadband gateways, home security automation, home wireless products and switches, partially offset by a decrease in gross shipments of our mobile and multimedia products. The increase was due primarily to continued growth in the retail business unit driven by strong demand for our products, including the Nighthawk

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series and recently introduced Arlo Smart Home cameras. The increase in Americas net revenue was partially offset by a reduction in in service provider demand driven, in part, by continued weakness in North American carrier spending.

The decrease in Americas net revenue for the nine months ended September 27, 2015 compared to the prior year periods was driven primarily by a reduction in gross shipments of our mobile and multimedia products, partially offset by an increase in gross shipments of our broadband gateways, home security automation and home wireless products. The decrease was due primarily to a reduction in service provider demand driven by continued weakness in North American carrier spending. In our retail channel, we continue to see strong demand for our products, including the Nighthawk series and recently introduced Arlo Smart Home cameras.

EMEA

The decrease in EMEA net revenue for the three and nine months ended September 27, 2015 compared to the prior year periods was driven primarily by a reduction in gross shipments of broadband gateways, home wireless, network storage products and switches, partially offset by an increase in gross shipments of home security automation and mobile products. The decrease was primarily attributable to a reduction in gross shipments driven, in part, by continued weakness in European carrier spending, combined with the negative effects of a high degree of variability in carrier customer ordering patterns, a characteristic inherent to the service provider business unit. Our success in the region continues to be challenged by a difficult small business market climate caused by weakening foreign currencies compared to the U.S. dollar and economic uncertainty surrounding the Greek economic crisis.

APAC

The decrease in APAC net revenue for the three and nine months ended September 27, 2015 compared to the prior year periods was driven primarily by a reduction in gross shipments of mobile and home wireless products, partially offset by an increase in gross shipments of our broadband gateway and home security automation products. Similar to EMEA, APAC net revenue was constrained by weakening foreign currencies compared to the U.S. dollar.

Cost of Revenue and Gross Margin

Cost of revenue consists primarily of the following: the cost of finished products from our third party contract manufacturers; overhead costs, including purchasing, product planning, inventory control, warehousing and distribution logistics; third-party software licensing fees; inbound freight; warranty costs associated with returned goods; write-downs for excess and obsolete inventory, amortization expense of certain acquired intangibles and acquisition accounting adjustments to inventory.

We outsource our manufacturing, warehousing and distribution logistics. We believe this outsourcing strategy allows us to better manage our product costs and gross margin. Our gross margin can be affected by a number of factors, including fluctuation in foreign exchange rates, sales returns, changes in average selling prices, end-user customer rebates and other sales incentives, changes in our cost of goods sold due to fluctuations in prices paid for components, net of vendor rebates, warranty and overhead costs, inbound freight, conversion costs, charges for excess or obsolete inventory and amortization of acquired intangible assets. The following table presents costs of revenue and gross margin, for the periods indicated:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Cost of revenue	$245,566	(2.2)%	$251,005	$677,569	(8.8)%	$742,889
Gross margin percentage	28.2%		29.0%	27.9%		28.6%

Cost of Revenue

Cost of revenue decreased for the three and nine months ended September 27, 2015 compared to the prior year periods due primarily to the decrease in net revenue and related product costs attributable, in part, to continued weakness in carrier spending in North America and Europe, partially offset by higher freight costs.

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Gross Margin

Our gross margin decreased for the three months ended September 27, 2015 compared to the prior year period due primarily to weakening foreign currencies compared to the U.S. dollar and, to a lesser extent, an increase in per unit freight costs and warranty costs.

Our gross margin decreased for the nine months ended September 27, 2015 compared to the prior year period due primarily to weakening foreign currencies compared to the U.S. dollar and, to a lesser extent, an increase in per unit freight costs, partially offset by the positive effects of lower excess and obsolete inventory charges combined with a benefit recognized in the first quarter of 2015 relating to royalties previously accrued relating to the Ericsson patent litigation.

We expect gross margin percentage to remain relatively flat in the near term. Forecasting future gross margin percentages is difficult, and there are a number of risks related to our ability to maintain or improve our current gross margin levels. Our cost of revenues as a percentage of revenues can vary significantly based upon a number of factors such as the following: uncertainties surrounding revenue levels, including future pricing and/or potential discounts as a result of the economy or in response to the strengthening of the U.S. dollar in our international markets, and related production level variances; competition; changes in technology; changes in product mix; variability of stock-based compensation costs; royalties to third parties; fluctuations in freight and repair costs; manufacturing and purchase price variances; changes in prices on commodity components; warranty costs; and the timing of sales, particularly to service providers.

Operating Expenses

Research and Development

Research and development expenses consist primarily of personnel expenses, payments to suppliers for design services, safety and regulatory testing, product certification expenditures to qualify our products for sale into specific markets, prototypes and other consulting fees. Research and development expenses are recognized as they are incurred. We have invested in building our research and development organization to enhance our ability to introduce innovative and easy-to-use products. The following table presents research and development expense, for the periods indicated:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Research and development expense	$21,572	(7.6)%	$ 23,337	$63,126	(7.2)%	$ 67,994

Research and development expense decreased for the three months ended September 27, 2015 compared to the prior year period due primarily to a reduction in personnel-related costs of $1.4 million, driven by a reduction in headcount attributable to the restructuring activities executed in the first quarter of 2015, professional services of $0.7 million and facility-related expenses of $0.2 million, partially offset by an increase in variable compensation costs of $0.7 million.

Research and development expense decreased for the nine months ended September 27, 2015 compared to the prior year period due primarily to a reduction in personnel-related costs of $3.8 million, driven by a reduction in headcount attributable to the restructuring activities executed in the first quarter of 2015, and projects and professional services of $1.4 million.

Headcount decreased by 34 employees to 323 employees at September 27, 2015 compared to 357 employees at September 28, 2014.

We believe that innovation and technological leadership is critical to our future success, and we are committed to continuing a significant level of research and development to develop new technologies and products to combat competitive pressures. We continue to invest in research and development to expand our cloud platform capabilities, grow our home security camera and home automation device portfolio, develop innovative whole home WiFi coverage solutions and be first to market with the latest LTE technology. We expect research and development expenses to decrease as a percentage of revenue in the near term. Research and development expenses will fluctuate depending on the timing and number of development activities in any given quarter and could vary significantly as a percentage of revenue, depending on actual revenues achieved in any given quarter.

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Sales and Marketing

Sales and marketing expenses consist primarily of advertising, trade shows, corporate communications and other marketing expenses, product marketing expenses, outbound freight costs, amortization expenses, personnel expenses for sales and marketing staff and technical support expenses. The following table presents sales and marketing expense, for the periods indicated:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Sales and marketing expense	$35,923	(8.6)%	$ 39,283	$107,538	(8.4)%	$ 117,373

Sales and marketing expense decreased for the three months ended September 27, 2015 compared to the prior year period due primarily to a reduction in personnel-related costs of $2.2 million, driven by a reduction in headcount attributable to the restructuring activities executed in the first quarter of 2015, $0.2 million in marketing costs and $0.2 million in facility-related expenses.

Sales and marketing expense decreased for the nine months ended September 27, 2015 compared to the prior year period due primarily to a reduction in personnel-related costs of $5.7 million, driven by a reduction in headcount attributable to the restructuring activities executed in the first quarter of 2015, $1.9 million in outside professional services, $1.5 million in variable compensation, $0.5 million in marketing costs and $0.4 million in facility-related expenses, partially offset by an increase in freight costs of $0.3 million.

Headcount decreased by 34 employees to 349 employees at September 27, 2015 compared to 383 employees at September 28, 2014.

We expect our sales and marketing expense in the near term to remain relatively flat as a percentage of net revenue while we continue adjust our sales coverage to better align with our 2015 net revenue outlook, particularly for the service provider business unit. Expenses may fluctuate depending on revenue levels achieved as certain expenses, such as commissions, are determined based upon the revenues achieved. Forecasting sales and marketing expenses as a percentage of revenues is highly dependent on expected revenue levels and could vary significantly depending on actual revenues achieved in any given quarter. Marketing expenses will also fluctuate depending upon the timing, extent and nature of marketing programs as we introduce new products.

General and Administrative

General and administrative expenses consist of salaries and related expenses for executives, finance and accounting, human resources, information technology, professional fees, allowance for doubtful accounts and other general corporate expenses. The following table presents general and administrative expense, for the periods indicated:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
General and administrative expense	$11,803	0.7 %	$ 11,726	$33,192	(5.2)%	$ 34,995

General and administrative expense increased for the three months ended September 27, 2015 compared to the prior year period. The increase in variable compensation costs of $0.7 million was largely offset by reductions in personnel-related expenses of $0.5 million and facility, allocation and other expenses of $0.1 million.

General and administrative expense decreased for the nine months ended September 27, 2015 compared to the prior year period due primarily to a reduction in facilities, allocation and other expenses of $1.8 million, outside professional services of $1.2 million and personnel-related expenses of $0.2 million, partially offset by an increase in

variable compensation of $1.0 million and software-related expenses of $0.4 million.
Headcount decreased by 2 employees to 155 employees at September 27, 2015 compared to 157 employees at September 28, 2014.
We expect our general and administrative expenses to remain consistent with fiscal year 2014 as a percentage of net revenue in the near term but they could fluctuate depending on a number of factors, including the level and timing of expenditures associated

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with the litigation described in Note 7, Commitments and Contingencies, in the notes to unaudited condensed consolidated financial statements. Future general and administrative expense increases or decreases in absolute dollars are difficult to predict due to the lack of visibility of certain costs, including legal costs associated with defending claims against us, as well as legal costs associated with asserting and enforcing our intellectual property portfolio and other factors.

Restructuring and Other Charges

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Restructuring and other charges	$1,016	(25.3)%	$ 1,360	$6,384	191.5 %	$ 2,190

** Percentage change not meaningful.

Restructuring and other charges increased for the three months ended September 27, 2015 compared to the prior year period. Charges recognized in the third quarter of 2015 relate primarily to lease contract and employee termination charges associated with the restructuring actions announced in February 2015. Expenses incurred during the third quarter of 2014 relate primarily to lease contract termination charges.

Restructuring and other charges increased for the nine months ended September 27, 2015 compared to the prior year period. Expenses recognized for the nine months ended September 27, 2015 relate primarily to contract and employee termination charges, as well as other activities attributable to the restructuring actions announced in February 2015. Expenses recognized in the nine months ended September 28, 2014 relate primarily to contract termination charges and one-time employee separation charges associated with the departure of the retail business unit general manager.

In the third quarter of 2015 we completed the steps necessary to reduce the cost structure of the service provider business unit and supporting functions to match the reduced revenue outlook and to concentrate resources on LTE and long-term and profitable accounts. Management does not expect to incur any additional material charges associated with the restructuring actions announced in February 2015. We remain focused on improving profitability, while investing in key strategic growth areas. The areas that we are targeting continue to be LTE, 802.11ac, home security automation and our switching category of products. Restructuring actions are subject to significant risks, including delays in implementing expense control programs or workforce reductions and the failure to meet operational targets due to the loss of employees, all of which would impair our ability to achieve anticipated cost reductions. If we do not achieve anticipated cost reductions, our financial results could be negatively impacted. We do not believe that the estimated annual cost savings as a result of restructuring actions taken by the Company will result in a significant reduction of operating expenses as a percentage of net revenue in the near term.

For further discussion of restructuring and other charges, refer to Note 13, Restructuring and Other Charges, of the notes to unaudited condensed consolidated financial statements.

Litigation Reserves, Net

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Litigation reserves, net	$—	(100.0)%	$ 69	$(2,690)	**	$ 254

** Percentage change not meaningful.

No significant litigation reserves were recognized during the three months ended September 27, 2015 or September 28, 2014.

We recognized a benefit of $2.7 million during the nine months ended September 27, 2015 resulting from adjustments recorded to release litigation reserves previously accrued associated with the Ericsson patent litigation matter. In contrast, we recognized an expense of $0.3 million during the nine months ended September 28, 2014 for costs related to the settlement of lawsuits.

For a detailed discussion of our litigation matters, refer to Note 7, Commitments and Contingencies, in the notes to unaudited condensed consolidated financial statements.

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Interest Income and Other Income (Expense), Net

Interest income represents amounts earned on our cash, cash equivalents and short-term investments. Other income (expense), net primarily represents gains and losses on transactions denominated in foreign currencies and other miscellaneous income and expenses. The following table presents interest income and other income (expense), net, for the periods indicated:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Interest income	$65	(4.4)%	$ 68	$184	5.7 %	$ 174
Other income (expense), net	(199)	(108.9)%	2,246	(67)	(103.5)%	1,911
Total interest income and other income (expense), net	$(134)	(105.8)%	$ 2,314	$117	(94.4)%	$ 2,085

** Percentage change not meaningful.

Total interest income and other income (expense), net, decreased for the three and nine months ended September 27, 2015 compared to the prior year period. In the third quarter of 2014, we recognized income of $2.8 million relating to the execution of a litigation settlement agreement, which was partially offset by foreign currency losses incurred. In contrast, no significant other income (expense) was recognized during the three and nine months ended September 27, 2015.

Our foreign currency hedging program effectively reduced volatility associated with hedged currency exchange rate movements during the three and nine months ended September 27, 2015. For a detailed discussion of our hedging program and related foreign currency contracts, refer to Note 4, Derivative Financial Instruments, in the notes to unaudited condensed consolidated financial statements.

Provision for Income Taxes

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(In thousands, except percentage data)					
Provision for income taxes	$10,780	21.8 %	$ 8,847	$28,053	1.7 %	$ 27,582
Effective tax rate	41.7 %		30.6 %	51.2 %		36.0 %

During the three and nine months ended September 27, 2015, we incurred losses in a jurisdiction where no tax benefit could be recorded. As a result, the forecasted losses from this jurisdiction were excluded from the determination of tax expense for the respective periods. The increases in the effective tax rate for the three and nine months ended September 27, 2015 compared to the prior year periods were due primarily to an increase in losses incurred in a jurisdiction where no tax benefit could be recorded, as well as a shift in the distribution of earnings to jurisdictions with relatively higher tax rates. We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Our future foreign tax rate could be affected by changes in the composition in earnings in countries with tax rates differing from the U.S. federal rate. We are under examination in various U.S. and foreign jurisdictions.

In July 2015, the United States Tax Court (the “Court”) issued a taxpayer-favorable opinion with respect to Altera’s litigation with the Internal Revenue Service (“IRS”). The litigation relates to the treatment of share-based compensation expense in an inter-company cost-sharing arrangement with the taxpayer’s foreign subsidiary. In its opinion, the Court accepted Altera’s position of excluding share-based compensation in its cost sharing arrangement and concluded that the related IRS Regulations were invalid. Because there is uncertainty related to the IRS response to the Court’s opinion, the final resolution of this litigation, and the potential favorable benefits to us, we did not record any benefit for the three and nine months ended September 27, 2015. Management will continue to monitor developments related to this case and the potential impact of those developments on our current and future financial statements.

Segment Information

A description of our products and services, as well as segment financial data, for each segment and a reconciliation of segment contribution income to income before income taxes can be found in Note 10, Segment Information and Operations by Geographic Area, in the Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q.

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Retail

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(in thousands, except percentage data)					
Net revenue	$164,081	24.9 %	$ 131,341	$416,847	15.7 %	$ 360,236
Percentage of net revenue	48.0 %		37.1 %	44.3 %		34.6 %
Contribution income	$21,149	(3.0)%	$ 21,813	$53,715	4.9 %	$ 51,222
Contribution margin	12.9 %		16.6 %	12.9 %		14.2 %

Net revenue increased for the three and nine months ended September 27, 2015 compared to the prior year periods due primarily to an increase in gross shipments of broadband gateways, home wireless and home security automation products, partially offset by a reduction in gross shipments of multimedia products. Geographically, we experienced growth in the Americas, while net revenue in EMEA declined due primarily to challenges resulting from the macro-economic environment, increased competition and pricing pressures we continue to experience in the region, as well as weakening foreign currencies compared to the U.S. dollar. Net revenue in APAC also declined in the three and nine month compared to the prior year period. We continue to see strong end-user demand for our retail products, including the Nighthawk series and recently introduced Arlo Smart Home cameras. Through the nine months ended September 27, 2015, we have continued to expand our distribution of Arlo with U.S. retail customers and in select international markets, driving sequential gross shipment growth in each of the first three quarters of 2015. In contrast, no net revenue was generated by this product in 2014.

Contribution income decreased for the three months ended September 27, 2015 compared to the prior year period due primarily to weakening foreign currencies compared to the U.S. dollar and an increase in operating expenses occurring at a higher rate than the increase in net revenue. Contribution income was also impacted by an increase in freight costs of $2.8 million, driven by an increase in gross shipments.

Contribution income increased for the nine months ended September 27, 2015 compared to the prior year period due primarily to a decrease in excess and obsolete inventory charges and per unit warranty expense relative to the increase in net revenue.

Commercial

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(in thousands, except percentage data)					
Net revenue	$65,187	(9.4)%	$ 71,974	$200,935	(11.2)%	$ 226,284
Percentage of net revenue	19.1 %		20.4 %	21.4 %		21.8 %
Contribution income	$13,700	(9.3)%	$ 15,112	$42,507	(17.9)%	$ 51,781
Contribution margin	21.0 %		21.0 %	21.2 %		22.9 %

Net revenue decreased for the three months ended September 27, 2015 compared to the prior year period due primarily to a reduction in gross shipments of network storage, wireless products and switches. Geographically, we experienced a reduction in net revenue in EMEA, offset by growth in Americas and, to a lesser extent, APAC.

Net revenue decreased for the nine months ended September 27, 2015 compared to the prior year period due primarily to a reduction in gross shipments of network storage, wireless products and switches. Geographically, we experienced a reduction in EMEA and APAC net revenue, partially offset by growth in the Americas.

For the three and nine months ended September 27, 2015, net revenue continued to be impacted by the difficult small business market climate in Europe, caused by weakening foreign currencies compared to the U.S. dollar driving increased pricing pressures, and economic uncertainty surrounding the Greek economic crisis.

Contribution income decreased for the three and nine months ended September 27, 2015 compared to the prior year periods due primarily to a reduction in net revenue.

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Service Provider

	Three Months Ended			Nine Months Ended		
	September 27, 2015	% Change	September 28, 2014	September 27, 2015	% Change	September 28, 2014
	(in thousands, except percentage data)					
Net revenue	$112,625	(24.9)%	$150,023	$322,050	(29.0)%	$453,813
Percentage of net revenue	32.9%		42.5%	34.3%		43.6%
Contribution income	$14,819	4.6%	$14,164	$27,472	(36.0)%	$42,918
Contribution margin	13.2%					