NETGEAR, INC
Form 10-Q
August 05, 2016
Table of Contents

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 July 3, 2016.
¨ 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	77-0419172
(State or other jurisdiction of incorporation or organization)	(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 ¨	Accelerated filer	x
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 32,761,172 as of July 29, 2016.

Table of Contents

TABLE OF CONTENTS

PART I: FINANCIAL INFORMATION

Item 1.	Financial Statements	3
	Unaudited Condensed Consolidated Balance Sheets	3
	Unaudited Condensed Consolidated Statements of Operations	4
	Unaudited Condensed Consolidated Statements of Comprehensive Income	5
	Unaudited Condensed Consolidated Statements of Cash Flows	6
	Notes to Unaudited Condensed Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	31
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	41
Item 4.	Controls and Procedures	41
PART II: OTHER INFORMATION		
Item 1.	Legal Proceedings	42
Item 1A.	Risk Factors	42
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	63
Item 3.	Defaults Upon Senior Securities	63
Item 4.	Mine Safety Disclosures	63
Item 5.	Other Information	63
Item 6.	Exhibits	64
Signatures		65

Table of Contents

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

	July 3, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$226,011	$ 181,945
Short-term investments	126,661	96,321
Accounts receivable, net	230,550	290,642
Inventories	207,841	213,118
Prepaid expenses and other current assets	36,363	39,117
Total current assets	827,426	821,143
Property and equipment, net	19,273	22,384
Intangibles, net	40,459	48,947
Goodwill	81,721	81,721
Other non-current assets	71,887	76,374
Total assets	$1,040,766	$ 1,050,569
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$80,714	$ 90,546
Accrued employee compensation	31,217	27,868
Other accrued liabilities	132,124	166,282
Deferred revenue	29,261	29,125
Income taxes payable	—	1,951
Total current liabilities	273,316	315,772
Non-current income taxes payable	14,913	14,444
Other non-current liabilities	11,740	11,643
Total liabilities	299,969	341,859
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock	33	33
Additional paid-in capital	539,621	513,047
Accumulated other comprehensive income	59	3
Retained earnings	201,084	195,627
Total stockholders' equity	740,797	708,710
Total liabilities and stockholders' equity	$1,040,766	$ 1,050,569

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

Table of Contents

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

	Three Months Ended		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Net revenue	$311,655	$288,782	$621,911	$597,939
Cost of revenue	213,867	211,126	423,558	432,003
Gross profit	97,788	77,656	198,353	165,936
Operating expenses:				
Research and development	21,804	21,102	43,941	41,554
Sales and marketing	36,089	34,013	73,366	71,615
General and administrative	13,035	10,366	25,884	21,389
Restructuring and other charges	1,311	974	3,989	5,368
Litigation reserves, net	35	—	45	(2,690)
Total operating expenses	72,274	66,455	147,225	137,236
Income from operations	25,514	11,201	51,128	28,700
Interest income	279	67	513	119
Other income (expense), net	(332)	(343)	(698)	132
Income before income taxes	25,461	10,925	50,943	28,951
Provision for income taxes	9,427	7,258	18,320	17,273
Net income	$16,034	$3,667	$32,623	$11,678
Net income per share:				
Basic	$0.49	$0.11	$1.00	$0.34
Diluted	$0.48	$0.11	$0.98	$0.34
Weighted average shares used to compute net income per share:				
Basic	32,639	33,792	32,578	34,227
Diluted	33,493	34,308	33,390	34,790

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

Table of Contents

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

	Three Months Ended		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Net income	$16,034	$3,667	$32,623	$11,678
Other comprehensive income (loss), before tax:				
Unrealized gain (loss) on derivative instruments	511	(88)	(36)	(112)
Unrealized gain on available-for-sale securities	46	18	147	28
Other comprehensive income (loss), before tax	557	(70)	111	(84)
Tax expense related to items of other comprehensive income	(17)	(7)	(55)	(11)
Other comprehensive income (loss), net of tax	540	(77)	56	(95)
Comprehensive income	$16,574	$3,590	$32,679	$11,583

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

Table of Contents

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

	Six Months Ended					
	July 3, 2016			June 28, 2015		
Cash flows from operating activities:						
Net income	$	32,623		$	11,678	
Adjustments to reconcile net income to net cash provided by operating activities:						
Depreciation and amortization	16,887			18,692		
Purchase premium amortization/discount accretion on investments, net	56			(58		)
Non-cash stock-based compensation	9,430			8,406		
Income tax impact associated with stock option exercises	768			(799		)
Excess tax benefit from stock-based compensation	(1,426		)	(240		)
Deferred income taxes	3,857			2,220		
Changes in assets and liabilities:						
Accounts receivable	60,092			29,196		
Inventories	5,277			34,215		
Prepaid expenses and other assets	3,066			6,428		
Accounts payable	(9,866		)	(34,508		)
Accrued employee compensation	3,349			(2,999		)
Other accrued liabilities	(34,091		)	(20,912		)
Deferred revenue	136			(3,209		)
Income taxes payable	(1,482		)	(9,603		)
Net cash provided by operating activities	88,676			38,507		
Cash flows from investing activities:						
Purchases of short-term investments	(80,254		)	(25,105		)
Proceeds from sales and maturities of short-term investments	50,147			65,142		
Purchase of property and equipment	(5,060		)	(8,200		)
	(35,167		)	31,837		

Net cash provided by (used in) investing activities				
Cash flows from financing activities:				
Purchase and retirement of common stock	(27,167	)	(81,036	)
Proceeds from exercise of stock options	14,653		4,471	
Proceeds from issuance of common stock under employee stock purchase plan	1,645		1,502	
Excess tax benefit from stock-based compensation	1,426		240	
Net cash used in financing activities	(9,443	)	(74,823	)
Net increase (decrease) in cash and cash equivalents	44,066		(4,479	)
Cash and cash equivalents, at beginning of period	181,945		141,234	
Cash and cash equivalents, at end of period	$ 226,011		$ 136,755	

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

Table of Contents
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, 2015 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, 2015.
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 six months ended July 3, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016 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, 2015. The Company’s significant accounting policies have not materially changed during the six months ended July 3, 2016.

Recent Accounting Pronouncements

Accounting Pronouncement Recently Adopted

In November 2015, the FASB issued ASU 2015-17, "Balance Sheet Classification of Deferred Taxes" (Topic 740), which simplifies the presentation of deferred income taxes. This ASU requires that deferred tax assets and liabilities be classified as non-current in a statement of financial position. ASU 2015-17 may be adopted either prospectively or

retrospectively and is effective for reporting periods beginning after December 15, 2016, with early adoption permitted. The Company elected early adoption ASU 2015-17 effective December 31, 2015 on a prospective basis. Adoption of this ASU resulted in a reclassification of the Company's net current deferred tax asset to the net non-current deferred tax asset in its Consolidated Balance Sheet as of December 31, 2015. No prior periods were retrospectively adjusted.

Accounting Pronouncements Not Yet Effective

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" (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. In 2016, the FASB issued additional guidance to clarify the implementation guidance (ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations; ASU 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing; and ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients). The Company is in the process of evaluating the available transition methods and the impact of the guidance 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). The new guidance changes the subsequent measurement of inventory from lower of cost or market to lower of cost and net realizable value. ASU 2015-11 should be applied on a prospective basis and is effective for the Company 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.

In January 2016, the FASB issued ASU 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10). The changes to the current US GAAP financial instruments model primarily affect the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. This standard is effective for annual and interim reporting periods beginning after December 15, 2017. The Company is currently evaluating what impact, if any, the adoption of this standard will have on its financial position, results of operations or cash flows.

In February 2016, FASB issued ASU No. 2016-02, "Leases" (Topic 842), which requires lessees to recognize on the balance sheet a right-of-use asset, representing its right to use the underlying asset for the lease term, and a corresponding lease liability for all leases with terms greater than twelve months. This ASU becomes effective for the Company in the first quarter fiscal 2019 and early adoption is permitted. This ASU is required to be applied with a modified retrospective approach and requires application of the new standard at the beginning of the earliest comparative period presented. The Company is currently evaluating what impact the adoption of this standard will have on its financial position, results of operations or cash flows.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting" (Topic 718), which simplifies the accounting for share-based payment transactions, including the income tax consequences, forfeitures, and statutory tax withholding requirements, as well as classification on the statement of cash flows. ASU 2016-09 is effective for the Company beginning in the first quarter fiscal 2017, with early adoption permitted (an entity that elects early adoption must adopt all of the amendments in the same period). The Company is currently evaluating what impact the adoption of this standard will have on its financial position, results of operations or cash flows.

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 3. Balance Sheet Components

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

	As of July 3, 2016				December 31, 2015			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. treasuries	$125,103	$ 83	$ —	$125,186	$95,057	$ 1	$ (65)	$94,993
Certificates of deposit	151	—	—	151	147	—	—	147
Total	$125,254	$ 83	$ —	$125,337	$95,204	$ 1	$ (65)	$95,140

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 July 3, 2016	December 31, 2015
Gross accounts receivable	$248,796	$ 309,926
Allowance for doubtful accounts	(1,255)	(1,255)
Allowance for sales returns	(14,203)	(15,904)
Allowance for price protection	(2,788)	(2,125)
Total allowances	(18,246)	(19,284)
Total accounts receivable, net	$230,550	$ 290,642

Inventories (in thousands)

	As of July 3, 2016	December 31, 2015
Raw materials	$6,371	$ 4,292
Work in process	1	2
Finished goods	201,469	208,824
Total inventories	$207,841	$ 213,118

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.

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

Property and equipment, net (in thousands)

	As of July 3, 2016	December 31, 2015
Computer equipment	$11,542	$ 11,161
Furniture, fixtures and leasehold improvements	19,072	18,317
Software	31,287	30,396
Machinery and equipment	69,187	66,662
Total property and equipment, gross	131,088	126,536
Accumulated depreciation and amortization	(111,815)	(104,152)
Total property and equipment, net	$19,273	$ 22,384

Depreciation and amortization expense pertaining to property and equipment was $4.2 million and $8.1 million for the three and six months ended July 3, 2016, respectively, and $4.6 million and $9.4 million for the three and six months ended June 28, 2015, respectively.

Intangibles, net (in thousands)

	Gross	Accumulated Amortization	Net
July 3, 2016			
Technology	$61,099	$ (52,902)	$8,197
Customer contracts and relationships	56,500	(26,833)	29,667
Other	10,545	(7,950)	2,595
Total intangibles, net	$128,144	$ (87,685)	$40,459

	Gross	Accumulated Amortization	Net
December 31, 2015			
Technology	$61,099	$ (48,485)	$12,614
Customer contracts and relationships	56,500	(23,290)	33,210
Other	10,545	(7,422)	3,123
Total intangibles, net	$128,144	$ (79,197)	$48,947

Amortization of intangibles was $4.3 million and $8.5 million for the three and six months ended July 3, 2016, respectively, and $4.3 million and $8.8 million for the three and six months ended June 28, 2015, respectively.

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
2016 (remaining six months)	$8,433
2017	11,386
2018	7,871
2019	6,028
2020	5,316
Thereafter	1,425
Total estimated amortization expense	$40,459

Other non-current assets (in thousands)

	As of July 3, 2016	December 31, 2015
Non-current deferred income taxes	$64,588	$ 68,445
Other	7,299	7,929
Total other non-current assets	$71,887	$ 76,374

Other accrued liabilities (in thousands)

	As of July 3, 2016	December 31, 2015
Sales and marketing programs	$52,226	$ 69,693
Warranty obligation	50,393	56,706
Freight	5,998	5,748
Other	23,507	34,135
Total other accrued liabilities	$132,124	$ 166,282

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, Canadian dollars, 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 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.

Table of Contents

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

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 July 3, 2016 and December 31, 2015 are summarized as follows (in thousands):

Derivative Assets	Balance Sheet Location	Fair Value at July 3, 2016	Balance Sheet Location	Fair Value at December 31, 2015
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	$ 1,453	Prepaid expenses and other current assets	$ 3,203
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	28	Prepaid expenses and other current assets	2
Total		$ 1,481		$ 3,205

Derivative Liabilities	Balance Sheet Location	Fair Value at July 3, 2016	Balance Sheet Location	Fair Value at December 31, 2015
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	$ 524	Other accrued liabilities	$ 447
Derivative liabilities designated as hedging instruments	Other accrued liabilities	19	Other accrued liabilities	4
Total		$ 543		$ 451

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 July 3, 2016 and December 31, 2015 (in thousands):

As of July 3, 2016				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
	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	Net Amount

Barclays	$ 38	$ —	$ 38	$ (38)	$ —	$ —
Wells Fargo	$ 1,443	$ —	$ 1,443	$ (346)	$ —	$ 1,097
Total	$ 1,481	$ —	$ 1,481	$ (384)	$ —	$ 1,097

As of December 31, 2015				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
	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	Net Amount
Barclays	$ 577	$ —	$ 577	$ (56)	$ —	$ 521
Wells Fargo	2,628	—	2,628	(395)	—	2,233
Total	$ 3,205	$ —	$ 3,205	$ (451)	$ —	$ 2,754

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

The following tables set forth the offsetting of derivative liabilities as of July 3, 2016 and December 31, 2015 (in thousands):

As of July 3, 2016	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		Net Amount
				Financial Instruments	Cash Collateral Pledged	
Barclays	$ 197	$ —	$ 197	$ (38)	$ —	$ 159
Wells Fargo	346	—	346	(346)	—	—
Total	$ 543	$ —	$ 543	$ (384)	$ —	$ 159

As of December 31, 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		Net Amount
				Financial Instruments	Cash Collateral Pledged	
Barclays	$ 56	$ —	$ 56	$ (56)	$ —	$ —
Wells Fargo	395	—	395	(395)	—	—
Total	$ 451	$ —	$ 451	$ (451)	$ —	$ —

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 seven forward contracts per quarter with an average size of approximately $8.0 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 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 six months ended July 3, 2016 and June 28, 2015.

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

The effects of the Company's derivative instruments on OCI and the unaudited condensed consolidated statement of operations for the three and six months ended July 3, 2016 and June 28, 2015 are summarized as follows (in thousands):

Derivatives Designated as Hedging Instruments	Three Months Ended July 3, 2016				
	Gain (Loss) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (1)	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	$88	Net revenue	$ (407)	Other income (expense), net	$ 18
Foreign currency forward contracts	—	Cost of revenue	(2)	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(14)	Other income (expense), net	—
Total	$88		$ (423)		$ 18

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

Derivatives Designated as Hedging Instruments	Six Months Ended July 3, 2016				
	Gain (Loss) Recognized in OCI - Effective Portion (1)	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (1)	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	$(699)	Net revenue	$ (719)	Other income (expense), net	$ 53
Foreign currency forward contracts	—	Cost of revenue	—	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	56	Other income (expense), net	—
Total	$(699)		$ (663)		$ 53

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

Derivatives Designated as Hedging Instruments	Three Months Ended June 28, 2015				
	Gain (Loss) Recognized in OCI - Effective	Location of Gain (Loss) Reclassified from OCI into Income -	Gain (Loss) Reclassified from OCI into Income -	Location of Gain (Loss) Recognized in Income and Excluded from	Amount of Gain (Loss) Recognized in Income and Excluded from

	Portion	Effective Portion	Effective Portion (1)	Effectiveness Testing	Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$(688)	Net revenue	$ (775)	Other income (expense), net	$ (15)
Foreign currency forward contracts	—	Cost of revenue	5	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	170	Other income (expense), net	—
Total	$(688)		$ (600)		$ (15)

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

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

	Six Months Ended June 28, 2015				
Derivatives Designated as Hedging Instruments	Gain (Loss) Recognized in OCI - Effective Portion (1)	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gain (Loss) Reclassified from OCI into Income - Effective Portion (1)	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	$(883)	Net revenue	$ (922)	Other income (expense), net	$ (34)
Foreign currency forward contracts	—	Cost of revenue	4	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	147	Other income (expense), net	—
Total	$(883)		$ (771)		$ (34)

(1) 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 19 non-designated derivatives per quarter. The average size of its non-designated hedges is approximately $3.0 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 six months ended July 3, 2016 and June 28, 2015 are as follows (in thousands):

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		Six Months Ended	
		July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Foreign currency forward contracts	Other income (expense), net	$1,185	$(1,832)	$(759)	$2,011

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.

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

Net income per share for the three and six months ended July 3, 2016 and June 28, 2015 are as follows (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Numerator:				
Net income	$16,034	$ 3,667	$32,623	$11,678
Denominator:				
Weighted average common shares - basic	32,639	33,792	32,578	34,227
Potentially dilutive common share equivalent	854	516	812	563
Weighted average common shares - dilutive	33,493	34,308	33,390	34,790
Basic net income per share	$0.49	$ 0.11	$1.00	$0.34
Diluted net income per share	$0.48	$ 0.11	$0.98	$0.34
Anti-dilutive employee stock-based awards, excluded	431	2,631	$310	$2,440

Note 6. Income Taxes

The income tax provision for the three and six months ended July 3, 2016 was $9.4 million, or an effective tax rate of 37.0%, and $18.3 million, or an effective tax rate of 36.0% respectively. The income tax provision for the three and six months ended June 28, 2015 was $7.3 million, or an effective tax rate of 66.4%, and $17.3 million, or an effective tax rate of 59.7%, respectively. The effective tax rate for the three and six months ended July 3, 2016 compared to the three and six months ended June 28, 2015 decreased primarily due to changes in earnings incurred in a jurisdiction where a loss was not tax benefited for the three and six months ended June 28, 2015. For the three and six months ended June 28, 2015, the forecasted loss from this jurisdiction was excluded from the determination of tax expense. For the three months ended July 3, 2016, the Company did not exclude any jurisdictions from the determination of tax expense. The Company is subject to income taxes in the U.S. and numerous foreign jurisdictions. The 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. The Company is under examination in various U.S. and foreign jurisdictions.

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 $0.6 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.

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

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 July 3, 2016, the Company had approximately $138 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		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Balance as of beginning of the period	$49,908	$42,877	$56,706	$44,888
Provision for warranty obligation made during the period	18,593	14,982	34,808	31,237
Settlements made during the period	(18,108)	(16,892)	(41,121)	(35,158)
Balance at end of period	$50,393	$40,967	$50,393	$40,967

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 July 3, 2016.

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 July 3, 2016.

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 equity awards 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 July 3, 2016.

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

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 alleged 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 June 8, 2011, Ericsson filed an amended complaint that added Dell, Toshiba and Belkin as defendants. At the status conference held on June 9, 2011, the Court set a Markman (claim construction) hearing for June 28, 2012 and trial for June 3, 2013. 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. 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.

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 equated to 15 cents per unit for each accused 802.11 device sold by each defendant (5 cent per patent).

On December 16, 2013, the Company and 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.

In 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.

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.

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, August 2015, and December 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, the 2008 through 2010 tax years, and the 2011 through 2012 tax years, respectively.

In May 2014, the Company filed with the Provincial Tax Court of Milan an appeal brief, including 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 December 19, 2014. The Tax Court decided 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. On February 26, 2016 the Regional Tax Court conducted the appeals hearing for the 2004 year, ruling in favor of the Company. On June 13, 2016, the Inland Revenue Agency appealed the decision to the Supreme Court. The Company has filed a counter appeal.

In June, 2015, the Company filed with the Provincial Tax Court of Milan an appeal brief including a Request for Hearing in Open Court and Request for Suspension of the Tax Assessment for the 2005 through 2007 tax years. The hearing for suspension was held and the Request for Suspension of payment was granted. The hearing for the validity of the tax assessment for 2005 and 2006 was held in December 2015 with the Provincial Tax Court issuing its decision in favor of the Company. The Inland Revenue Agency filed its appeal with the Regional Tax Court.

The hearing for the validity of the tax assessment for 2007 was held on March 10, 2016 with the Provincial Tax Court who issued its decision in favor of the Company on April 7, 2016. The Inland Revenue Agency has until November 7, 2016 to file for an appeal to the Regional Tax Court with regard to the 2007 tax year.

With respect to 2008 through 2010, the Company filed its briefs with the Tax Court in October 2015 and the hearing for the validity of the tax assessments was held on April 21, 2016 and a decision favorable to the Company was issued on May 12, 2016. The Inland Revenue Agency has until December 9, 2016 to file an appeal to the Regional Tax Court.

With respect to 2011 through 2012, the Company has filed its appeal brief on February 26, 2016 the Provincial Tax Court to contest this assessment. The hearing for suspension was held and the Request for Suspension of payment was granted.

With regard to all tax years, 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 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. On July 30, 2015 the Court granted the Company's motion to transfer venue to the Northern District of California. In addition, the Company learned that Amazon and Blizzard filed petitions for the inter partes reviews ("IPRs") for the patents in suit. On October 30, 2015, the Company and Via Vadis filed a joint stipulation requesting that the Court vacate all deadlines and enter a stay of all proceedings in the case pending the Patent Trial and Appeal Board's final non-appealable decision on the IPRs initiated by Amazon and Blizzard. On November 2, 2015 the Court granted the requested stay. On March 8, 2016, the Patent Trial and Appeal Board issued written decisions instituting the IPRs jointly filed by Amazon and Blizzard.

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 CMS 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 answered the complaint on September 15, 2015. On November 24, 2015, CMS served its infringement contentions on the Company, and CMS is generally attempting to assert that the patents in suit cover the Power over Ethernet standard (802.3af and 802.3at) used by certain of NETGEAR's products.

On December 3, 2015, the Company filed with the Court a motion to transfer venue to the District Court for the Northern District of California and their memorandum of law in support thereof. On December 23, 2015, CMS filed its response to the Company's motion to transfer, and, on January 8, 2016, the Company filed its reply brief in support of its motion to transfer venue. On January 15, 2016, the Court granted the Company's motion to transfer venue to the District Court for the Northern District of California. The initial case management conference in the Northern District of California occurred on May 13, 2016, and the claim construction hearing is scheduled for December 20, 2016. Discovery is ongoing.

Table of Contents

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

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

Wi3, INC. v. NETGEAR, Inc.

On November 12, 2015, a lawsuit was filed against the Company by a company called Wi3, INC. (“Wi3”) in the United States District Court, Western District of New York. The patent No. 6,108,331 (the “'331 Patent”) is entitled “Single Medium Wiring Scheme for Multiple Signal Distribution in Building and Access Port Therefor,” and was filed in 1998, and should expire in July 2018. The complaint alleges direct and indirect infringement, and accuses NETGEAR’s MoCA Network Adapters and/or Network Extenders (including at least model MCA1001 v2) of infringing at least claims 26, 27, 29, and 30. The complaint alleges no pre-suit knowledge of the patent, but seeks enhanced damages. The patent has been asserted in three prior cases, and all three cases were resolved in the early stages.

The Company filed its answer to the Wi3 complaint on March 11, 2016. In the answer, the Company denied the infringement allegations and put forth several counterclaims. Subsequent to the Company’s answer, the parties participated in some motion practice resulting in an amended answer and counterclaims being filed by the Company on April 1, 2016. Wi3 answered the Company’s amended answer and counterclaims on April 13, 2016. The initial case management conference is scheduled for August 17, 2016, and the claim construction hearing is scheduled for September 13, 2017.

The Company does not expect there to be a material financial impact to the Company resulting from this litigation matter.

Tessera v. NETGEAR, Inc.

On May 23, 2016, Tessera Technologies, Inc., Tessera, Inc., and Invensas Corp. (collectively, “Tessera”) filed a complaint requesting that the U.S. International Trade Commission (“Commission”) commence an investigation pursuant to Section 337 by reason of alleged infringement of certain patent claims by the Company and other respondents. On June 20, 2016, the Commission issued the related Notice of Investigation, and the Investigation was instituted on June 24, 2016.

The Tessera complaint alleges that the following “Proposed Respondents” unlawfully import into the U.S., sell for importation, and/or sell within the U.S. after importation certain semiconductor devices, semiconductor device packages, and products containing the same that infringe one or more claims of U.S. Patent Nos. 6,856,007 (the ‘007 patent), 6,849,946 (the ‘946 patent), and 6,133,136 (the ‘136 patent) (collectively, the “asserted patents”): Broadcom Limited of Singapore; Broadcom Corp. of Irvine, California; Avago Technologies Limited of Singapore; Avago Technologies U.S. Inc. of San Jose, California; Arista Networks, Inc. of Santa Clara, California; ARRIS International plc of Suwanee, Georgia; ARRIS Group, Inc. of Suwanee, Georgia; ARRIS Technology, Inc. of Horsham, Pennsylvania; ARRIS Enterprises LLC of Suwanee, Georgia; ARRIS Solutions, Inc. of Suwanee, Georgia; Pace Ltd. (formerly Pace plc) of England; Pace Americas, LLC of Boca Raton, Florida; Pace USA, LLC of Boca Raton, Florida; ASUSTeK Computer Inc. of Taiwan; ASUS Computer International of Fremont, California; Comcast Cable Communications, LLC of Philadelphia, Pennsylvania; Comcast Cable Communications Management, LLC of Philadelphia, Pennsylvania; Comcast Business Communications, LLC of Philadelphia, Pennsylvania; HTC Corp. of Taiwan; HTC America, Inc. of Bellevue, Washington; Technicolor S.A. of France; Technicolor USA, Inc. of Indianapolis, Indiana; Technicolor Connected Home USA LLC of Indianapolis, Indiana; and the Company.

According to the complaint, the asserted patents generally relate to semiconductor packaging technology. In particular, the ‘007 patent relates to a compact and economical semiconductor chip assembly that includes a packaged semiconductor chip, a chip carrier with a metallic thermal conductor, and a circuit panel with a thermal conductor mounting. The ‘946 patent relates to a semiconductor layout configuration and method that results in a more efficient planarization process for a semiconductor chip. Lastly, the ‘136 patent relates to a structure for metal interconnects used in semiconductor packaging.

In the complaint, Tessera states that the Proposed Respondents import and sell products that infringe the asserted patents. In particular, the complaint refers to multiple categories of accused semiconductor products associated with Broadcom and asserts that the remaining Proposed Respondents import and sell products that contain these infringing Broadcom semiconductor products. Tessera requested that the Commission issue a permanent limited exclusion order and a permanent cease and desist order directed at the Proposed Respondents and related entities.

The claim construction hearing for the Investigation is scheduled for December 1, 2016; the evidentiary hearing is scheduled for March 27 - 31, 2017; and the target date for completion of the Investigation is October 24, 2017.

Concurrently with the filing of the instant ITC complaint, Tessera also filed a complaint against Broadcom Corp. in the U.S. District Court for the District of Delaware alleging infringement of the asserted patents. The Company has not been sued in Delaware or any other jurisdiction other than the ITC.

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

Symbology v. NETGEAR, Inc.

On June 7, 2016, the Company and numerous other companies were sued in the Eastern District of Texas by a non-practicing entity named Symbology Innovations, LLC (“Symbology”). The lawsuit alleges infringement of three patents: U.S. Patent Nos. 8,424,752 (the ‘752 Patent); 8,651,369 (the ‘369 Patent); and 8,936,190 (the ‘190 Patent) (collectively “Patents in Suit”). The Patents in Suit are all entitled “System and method for presenting information about an object on a portable electronic device”, and the complaint targets the Company’s use of QR codes. In total, Symbology has filed approximately 50 lawsuits against 50 companies alleging infringement of the Patents in Suit.

The alleged infringers Symbology is targeting are advertisers using QR codes. The plaintiff generally is alleging that the Patents in Suit cover the use of QR codes to display content from a website, such as using a mobile phone to scan the QR code, whereby the phone gets the URL from the QR code and fetches the associated web page and then displays it on the mobile phone.

The Company was served with the complaint on July 8, 2016, and its answer is due on August 29, 2016.

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.

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.

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

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 six months ended July 3, 2016 and June 28, 2015 are discussed below. As of July 3, 2016, 1.6 million shares remained authorized for repurchase under the repurchase program approved by the Board in July 2015. All shares authorized under previously approved programs were fully utilized. The Company repurchased, reported based on trade date, 0.6 million shares of common stock at a cost of $23.3 million during the six months ended July 3, 2016. The Company repurchased, reported based on trade date, 2.7 million shares of common stock at a cost of $84.6 million under the repurchase authorization during the six months ended June 28, 2015.
The Company repurchased, as reported based on trade date, approximately 91,000 shares of common stock at a cost of $3.9 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 six months ended July 3, 2016. Similarly, during the six months ended June 28, 2015, the Company repurchased approximately 73,000 shares of common stock at a cost of $2.3 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.
Accumulated Other Comprehensive Income, Net

The following table sets forth the changes in accumulated other comprehensive income ("AOCI") by component, for the six months ended July 3, 2016 and June 28, 2015 (in thousands):

	Gains and losses on available-for-sale securities	Gains and losses on derivatives	Total
Beginning balance as of December 31, 2015	$ (40)	$ 43	$ 3
Other comprehensive income (loss) before reclassifications	92	(699)	(607)
Amounts reclassified from accumulated other comprehensive income	—	663	663
Net current period other comprehensive income (loss)	92	(36)	56
Ending balance as of July 3, 2016	$ 52	$ 7	$ 59

	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	17	(883)	(866)
Amounts reclassified from accumulated other comprehensive income	—	771	771
Net current period other comprehensive income (loss)	17	(112)	(95)
Ending balance as of June 28, 2015	$ 12	$ (69)	$ (57)

23

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

The following tables provide details about significant amounts reclassified out of each component of AOCI for the three and six months ended July 3, 2016 and June 28, 2015 (in thousands):

Details about Accumulated Other Comprehensive Income Components	Three Months Ended July 3, 2016		Six Months Ended July 3, 2016	
	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	$(407)	Net revenue	$(719)	Net revenue
Foreign currency forward contracts	(2)	Cost of revenue	—	Cost of revenue
Foreign currency forward contracts	(14)	Operating expenses	56	Operating expenses
	(423)	Total before tax	(663)	Total before tax
	148	Tax impact	232	Tax impact
	$(275)	Total, net of tax	$(431)	Total, net of tax

Details about Accumulated Other Comprehensive Income Components	Three Months Ended June 28, 2015		Six Months Ended June 28, 2015	
	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	$(775)	Net revenue	$(922)	Net revenue
Foreign currency forward contracts	5	Cost of revenue	4	Cost of revenue
Foreign currency forward contracts	170	Operating expenses	147	Operating expenses
	(600)	Total before tax	(771)	Total before tax
	—	Tax impact (1)	—	Tax impact (1)
	$(600)	Total, net of tax	$(771)	Total, net of tax

(1) Under the Company's 2015 tax structure, all hedging gains and losses from derivative contracts were ultimately borne by a legal entity in a jurisdiction with no income tax.

Note 9. Employee Benefit Plans

2006 Long Term Incentive Plan

The Company's 2006 Long Term Incentive Plan (the "2006 Plan") expired on April 13, 2016 by its terms. No further equity awards can be granted under the 2006 Plan. The 2006 Plan will continue to govern awards previously granted under it.

2016 Equity Incentive Plan

In April 2016, the Company's Board of Directors adopted the 2016 Equity Incentive Plan (the "2016 Plan") which was approved by the Company's stockholders at the 2016 Annual Meeting of Stockholders on June 3, 2016. The 2016 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares and performance units to eligible directors, employees and consultants of the Company. Award vesting periods for this plan are generally four years. The maximum aggregate number of shares that may be issued under the 2016 Plan is 2,500,000 Shares, plus (i) any shares that were available for grant under the Company’s 2006 Plan as of immediately prior to the 2006 Plan's expiration by its terms, which was 699,827 shares, plus (ii) any shares granted under the 2006 Plan that expire, are forfeited to or repurchased by the Company. As of July 3, 2016,

approximately 3.1 million shares were reserved for future grants under the 2016 Plan.

Options granted under the 2016 Plan may be either incentive stock options or nonstatutory stock options. Incentive stock options (“ISO”) may be granted only to Company employees (including officers and directors who are also employees). Nonstatutory stock options (“NSO”) may be granted to Company employees, directors and consultants. Options may be granted for periods of up to ten years and at prices no less than the estimated fair value of the common stock on the date of grant. In addition, the exercise price of an ISO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. Options granted under the 2016 Plan generally vest over four years, the first tranche at the end of twelve months and the remaining shares underlying the option vesting monthly over the remaining three years.

Stock Appreciation Rights may be granted under the 2016 Plan subject to the terms specified by the plan administrator, provided that the term of any such right may not exceed ten (10) years from the date of grant. The exercise price may not be less than the fair market value of the Company’s common stock on the date of grant. Restricted stock awards may be granted under the 2016 Plan subject to the terms specified by the plan administrator. The period over which any restricted award may fully vest is generally no less than three (3) years. Restricted stock awards are nonvested stock awards that may include grants of restricted stock or grants of restricted stock units. Restricted stock awards are rights to acquire or purchase shares that generally are subject to transferability and forfeitability restrictions for a specified period. Restricted stock has the same voting rights as other common stock and is considered to be currently issued and outstanding. Restricted stock units do not have the voting rights of common stock, and the shares underlying the restricted stock units are not considered issued and outstanding. The Company expenses the cost of the restricted stock awards, which is determined to be the fair market value of the shares at the date of grant, ratably over the period during which the restrictions lapse.

Performance units and performance shares are awards that result in a payment to a participant only if specified performance objectives or other vesting provisions are achieved during a specified performance period. Each performance unit will have an initial value established by the Administrator on or before the grant date. Each performance share will have an initial value equal to the fair market value of a share on the grant date. The plan administrator will determine the number of performance awards that will be granted and will establish the performance goals and other conditions for payment of such performance awards. The period of measuring the achievement of performance goals will be specified by an award agreement.

Other stock or cash awards may be granted under the 2016 Plan subject to the terms specified by the plan administrator.

Any shares subject to restricted stock, restricted stock units, performance units, or performance shares awarded under the 2016 Plan will be counted against the shares available for issuance under the 2016 Plan as one and fifty-eight hundredths (1.58) shares for every one share subject to such awards. Any shares of common stock subject to an award that is forfeited, settled in cash, expires or is otherwise settled without the issuance of shares shall again be available for awards under the 2016 Plan. Additionally, any shares that are tendered by a participant of the 2016 Plan or retained by the Company as full or partial payment to the Company for the purchase of an award or to satisfy tax withholding obligations in connection with an award shall no longer again be made available for issuance under the 2016 Plan.

Employee Stock Purchase Plan

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. Prior to February 16, 2016, employees could purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date. As the price of the shares was determined at the purchase date, the Company recognized expense based on the 15% discount at purchase. Beginning February 16, 2016, the terms of the plan include a look-back feature that enables employees to purchase stock semi-annually at a price equal to 85% of the lesser of the fair market value at the beginning of the offering period or the purchase date. The duration of each offering period is generally six-months. The fair value of the shares offered under the ESPP is estimated at grant using a Black-Scholes option valuation model. In April 2016, the Company approved an amendment to the 2003 Employee Stock Purchase plan to increase the number of shares of common stock authorized for sale under the Purchase Plan by 1,000,000 shares to a total of 2,000,000 shares. As of July 3, 2016, approximately 1.05 million shares were available for issuance under the ESPP.

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

Option Activity
Stock option activity during the six months ended July 3, 2016 was as follows:

	Number of shares	Weighted Average Exercise Price Per Share
	(in thousands)	(in dollars)
Outstanding at December 31, 2015	2,461	$ 30.08
Granted	328	39.53
Exercised	(470)	30.87
Cancelled	(14)	34.09
Expired	(1)	34.68
Outstanding at July 3, 2016	2,304	$ 31.24

RSU Activity

RSU activity during the six months ended July 3, 2016 was as follows:

	Number of shares	Weighted Average Grant Date Fair Value Per Share
	(in thousands)	(in dollars)
Outstanding at December 31, 2015	964	$ 31.63
RSUs granted	442	40.36
RSUs vested	(299)	31.25
RSUs cancelled	(66)	30.82
Outstanding at July 3, 2016	1,041	$ 35.50

Valuation and Expense Information
The fair value of each option award and share granted under the ESPP commencing February 16, 2016 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 for options and ESPP shares 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 for options and ESPP shares 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 six months ended July 3, 2016 and June 28, 2015 and purchase rights granted under the ESPP commencing February 16, 2016 during the three and six months ended July 3, 2016.

	Three Months Ended	Six Months Ended

	ESPP (1)	Stock Options		ESPP	Stock Options	
	July 3, 2016	July 3, 2016	June 28, 2015	July 3, 2016	July 3, 2016	June 28, 2015
Expected life (in years)	N/A	N/A	4.5	0.5	4.4	4.5
Risk-free interest rate	N/A	N/A	1.45%	0.42%	1.28%	1.44%
Expected volatility	N/A	N/A	39.3%	44.7%	35.4%	39.3%
Dividend yield	N/A	N/A	—	—	—	—

(1) No purchase rights were granted under the ESPP during the three months ended July 3, 2016.

Table of Contents
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		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Cost of revenue	$451	$ 336	$890	$ 832
Research and development	1,118	773	1,984	1,618
Sales and marketing	1,338	1,272	2,535	2,665
General and administrative	2,112	1,677	4,021	3,291
Total stock-based compensation	$5,019	$ 4,058	$9,430	$ 8,406

As of July 3, 2016, $7.4 million of unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.9 years. $27.3 million of unrecognized compensation cost related to unvested RSUs, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.8 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 has identified its CEO as the CODM and 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 video security, storage and digital media 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. Each business unit contains leadership focused on the product development efforts, both from a product marketing and engineering standpoint, to service the unique needs of these customer segments. 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 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.

27

Table of Contents
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		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
Net revenue:				
Retail	$170,646	$131,809	$328,189	$252,766
Commercial	73,671	63,017	142,103	135,748
Service provider	67,338	93,956	151,619	209,425
Total net revenue	311,655	288,782	621,911	597,939
Contribution income:				
Retail	$25,660	$16,247	$49,959	$32,566
Retail contribution margin	15.0 %	12.3 %	15.2 %	12.9 %
Commercial	18,551	12,564	33,388	28,807
Commercial contribution margin	25.2 %	19.9 %	23.5 %	21.2 %
Service Provider	8,252	3,895	22,710	12,653
Service Provider contribution margin	12.3 %	4.1 %	15.0 %	6.0 %
Total segment contribution income	52,463	32,706	106,057	74,026
Corporate and unallocated costs	(16,418)	(12,230)	(33,134)	(25,196)
Amortization of intangibles (1)	(4,166)	(4,243)	(8,331)	(8,639)
Stock-based compensation expense	(5,019)	(4,058)	(9,430)	(8,406)
Restructuring and other charges	(1,311)	(974)	(3,989)	(5,368)
Losses on inventory commitments due to restructuring	—	—	—	(407)
Litigation reserves, net	(35)	—	(45)	2,690
Interest income	279	67	513	119
Other income (expense), net	(332)	(343)	(698)	132
Income before income taxes	$25,461	$10,925	$50,943	$28,951

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(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		Six Months Ended	
	July 3, 2016	June 28, 2015	July 3, 2016	June 28, 2015
United States (U.S.)	$203,508	$168,282	$392,874	$338,874
Americas (excluding U.S.)	7,400	4,177	11,884	7,371
EMEA	51,653	67,993	116,158	157,102
Australia	28,851	31,008	59,984	60,661
APAC (excluding Australia)	20,243	17,322	41,011	33,931
Total net revenue	$311,655	$288,782	$621,911	$597,939

28

Table of Contents

NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Long-lived assets include purchased intangibles, goodwill and property and equipment. The Company's property and equipment are located in the following geographic locations (in thousands):

	As of July 3, 2016	December 31, 2015
United States	$8,677	$ 9,832
Canada	3,422	3,586
EMEA	310	468
China	5,013	6,562
APAC (excluding China)	1,851	1,936
	$19,273	$ 22,384

Note 11. Fair Value Measurements (in thousands)

The following tables summarize assets and liabilities measured at fair value on a recurring basis as of July 3, 2016:

	As of July 3, 2016			
	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	$10,634	$ 10,634	$ —	$ —
Available-for-sale securities—U.S. treasuries (1)	125,186	125,186	—	—
Available-for-sale securities—certificates of deposit (1)	151	151	—	—
Trading securities—mutual funds (1)	1,324	1,324	—	—
Foreign currency forward contracts (2)	1,481	—	1,481	—
Total assets measured at fair value	$138,776	$ 137,295	$ 1,481	$ —

(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 July 3, 2016			
	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)	$543	$ —	$ 543	$ —
Total liabilities measured at fair value	$543	$ —	$ 543	$ —

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

Table of Contents

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, 2015:

	As of December 31, 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	$10,976	$ 10,976	$ —	$ —
Available-for-sale securities—U.S. treasuries (1)	94,993	94,993	—	—
Available-for-sale securities—certificates of deposit (1)	147	147	—	—
Trading securities—mutual funds (1)	1,181	1,181	—	—
Foreign currency forward contracts (2)	3,205	—	3,205	—
Total assets measured at fair value	$110,502	$ 107,297	$ 3,205	$ —

(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, 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)	$451	$ —	$ 451	$ —
Total liabilities measured at fair value	$451	$ —	$ 451	$ —

(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 July 3, 2016 and December 31, 2015, 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 $2.7 million and $4.8 million for the three and six months ended July 3, 2016, respectively, and $2.4 million and $5.6 million for the three and six months ended June 28, 2015, respectively.

Note 13. Restructuring and Other Charges

The Company incurred restructuring and other charges of $1.3 million and $4.0 million during the three and six months ended July 3, 2016, respectively. Restructuring and other charges recognized in the second quarter of 2016 related primarily to severance as headcount reductions occurred within the commercial business unit. The headcount reductions were implemented in line with channel shift and changing buying behaviors being experienced for the commercial business unit products. Restructuring and other charges recognized in the first quarter of 2016, and the first and second quarter of 2015, respectively, related to actions

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

to resize our service provider business unit and supporting functions. The actions were taken to match the reduced revenue outlook and to concentrate resources on LTE Advanced and long-term and profitable accounts. Charges incurred in these periods primarily related to severance, other one-time termination benefits and other associated costs attributable to the restructuring actions announced in February 2015 and January 2016, respectively.

Accrued restructuring and other charges are classified within other accrued liabilities in the unaudited condensed consolidated balance sheets. 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 six months ended July 3, 2016 (in thousands):

	Accrued Restructuring and Other Charges at December 31, 2015	Additions (1)	Cash Payments	Adjustments	Accrued Restructuring and Other Charges at July 3, 2016
Restructuring					
Employee termination charges	$ 13	$ 3,128	$ (2,308)	$ (40)	$ 793
Lease contract termination and other charges	1,253	582	(286)	—	1,549
Total Restructuring and other charges	$ 1,266	$ 3,710	$ (2,594)	$ (40)	$ 2,342

(1) Total restructuring and other charges recognized in the Company's unaudited condensed consolidated statement of operations for the six months ended July 3, 2016 includes non-cash charges and adjustments, net of $0.3 million. These amounts have been excluded from the table above.

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. Each business unit contains leadership focused on the product development efforts, both from a product marketing and engineering standpoint, to service the unique needs of these customer segments. The retail business unit is focused on individual consumers and consists of high performance, dependable and easy-to-use home networking, home video security, storage and digital media 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 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, Staples, Target, Wal-Mart, Argos (U.K.), Dixons (U.K.), PC World (U.K.), MediaMarkt (Europe), Darty (France), JB HiFi (Australia), Elkjop (Norway) and Sunning and Guomei (China). Online retailers include Amazon.com worldwide, Newegg.com (US), JD.com and Alibaba (China), as well as NBB.com (Germany) and Coolblue.com (Netherlands). 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"), xDSL, 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 second quarter of 2016, we experienced a 7.9% increase in net revenue compared to the second quarter of 2015, driven primarily by increases in retail net revenue, to a lesser extent, commercial business unit net revenue, partially offset by a decrease in service provider net revenue. Retail net revenue in the second quarter of 2016 increased 29% compared to the prior year period due to an increase in gross shipments of home security camera products, broadband gateways and home wireless products. Additionally, the increase in retail net revenue was due to a continued focus to increase average selling prices by offering premium differentiated products. We continue to see strong demand for our retail products, including the Nighthawk family and Arlo Smart Home cameras. Commercial net revenue in the second quarter of 2016 increased compared to the prior year period due to an increase in gross shipments of switches, partially offset by a reduction in gross shipment of network storage products. Service provider net revenue in the second quarter of 2016 decreased compared to the prior year period due primarily to a reduction in gross shipments of broadband gateways and mobile products. As previously announced, in 2015 we began to execute on our plans to resize our service provider business for higher profitability by focusing on higher margin products and accounts while reducing the cost structure of this business unit. In line with this objective, we made further restructuring efforts in the first quarter of 2016. On a geographic basis, net revenue increased in the Americas and slightly increased in APAC, offset by a decline in EMEA. The increase in Americas was driven primarily by an increase in gross shipments of our broadband gateways, home security cameras and home wireless products, partially offset by a decrease in gross shipments of our mobile products. The increase in APAC was driven by an increase in gross shipments of broadband gateways and switches, partially offset by a reduction in gross shipments of our mobile products. The decrease in EMEA was driven primarily by a reduction in gross shipments of broadband gateways, partially offset by an increase in gross shipments of home security camera products.

Looking forward, we expect growth in our retail business unit mainly driven by gaining additional market share for home security camera products, cable products sold in retail and WiFi high end router and extender products. We expect growth in our commercial business unit driven by the sales of our 11 ac WLAN products and web-managed PoE and 10Gig switches. We also expect approximately $65 million per quarter revenue run rate for the service provider business unit for the remainder of 2016 as we continue to remain focused on improving profitability.

Table of Contents

Results of Operations

The following table sets forth the unaudited condensed consolidated statements of operations for the three and six months ended July 3, 2016, with the comparable reporting period in the preceding year.

	Three Months Ended				Six Months Ended			
	July 3, 2016		June 28, 2015		July 3, 2016		June 28, 2015	
	(In thousands, except percentage data)							
Net revenue	$311,655	100.0 %	$288,782	100.0 %	$621,911	100.0 %	$597,939	100.0 %
Cost of revenue	213,867	68.6 %	211,126	73.1 %	423,558	68.1 %	432,003	72.2 %
Gross profit	97,788	31.4 %	77,656	26.9 %	198,353	31.9 %	165,936	27.8 %
Operating expenses:								
Research and development	21,804	7.0 %	21,102	7.3 %	43,941	7.1 %	41,554	6.9 %
Sales and marketing	36,089	11.6 %	34,013	11.8 %	73,366	11.8 %	71,615	12.0 %
General and administrative	13,035	4.2 %	10,366	3.6 %	25,884	4.2 %	21,389	3.6 %
Restructuring and other charges	1,311	0.4 %	974	0.3 %	3,989	0.6 %	5,368	0.9 %
Litigation reserves, net	35	0.0 %	—	— %	45	0.0 %	(2,690)	(0.4)%
Total operating expenses	72,274	23.2 %	66,455	23.0 %	147,225	23.7 %	137,236	23.0 %
Income from operations	25,514	8.2 %	11,201	3.9 %	51,128	8.2 %	28,700	4.8 %
Interest income	279	0.1 %	67	0.0 %	513	0.1 %	119	0.0 %
Other income (expense), net	(332)	(0.1)%	(343)	(0.1)%	(698)	(0.1)%	132	0.0 %
Income before income taxes	25,461	8.2 %	10,925	3.8 %	50,943	8.2 %	28,951	4.8 %
Provision for income taxes	9,427	3.1 %	7,258	2.5 %	18,320	3.0 %	17,273	2.8 %
Net income	$16,034	5.1 %	$3,667	1.3 %	$32,623	5.2 %	$11,678	2.0 %

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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Americas	$210,908	22.3 %	$172,459	$404,758	16.9 %	$346,245
Percentage of net revenue	67.6 %		59.8 %	65.1 %		57.9 %
EMEA	$51,653	(24.0)%	$67,993	$116,158	(26.1)%	$157,102
Percentage of net revenue	16.6 %		23.5 %	18.7 %		26.3 %
APAC	$49,094	1.6 %	$48,330	$100,995	6.8 %	$94,592
Percentage of net revenue	15.8 %		16.7 %	16.2 %		15.8 %
Total net revenue	$311,655	7.9 %	$288,782	$621,911	4.0 %	$597,939

Americas

The increase in Americas net revenue for the three and six months ended July 3, 2016 compared to the prior year periods was driven primarily by an increase in gross shipments of our broadband gateways, home security camera

products, home wireless products and switches, partially offset by a decrease in gross shipments of our mobile products. The increase was primarily due to continued growth in the retail business unit driven by strong demand for our products, including the Nighthawk family and Arlo Smart Home cameras. Additionally, the increase was due to a continued focus to increase the average selling prices on our retail products. The increase in Americas net revenue was partially offset by a reduction in service provider net revenues. Service provider

Table of Contents

net revenue fell versus the prior year period as we continue to prioritize profitability with respect to service provider business opportunities.

EMEA

The decrease in EMEA net revenue for the three and six months ended July 3, 2016 compared to the prior year was driven primarily by a reduction in gross shipments of broadband gateways, partially offset by an increase in gross shipments of home security camera products and switches. The decrease in gross shipments was driven by a decline in service provider gross shipments as we continue to prioritize profitability with respect to service provider business opportunities. In the period ended June 28, 2015 we recorded a charge of $3.3 million against net revenue relating to an anticipated credit to a customer to resolve a disputed quality issue. We no longer believe there to be a quality issue after obtaining two independent party reports, and consequently the full amount of this charge was reversed in the three months ended April 3, 2016. The reversal of this charge positively benefited EMEA net revenue through the six months ended July 3, 2016 partially offsetting the underlying service provider business unit decline. Further, the decline in service provider net revenue was offset by growth in retail business unit, and to a lesser extent, commercial business unit net revenue in both the three and six months ended July 3, 2016.

APAC

The increase in APAC net revenue for the three and six months ended July 3, 2016 compared to the prior year was driven primarily by an increase in gross shipments of broadband gateways and switches, partially offset by a reduction in gross shipments of our mobile products. The increase was due, in part, to improved performance in both our commercial and service provider business units.

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 and duty; warranty costs associated with returned goods; write-downs for excess and obsolete inventory, amortization expense of certain acquired intangibles and restructuring 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 and duty, 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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Cost of revenue	$213,867	1.3 %	$211,126	$423,558	(2.0)%	$432,003
Gross margin percentage	31.4 %		26.9 %	31.9 %		27.8 %

Cost of Revenue

Cost of revenue increased for the three months ended July 3, 2016 compared to the prior year period due in part to increased net revenue of $22.9 million. The shift in net revenue away from service provider business unit toward the

retail business unit positively impacted cost of revenue as the increase in cost of revenue lagged the increase in net revenue for the period.

Cost of revenue decreased for the six months ended July 3, 2016 compared to the prior year period. Retail business unit net revenue grew $75.4 million, offset by declines in service provider net revenue of $57.8 million. The shift in business unit net revenue was primarily attributable to the decline as cost of revenue associated with retail business unit products represent a lower proportion of net revenue than service provider business unit products.

Gross Margin

Our gross margin increased for the three and six months ended July 3, 2016 compared to the prior year period. The change in business unit net revenue from service provider to retail combined with higher average selling prices on our retail business unit products are primarily attributable to the improved performance. In addition, gross margins for the six months ended July 3, 2016

Table of Contents

were positively impacted by the reversal in first quarter 2016 of a $3.3 million charge recorded previously against net revenue. The charge was originally recorded in the second quarter of 2015 and related to an anticipated credit to a customer to resolve a disputed quality issue.

We expect gross margin achievement will increase versus the prior year 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, duty 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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Research and development expense	$21,804	3.3 %	$21,102	$43,941	5.7 %	$41,554

Research and development for the three months ended July 3, 2016 increased $0.7 million year over year. The increase was attributable to increased variable compensation of $1.4 million offset by lower outside engineering services of $1.1 million. Outside engineer expenses in the three months ended July 3, 2016 decreased as a result of reduced revenue expectations for our service provider business unit on a year over year basis. Research and development expense increased for the six months ended July 3, 2016 compared to the prior year period due primarily to an increase in variable compensation of $2.9 million. The increase was offset primarily by a $1.0 million reduction in outside engineering services associated with our service provider business unit.

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, and develop innovative WiFi and LTE Advanced coverage solutions. In the near future, we expect research and development expenses to grow in absolute dollars as we are allocating resources in the key areas that we expect will drive future growth and profitability. 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.

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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Sales and marketing expense	$36,089	6.1 %	$34,013	$73,366	2.4 %	$71,615

Table of Contents

Sales and marketing expense increased for the three months ended July 3, 2016 compared to the prior year period. The increase was attributable to increases in product marketing expenses of $0.8 million, variable compensation of $0.7 million and personnel-related costs of $0.5 million.
Sales and marketing expense increased for the six months ended July 3, 2016 compared to the prior year period. The increase was mainly attributable to increases in variable compensation of $1.3 million and personnel-related costs of $1.0 million, partially offset by a reduction in freight cost of $0.8 million.
We expect our sales and marketing expense in the near term to remain relatively flat as a percentage of net revenue while we continue to adjust our sales coverage to better align with our 2016 net revenue outlook. 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, including legal costs associated with defending claims against us, allowance for doubtful accounts and other general corporate expenses. The following table presents general and administrative expense, for the periods indicated:

	Three Months Ended			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
General and administrative expense	$13,035	25.7 %	$10,366	$25,884	21.0 %	$21,389

General and administrative expense increased for the three months ended July 3, 2016 compared to the prior year period mainly due to increases in variable compensation costs of $1.2 million and personnel related expense of $0.8 million.
General and administrative expense increased for the six months ended July 3, 2016 compared to the prior year period mainly due to increases in variable compensation costs of $2.1 million and personnel related expense of $1.2 million.
We expect our general and administrative expenses to remain flat 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 with litigation defense costs in connection 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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Restructuring and other charges	$1,311	34.6 %	$ 974	$3,989	(25.7)%	$ 5,368

Restructuring and other charges recognized in the second quarter of 2016 related primarily to severance as headcount reductions occurred within our commercial business unit. The headcount reductions were implemented in line with channel shift and changing buying behaviors being experienced for our commercial business unit products.

Restructuring and other charges recognized in the first quarter of 2016, and the first and second quarter of 2015 respectively related to actions to resize our service provider business unit and supporting functions. The actions were taken to match the reduced revenue outlook and to concentrate resources on LTE Advanced and long-term and profitable accounts. Charges incurred in these periods primarily related to severance, other one-time termination benefits and other associated costs attributable to the restructuring actions announced in February 2015 and January 2016, respectively.

Management does not expect to incur any additional material charges associated with the two restructuring actions executed in the first half of 2016. Restructuring actions are subject to significant risks, including delays in implementing expense control

Table of Contents

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.

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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Litigation reserves, net	$35	**	$ —	$45	**	$(2,690)

**Percentage change not meaningful.

No significant litigation reserves or benefits were recognized during the three and six months ended July 3, 2016. By contrast, we recognized a benefit of $2.7 million during the six months ended June 28, 2015 resulting from adjustments recorded to release accrued litigation reserves associated with the Ericsson patent litigation matter.

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

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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Interest income	$279	**	$67	$513	**	$ 119
Other income (expense), net	(332)	(3.2)%	(343)	(698)	**	132
Total interest income and other income (expense), net	$(53)	**	$(276)	$(185)	**	$ 251

**Percentage change not meaningful.

Interest income increased for the three and six months ended July 3, 2016 compared to the prior year periods due to increases in both short term investment average balances and yields obtained on such balances being more favorable than the prior year period.

Other income (expense), net, decreased slightly for the three months ended July 3, 2016 and changed from benefits to expense in the six months ended July 3, 3016 compared to the prior year periods. The expense in 2016 primarily related to impairment of a receivable from sale of cost method investment and losses recognized relating to foreign currency. Our foreign currency hedging program effectively reduced volatility associated with hedged currency exchange rate movements during the three and six months ended July 3, 2016. 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			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(In thousands, except percentage data)					
Provision for income taxes	$9,427	29.9 %	$7,258	$18,320	6.1 %	$17,273
Effective tax rate	37.0 %		66.4 %	36.0 %		59.7 %

Table of Contents

The decrease in the effective tax rate for the three and six months ended July 3, 2016 compared to the three and six months ended June 28, 2015 was due primarily to changes in earnings incurred in a jurisdiction where a loss was not tax benefited for the three and six months ended June 28, 2015. For the three and six months ended June 28, 2015, the forecasted loss from this jurisdiction was excluded from the determination of tax expense. For the three and six months ended July 3, 2016, we did not exclude any jurisdictions from the determination of tax expense. 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.

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.

Retail

	Three Months Ended			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(in thousands, except percentage data)					
Net revenue	$170,646	29.5 %	$131,809	$328,189	29.8 %	$252,766
Percentage of net revenue	54.8 %		45.7 %	52.8 %		42.3 %
Contribution income	$25,660	57.9 %	$16,247	$49,959	53.4 %	$32,566
Contribution margin	15.0 %		12.3 %	15.2 %		12.9 %

Retail net revenue increased for the three and six months ended July 3, 2016 compared to the prior year period due primarily to an increase in gross shipments of home security camera products, broadband gateways and home wireless products. Additionally, the increase in retail net revenue was due to a continued focus to increase average selling prices on our retail products. Geographically, we experienced growth in the Americas, a modest increase in EMEA net revenue, while net revenue for APAC declined slightly. We continue to see strong end-user demand for our recently introduced retail products, including the Nighthawk series and Arlo Smart Home cameras.

Contribution income increased for the three and six months ended July 3, 2016 compared to the prior year periods due primarily to growth in net revenue. Additionally our strategy of pursuing higher average selling prices resulted in higher gross margins and profitability for the retail business unit.

Commercial

	Three Months Ended			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(in thousands, except percentage data)					
Net revenue	$73,671	16.9 %	$63,017	$142,103	4.7 %	$135,748
Percentage of net revenue	23.6 %		21.8 %	22.8 %		22.7 %
Contribution income	$18,551	47.7 %	$12,564	$33,388	15.9 %	$28,807
Contribution margin	25.2 %		19.9 %	23.5 %		21.2 %

Commercial net revenue increased for the three and six months ended July 3, 2016 compared to the prior year periods due primarily to an increase in gross shipments of switches, partially offset by a reduction in gross shipments of network storage products. Geographically, we experienced growth in all three regions.

Contribution income increased for the three and six months ended July 3, 2016 compared to the prior year periods due primarily to growth in net revenue. The growth in net revenue did not require corresponding investment in operating expense enabling greater contribution income return. Contribution income was further improved by the performance of the switch product portfolio which delivered improved gross margins.

Table of Contents

Service Provider

	Three Months Ended			Six Months Ended		
	July 3, 2016	% Change	June 28, 2015	July 3, 2016	% Change	June 28, 2015
	(in thousands, except percentage data)					
Net revenue	$67,338	(28.3)%	$93,956	$151,619	(27.6)%	$209,425
Percentage of net revenue	21.6 %		32.5 %	24.4 %		35.0 %
Contribution income	$8,252	111.9 %	$3,895	$22,710	79.5 %	$12,653
Contribution margin	12.3 %		4.1 %	15.0 %		6.0 %

Service provider net revenue decreased for the three and six months ended July 3, 2016 compared to the prior year periods due primarily to a reduction in gross shipments of broadband gateways and mobile products. Geographically, we experienced a reduction in service provider net revenue in EMEA and the Americas. The reduction was partially offset by growth in APAC. As previously announced, we took steps to restructure the service provider business unit in the first and second quarter of 2015 and again in the first quarter of 2016. The actions were taken to match the reduced revenue outlook and to concentrate resources on LTE Advanced and long-term and profitable accounts.
Contribution income increased for the three and six months ended July 3, 2016 compared to the prior year periods as restructuring efforts taken yielded additional contribution income through reductions in operating expenses combined with higher gross margin achievement. On a year over year basis, operating expenses decreased approximately 50% as a result of headcount reduction. Contribution income for the six months ended July 3, 2016 was further positively impacted by the reversal of the $3.3 million charge recorded against net revenue in the second quarter of 2015. The charge related to an anticipated credit to a customer to resolve a disputed quality issue. We no longer believe there to be a quality issue after obtaining two independent party reports, and consequently the full amount of this charge was reversed in the first quarter of 2016.

Liquidity and Capital Resources

Our cash and cash equivalents balance increased from $181.9 million as of December 31, 2015 to $226.0 million as of July 3, 2016. Our short-term investments, which represent the investment of funds available for current operations, increased from $96.3 million as of December 31, 2015 to $126.7 million as of July 3, 2016 as we increased purchases of Treasuries. Operating activities during the six months ended July 3, 2016 provided cash of $88.7 million, compared to $38.5 million provided in the six months ended June 28, 2015, resulting primarily from increase in net income and changes in working capital. Investing activities during the six months ended July 3, 2016 used cash of $35.2 million, mainly due to net purchase of short-term investments and purchases of property and equipment. During the six months ended July 3, 2016, financing activities used cash of $9.4 million, primarily due to the repurchase of common stock, partially offset by proceeds from the issuance of common stock upon exercise of stock options and our employee stock purchase program.
Our days sales outstanding ("DSO") was 67 days as of July 3, 2016, which decreased from 77 days as of December 31, 2015. DSO as of December 31, 2015 was higher due to seasonal payment terms extended to our larger retail customers; as of July 3, 2016 we have returned to a more normal range of DSO as these extended terms are no longer applicable. Additionally, the reduction in service provider net revenue contributed to DSO improvement as the standard payment terms with service provider customers is significantly longer than our standard payment terms for our other customers.
Our accounts payable decreased from $90.5 million at December 31, 2015 to $80.7 million at July 3, 2016. The decrease was primarily attributable to timing of payments.

Inventory decreased by $5.3 million from $213.1 million at December 31, 2015 to $207.8 million at July 3, 2016. In the three months ended July 3, 2016, we experienced annualized ending inventory turns of approximately 4.1, down from 4.8 turns in the three months ended December 31, 2015.

We enter into foreign currency forward-exchange contracts, which typically mature in three to five months, to hedge a portion of our exposure to foreign currency fluctuations of foreign currency-denominated revenue, costs of revenue, certain operating expenses, receivables, payables, and cash balances. We record, in the unaudited condensed consolidated balance sheet at each reporting period, the fair value of our forward-exchange contracts and record any fair value adjustments in our unaudited condensed consolidated statements of operations and in our unaudited condensed consolidated balance sheet. Gains and losses associated with currency rate changes on hedge contracts that are non-designated under the authoritative guidance for derivatives and hedging are recorded within other income (expense), net, offsetting foreign exchange gains and losses on our monetary assets and liabilities.

Gains and losses associated with currency rate changes on hedge contracts that are cash flow hedges under the authoritative guidance for derivatives and hedging are recorded within accumulated other comprehensive income until the related revenue, costs of revenue, or expenses are recognized.

From time to time, our Board of Directors has authorized programs under which we may repurchase shares of our common stock, depending on market conditions, in the open market or through privately negotiated transactions. Under these 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 our common stock. During the six months ended July 3, 2016, we repurchased and retired, reported based on trade date, approximately 0.6 million shares of common stock at a cost of $23.3 million. During the six months ended June 28, 2015, we repurchased and retired, reported based on trade date, 2.7 million shares of common stock at a cost of $84.6 million. As of July 3, 2016, 1.6 million shares remained authorized for repurchase under the repurchase program approved by the Board in July 2015. All shares authorized under previously approved programs were fully utilized. We plan to continue to repurchase shares opportunistically.

We repurchased, as reported based on trade date, approximately 91,000 shares of common stock at a cost of $3.9 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 six months ended July 3, 2016. Similarly, during the six months ended June 28, 2015, we repurchased approximately 73,000 shares of our common stock at a cost of $2.3 million under the same program to help facilitate tax withholding for RSUs. These shares were retired upon repurchase.

Based on our current plans and market conditions, we believe that our existing cash, cash equivalents and short-term investments will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months. However, we may require or desire additional funds to support our operating expenses and capital requirements or for other purposes, such as acquisitions, and may seek to raise such additional funds through public or private equity financing or from other sources. We cannot assure you that additional financing will be available at all or that, if available, such financing would be obtainable on terms favorable to us and would not be dilutive. Our future liquidity and cash requirements will depend on numerous factors, including the introduction of new products and potential acquisitions of related businesses or technology.

Contractual Obligations

There have been no material changes during the six months ended July 3, 2016 to the contractual obligations disclosed in Part II, Item 7, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

We lease office space, cars and equipment under non-cancelable operating leases with various expiration dates through December 2026. The terms of certain of our facility leases provide for rental payments on a graduated scale. We recognize rent expense on a straight-line basis over the lease period and have accrued for rent expense incurred but not paid.

We enter into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of the 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 July 3, 2016, we had approximately $138 million in non-cancelable purchase commitments with suppliers. We establish a loss liability for all products we do not expect to sell for which we have committed purchases from suppliers. Such losses have not been material to date. From time to time our suppliers procure unique complex components on our behalf. If these components do not meet specified technical criteria or are defective, we should not be obligated to purchase the materials. However, disputes may arise as a result and significant resources may be spent resolving such disputes.

As of July 3, 2016, we had $14.9 million of total gross unrecognized tax benefits and related interest. The timing of any payments that could result from these unrecognized tax benefits will depend upon a number of factors. The

possible reduction in liabilities for uncertain tax positions in multiple jurisdictions that may impact the statement of operations in the next 12 months is approximately $0.6 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

Off-Balance Sheet Arrangements

As of July 3, 2016, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

Table of Contents

Critical Accounting Policies and Estimates

For a complete description of what we believe to be the critical accounting policies and estimates used in the preparation of our unaudited condensed consolidated financial statements, refer to our Annual Report on Form 10-K for the year ended December 31, 2015. There have been no changes to our critical accounting policies and estimates during the six months ended July 3, 2016.

Recent Accounting Pronouncements

See Note 2, Summary of Significant Accounting Policies, in Notes to Unaudited Condensed Consolidated Financial Statements in Item 1 of Part I of this Report on Form 10-Q, for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on financial condition and results of operations, which are hereby incorporated by reference.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

During the six months ended July 3, 2016, there were no material changes to our market risk disclosures as set forth in Part II Item 7A "Quantitative and Qualitative Disclosures About Market Risk" in our Annual Report on Form 10-K for the year ended December 31, 2015.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on an evaluation under the supervision and with the participation of our management (including our Chief Executive Officer and Chief Financial Officer), our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), were effective as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially effect, our internal control over financial reporting. It should be noted that any system of controls, however well designed and operated, can provide only reasonable assurance, and not absolute assurance, that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals in all future circumstances.

Table of Contents

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

The information set forth under Note 7, Commitments and Contingencies, in Item 1 of Part I of this Quarterly Report on Form 10-Q, is incorporated herein by reference. For an additional discussion of certain risks associated with legal proceedings, see the section entitled "Risk Factors" in Part II, Item 1A of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

Investing in our common stock involves a high degree of risk. The risks described below are not exhaustive of the risks that might affect our business. Other risks, including those we currently deem immaterial, may also impact our business. Any of the following risks could materially adversely affect our business operations, results of operations and financial condition and could result in a significant decline in our stock price. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the unaudited condensed consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q

We have marked with an asterisk (*) those risks described below that reflect substantive changes from the risks described under Part I, Item 1A "Risk Factors" included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 19, 2016.

* We expect our operating results to fluctuate on a quarterly and annual basis, which could cause our stock price to fluctuate or decline.

Our operating results are difficult to predict and may fluctuate substantially from quarter-to-quarter or year-to-year for a variety of reasons, many of which are beyond our control. If our actual results were to fall below our estimates or the expectations of public market analysts or investors, our quarterly and annual results would be negatively impacted and the price of our stock could decline. Other factors that could affect our quarterly and annual operating results include those listed in the risk factors section of this report and others such as:

- changes in the pricing policies of or the introduction of new products by us or our competitors;

- slow or negative growth in the networking product, personal computer, Internet infrastructure, Smart Home, home electronics and related technology markets, as well as decreased demand for Internet access;

- seasonal shifts in end market demand for our products, particularly in our retail business;

- delays in the introduction of new products by us or market acceptance of these products;

- shift in overall product mix sales from higher to lower margin products, or from one business unit to another, that would adversely impact our margins;

- delay or failure of our service provider customers to purchase at the volumes that they forecast;

- unanticipated increase in costs, including air freight, associated with shipping and delivery of our products;

- foreign currency exchange rate fluctuations in the jurisdictions where we transact sales and expenditures in local currency;

- component supply constraints from our vendors;
- unfavorable level of inventory and turns;
- changes in or consolidation of our sales channels and wholesale distributor relationships or failure to manage our sales channel inventory and warehousing requirements;
- delay or failure to fulfill orders for our products on a timely basis;

Table of Contents

- changes in international trade policy that adversely affect customs, tax or duty rates, including consequences of the recent "Brexit" referendum in the United Kingdom;
- operational disruptions, such as transportation delays or failure of our order processing system, particularly if they occur at the end of a fiscal quarter;
- disruptions or delays related to our financial and enterprise resource planning systems;
- our inability to accurately forecast product demand, particularly from our service provider sales channel, resulting in increased inventory exposure;
- the inability to maintain stable operations by our suppliers and other parties with which we have commercial relationships;
- allowance for bad debts exposure with our existing customers and new customers, particularly as we expand into new international markets;
- unanticipated shift or decline in profit by geographical region that would adversely impact our tax rate;
- geopolitical disruption leading to delay or even stoppage of our operations in manufacturing, transportation, technical support and research and development;
- terms of our contracts with customers or suppliers that cause us to incur additional expenses or assume additional liabilities;
- an increase in price protection claims, redemptions of marketing rebates, product warranty and stock rotation returns or allowance for doubtful accounts;
- litigation involving alleged patent infringement;
- epidemic or widespread product failure, or unanticipated safety issues, in one or more of our products;
- challenges associated with integrating acquisitions that we make, or with realizing value from our strategic investments in other companies;
- failure to effectively manage our third party customer support partners, which may result in customer complaints and/or harm to the NETGEAR brand;
- our inability to monitor and ensure compliance with our anti-corruption compliance program and domestic and international anti-corruption laws and regulations, whether in relation to our employees or with our suppliers or customers;
- labor unrest at facilities managed by our third-party manufacturers;
- our failure to implement and maintain the appropriate internal controls over financial reporting which may result in restatements of our financial statements; and
- any changes in accounting rules.

As a result, period-to-period comparisons of our operating results may not be meaningful, and you should not rely on them as an indication of our future performance.

Our stock price may be volatile and your investment in our common stock could suffer a decline in value.

There has been significant volatility in the market price and trading volume of securities of technology and other companies, which may be unrelated to the financial performance of these companies. These broad market fluctuations may negatively affect the market price of our common stock.

Table of Contents

Some specific factors that may have a significant effect on our common stock market price include:

- actual or anticipated fluctuations in our operating results or our competitors' operating results;
- actual or anticipated changes in the growth rate of the general networking sector, our growth rates or our competitors' growth rates;
- conditions in the financial markets in general or changes in general economic conditions, including government efforts to stabilize currencies;
- interest rate or currency exchange rate fluctuations;
- our ability to forecast or report accurate financial results; and
- changes in stock market analyst recommendations regarding our common stock, other comparable companies or our industry generally.

* If we fail to continue to introduce or acquire new products that achieve broad market acceptance on a timely basis, we will not be able to compete effectively and we will be unable to increase or maintain net revenue and gross margins.

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop or acquire, and introduce new products that achieve broad market acceptance. Our future success will depend in large part upon our ability to identify demand trends in the commercial business, retail, and service provider markets and quickly develop or acquire, and manufacture and sell products that satisfy these demands in a cost effective manner. In order to differentiate our products from our competitors' products, we must continue to increase our focus and capital investment in research and development, including software development. For example, we have committed a substantial amount of resources to the development, manufacture and sale of our Nighthawk series and Arlo Smart Home camera products and to introducing additional and improved models in these lines. If these products do not continue to achieve widespread market acceptance, or if we are unsuccessful in capitalizing on other Smart Home market opportunities, our future growth may be slowed and our financial results could be harmed. Successfully predicting demand trends is difficult, and it is very difficult to predict the effect introducing a new product will have on existing product sales. We will also need to respond effectively to new product announcements by our competitors by quickly introducing competitive products.

In addition, we have acquired companies and technologies in the past and as a result, have introduced new product lines in new markets. We may not be able to successfully manage integration of the new product lines with our existing products. Selling new product lines in new markets will require our management to learn different strategies in order to be successful. We may be unsuccessful in launching a newly acquired product line in new markets which requires management of new suppliers, potential new customers and new business models. Our management may not have the experience of selling in these new markets and we may not be able to grow our business as planned. For example, in April 2013, we completed the acquisition of the AirCard product line from Sierra Wireless. Similarly, we acquired certain technology and intellectual property in connection with our acquisition of AVAAK, Inc. in July 2012 that has been key to the development of our Arlo Smart Home camera products. If we are unable to effectively and successfully further develop these new product lines, we may not be able to increase or maintain our sales and our gross margins may be adversely affected.

We have experienced delays and quality issues in releasing new products in the past, which resulted in lower quarterly net revenue than expected. In addition, we have experienced, and may in the future experience, product introductions

that fall short of our projected rates of market adoption. Online Internet reviews of our products are increasingly becoming a significant factor in the success of our new product launches, especially in the retail business unit. If we are unable to quickly respond to negative reviews, including end user reviews posted on various prominent online retailers, our ability to sell these products will be harmed. Any future delays in product development and introduction, or product introductions that do not meet broad market acceptance, or unsuccessful launches of new product lines could result in:

- loss of or delay in revenue and loss of market share;

- negative publicity and damage to our reputation and brand;

- a decline in the average selling price of our products;

- adverse reactions in our sales channels, such as reduced shelf space, reduced online product visibility, or loss of sales channel; and

- increased levels of product returns.

Throughout the past few years, we have significantly increased the rate of our new product introductions. If we cannot sustain that pace of product introductions, either through rapid innovation or acquisition of new products or product lines, we may not be able to maintain or increase the market share of our products. In addition, if we are unable to successfully introduce or acquire new products with higher gross margins, our net revenue and overall gross margin would likely decline.

* We rely on a limited number of traditional and online retailers, wholesale distributors and service provider customers for a substantial portion of our sales, and our net revenue could decline if they refuse to pay our requested prices or reduce their level of purchases or if there is significant consolidation in our customer base which results in fewer customers for our products.

We sell a substantial portion of our products through traditional and online retailers, including Best Buy Co., Inc., Amazon.com, Inc. and their affiliates, wholesale distributors, including Ingram Micro, Inc. and Tech Data Corporation, and service providers, such as AT&T. We expect that a significant portion of our net revenue will continue to come from sales to a small number of customers for the foreseeable future. In addition, because our accounts receivable are often concentrated with a small group of purchasers, the failure of any of them to pay on a timely basis, or at all, would reduce our cash flow. We are also exposed to increased credit risk if any one of these limited numbers of customers fails or becomes insolvent. We generally have no minimum purchase commitments or long-term contracts with any of these customers. These purchasers could decide at any time to discontinue, decrease or delay their purchases of our products. If our customers increase the size of their product orders without sufficient lead-time for us to process the order, our ability to fulfill product demands would be compromised. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. Accordingly, the prices that they pay for our products are subject to negotiation and could change at any time. Our ability to maintain strong relationships with our principal customers is essential to our future performance. If any of our major customers reduce their level of purchases or refuse to pay the prices that we set for our products, our net revenue and operating results could be harmed. Our traditional retail customers have faced increased and significant competition from online retailers, and some of these traditional retail customers have increasingly become a smaller portion of our business. If key retail customers continue to reduce their level of purchases, our business could be harmed.

Additionally, consolidation among our customer base may allow certain customers to command increased leverage in negotiating prices and other terms of sale, which could adversely affect our profitability. In addition, if, as a result of increased leverage, customer pressures require us to reduce our pricing such that our gross margins are diminished, we could decide not to sell our products to a particular customer, which could result in a decrease in our revenue. Consolidation among our customer base may also lead to reduced demand for our products, elimination of sales opportunities, replacement of our products with those of our competitors and cancellations of orders, each of which would harm our operating results. Consolidation among our service provider customers worldwide may also make it more difficult to grow our service provider business, given the fierce competition for the already limited number of service providers worldwide and the long sales cycles to close deals. For example, in June 2013, Liberty Global, a service provider with operations worldwide, completed its acquisition of Virgin Media Limited, one of our significant historical customers. Because we have not conducted business with Liberty Global in the past, it directed Virgin Media to develop relationships and business with other Liberty Global vendors, many of which are our competitors. This situation has contributed to a substantial reduction in purchases of our products by Virgin Media Limited in

2016. In addition, in May 2016, Charter Communications completed its acquisitions of Time Warner Cable and Bright House Networks. If consolidation among our customer base becomes more prevalent, our operating results may be harmed.

If we fail to overcome the challenges associated with managing our broadband service provider sales channel, our net revenue and gross profit will be negatively impacted.

We sell a substantial portion of our products through broadband service providers worldwide. Our service provider business unit accounted for a significant portion of our growth in recent years and became a larger proportion of our business, especially after our acquisition of the Sierra Wireless AirCard business. However, the service provider business is challenging and exceptionally competitive. In the first quarter of 2015, we undertook a reorganization of our service provider business unit to reduce the cost structure of the unit and supporting functions in order to match a reduced revenue outlook. In the first quarter of 2016, we took additional steps to re-size the cost structure of this unit and to redeploy certain resources internally to focus on other initiatives. These reorganization efforts also sought to concentrate our resources on long-term and profitable accounts. The reorganization may not be successful in meeting these goals or the other challenges posed by the service provider channel. Difficulties and challenges in selling to service providers include a longer sales cycle, more stringent product testing and validation

requirements, a higher level of customization demands, requirements that suppliers take on a larger share of the risk with respect to contractual business terms, competition from established suppliers, pricing pressure resulting in lower gross margins, and irregular and unpredictable ordering habits. For example, rigorous service provider certification processes may delay our sale of new products, or our products ultimately may fail these tests. In either event, we may lose some or all of the amounts we expended in trying to obtain business from the service provider, as well as lose the business opportunity altogether. In addition, even if we have a product which a service provider customer may wish to purchase, we may choose not to supply products to the potential service provider customer if the contract requirements, such as service level requirements, penalties, and liability provisions, are too onerous. Accordingly, our business may be harmed and our revenues may be reduced. We have, in exceptional limited circumstances, while still in contract negotiations, shipped products in advance of and subject to agreement on a definitive contract. We do not record revenue from these shipments until a definitive contract exists. There is risk that we do not ultimately close and sign a definitive contract. If this occurs, the timing of revenue recognition is uncertain and our business would be harmed. In addition, we often commence building custom-made products prior to execution of a contract in order to meet the customer's contemplated launch dates and requirements. Service provider products are generally custom-made for a specific customer and may not be salable to other customers or in other channels. If we have pre-built custom-made products but do not come to agreement on a definitive contract, we may be forced to scrap the custom-made products or re-work them at substantial cost and our business would be harmed.

Further, successful engagements with service provider customers requires a constant analysis of technology trends. If we are unable to anticipate technology trends and service provider customer product needs, and to allocate research and development resources to the right projects, we may not be successful in continuing to sell products to service provider customers. In addition, because our service provider customers command significant resources, including for software support, and demand extremely competitive pricing, certain ODMs have declined to develop service provider products on an ODM basis. Accordingly, as our ODMs increasingly limit development of our service provider products, our service provider business will be harmed if we cannot replace this capability with alternative ODMs or in-house development.

Orders from service providers generally tend to be large but sporadic, which causes our revenues from them to fluctuate and challenges our ability to accurately forecast demand from them. In particular, managing inventory and production of our products for our service provider customers is a challenge. Many of our service provider customers have irregular purchasing requirements. These customers may decide to cancel orders for customized products specific to that customer, and we may not be able to reconfigure and sell those products in other channels. These cancellations could lead to substantial write-offs. In addition, these customers may issue unforecasted orders for products which we may not be able to produce in a timely manner and as such, we may not be able to accept and deliver on such unforecasted orders. In certain cases, we may commit to fixed-price, long term purchase orders, with such orders priced in foreign currencies which could lose value over time in the event of adverse changes in foreign exchange rates. Even if we are selected as a supplier, typically a service provider will also designate a second source supplier, which over time will reduce the aggregate orders that we receive from that service provider. Further, as the technology underlying our products deployed by broadband service providers matures and more competitors offer alternative products with similar technology, we anticipate competing in an extremely price sensitive market and our margins may be affected. If we are unable to introduce new products with sufficiently advanced technology to attract service provider interest in a timely manner, our service provider customers may then require us to lower our prices, or they may choose to purchase products from our competitors. If this occurs, our business would be harmed and our revenues would be reduced.

If we were to lose a service provider customer for any reason, we may experience a material and immediate reduction in forecasted revenue that may cause us to be below our net revenue and operating margin expectations for a particular period of time and therefore adversely affect our stock price. For example, many of our competitors in the service provider space aggressively price their products in order to gain market share. We may not be able to match the lower

prices offered by our competitors. Many of the service provider customers will seek to purchase from the lowest cost provider, notwithstanding that our products may be higher quality or that our products were previously validated for use on their proprietary network. Accordingly, we may lose customers who have lower, more aggressive pricing and our revenues may be reduced. These particular challenges are a significant reason for the reduced service provider business unit revenue outlook that we announced in the first quarter of 2015 and that we further reduced in the first quarter of 2016. In addition, service providers may choose to prioritize the implementation of other technologies or the roll out of other services than home networking. Weakness in orders from this industry could have a material adverse effect on our business, operating results, and financial condition. We have seen slowdowns in capital expenditures by certain of our service provider customers in the past, and believe there may be potential for similar slowdowns in the future. Any slowdown in the general economy, over supply, consolidation among service providers, regulatory developments and constraint on capital expenditures could result in reduced demand from service providers and therefore adversely affect our sales to them. If we do not successfully overcome these challenges, we will not be able to profitably manage our service provider sales channel and our financial results will be harmed.

Table of Contents

We depend on large, recurring purchases from certain significant customers, and a loss, cancellation or delay in purchases by these customers could negatively affect our revenue.

The loss of recurring orders from any of our more significant customers could cause our revenue and profitability to suffer. Our ability to attract new customers will depend on a variety of factors, including the cost-effectiveness, reliability, scalability, breadth and depth of our products. In addition, a change in the mix of our customers, or a change in the mix of direct and indirect sales, could adversely affect our revenue and gross margins.

Although our financial performance may depend on large, recurring orders from certain customers and resellers, we do not generally have binding commitments from them. For example:

- our reseller agreements generally do not require substantial minimum purchases;

- our customers can stop purchasing and our resellers can stop marketing our products at any time; and

- our reseller agreements generally are not exclusive.

Further, our revenue may be impacted by significant one-time purchases which are not contemplated to be repeatable. While such purchases are reflected in our financial statements, we do not rely on and do not forecast for continued significant one-time purchases. As a result, lack of repeatable one-time purchases will adversely affect our revenue.

Because our expenses are based on our revenue forecasts, a substantial reduction or delay in sales of our products to, or unexpected returns from, customers and resellers, or the loss of any significant customer or reseller, could harm or otherwise have a negative impact to our operating results. Although our largest customers may vary from period to period, we anticipate that our operating results for any given period will continue to depend on large orders from a small number of customers.

Some of our competitors have substantially greater resources than we do, and to be competitive we may be required to lower our prices or increase our sales and marketing expenses, which could result in reduced margins and loss of market share.

We compete in a rapidly evolving and fiercely competitive market, and we expect competition to continue to be intense, including price competition. Our principal competitors in the home market for networking and Smart Home devices include Apple, ASUS, Belkin/Linksys, Devolo, D-Link, Eero, Google, Logitech, Nest Labs (owned by Google), Ring, Samsung, Swann, Synology, TP Link and Western Digital. Our principal competitors in the commercial business market include Allied Telesys, Barracuda, Buffalo, Cisco Systems, Dell, D-Link, Fortinet, Hewlett-Packard, Huawei, QNAP Systems, Seagate Technology, Synology, Ubiquity, WatchGuard and Western Digital. Our principal competitors in the broadband service provider market include Actiontec, Arcadyan, ARRIS, AVM, Compal Broadband, D-Link, Hitron, Huawei, Novatel Wireless, Sagem, Scientific Atlanta (a Cisco Systems company), Sercomm, SMC Networks, TechniColor, TP-Link, Ubee, ZTE and ZyXEL. Other competitors include numerous local vendors such as Xiomi in China, and Buffalo in Japan. In addition, these local vendors may target markets outside of their local regions and may increasingly compete with us in other regions worldwide. Our potential competitors also include other consumer electronics vendors, including LG Electronics, Microsoft, Panasonic, Sony, Toshiba and Vizio, who could integrate networking and streaming capabilities into their line of products, such as televisions, set top boxes and gaming consoles, and our channel customers who may decide to offer self-branded networking products. We also face competition from service providers who may bundle a free networking device with their broadband service offering, which would reduce our sales if we are not the supplier of choice to those service providers. In the service provider space, we are also facing significant and increased competition from original design manufacturers, or ODMs, and contract manufacturers who are selling and attempting to sell their products directly to

service providers around the world.

Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers, and exert more influence on sales channels than we can. In addition, certain competitors may have different business models, such as integrated manufacturing capabilities, that may allow them to achieve cost savings and to compete on the basis of price. Other competitors may have fewer resources, but may be more nimble in developing new or disruptive technology or in entering new markets. We anticipate that current and potential competitors will also intensify their efforts to penetrate our target markets. For example, price competition is intense in our industry in certain geographical regions and product categories. Many of our competitors in the service provider and retail spaces price their products significantly below our product costs in order to gain market share. Average sales prices have declined in the past and may again decline in the future. These competitors may have more advanced technology, more extensive distribution channels, stronger brand names, greater access to shelf space in retail

Table of Contents

locations, bigger promotional budgets and larger customer bases than we do. In addition, many of these competitors leverage a broader product portfolio and offer lower pricing as part of a more comprehensive end-to-end solution which we may not have. These companies could devote more capital resources to develop, manufacture and market competing products than we could. Our competitors may also acquire other companies in the market and leverage combined resources to gain market share. For example, in March 2013, Belkin completed its acquisition of the Linksys division from Cisco. Belkin and Linksys are two of our significant competitors. The combined company may have synergies which increase opportunities for Belkin to gain market share, especially in North America. If any of these companies are successful in competing against us, our sales could decline, our margins could be negatively impacted and we could lose market share, any of which could seriously harm our business and results of operations.

* We obtain several key components from limited or sole sources, and if these sources fail to satisfy our supply requirements or we are unable to properly manage our supply requirements with our third-party manufacturers, we may lose sales and experience increased component costs.

Any shortage or delay in the supply of key product components would harm our ability to meet scheduled product deliveries. Many of the semiconductors used in our products are specifically designed for use in our products and are obtained from sole source suppliers on a purchase order basis. In addition, some components that are used in all our products are obtained from limited sources. These components include connector jacks, plastic casings and physical layer transceivers. We also obtain switching fabric semiconductors, which are used in our Ethernet switches and Internet gateway products, and wireless local area network chipsets, which are used in all of our wireless products, from a limited number of suppliers. Semiconductor suppliers have experienced and continue to experience component shortages themselves, such as with substrates used in manufacturing chipsets, which in turn adversely impact our ability to procure semiconductors from them. Our third-party manufacturers generally purchase these components on our behalf on a purchase order basis, and we do not have any contractual commitments or guaranteed supply arrangements with our suppliers. If demand for a specific component increases, we may not be able to obtain an adequate number of that component in a timely manner. In addition, if worldwide demand for the components increases significantly, the availability of these components could be limited. Further, our suppliers may experience financial or other difficulties as a result of uncertain and weak worldwide economic conditions. Other factors which may affect our suppliers' ability or willingness to supply components to us include internal management or reorganizational issues, such as roll-out of new equipment which may delay or disrupt supply of previously forecasted components, or industry consolidation and divestitures, which may result in changed business and product priorities among certain suppliers. It could be difficult, costly and time consuming to obtain alternative sources for these components, or to change product designs to make use of alternative components. In addition, difficulties in transitioning from an existing supplier to a new supplier could create delays in component availability that would have a significant impact on our ability to fulfill orders for our products.

We provide our third-party manufacturers with a rolling forecast of demand, which they use to determine our material and component requirements. Lead times for ordering materials and components vary significantly and depend on various factors, such as the specific supplier, contract terms and demand and supply for a component at a given time. Some of our components have long lead times, such as wireless local area network chipsets, switching fabric chips, physical layer transceivers, connector jacks and metal and plastic enclosures. If our forecasts are not timely provided or are less than our actual requirements, our third-party manufacturers may be unable to manufacture products in a timely manner. For example, in the first quarter of 2013, our third-party manufacturers were not able to manufacture sufficient quantities of our new line of ReadyNAS products in order to meet demand, adversely affecting our profitability for the quarter. If our forecasts are too high, our third-party manufacturers will be unable to use the components they have purchased on our behalf. The cost of the components used in our products tends to drop rapidly as volumes increase and the technologies mature. Therefore, if our third-party manufacturers are unable to promptly use components purchased on our behalf, our cost of producing products may be higher than our competitors due to an oversupply of higher-priced components. Moreover, if they are unable to use components ordered at our direction, we

will need to reimburse them for any losses they incur.

If we are unable to obtain a sufficient supply of components, or if we experience any interruption in the supply of components, our product shipments could be reduced or delayed or our cost of obtaining these components may increase. Component shortages and delays affect our ability to meet scheduled product deliveries, damage our brand and reputation in the market, and cause us to lose sales and market share. For example, component shortages and disruptions in supply in the past have limited our ability to supply all the worldwide demand for our products, and our revenue was affected. In addition, at times sole suppliers of highly specialized components have provided components that were either defective or did not meet the criteria required by our customers, resulting in delays, lost revenue opportunities and potentially substantial write-offs.

Another example relates to the record flooding in Thailand in the third quarter of 2011. Many major manufacturers of hard disk drives and their component suppliers maintain significant operations in Thailand in areas affected by the flooding. These include most, if not all, of our direct and indirect suppliers of hard disk drives for our ReadyNAS product line. All of our major

Table of Contents

direct and indirect suppliers of hard disk drives informed us that our supply chain would be constrained for an indefinite amount of time, in some cases up to six months. Some therefore declared a force majeure event and have stated that, in addition to and because of the supply constraints, pricing for hard disk drives would increase significantly until they were able to stabilize the situation. As a result, we experienced increased prices in the cost of hard disk drives and ceased accepting any additional orders containing ReadyNAS products with hard disk drives at then current prices and all shipments of ReadyNAS products with hard disk drives were placed on hold. In addition, all sales and marketing promotions involving ReadyNAS products were terminated temporarily. Further, we declared the existence of a force majeure event under our contracts with certain customers. Accordingly, our business was harmed. Certain events or natural disasters that occur in the future ma