NETGEAR, INC
Form 10-Q
August 01, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the quarterly period ended June 29, 2014.
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from to
Commission file number: 000-50350
NETGEAR, Inc.
(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No x
The number of outstanding shares of the registrant's Common Stock, $0.001 par value, was 35,910,400 as of July 25, 2014.

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

	June 29, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$146,982	$143,009
Short-term investments	95,747	105,145
Accounts receivable, net	282,900	266,484
Inventories	194,533	224,456
Deferred income taxes	27,019	27,239
Prepaid expenses and other current assets	40,947	33,778
Total current assets	788,128	800,111
Property and equipment, net	28,151	27,194
Intangibles, net	75,180	84,118
Goodwill	155,916	155,916
Other non-current assets	30,617	26,591
Total assets	$1,077,992	$1,093,930
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$101,403	$114,531
Accrued employee compensation	19,684	16,551
Other accrued liabilities	128,849	143,218
Deferred revenue	33,381	24,496
Income taxes payable	—	1,287
Total current liabilities	283,317	300,083
Non-current income taxes payable	14,430	13,804
Other non-current liabilities	5,779	6,260
Total liabilities	303,526	320,147
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Common stock	36	37
Additional paid-in capital	438,150	421,901
Cumulative other comprehensive income	10	69
Retained earnings	336,270	351,776
Total stockholders' equity	774,466	773,783
Total liabilities and stockholders' equity	$1,077,992	$1,093,930

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

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

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Net revenue	$337,604	$357,719	$686,995	$651,118
Cost of revenue	240,418	254,289	491,884	459,951
Gross profit	97,186	103,430	195,111	191,167
Operating expenses:				
Research and development	22,476	23,981	44,657	39,319
Sales and marketing	38,179	40,406	78,090	76,795
General and administrative	11,894	12,319	23,269	24,646
Restructuring and other charges	(12)	1,587	830	1,557
Litigation reserves, net	68	3,555	185	3,603
Total operating expenses	72,605	81,848	147,031	145,920
Income from operations	24,581	21,582	48,080	45,247
Interest income	49	95	106	244
Other expense, net	(227)	(548)	(335)	(474)
Income before income taxes	24,403	21,129	47,851	45,017
Provision for income taxes	9,698	7,144	18,735	15,689
Net income	$14,705	$13,985	$29,116	$29,328
Net income per share:				
Basic	$0.41	$0.36	$0.80	$0.76
Diluted	$0.40	$0.36	$0.79	$0.75
Weighted average shares outstanding used to compute net income per share:				
Basic	36,139	38,539	36,381	38,493
Diluted	36,808	39,074	37,052	39,077

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

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

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Net income	$14,705	$13,985	$29,116	$29,328
Other comprehensive income (loss), before tax:				
Unrealized gain (loss) on derivative instruments	132	(82)	(73)	69
Unrealized gain (loss) on available-for-sale securities	16	(15)	23	(41)
Other comprehensive income (loss), before tax	148	(97)	(50)	28
Tax (expense) benefit related to items of other comprehensive income	(6)	6	(9)	16
Other comprehensive income (loss), net of tax	142	(91)	(59)	44
Comprehensive income	$14,847	$13,894	$29,057	$29,372

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

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

	Six Months Ended	
	June 29, 2014	June 30, 2013
Cash flows from operating activities:		
Net income	$29,116	$29,328
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	17,399	14,329
Purchase premium amortization/discount accretion on investments, net	69	621
Non-cash stock-based compensation	10,064	7,981
Income tax (benefit) expense associated with stock option exercises	(302)	514
Excess tax benefit from stock-based compensation	(294)	(569)
Deferred income taxes	(244)	(2,178)
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(16,416)	(32,469)
Inventories	29,924	(7,095)
Prepaid expenses and other assets	(10,972)	(12,240)
Accounts payable	(13,128)	51,255
Accrued employee compensation	3,133	(2,063)
Other accrued liabilities	(13,767)	4,823
Deferred revenue	8,795	6,072
Income taxes payable	(661)	(2,146)
Net cash provided by operating activities	42,716	56,163
Cash flows from investing activities:		
Purchases of short-term investments	(84,936)	(98,327)
Proceeds from sales and maturities of short-term investments	94,500	184,341
Purchase of property and equipment	(9,418)	(7,759)
Payments for patents	—	(275)
Proceeds from sale of cost method investment	—	3,890
Payments made in connection with business acquisitions	(1,050)	(144,815)
Net cash used in investing activities	(904)	(62,945)
Cash flows from financing activities:		
Purchase and retirement of treasury stock	(44,622)	(483)
Proceeds from exercise of stock options	5,161	3,545
Proceeds from issuance of common stock under employee stock purchase plan	1,328	1,053
Excess tax benefit from stock-based compensation	294	569
Net cash (used in) provided by financing activities	(37,839)	4,684
Net increase (decrease) in cash and cash equivalents	3,973	(2,098)
Cash and cash equivalents, at beginning of period	143,009	149,032
Cash and cash equivalents, at end of period	$146,982	$146,934

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

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

NETGEAR, Inc. (“NETGEAR” or the “Company”) was incorporated in Delaware in January 1996. The Company is a global networking company that delivers innovative products to consumers, businesses and service providers. The Company's products are built on a variety of proven technologies such as wireless, 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, 2013 has been derived from audited financial statements at such date. 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, 2013.
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 revenues and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three and six months ended June 29, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

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, 2013. The Company’s significant accounting policies have not materially changed during the six months ended June 29, 2014.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customer" (Topic 606). The guidance in this update supersedes the revenue recognition requirements in Topic 605, Revenue Recognition. Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also specifies the accounting for some costs to obtain or fulfill a contract with a customer. An entity should apply the amendments in the update either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. ASU 2014-09 is effective for the Company beginning in the first quarter fiscal 2017 with early adoption not permitted.

The Company is in the process of evaluating the available transition methods and the impact of this standard on its financial position, results of operations or cash flows.

3. Business Acquisitions

Arada Systems, Inc.

On June 21, 2013, the Company acquired certain assets and operations of Arada Systems, Inc. (“Arada”), a privately-held company that develops, licenses, and provides solutions for the next generation of uses of Wi-Fi, for a total purchase consideration of $5.3 million in cash. The Company believes the acquisition will bolster its wireless product offerings in its commercial business unit and strengthen its market position in the small to medium size campus wireless LAN market. The Company paid $4.2 million of the aggregate purchase price in the second quarter of 2013, and paid the remaining $1.1 million in the second quarter of 2014.

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

The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting. The results of Arada have been included in the unaudited condensed consolidated financial statements since the date of acquisition. Pro forma results of operations for the acquisition are not presented as the financial impact to the Company's unaudited condensed consolidated results of operations is not material.

The allocation of the purchase price was as follows (in thousands):

Property and equipment, net	$15
Intangibles, net	4,040
Goodwill	1,195
Total purchase price	$5,250

Of the $1.2 million of goodwill recorded on the acquisition of Arada, approximately $0.7 million and $1.2 million are deductible for U.S. federal and state income tax purposes, respectively. The goodwill recognized, which was assigned to the Company's commercial business unit, is primarily attributable to expected synergies resulting from the acquisition.

The Company designated $4.0 million of the acquired intangible assets as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 21.5%. The acquired existing technology is being amortized over its estimated useful life of five years.

AirCard Division of Sierra Wireless, Inc.

On April 2, 2013, the Company completed the acquisition of select assets and operations of the Sierra Wireless, Inc. AirCard business ("AirCard"), including customer relationships, a world-class LTE engineering team, certain intellectual property, inventory and property and equipment. The Company believes this acquisition will accelerate the mobile initiative of the service provider business unit to become a global leader in providing the latest in LTE data networking access devices.

The Company paid $140.0 million of the aggregate purchase price in the second quarter of 2013. The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting. The results of AirCard have been included in the consolidated financial statements since the date of acquisition. Revenue and earnings for AirCard as of the acquisition date are not presented as the business was fully integrated into the service provider business unit subsequent to the acquisition and therefore impracticable for the Company to quantify.

The allocation of the purchase price was as follows (in thousands):

Inventories	$2,874
Prepaid expenses	9,030
Other current assets	3,226
Property and equipment, net	7,455
Intangibles, net	69,700
Goodwill	53,841
Liabilities assumed	(6,096)
Total purchase price	$140,030

In the third quarter of 2013, the Company made an adjustment of $0.5 million to goodwill related to revised inventory estimates.

Of the $53.8 million of goodwill recorded on the acquisition of AirCard, approximately $36.6 million, $53.8 million and $2.3 million is deductible for U.S. federal, U.S. state and Canada income tax purposes, respectively. The goodwill recognized, which was assigned to the Company's service provider business unit, is primarily attributable to expected synergies resulting from the acquisition.

The Company designated $16.3 million of the acquired intangible assets as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 10.0%. The acquired technology is being amortized over its estimated useful

life of four years.

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NETGEAR, INC.
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The Company designated $40.5 million of the acquired intangible assets as customer relationships. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to existing customer relationships and discounted at 12.0%. The acquired customer relationships are being amortized over an estimated useful life of eight years.

The Company designated $2.3 million of the acquired intangible assets as non-compete agreements. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to the non-compete agreements and discounted at 12.0%. The acquired agreements are being amortized over an estimated useful life of five years.

The Company designated $1.1 million of the acquired intangible assets as backlog. The value was calculated based on the present value of the future contractual revenue and discounted at 10.0%. The acquired backlog was fully amortized in the second quarter of 2013.

The Company acquired $9.5 million in in-process research and development ("IPR&D") projects. The value was calculated based on the present value of future estimated cash flows discounted at 13.0%, derived from projections of future revenues attributable to the assets, expected economic life of the assets, and royalty rates. The IPR&D acquired is considered indefinite lived intangible assets until research and development efforts associated with the projects are completed or abandoned. The most significant of the acquired IPR&D projects relate to multimode LTE technologies, Mobile Hot Spot, USB dongle, and Module form factors. During the second quarter of 2014, the Company completed the remaining $0.1 million in IPR&D projects. As of June 29, 2014, $7.5 million of the acquired IPR&D has reached technical feasibility and was reclassified to definite-lived intangibles and with an estimated useful life of four years. In addition, the Company recorded an impairment charge of $2.0 million in the third quarter of 2013, related to the abandonment of certain IPR&D projects acquired.

Pro forma financial information

The unaudited pro forma financial information in the table below summarizes the combined results of our operations and those of AirCard for the periods shown as though the acquisition of AirCard occurred as of the beginning of the fiscal year 2012. The pro forma financial information for the periods presented includes the accounting effects of the business combination, including adjustments to the amortization of intangible assets, fair value of acquired inventory, acquisition-related costs, integration expenses and related tax effects of these adjustments, where applicable. This information is for informational purposes only, is subject to a number of estimates, assumptions and other uncertainties, and may not be indicative of the results of operations that would have been achieved if the acquisition had taken place at January 1, 2012.

The unaudited pro forma financial information is as follows:

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
	(in millions)	
Revenue	$358	$696
Net income	$16	$31

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. Balance Sheet Components (in thousands)

Available-For-Sale Short-Term Investments

	As of June 29, 2014				December 31, 2013			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. Treasuries	$94,945	$29	$—	$94,974	$104,595	$7	$(1)	$104,601
Certificates of Deposits	177	—	—	177	159	—	—	159
Total	$95,122	$29	$—	$95,151	$104,754	$7	$(1)	$104,760

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 short-term investments have unrealized losses greater than twelve months.

Cost Method Investments

As of June 29, 2014 and December 31, 2013, the carrying value of the Company's cost method investments was $1.3 million. These investments are included in other non-current assets in the unaudited condensed consolidated balance sheets and are carried at cost, adjusted for any impairment, because the Company does not have a controlling interest and does not have the ability to exercise significant influence over these companies. The Company monitors these investments for impairment on a quarterly basis, and adjusts carrying value for any impairment charges recognized. There were no impairments recognized in the three and six months ended June 29, 2014 and June 30, 2013. Realized gains and losses on these investments are reported in other expense, net in the unaudited condensed consolidated statements of operations.

Accounts receivable, net

	As of June 29, 2014	December 31, 2013
Gross accounts receivable	$303,980	$289,479
Allowance for doubtful accounts	(1,255)	(1,255)
Allowance for sales returns	(17,056)	(17,467)
Allowance for price protection	(2,769)	(4,273)
Total allowances	(21,080)	(22,995)
Total accounts receivable, net	$282,900	$266,484

Inventories

	As of June 29, 2014	December 31, 2013
Raw materials	$4,795	$8,676

Work in process	3,758	6,233
Finished goods	185,980	209,547
Total inventories	$194,533	$224,456

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

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.

Property and equipment, net

	As of June 29, 2014	December 31, 2013
Computer equipment	$8,916	$8,527
Furniture, fixtures and leasehold improvements	16,769	14,019
Software	27,988	25,722
Machinery and equipment	54,663	50,656
Construction in progress	18	21
Total property and equipment, gross	108,354	98,945
Accumulated depreciation and amortization	(80,203)	(71,751)
Total property and equipment, net	$28,151	$27,194

Depreciation and amortization expense pertaining to property and equipment was $4.2 million and $8.5 million for the three and six months ended June 29, 2014, respectively, and $4.4 million and $7.8 million for the three and six months ended June 30, 2013, respectively.

Intangibles, net

The following tables present details of the Company's purchased intangible assets:

	Gross	Accumulated Amortization	Net
June 29, 2014			
Technology	$61,099	$(34,460)	$26,639
Customer contracts and relationships	56,500	(12,663)	43,837
Other	10,545	(5,841)	4,704
Total intangibles, net	$128,144	$(52,964)	$75,180

	Gross	Accumulated Amortization	Net
December 31, 2013			
Technology	$60,999	$(29,593)	$31,406
Customer contracts and relationships	56,500	(9,120)	47,380
Other	10,545	(5,313)	5,232
Finite-lived intangibles, net	128,044	(44,026)	84,018
Indefinite-lived intangibles	100	—	100
Total intangibles, net	$128,144	$(44,026)	$84,118

Amortization of purchased intangible assets was $4.4 million and $8.9 million for the three and six months ended June 29, 2014, respectively, and $5.0 million and $6.5 million for the three and six months ended June 30, 2013,

respectively.

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

Estimated amortization expense related to intangibles for each of the next five years and thereafter is as follows:

Year Ending December 31	Amount
2014 (remaining six months)	$8,950
2015	17,283
2016	16,921
2017	11,386
2018	7,871
Thereafter	12,769
Total expected amortization expense	$75,180

Goodwill

The changes in the carrying amount of goodwill during the six months ended June 29, 2014 are as follows:

	Retail	Commercial	Service Provider	Total
Goodwill at December 31, 2013	$45,441	$36,279	$74,196	$155,916
Goodwill acquired during the period	—	—	—	—
Goodwill at June 29, 2014	$45,441	$36,279	$74,196	$155,916

There were no impairments to goodwill during the three and six months ended June 29, 2014 and June 30, 2013.

Other non-current assets

	As of June 29, 2014	December 31, 2013
Non-current deferred income taxes	$20,700	$20,235
Cost method investment	1,322	1,322
Other	8,595	5,034
Total other non-current assets	$30,617	$26,591

Other accrued liabilities

	As of June 29, 2014	December 31, 2013
Sales and marketing programs	$45,108	$47,941
Warranty obligation	41,934	48,754
Freight	6,035	5,790
Other	35,772	40,733
Total other accrued liabilities	$128,849	$143,218

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

5. Product Warranties

The Company provides for estimated future warranty obligations at the time revenue is recognized. The Company's standard warranty obligation to its direct customers generally provides for a right of return of any product for a full refund in the event that such product is not merchantable or is found to be damaged or defective. At the time revenue is recognized, an estimate of future warranty returns is recorded to reduce revenue in the amount of the expected credit or refund to be provided to its direct customers. At the time the Company records the reduction to revenue related to warranty returns, the Company includes within cost of revenue a write-down to reduce the carrying value of such products to net realizable value.

The Company's standard warranty obligation to its end-users provides for replacement of a defective product for one or more years. Factors that affect the warranty obligation include product failure rates, material usage and service delivery costs incurred in correcting product failures. The estimated cost associated with fulfilling the Company's warranty obligation to end-users is recorded in cost of revenue. Because the Company's products are manufactured by third party manufacturers, in certain cases the Company has recourse to the third party manufacturer for replacement or credit for the defective products. The Company gives consideration to amounts recoverable from its third party manufacturers in determining its warranty liability.

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

	Six Months Ended	
	June 29, 2014	June 30, 2013
Balance as of beginning of the period	$48,754	$46,659
Provision for warranty liability made during the period	27,455	33,586
Settlements made during the period	(34,275)	(34,070)
Balance at end of period	$41,934	$46,175

6. Derivative Financial Instruments

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

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

The Company may choose not to hedge certain foreign exchange exposures for a variety of reasons, including, but not limited to, immateriality, 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 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 expense, net in the unaudited condensed consolidated statement of operations.

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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 sheet to which they were recorded as of June 29, 2014, and December 31, 2013, are summarized as follows (in thousands):

Derivative Assets	Balance Sheet Location	Fair Value at June 29, 2014	Balance Sheet Location	Fair Value at December 31, 2013
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	$254	Prepaid expenses and other current assets	$842
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	30	Prepaid expenses and other current assets	63
Total		$284		$905

Derivative Liabilities	Balance Sheet Location	Fair Value at June 29, 2014	Balance Sheet Location	Fair Value at December 31, 2013
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	$1,072	Other accrued liabilities	$368
Derivative liabilities designated as hedging instruments	Other accrued liabilities	70	Other accrued liabilities	13
Total		$1,142		$381

For details of the Company's fair value measurements, see Note 13, 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 condensed consolidated balance sheets.

The following tables set forth the offsetting of derivative assets as of June 29, 2014 and December 31, 2013 (in thousands):

				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
As of June 29, 2014	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$—	$—	$—	$—	$—	$—
Wells Fargo Bank	284	—	284	(284)	—	—

Total	$284	$—	$284	$(284)	$—	$—

As of December 31, 2013	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Cash Collateral Pledged	Net Amount
Barclays	$905	$—	$905	$(287)	$—	$618
Wells Fargo Bank	—	—	—	—	—	—
Total	$905	$—	$905	$(287)	$—	$618

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The following tables set forth the offsetting of derivative liabilities as of June 29, 2014 and December 31, 2013 (in thousands):

As of June 29, 2014	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		Net Amount
				Financial Instruments	Cash Collateral Pledged	
Barclays	$435	$—	$435	$—	$—	$435
Wells Fargo Bank	707	—	707	(284)	—	423
Total	$1,142	$—	$1,142	$(284)	$—	$858

As of December 31, 2013	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	$287	$—	$287	$(287)	$—	$—
Wells Fargo Bank	94	—	94	—	—	94
Total	$381	$—	$381	$(287)	$—	$94

Cash flow hedges

To help manage the exposure of operating margins to fluctuations in foreign currency exchange rates, the Company hedges a portion of its anticipated foreign currency revenue, costs of revenue and certain operating expenses. These hedges are designated at the inception of the hedge relationship as cash flow hedges under the authoritative guidance for derivatives and hedging. Effectiveness is tested at least quarterly both prospectively and retrospectively using regression analysis to ensure that the hedge relationship has been effective and is likely to remain effective in the future. The Company typically hedges portions of its anticipated foreign currency exposure for three to five months. The Company enters into about five forward contracts per quarter with an average size of about $7 million USD equivalent related to its cash flow hedging program.

The Company expects to reclassify to earnings all of the amounts recorded in other comprehensive income ("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 other comprehensive income associated 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 on discontinued cash flow hedges during the three and six months ended June 29, 2014, and June 30, 2013.

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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 June 29, 2014, and June 30, 2013, are summarized as follows (in thousands):

	Three Months Ended June 29, 2014				
Derivatives Designated as Hedging Instruments	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$(7)	Net revenue	$(116)	Other expense, net	$ (39)
Foreign currency forward contracts	—	Cost of revenue	6	Other expense, net	—
Foreign currency forward contracts	—	Operating expenses	(29)	Other expense, net	—
Total	$(7)		$(139)		$ (39)

	Six Months Ended June 29, 2014				
Derivatives Designated as Hedging Instruments	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$(571)	Net revenue	$(541)	Other expense, net	$ (66)
Foreign currency forward contracts	—	Cost of revenue	8	Other expense, net	—
Foreign currency forward contracts	—	Operating expenses	35	Other expense, net	—
Total	$(571)		$(498)		$ (66)

	Three Months Ended June 30, 2013				
Derivatives Designated as Hedging Instruments	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					

Foreign currency forward contracts	$314	Net revenue	$445	Other expense, net	$(26)
Foreign currency forward contracts	—	Cost of revenue	(1)	Other expense, net	—
Foreign currency forward contracts	—	Operating expenses	(48)	Other expense, net	—
Total	$314		$396		$(26)

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	Six Months Ended June 30, 2013				
Derivatives Designated as Hedging Instruments	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Location of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized in Income and Excluded from Effectiveness Testing
Cash flow hedges:					
Foreign currency forward contracts	$492	Net revenue	$520	Other expense, net	$ (48)
Foreign currency forward contracts	—	Cost of revenue	(3)	Other expense, net	—
Foreign currency forward contracts	—	Operating expenses	(94)	Other expense, net	—
Total	$492		$423		$ (48)

(a) Refer to Note 10, Stockholders' Equity, which summarizes the cumulative other comprehensive income activity related to derivatives.

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 June 29, 2014, and June 30, 2013.

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 14 non-designated derivatives per quarter. The average size of its non-designated hedges is about $2 million USD equivalent and these hedges range from one to five months in duration.

The effects of the Company’s derivatives not designated as hedging instruments in other expense, net in the unaudited condensed consolidated statements of operations for the three and six months ended June 29, 2014 and June 30, 2013, are as follows (in thousands):

Derivatives Not Designated as Hedging Instruments	Location of Gains or (Losses) Recognized in Income on Derivative	Amount of Gains or (Losses) Recognized in Income on Derivative	
		Three Months Ended June 29, 2014	Six Months Ended June 29, 2014
Foreign currency forward contracts	Other expense, net	$(1,172)	$(1,938)

Derivatives Not Designated as Hedging Instruments	Location of Gains or (Losses) Recognized in Income on Derivative	Amount of Gains or (Losses) Recognized in Income on Derivative	
		Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Foreign currency forward contracts	Other expense, net	$1,617	$1,885

7. 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 equity awards under the employee benefit plans, 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

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employee must pay for exercising stock options, the amount of stock-based compensation cost for future services that the Company has not yet recognized, and the estimated tax benefit that would be recorded in additional paid-in capital upon exercise are assumed to be used to repurchase shares.
Net income per share for the three and six months ended June 29, 2014, and June 30, 2013, are as follows (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Net income	$14,705	$13,985	$29,116	$29,328
Weighted average shares outstanding:				
Basic	36,139	38,539	36,381	38,493
Dilutive potential common shares	669	535	671	584
Total diluted	36,808	39,074	37,052	39,077
Basic net income per share	$0.41	$0.36	$0.80	$0.76
Diluted net income per share	$0.40	$0.36	$0.79	$0.75

Weighted average stock options and unvested restricted stock awards to purchase 2.5 million shares and 2.9 million shares of the Company's stock for the three months ended June 29, 2014, and June 30, 2013, respectively, and 2.5 million and 2.8 million shares for the six months ended June 29, 2014, and June 30, 2013, respectively, were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive.

8. Income Taxes

The income tax provision for the three and six months ended June 29, 2014 was $9.7 million or an effective tax rate of 39.7% and $18.7 million or an effective tax rate of 39.2%, respectively. The income tax provision for the three and six months ended June 30, 2013 was $7.1 million or an effective tax rate of 33.8% and $15.7 million or an effective tax rate of 34.9%, respectively. The increase in the effective tax rate for the three and six month periods ended June 29, 2014, compared to the same period in the prior year was primarily caused by changes in US tax law related to the research tax credit. On December 31, 2011 provisions allowing for the research tax credit expired. On January 2, 2013 the American Taxpayer Relief Act of 2012 reinstated the research credit, retroactive to January 1, 2012 through December 31, 2013. Accordingly, the entire benefit for the 2012 research credit of approximately $0.7 million was recognized during the six months ended June 30, 2013. Additionally, the Company recorded credits related to 2013 in its tax provision for the three and six month periods. As of June 29, 2014, the research credit has not been reinstated. Accordingly, no tax benefit has been recorded during the three and six month periods ended June 29, 2014. Additionally, during the three and six month periods ended in both 2014 and 2013, the Company has incurred losses in a jurisdiction where no tax benefit could be recorded. Because a tax benefit could not be recorded, the forecasted earnings from this jurisdiction were excluded from the determination of the effective tax rate which results in an increase in the tax rate from foreign earnings. The loss in the three and six months ended June 29, 2014 is relatively higher than the loss incurred during the same periods in the prior year.

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 $2.8 million, excluding the interest, penalties and the effect of any related deferred tax assets or liabilities.

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9. Commitments and Contingencies

Leases

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

Purchase Obligations

The Company has entered into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31 to 45 days prior to the expected shipment date. Orders are non-cancelable within 30 days prior to the expected shipment date. At June 29, 2014, the Company had approximately $188 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.

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 these indemnification agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of June 29, 2014.

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 June 29, 2014.

Employment Agreements

The Company has signed various employment agreements with key executives pursuant to which, if their employment is terminated without cause, such employees are entitled to receive their base salary (and commission or bonus, as applicable) for 52 weeks (for the Chief Executive Officer), 39 weeks (for the Senior Vice President of Worldwide Operations and Support) and up to 26 weeks (for other key executives). Such employees will also continue to have stock options vest for up to a one-year period following such termination without cause. If a termination without cause

or resignation for good reason occurs within one year of a change in control, such employees are entitled to full acceleration (for the Chief Executive Officer) and up to two years acceleration (for other key executives) of any unvested portion of his or her equity awards. The Company has no liabilities recorded for these agreements as of June 29, 2014.

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 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

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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.

Northpeak Wireless, LLC v. NETGEAR, Inc.

In October 2008, a lawsuit was filed against the Company and 30 other companies by Northpeak Wireless, LLC (“Northpeak”) in the U.S. District Court, Northern District of Alabama. Northpeak alleges that the Company's 802.11b compatible products infringe certain claims of U.S. Patent Nos. 4,977,577 ("the '577 Patent") and 5,987,058 ("the '058 Patent"). The Company filed its answer to the lawsuit in the fourth quarter of 2008. On January 21, 2009, the District Court granted a motion to transfer the case to the U.S. District Court, Northern District of California. In August 2009, the parties stipulated to a litigation stay pending a reexamination request to the USPTO on the asserted patents. The reexaminations of the patents are proceeding. In March 2011, the USPTO confirmed the validity of the asserted claims of the '577 Patent over certain prior art references. In April 2011, the USPTO issued a final office action rejecting both asserted claims of the '058 Patent as being obvious in light of the prior art. In March 2013, the Board of Patent Appeals and Interferences of the USPTO affirmed the rejection of both asserted claims of the '058 Patent. One of the defendants in the case, Intel, recently filed a second petition for reexamination against the ‘577 patent. The USPTO initially rejected all claims of the ‘577 patent under Intel’s petition, and Northpeak responded. Ultimately, the USPTO allowed certain modified claims of the ‘577 patent and issued a reexamination certificate for it. The parties are planning to submit a Case Management Conference statement to the Court by late September 2014. The district court case remains stayed by stipulation, and no trial date has been set. The Company does not expect there to be a material financial impact to the Company because of this litigation matter.

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; 6,330,435; 6,424,625; 6,519,223; 6,772,215; 5,987,019; 6,466,568; and 5,771,468 ("the '468 Patent"). Ericsson generally alleges that the Company and the other defendants have infringed and continue to infringe the Ericsson patents through the defendants' IEEE 802.11-compliant products. In addition, Ericsson alleged that the Company infringed the claimed methods and apparatuses of the '468 Patent through the Company's PCMCIA routers. The Company filed its answer to the Ericsson complaint on December 17, 2010 where it asserted the affirmative defenses of noninfringement and invalidity of the asserted patents. On March 1, 2011, the defendants filed a motion to transfer venue to the District Court for the Northern District of California and their memorandum of law in support thereof. On March 21, 2011, Ericsson filed its opposition to the motion, and on April 1, 2011, defendants filed their reply to Ericsson's opposition to the motion to transfer. On June 8, 2011, Ericsson filed an amended complaint that added Dell, Toshiba and Belkin as defendants. At the status conference held on Jun 9, 2011, the Court set a Markman hearing for June 28, 2012 and trial for June 3, 2013. On June 14, 2011, Ericsson submitted its infringement contentions against the Company. On September 29, 2011, the Court denied the defendants' motion to transfer venue

to the Northern District of California. In advance of the Markman hearing, the parties on March 9, 2012 exchanged proposed constructions of claim terms and on April 9, 2012 filed the Joint Claim Construction Statement with the District Court. On May 8, 2012, Ericsson submitted its opening Markman brief and on June 1, 2012 the defendants submitted their responsive Markman brief. Ericsson's Reply Markman brief was submitted June 15, 2012, and on June 28, 2012 the Markman hearing was held in the Eastern District of Texas. On June 21, 2012, Ericsson dismissed the '468 Patent (“Multi-purpose base station”) with prejudice and gave the Company a covenant not to sue as to products in the marketplace now or in the past. On June 22, 2012, Intel filed its Complaint in Intervention, meaning that Intel became an official defendant in the Ericsson case. The parties thereafter completed fact discovery and exchanged expert reports. During the exchange of the expert reports, Ericsson dropped the '516 patent (the OFDM “pulse shaping” patent). In addition, Ericsson dropped the '223 Patent (packet discard patent) against all the defendants' products, except for those products that use Intel chips. Thus, Ericsson has now dropped the '468 Patent (wireless base station), the '516 Patent (OFDM pulse shaping), and the '223 Patent (packet discard patent) for all non-Intel products. The five remaining patents are all only asserted against 802.11-compliant products.

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

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

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

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

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

The Company accrued and expensed the approximately $3.6 million in damages during the second quarter of 2013 to satisfy the verdict, and as of the end of the second quarter of 2014, had accrued and expensed a total of approximately $4.0 million to cover the aforementioned verdict, prejudgment interest, post-judgment interest, and costs.

ReefEdge Networks, LLC v. NETGEAR, Inc.

On September 17, 2012, the Company was sued by ReefEdge Networks, LLC, a non-practicing entity. The Company received an extension from the plaintiff until November 8, 2012 to answer the complaint and answered the complaint on that date.

The complaint alleges that the Company infringes three related patents: 6,633,761 B1; 6,975,864 B2; 7,197,308 B2. In general terms, these asserted patents involve seamlessly handing-off portable wireless devices from one access point to another so as to provide roaming within a wireless network.

The complaint specifically accuses the Company's ProSafe wireless controller of infringing these three patents. On August 15, 2012, ReefEdge filed complaints in Delaware against Aruba Networks Inc., Cisco Systems Inc., Meru Networks Inc., and Ruckus Wireless Inc. alleging infringement of the same three patents. In the second tranche of lawsuits, ReefEdge sued--in addition to the Company-Brocade Communications Systems, Inc., Extreme Networks Inc., ADTRAN, Inc., Alcatel-Lucent Inc., D-Link Systems, Inc., Enterasys Networks, Inc., Motorola Solutions Inc., CDW Corporation, Avaya Inc., and ZyXEL Communications Corporation. During the third quarter of 2013, the Company submitted its initial disclosures to ReefEdge and also produced its core technical documents to ReefEdge. Without admitting any wrongdoing or violation of law and to avoid the distraction and expense of continued litigation and the uncertainty of a jury verdict on the merits, on April 2, 2014, the Company and ReefEdge settled the lawsuit for a one-time payment from the Company to ReefEdge in return for a fully-paid-up license from ReefEdge to

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the Company to all of ReefEdge's currently-held patents. The Court dismissed the case with prejudice on April 14, 2014. The settlement did not have a material financial impact to the Company.

Pragmatus Telecom, LLC v. NETGEAR, Inc.

On December 6, 2012, Pragmatus Telecom, LLC ("Pragmatus"), filed a lawsuit against the Company asserting that the Company's use of a system "to provide live chat service over the Internet" infringes U.S. Patent Nos. 6,311,231, 6,668,286, and 7,159,043 ("'231 patent", "'286 patent", and "'043 patent", respectively).

The '231 patent is entitled "Method and System for Coordinating Data and Voice Communications via Customer Contact," the '286 patent is entitled "Method and System for Coordinating Data and Voice Communications via Customer Contact Channel Changing System Over IP," and the '043 patent is entitled "Method and System for Coordinating Data and Voice Communications via Contact Channel Changing System," The patents very generally allegedly relate to "live chat" services of companies, which can give customers the ability to exchange text messages with a virtual or real customer support person. It appears that most companies named in the various lawsuits by Pragmatus license the "live chat" technology and software from a third-party supplier. A few of these third-party suppliers have been named in some of the over 100 lawsuits filed by Pragmatus in California, Delaware, and the Eastern District of Texas, and two third-party suppliers of text-chat (LivePerson and LogMeIn) have filed declaratory judgment actions on the patents in suit in Delaware.

Pragmatus and the Company agreed to extend the deadline for the Company to answer or otherwise respond to Pragmatus's complaint until February 11, 2013. The Company answered the complaint on that day by denying Pragmatus's infringement allegations and requesting a declaratory judgment by the Court that the patents in suit are not infringed and invalid. On February 20, 2013, the Company filed a motion to stay the case, and, on March 6, 2013, Pragmatus filed its opposition to the Company's motion to stay the case. The Company filed its reply on March 13, 2013. On May 14, 2013, the Court granted the Company's motion to stay "pending final exhaustion of all pending reexamination proceedings." On June 22, 2013, both the '231 and '286 patents, which were the two asserted patents against the Company that were put into reexam by the defendants in a parallel Delaware action and the basis of the stay in the Pragmatus' case against the Company, emerged from reexam. In addition, the Delaware court lifted the stay in the Pragmatus cases pending in Delaware. The parties submitted a status report to the Court in January of 2014 indicating that: (1) the '231 Patent emerged from reexamination with all claims confirmed, and all rights of appeal have been exhausted; (2) the request for reexamination of the '043 Patent was denied; and (3) all claims of the '286 patent were confirmed during reexamination, but the reexamination requestor appealed the examiner's decision and the matter is now on appeal. The parties have asked the Court to lift the stay of the case and set a case management conference and an early neutral evaluation, and the Court has not yet acted on the parties' request.

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

Freeny v. NETGEAR, Inc.

On April 29, 2013, the Company and several other companies, including Apple, ASUSTek, Belkin, Buffalo, D-Link, IC Intracom, Ruckus, TP-Link, Vizio, and Western Digital, were sued in separate actions in the Eastern District of Texas by Charles C. Freeny III, Bryan E. Freeny, and James P. Freeny. The complaint alleges that dual-band wireless routers infringe U.S. Patent No. 7,110,744. The patent lists Charles Freeny as the inventor. Mr. Freeny's sons, Charles III and Bryan, now own the '744 patent, as Mr. Freeny is deceased. On June 21, 2013, the Company's answer and counterclaims were timely filed with the Court. The initial status conference was held on August 8, 2013. At the status conference, the Markman hearing was scheduled for August 7, 2014, which has since been scheduled for August 29,

2014, and the trial date was set for April 6, 2015.

On August 2, 2013, the plaintiffs produced its initial infringement contentions to the Company. The Company's initial disclosures were given to the plaintiffs on September 23, 2013, and, on October 10, 2013, the Company produced initial technical documents, as required by the Court's local rules. Discovery is ongoing.

The Company, along with Belkin, filed a petition for an inter partes review of the '744 patent on April 28, 2014. Belkin, shortly thereafter, settled with the plaintiff, and all defendants other than the Company and Vizio have settled with the plaintiff.

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

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NETGEAR, Inc. v. ASUS

On July 22, 2013, the Company filed a complaint against ASUSTEK COMPUTER, INC. and ASUS COMPUTER INTERNATIONAL, INC. (collectively "ASUS") seeking permanent injunctive relief, damages and declaratory relief for false advertising in violation of the Lanham Act, damages for tortious interference with the Company's prospective business relations, injunctive relief for unfair competition in violation of California Business and Professions Code, injunctive relief for false advertising pursuant to California Business and Professions Code, damages and injunctive relief pursuant the Sherman Antitrust Act, and various forms of declaratory relief.

The Company has asserted that contrary to ASUS's representations to the Federal Communications Commission ("FCC"), ASUS's wireless routers, including without limitation models RT-N65U and RT-AC66U, produce power outputs far in excess of those represented to the FCC, produce power outputs that exceed FCC maximum output levels, unlawfully cause interference with adjacent bandwidths (potentially including critically important navigation, communications, and safety devices), and operate in a manner that has never been accurately reported to the FCC. The Company contends that ASUS's representations that its RT-N65U and RT-AC66U wireless routers are FCC compliant are false, and are made with the intent to deceive potential consumers. The Company further contends that ASUS's misrepresentations regarding compliance of its wireless routers with the FCC regulations constitute unfair competition and false advertising, tortuously interfere with the Company's prospective business advantage, and have harmed the Company because the Company has lost expected sales due to such wrongful conduct and misrepresentations by ASUS.

After a series of extensions to answer the complaint granted by the Company to Asus, on September 3, 2013, Asus filed a motion to dismiss the complaint. Asus's motion was generally based on the following arguments: a) the Company's claims are preempted by FCC regulations; b) the Company is improperly seeking a private cause of action for violation of FCC regulations that create no such cause of action; c) the Company's claims should be stayed or dismissed in deference to the primary jurisdiction of the FCC; and d) the Company fails to allege with sufficient specificity the nature of defendants' wrongful conduct nor how that conduct caused injury to the Company.

On October 7, 2013, the Company responded to ASUS's motion to dismiss by arguing that: a) the defendants violated unambiguous FCC regulations, thus, the Company's claims are in harmony, not conflict, with the FCC's regulatory goals; b) the Company's damages arise not from defendants' private, regulatory dealings with the FCC, but rather from ASUS's conduct in the marketplace -- a realm regulated not by the FCC but by the courts; c) the Court should be allowed to adjudicate garden variety claims of false advertising, unfair competition, and deceptive trade practices that in no way implicate complex regulatory interpretations or policy judgments; and d) the complaint pleads facts in exacting detail.

On December 12, 2013, the Court refused to dismiss the Company's antitrust and false advertising suit against ASUS by denying ASUS's motion, thereby indicating that proceeding with the case would not violate the FCC's authority. In July 2014, the Company and ASUS entered into a settlement agreement, the terms of which are confidential, but which included an undisclosed amount to be paid by ASUS to the Company, which amount is expected to be collected in the Company's fiscal third quarter of 2014.

Spansion LLC v. NETGEAR, Inc.

On August 1, 2013, Spansion LLC ("Spansion") filed a section 337 complaint with the U.S. International Trade Commission ("ITC") naming: the Company; Belkin International, Inc. ("Belkin"); ASUSTek Computer Inc. and Asus Computer International (collectively, "Asus"); D-Link Corporation and D-Link System, Inc. (collectively, "D-Link");

Nintendo Co., Ltd. and Nintendo of America, Inc. (collectively, “Nintendo”); and Macronix America, Inc., Macronix Asia Limited, and Macronix (Hong Kong) Co., Ltd. (collectively “Macronix”), as proposed respondents. The Complaint is styled Certain Flash Memory Chips and Products Containing the Same. Spansion is seeking a general exclusion order, or in the alternative a limited exclusion order, as well as a cease and desist order.

Spansion has asserted six patents related to the manufacture, structure, and operation of flash memory cells, as well as security protection systems for flash memory devices:

• US Patent No. 6,369,416 “Semiconductor Device with Contacts Having a Sloped Profile
• US Patent No. 6,459,625 “Three Metal Process for Optimizing Layout Density”
• US Patent No. 6,731,536 “Password and Dynamic Protection of Flash Memory Data”
• US Patent No. 6,900,124 “Patterning for Elliptical Vss Contact on Flash Memory

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• US Patent No. 7,018,922 “Patterning for Elongated Vss Contact on Flash Memory
• US Patent No. 7,151,027 “Method and Device for Reducing Interface Area of a Memory Device”

Four of the asserted patents, the '416, '625, '124, and '922 patents, were previously asserted by Spansion in the 337-TA-735 Investigation against Samsung, Apple, Nokia, PNY, RIM, and Transcend. ITC records indicate the 735 Investigation terminated based on settlement agreements prior to the hearing on the merits.

The accused products are identified as flash memory chips manufactured and sold by Macronix, as well as downstream products which contain the accused Macronix flash memory chips. The Complaint specifically identifies the Company WNR1000 wireless router, as an exemplary accused product, but makes clear that Spansion intends to expand the scope of accused products to include additional products, if any, which contain the accused Macronix flash memory chips.

In addition, on August 1, 2013, Spansion filed a parallel similar complaint against the same parties in the Northern District of California. Discovery in the ITC case has commenced and is ongoing, and the Northern District of California case has been stayed pending the outcome of the ITC case.

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

Garnet Digital v. NETGEAR, Inc.

On September 9, 2013, the Company was sued in the Eastern District of Texas by a non-practicing entity named Garnet Digital (“Garnet”) that is based in Texas. There is one asserted patent, U.S. Pat. No. 5,379,421 (the ‘421 patent), which is directed to an interactive terminal for the access of remote database information. Garnet is alleging infringement by the Company by its products or systems, such as the NTV200, that are responsive to output signals from a telephone.

The patent has previously been litigated against Apple, Samsung, RIM, and a number of other wireless companies in Eastern Texas and the ITC. Garnet’s lawsuit against the Company is one of multiple cases filed by Garnet in the Eastern District of Texas Other defendants sued by Garnet in the Eastern District of Texas include: Boxee, D-Link Systems, Logitech, Roku, TiVo, DirecTV, DISH Network, Verizon, AT&T, Comcast, Panasonic, Western Digital, Pioneer, Yamaha, Denon, D&M Holdings, Marantz, and Onkyo. The Company answered the complaint on December 9, 2013 by asserting various affirmative defenses. In February of 2014, the court consolidated the Company’s case with the other pending Garnet Digital cases in the Eastern District of Texas.

In May 2014, the remaining defendants (NETGEAR, Inc., Seagate Technology LLC, DISH Network Corporation, and DISH Network L.L.C.) agreed with the plaintiff and the Court via stipulation that the defendants will either pay Garnet Digital $50,000 each or $0 each depending on the results of a limited, but case dispositive, summary judgment motion by the defendants. The summary judgment motion concerned one specific claim construction issue for the Court -- can claim 14 of the ‘421 patent be directly infringed by selling a device that has the capability of being coupled to a telephone and television, but that is not sold coupled to a telephone or television? The defendants and plaintiff submitted briefs on this issue to the Court in June of 2014, and the Court held a hearing on the issue on July 17, 2014. On July 23, 2014, the Court ruled in the defendants’ favor on the summary judgment motion and ordered the parties to file a joint motion to dismiss the case within 21 days of this Order.

This litigation matter will not have a material financial impact to the Company.

Penovia LLC v. NETGEAR, Inc.

On September 27, 2013, a non-practicing entity named Penovia LLC ("Penovia") filed suit against the Company in the Eastern District of Texas. Penovia asserts the Company's wireless routers infringe U.S. Patent No. 5,822,221 (the "'221 patent"), entitled "Office Machine Monitoring Device." Penovia's complaint specifically names the DGN2000 Wireless-N product as an example of an infringing product. Penovia admits in the complaint that the '221 patent expired on October 13, 2010, due to a lapse in maintenance fee payments. Consequently, Penovia seeks damages for an approximately three year period of time starting six years before the filing date of the complaint, September 27, 2007, and ending on October 13, 2010. Penovia has asserted the '221 patent in 22 cases, all in the Eastern District of Texas. Penovia filed nine cases on May 21, 2013, and filed the remainder on September 27, 2013. The Company filed its answer on November 26, 2013 - asserting various affirmative defenses. On December 23, 2013 received Penovia's infringement contentions. Without admitting any wrongdoing or violation of law and to avoid the distraction and expense of continued litigation and the uncertainty of a jury verdict on the merits, on March 28, 2014, the Company and Penovia settled the lawsuit for a one-time payment from the Company to Penovia in return for a fully-paid-up license from

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Penovia to the Company to the patent in suit. The Court dismissed the case with prejudice on April 8, 2014. The settlement did not have a material financial impact to the Company.

Innovative Wireless Solutions LLC v. NETGEAR, Inc.

In November of 2013, Innovative Wireless Solutions filed a new wave of suits targeting 14 wireless router and networking companies, Adtran, Arris, Aruba Networks, Belkin, Buffalo, Engenius Technologies, Fortinet, IC Intracom, Motorola Solutions, SMC Networks, Ubiquiti Networks, Western Digital, and Zoom Telephonics. Previously, in April of 2013, Innovative Wireless had filed 41 suits targeting hotels and restaurant chains over wireless Internet services. The Company was sued on November 6, 2013 in the District of Delaware.

The three patents-in-suit (5,912,895 entitled “Information network access apparatus and methods for communicating information packets via telephone lines” (the “‘895 Patent”); 6,327,264 entitled “Information network access apparatus and methods for communicating information packets via telephone lines” (the “’264 Patent”); and 6,587,473 entitled “Information network access apparatus and methods for communicating information packets via telephone lines” (the “‘473 Patent”) originally were part of a portfolio of Nortel Networks’ patents before they reached Innovative Wireless in March 2013.

The Company filed its answer on January 13, 2014, asserting various affirmative defenses. The initial scheduling conference occurred on May 22, 2014. At the conference, the Court requested that the parties agree on a dispositive motion and trial schedule, including determining the chronological order for the trials of the numerous separate cases filed by the plaintiff. In June 2014, the Company submitted its Rule 26(a) initial disclosures Default Disclosures, as required by the Local Rules. On July 14, 2014, the plaintiff submitted its Initial Identification of Asserted Claims and Accused Products. In total, IWS identified 39 categories of products (spanning 110 separate product models) as allegedly infringing products. Discovery has commenced. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

IOdapt LLP v. NETGEAR, Inc.

On March 7, 2014, the Company was sued by a non-practicing entity named IOdapt LLP in the United States District Court, Eastern District of Texas, Marshall Division. The alleged infringed patent, 8,402,109 (“the '109 Patent”) entitled “Wireless Router Remote Firmware Upgrade,” purportedly covers the remote firmware upgrading of wireless routers. The ‘109 Patent stems from a provisional patent application submitted in Feb. 2005. More particularly, it is a continuation in part of another issued patent, U.S. Patent No. 8,326,936, which in turn, is a continuation of U.S. Patent No. 7,904,518. The Company’s products identified in the Complaint as accused products are: AC1900-R7000, N450-WNR2500 and WNDR4720.

In late April and early May of 2014, the Company submitted its answer and counterclaims to the complaint, moved to transfer the case to the Northern District of California, and moved to dismiss IOdapt’s willful infringement allegations against the Company. In response to the Company’s motion to dismiss, IOdapt amended its complaint to remove the willful infringement allegations. The Company then submitted a revised answer and counterclaims with slight adjustments made to account for IOdapt’s amendments to remove references to willful infringement. Cisco, Belkin, and Buffalo were also recently sued by IOdapt. On June 9, 2014, IOdapt submitted its Opposition to the Company’s Motion to Transfer. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

SMARTDATA, S.A., v. NETGEAR, Inc.

On April 18, 2014, a non-practicing entity named SMARTDATA, S.A. (“SmartData”) sued the Company in the United States District Court, Northern District of California alleging infringement of U.S. Patent No. 7,158,757, entitled “Modular Computer” (“the ‘757 Patent”). SmartData alleges that the Company's various Push2TV products - PTV3000, PTVU1000, PTV2000, and PTV1000 - infringe the '757 patent. The claims of the '757 patent generally require three components, and it appears that SmartData is arguing that infringement occurs when the Company’s Push2TV products are combined with a television and computer.

The Company has not yet answered the complaint and has received an extension until August 4, 2014 to do so. It is too early to reasonably estimate any financial impact to the Company because of this litigation matter.

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TQP Development, LLC v. NETGEAR, Inc.

On April 23, 2014, a non-practicing entity named TQP Development, LLC sued the Company and a host of other defendants the United States District Court, Eastern District of Texas, Marshall Division alleging infringement of U.S. Patent No. 5,412,730 ("the'730 Patent") entitled "Encrypted Data Transmission System Employing Means for Randomly Altering the Encryption Keys." There are two claims, one independent and one dependent, and TQP alleges that the Company infringes by using the methods in conjunction with its website(s). The patent expired on May 2, 2012, and about 138 cases have been filed by TQP against defendants on the '730 Patent, the majority of which were filed after its expiration.

Shortly after filing the complaint against the Company, TQP dismissed the complaint against the Company without prejudice, meaning that it could file the complaint again. This litigation matter did not have a material financial impact to the Company.

Olivistar, LLC v. NETGEAR, Inc.

On April 25, 2013, a non-practicing entity named Olivistar, LLC ("Olivistar") sued the Company and a host of other defendants in the United States District Court, Eastern District of Texas, Marshall Division alleging infringement of U.S. Patents Nos. 6,839,731 entitled "System and Method for Providing Data Communication in a Device Network" (the "'731 patent") and 8,239,481 entitled "System and Method for Implementing Open-Control Remote Device Control" (the "'481 patent"). Olivistar alleges that the Company's various VueZone Home Video Monitoring Systems infringe the two patents.

On June 30, 2014, the Company submitted its answer and counterclaims to Olivistar's complaint. It is too early to reasonably estimate any financial impact to the Company because of 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 European Union ("EU") enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods, including home and commercial business networking products, financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. The deadline for the individual member states of the EU to transpose the directive into law in their respective countries was August 13, 2004 (such legislation, together with the directive, the "WEEE Legislation"). Producers participating in the market were financially responsible for implementing these responsibilities under the WEEE Legislation beginning in August 13, 2005. The Company adopted the authoritative guidance for asset retirement and environmental obligations in the third quarter of fiscal 2005 and has determined that its effect did not have a material impact on the Company's unaudited condensed consolidated results of operations and financial position for the three and six months ended June 29, 2014

and June 30, 2013. The WEEE Directive was recast on July 24, 2012, published on August 13, 2012, and will be implemented by all member states on February 14, 2014. The Company expects no material impact on its consolidated results of operations and financial positions due to this recasting. Similar WEEE Legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China, India, Australia and Japan. The Company continues to monitor WEEE Legislation and similar legislation in other jurisdictions as individual countries issue their implementation guidance. The Company believes it has met the applicable requirements of current WEEE Legislation and similar legislation in other jurisdictions, to the extent implementation requirements has been published.

Additionally, the EU enacted the Restriction of Hazardous Substances Directive ("RoHS Legislation"), the REACH Regulation, Packaging Directive and the Battery Directive. EU RoHS Legislation, along with similar legislation in China, requires manufacturers to ensure certain substances, including polybrominated biphenyls ("PBD"), polybrominated diphenyl ethers ("PBDE"), mercury, cadmium, hexavalent chromium and lead (except for allowed exempted materials and applications), are below specified maximum concentration values in certain products put on the market after July 1, 2006. The RoHS Directive was recast on July 21, 2011 and went into force on January 3, 2013. The Company expects no material impact on its consolidated results of operations and financial positions due to this recasting. The REACH Regulation requires manufacturers to ensure the published

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lists of substances of very high concern in certain products are below specified maximum concentration values. The Battery Directive controls use of certain types of battery technology in certain products and requires mandatory marking. The Company believes it has met the requirements of the RoHS Directive Legislation, the REACH Regulation and the Battery Directive Legislation.

Additionally, the EU enacted the Energy Using Product (“EuP”) Directive, which came into force in August 2007. The EuP Directive required manufacturers of certain products to meet minimum energy efficiency performance requirements. These requirements were documented in EuP implementing measures issued for specific product categories. The implementing measures affecting the Company's products are minimum power supply efficiencies and may include required equipment standby modes, which also reduce energy consumption. The EuP Directive was repealed in November 2009 and replaced by the Energy Related Products ("ErP") Directive, which includes the same implementing measures of the former EuP Directive and new implementing measures applicable to the Company's products. The Company is in compliance with applicable implementing measures of the ErP Directives since it came into force.

Additionally, in 2010, the U. S. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Pursuant to Section 1502 of the Dodd-Frank Act, in August 2012, the U.S. Securities and Exchange Commission adopted Rule 13p-1 under the Securities Exchange Act of 1934, as amended. Rule 13p-1 is commonly known as the “Conflict Minerals Rule.” This rule is intended to address human rights violations arising from the forced labor, child labor, rape, murder and other hostilities related to mining operations in Africa, namely in the eastern Democratic Republic of the Congo (“DRC”) and nearby regions. This rule requires public companies to make disclosures regarding whether specified minerals in company products are sourced from the DRC or its surrounding countries (covered countries) in an effort to encourage companies to obtain these minerals from sources that do not directly or indirectly finance or benefit armed groups operating in these countries. The specified minerals, referred to as conflict minerals, are Tin, Tungsten, Tantalum and Gold, which are necessary in the manufacture of electronics components and equipment. Publicly traded companies, such as the Company, will be required to disclose certain information concerning the origin of conflict minerals contained in their products. In addition, the Organization for Economic Co-operation and Development (“OECD”) has published Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas. The Company intends to utilize this internationally recognized OECD framework to conduct any required due diligence under the Conflict Minerals Rule.

10. Stockholders' Equity

Common Stock Repurchase Program

On October 21, 2008, the Company’s Board of Directors authorized management to repurchase up to 6.0 million shares of the Company’s outstanding common stock. Under this authorization, 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. The Company repurchased 1.3 million shares of common stock at a cost of $43.1 million under this authorization during the six months ended June 29, 2014, which leaves approximately 1.5 million shares remaining in our buyback program. The Company did not repurchase any shares under this authorization during the six months ended June 30, 2013.
The Company repurchased approximately 47,000 shares of common stock at a cost of $1.5 million under a repurchase program to help administratively facilitate the withholding and subsequent remittance of personal income and payroll taxes for individuals receiving RSUs during the six months ended June 29, 2014. Similarly, during the six months ended June 30, 2013, the Company repurchased approximately 13,000 shares of common stock at a cost of $0.5

million under the same program to help facilitate tax withholding for RSUs.

These shares were retired upon repurchase. The Company's policy related to repurchases of its common stock is to charge the excess of cost over par value to retained earnings. All repurchases were made in compliance with Rule 10b-18 under the Securities Exchange Act of 1934, as amended.

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Cumulative Other Comprehensive Income

The following table sets forth the changes in accumulated other comprehensive income by component, net of tax, as of June 29, 2014 and December 31, 2013 (in thousands):

	Gains and losses on available for sale securities	Gains and losses on derivatives	Total
Beginning balance as of December 31, 2013	$4	$65	$69
Other comprehensive income before reclassifications	14	(571)	(557)
Amounts reclassified from accumulated other comprehensive income	—	498	498
Net current period other comprehensive loss	14	(73)	(59)
Ending balance as of June 29, 2014	$18	$(8)	$10

The following tables provide details about significant amounts reclassified out of each component of accumulated other comprehensive income for the three and six months ended June 29, 2014, and June 30, 2013 (in thousands):

	Three Months Ended June 29, 2014		Six Months Ended June 29, 2014	
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations
Gains and losses on cash flow hedge:				
Foreign currency forward contracts	$(116)	Net revenue	$(541)	Net revenue
Foreign currency forward contracts	6	Cost of revenue	8	Cost of revenue
Foreign currency forward contracts	(29)	Operating expenses	35	Operating expenses
	(139)	Total before tax	(498)	Total before tax
	—	Tax expense (1)	—	Tax expense (1)
	$(139)	Total, net of tax	$(498)	Total, net of tax

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

	Three Months Ended June 30, 2013		Six Months Ended June 30, 2013	
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations	Amount Reclassified from AOCI	Affected Line Item in the Statement of Operations
Gains and losses on cash flow hedge:				
Foreign currency forward contracts	$445	Net revenue	$520	Net revenue
Foreign currency forward contracts	(1)	Cost of revenue	(3)	Cost of revenue
Foreign currency forward contracts	(48)	Operating expenses	(94)	Operating expenses
	396	Total before tax	423	Total before tax
	—	Tax expense (1)	—	Tax expense (1)
	$396	Total, net of tax	$423	Total, net of tax

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

11. Employee Benefit Plans

The Company grants options and restricted stock units from the Amended and Restated 2006 Long-Term Incentive Plan, under which awards may be granted to all employees. Award vesting periods for this plan is generally four years. In June 2014, the Company adopted amendments to the 2006 Plan which increased the number of shares of the Company’s common stock that may be issued under the 2006 plan by an additional 1,500,000 shares. As of June 29, 2014, a total of 2,002,221 shares from 2006 plan were reserved for future grants under the plan. During the second quarter of 2013, the Company's 2003 Stock Plan expired and the remaining unissued 62,791 reserved shares were retired accordingly.

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Additionally, the Company sponsors an Employee Stock Purchase Plan (the "ESPP"), pursuant to which eligible employees may contribute up to 10% of base compensation, subject to certain income limits, to purchase shares of the Company's common stock. Employees may purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date. As of June 29, 2014, a total of 261,025 shares were reserved for future grants under the ESPP.

Option Activity

Stock options activity during the six months ended June 29, 2014, was as follows:

	Number of shares	Weighted Average Exercise Price Per Share
	(in thousands)	(in dollars)
Outstanding at December 31, 2013	4,165	$30.11
Granted	389	32.79
Exercised	(218)	23.71
Cancelled	(59)	35.77
Expired	(111)	36.42
Outstanding at June 29, 2014	4,166	$30.45

RSU Activity

RSU activity during the six months ended June 29, 2014, was as follows:

	Number of shares	Weighted Average Grant Date Fair Value Per Share
	(in thousands)	(in dollars)
Outstanding at December 31, 2013	731	$29.40
RSUs granted	433	33.11
RSUs vested	(178)	30.05
RSUs cancelled	(31)	29.15
Outstanding at June 29, 2014	955	$30.89

Valuation and Expense Information

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

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The following table sets forth the weighted average assumptions used to fair value option grants during the three and six months ended June 29, 2014 and June 30, 2013:

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Expected life (in years)	4.5	4.5	4.5	4.4
Risk-free interest rate	1.44%	0.67%	1.44%	0.69%
Expected volatility	42.6%	47.3%	42.6%	48.2%
Dividend yield	—	—	—	—

The following table sets forth the total 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	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Cost of revenue	$489	$406	$960	$595
Research and development	1,227	1,135	2,623	1,807
Sales and marketing	1,401	1,310	3,350	2,540
General and administrative	1,817	1,540	3,131	3,039
Total stock-based compensation	$4,934	$4,391	$10,064	$7,981

As of June 29, 2014, $15.3 million of total unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 2.51 years. Additionally, $20.9 million of total unrecognized compensation cost related to non-vested RSUs, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 3.05 years.

12. Segment Information, Operations by Geographic Area and Significant Customers

Operating segments are components of an enterprise about which separate financial information is available and is regularly evaluated by management, namely the Chief Operating Decision Maker ("CODM") of an organization, in order to determine operating and resource allocation decisions. By this definition, the Company operates in three specific business units: retail, commercial, and service provider. The retail business unit consists of high performance, dependable and easy-to-use home networking, home video monitoring, 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 size 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 is managed by a Senior Vice President/General Manager. 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.

In the first quarter of 2014, the CEO began temporarily serving as interim General Manager of the retail business unit due to the previous general manager's departure from the Company. As of June 29, 2014, the CEO continues to serve as interim general manager and will do so until a replacement is established.

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 expenses,

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corporate marketing expenses, general and administrative costs, stock-based compensation expenses, amortization of intangibles, acquisition-related integration costs, restructuring costs, litigation reserves and interest income and other expense, net. The Company does not evaluate operating segments using discrete asset information.

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	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Net revenue:				
Retail	$110,663	$117,395	$228,895	$243,717
Commercial	75,447	88,446	154,310	159,297
Service provider	151,494	151,878	303,790	248,104
Total net revenue	337,604	357,719	686,995	651,118
Contribution income:				
Retail	$14,726	$15,761	$29,409	$34,379
Retail contribution margin	13.3 %	13.4 %	12.8 %	14.1 %
Commercial	17,129	20,476	36,669	34,287
Commercial contribution margin	22.7 %	23.2 %	23.8 %	21.5 %
Service Provider	15,235	14,090	28,754	23,581
Service Provider contribution margin	10.1 %	9.3 %	9.5 %	9.5 %
Total segment contribution income	47,090	50,327	94,832	92,247
Corporate and unallocated costs	(13,128)	(13,558)	(26,884)	(26,024)
Amortization of intangible assets (1)	(4,391)	(4,872)	(8,781)	(6,343)
Stock-based compensation expense	(4,934)	(4,391)	(10,064)	(7,981)
Restructuring and other charges	12	(1,587)	(830)	(1,557)
Acquisition-related expense	—	(214)	(8)	(924)
Impact to cost of sales from acquisition accounting adjustments to inventory	—	(568)	—	(568)
Litigation reserves, net	(68)	(3,555)	(185)	(3,603)
Interest income	49	95	106	244
Other expense, net	(227)	(548)	(335)	(474)
Income before income taxes	$24,403	$21,129	$47,851	$45,017

(1) Amount excludes amortization expense related to patents within purchased intangible assets in costs of revenues.

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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	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
United States	$182,222	$196,136	$372,498	$349,849
Americas (excluding U.S.)	5,312	4,712	9,815	7,675
United Kingdom	42,574	41,972	83,774	82,830
EMEA (excluding U.K.)	57,862	66,395	123,455	132,662
APAC	49,634	48,504	97,453	