MICROCHIP TECHNOLOGY INC
Form 10-Q
August 06, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2015.
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from __________ to __________

Commission File Number: 0-21184

MICROCHIP TECHNOLOGY INCORPORATED
(Exact Name of Registrant as Specified in Its Charter)

Delaware	86-0629024
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

2355 W. Chandler Blvd., Chandler, AZ 85224-6199
(480) 792-7200
(Address, Including Zip Code, and Telephone Number,
Including Area Code, of Registrant's
Principal Executive Offices)

Indicate by checkmark 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 the filing requirements for the past 90 days. Yes x No o

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 o

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

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

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

Shares Outstanding of Registrant's Common Stock

Class	Outstanding at August 4, 2015
Common Stock, $0.001 par value	211,091,149 shares

MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES

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MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)
(unaudited)

Item1. Financial Statements

ASSETS	June 30, 2015		March 31, 2015	
Cash and cash equivalents	$563,547		$607,815	
Short-term investments	969,003		1,351,054	
Accounts receivable, net	277,033		273,937	
Inventories	303,690		279,456	
Prepaid expenses	33,927		34,717	
Deferred tax assets	71,045		71,045	
Assets held for sale	13,669		13,989	
Other current assets	23,700		32,604	
Total current assets	2,255,614		2,664,617	
Property, plant and equipment, net	595,247		581,572	
Long-term investments	898,024		383,326	
Goodwill	571,660		571,271	
Intangible assets, net	470,488		504,417	
Other assets	65,952		75,510	
Total assets	$4,856,985		$4,780,713	
LIABILITIES AND EQUITY				
Accounts payable	$93,655		$86,866	
Accrued liabilities	111,124		100,978	
Deferred income on shipments to distributors	167,529		166,128	
Total current liabilities	372,308		353,972	
Senior convertible debentures	1,169,583		1,174,036	
Junior convertible debentures	192,162		190,870	
Long-term line of credit	496,952		461,952	
Long-term income tax payable	98,001		114,336	
Long-term deferred tax liability	380,403		381,192	
Other long-term liabilities	48,694		43,329	
Stockholders' equity:				
Preferred stock, $0.001 par value; authorized 5,000,000 shares; no shares issued or outstanding	—		—	
Common stock, $0.001 par value; authorized 450,000,000 shares; 218,789,994 shares issued and 202,407,537 shares outstanding at June 30, 2015; 218,789,994 shares issued and 202,080,306 shares outstanding at March 31, 2015	202		202	
Additional paid-in capital	1,001,935		999,515	
Common stock held in treasury: 16,382,457 shares at June 30, 2015; 16,709,688 shares at March 31, 2015	(505,960	)	(515,679	)
Accumulated other comprehensive (loss) income	(5,171	)	11,076	
Retained earnings	1,607,876		1,549,540	
Microchip Technology stockholders' equity	2,098,882		2,044,654	
Noncontrolling interests	—		16,372	

Total equity	2,098,882	2,061,026
Total liabilities and equity	$4,856,985	$4,780,713

See accompanying notes to condensed consolidated financial statements

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MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended June 30,	
	2015	2014
Net sales	$533,952	$528,876
Cost of sales (1)	224,935	222,357
Gross profit	309,017	306,519
Operating expenses:		
Research and development (1)	84,680	84,370
Selling, general and administrative (1)	66,849	69,255
Amortization of acquired intangible assets	34,612	36,644
Special charges, net	1,557	304
	187,698	190,573
Operating income	121,319	115,946
Losses on equity method investments	(177)	(32)
Other income (expense):		
Interest income	5,528	4,742
Interest expense	(24,052)	(13,678)
Other income, net	16,947	13
Income before income taxes	119,565	106,991
Income tax (benefit) provision	(10,895)	17,082
Net income	130,460	89,909
Less: Net loss attributable to noncontrolling interests	207	—
Net income attributable to Microchip Technology	$130,667	$89,909
Basic net income per common share attributable to Microchip Technology stockholders	$0.65	$0.45
Diluted net income per common share attributable to Microchip Technology stockholders	$0.60	$0.40
Dividends declared per common share	$0.3575	$0.3555
Basic common shares outstanding	202,232	200,187
Diluted common shares outstanding	216,767	224,527
(1) Includes share-based compensation expense as follows:		
Cost of sales	$1,657	$2,055
Research and development	7,098	6,309
Selling, general and administrative	5,357	4,957

See accompanying notes to condensed consolidated financial statements

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MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three Months Ended June 30,	
	2015	2014
Net income	$130,460	$89,909
Less: Net loss attributable to noncontrolling interests	207	—
Net income attributable to Microchip Technology	130,667	89,909
Components of other comprehensive (loss) income:		
Available-for-sale securities:		
Unrealized holding (losses) gains, net of tax effect of $0 and $12, respectively	(2,012)	3,060
Reclassification of realized transactions, net of tax effect of $0 and $12, respectively	(13,959)	(22)
Other comprehensive (loss) income, net of taxes	(15,971)	3,038
Less: Other comprehensive (income) loss attributable to noncontrolling interests	—	—
Other comprehensive (loss) income attributable to Microchip Technology	(15,971)	3,038
Comprehensive income	114,489	92,947
Less: Comprehensive loss attributable to noncontrolling interests	207	—
Comprehensive income attributable to Microchip Technology	$114,696	$92,947

See accompanying notes to condensed consolidated financial statements

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MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended June 30,	
	2015	2014
Cash flows from operating activities:		
Net income	$130,460	$89,909
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	60,375	60,988
Deferred income taxes	(17,509)	(2,319)
Share-based compensation expense related to equity incentive plans	14,112	13,321
Excess tax benefit from share-based compensation	(263)	—
Amortization of debt discount on convertible debentures	11,772	2,365
Amortization of debt issuance costs	958	544
Losses on equity method investments	177	32
Gain on sale of assets	(560)	—
Impairment of intangible assets	—	406
Realized gain on available-for-sale investment	(13,959)	—
Realized gain on equity method investment	(2,225)	—
Amortization of premium on available-for-sale investments	2,396	2,589
Changes in operating assets and liabilities:		
Increase in accounts receivable	(3,096)	(37,247)
(Increase) decrease in inventories	(23,893)	24,991
Increase (decrease) in deferred income on shipments to distributors	1,401	(1,215)
Increase (decrease) in accounts payable and accrued liabilities	16,157	(4,415)
Change in other assets and liabilities	5,225	15,839
Net cash provided by operating activities	181,528	165,788
Cash flows from investing activities:		
Purchases of available-for-sale investments	(570,501)	(172,506)
Sales and maturities of available-for-sale investments	433,446	321,203
Sale of equity method investment	2,667	—
Purchase of additional controlling interest in ISSC	(18,051)	—
Acquisition of Supertex, net of cash acquired	—	(375,365)
Investments in other assets	(1,766)	(1,123)
Proceeds from sale of assets	627	—
Capital expenditures	(33,611)	(44,637)
Net cash used in investing activities	(187,189)	(272,428)
Cash flows from financing activities:		
Repayments of revolving loan under credit facility	(110,000)	(170,000)
Proceeds from borrowings on revolving loan under credit facility	145,000	504,375
Repayments of long-term borrowings	—	(4,375)
Deferred financing costs	(406)	—
Payment of cash dividends	(72,331)	(71,202)
Proceeds from sale of common stock	3,497	4,125
Tax payments related to shares withheld for vested restricted stock units	(4,464)	(4,968)
Capital lease payments	(166)	(148)
Excess tax benefit from share-based compensation	263	—

Net cash (used in) provided by financing activities	(38,607)	257,807
Net (decrease) increase in cash and cash equivalents	(44,268)	151,167
Cash and cash equivalents at beginning of period	607,815	466,603
Cash and cash equivalents at end of period	$563,547	$617,770

See accompanying notes to condensed consolidated financial statements

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MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Microchip Technology Incorporated and its majority-owned subsidiaries (the Company). The Company owned 100% of the outstanding stock in all of its subsidiaries as of June 30, 2015. During the three months ended June 30, 2015, the Company purchased the remaining shares of ISSC Technologies Corporation (ISSC) as further discussed in Note 2. The noncontrolling interest in the Company's net income from ISSC has been excluded from net income attributable to the Company in the Company's condensed consolidated statements of income. All intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (US GAAP), pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). The information furnished herein reflects all adjustments which are, in the opinion of management, of a normal recurring nature and necessary for a fair statement of the results for the interim periods reported. Certain information and footnote disclosures normally included in audited consolidated financial statements have been condensed or omitted pursuant to such SEC rules and regulations. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2015. The results of operations for the three months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the fiscal year ending March 31, 2016 or for any other period.

(2) Business Acquisitions
Acquisition of ISSC
On July 17, 2014, the Company acquired an 83.5% interest in Taiwan based ISSC, a leading provider of low power Bluetooth and advanced wireless solutions for the Internet of Things (IoT) market. The Company acquired the 83.5% ownership interest through a tender offer process. Since the completion of the tender offer, the Company has continued to acquire additional shares of ISSC, and as of June 30, 2015, the Company had completed the acquisition of 100% of the outstanding shares of ISSC.
The acquisition was accounted for under the acquisition method of accounting. The table below represents the allocation of the purchase price, including adjustments to the purchase price allocation from the previously reported figures at March 31, 2015, to the net assets acquired based on their estimated fair values as of July 17, 2014 as well as the associated estimated useful lives of the acquired intangible assets at that date. The purchase price allocation was finalized as of June 30, 2015 (amounts in thousands):

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Assets acquired	Previously Reported March 31, 2015	Adjustments	June 30, 2015
Cash and cash equivalents	$15,120	$—	$15,120
Short-term investments	27,063	—	27,063
Accounts receivable, net	8,792	—	8,792
Inventories	16,542	—	16,542
Prepaid expenses and other current assets	2,501	—	2,501
Property, plant and equipment, net	2,637	—	2,637
Goodwill	154,399	389	154,788
Purchased intangible assets	147,800	—	147,800
Other assets	1,370	—	1,370
Total assets acquired	376,224	389	376,613
Liabilities assumed			
Accounts payable	(9,860)	—	(9,860)
Other current liabilities	(16,535)	—	(16,535)
Long-term income tax payable	(4,402)	(389)	(4,791)
Deferred tax liability	(25,126)	—	(25,126)
Other long-term liabilities	(245)	—	(245)
Total liabilities assumed	(56,168)	(389)	(56,557)
Net assets acquired including noncontrolling interest	320,056	—	320,056
Less: noncontrolling interest	(52,467)	—	(52,467)
Net assets acquired	$267,589	$—	$267,589

Purchased Intangible Assets	Useful Life (in years)	July 17, 2014 (in thousands)
Core/developed technology	10	$68,900
In-process technology	10	27,200
Customer-related	3	51,100
Backlog	1	600
		$147,800

Acquisition of Supertex

On April 1, 2014, the Company acquired Supertex Inc., a publicly traded company based in Sunnyvale, California. Supertex is a leader in high voltage analog and mixed signal technologies, with a strong position in the medical, lighting and industrial control markets.

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The acquisition was accounted for under the acquisition method of accounting. The table below represents the allocation of the purchase price to the net assets acquired based on their estimated fair values as of April 1, 2014 as well as the associated estimated useful lives of the acquired intangible assets at that date. The purchase price allocation was finalized on March 31, 2015 (amounts in thousands):

Assets acquired	March 31, 2015	
Cash and cash equivalents	$14,790	
Short-term investments	140,984	
Accounts receivable, net	7,047	
Inventories	27,630	
Prepaid expenses	1,493	
Deferred tax assets	2,456	
Other current assets	12,625	
Property, plant and equipment, net	15,679	
Goodwill	143,160	
Purchased intangible assets	89,600	
Other assets	325	
Total assets acquired	455,789	
Liabilities assumed		
Accounts payable	(8,481	)
Accrued liabilities	(19,224	)
Long-term income tax payable	(3,796	)
Deferred tax liability	(32,511	)
Total liabilities assumed	(64,012	)
Net assets acquired	$391,777	

Purchased Intangible Assets	Useful Life (in years)	April 1, 2014 (in thousands)
Core/developed technology	10	$68,900
In-process technology	10	1,900
Customer-related	2	17,700
Backlog	1	1,100
		$89,600

(3) Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09-Revenue from Contracts with Customers, which will supersede nearly all existing revenue recognition guidance under US GAAP. The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The Company is evaluating its existing revenue recognition policies to determine whether any contracts in the scope of the guidance will be materially affected by the new requirements. The effects may include identifying performance obligations in existing arrangements, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. On July 9, 2015, the FASB delayed the effective date by one year. In accordance with the delay, the new standard is effective for us beginning in the first quarter of the Company's 2019 fiscal year. Early adoption is permitted, but not before the original effective date of December 15, 2016. The standard allows for either "full retrospective" adoption, meaning the standard is applied to all of the periods presented, or "modified

retrospective" adoption, meaning the standard is applied only to the most current period presented in the financial statements. The Company is currently evaluating the transition method that will be elected.

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In April 2015, the FASB issued ASU 2015-03-Simplifying the Presentation of Debt Issuance Costs. This standard amends existing guidance to require the presentation of debt issuance costs in the balance sheet as a deduction from the carrying amount of the related debt liability instead of a deferred charge. It is effective for annual reporting periods beginning after December 15, 2015, but early adoption is permitted. The Company is currently evaluating the impact the adoption of this standard will have on its consolidated financial statements.

In April 2015, the FASB issued ASU 2015-05-Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40), Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. This standard provides guidance about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the software license element of the arrangement should be accounted for consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 is effective for fiscal years beginning after December 15, 2015, and interim periods within those years. This standard can be adopted either prospectively to all arrangements entered into or materially modified after the effective date or retrospectively. The Company is currently evaluating the impact the adoption of this standard will have on its consolidated financial statements.

(4) Special Charges

The Company incurred special charges related to severance, office closing and other costs associated with its acquisition activity of $1.6 million and $0.3 million for the three months ended June 30, 2015 and June 30, 2014, respectively.

(5) Segment Information

The Company's reportable segments are semiconductor products and technology licensing. The Company does not allocate operating expenses, interest income, interest expense, other income or expense, or provision for or benefit from income taxes to these segments for internal reporting purposes, as the Company does not believe that allocating these expenses is beneficial in evaluating segment performance. Additionally, the Company does not allocate assets to segments for internal reporting purposes as it does not manage its segments by such metrics.

The following table represents net sales and gross profit for each segment for the three months ended June 30, 2015 (amounts in thousands):

	Three Months Ended June 30, 2015	
	Net Sales	Gross Profit
Semiconductor products	$510,689	$285,754
Technology licensing	23,263	23,263
	$533,952	$309,017

The following table represents net sales and gross profit for each segment for the three months ended June 30, 2014 (amounts in thousands):

	Three Months Ended June 30, 2014	
	Net Sales	Gross Profit
Semiconductor products	$508,439	$286,082
Technology licensing	20,437	20,437
	$528,876	$306,519

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(6) Investments

The Company's investments are intended to establish a high-quality portfolio that preserves principal, meets liquidity needs, avoids inappropriate concentrations, and delivers an appropriate yield in relationship to the Company's investment guidelines and market conditions. The following is a summary of available-for-sale securities at June 30, 2015 (amounts in thousands):

	Available-for-sale Securities			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Government agency bonds	$799,662	$494	$(1,150)	$799,006
Municipal bonds	41,142	9	(765)	40,386
Auction rate securities	9,825	—	—	9,825
Corporate bonds and debt	1,017,832	1,149	(1,171)	1,017,810
	$1,868,461	$1,652	$(3,086)	$1,867,027

The following is a summary of available-for-sale securities at March 31, 2015 (amounts in thousands):

	Available-for-sale Securities			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Government agency bonds	$741,780	$676	$(200)	$742,256
Municipal bonds	41,552	155	(9)	41,698
Auction rate securities	9,825	—	—	9,825
Time deposits [1]	506	—	—	506
Corporate bonds and debt	924,818	2,376	(265)	926,929
Marketable equity securities	1,362	11,804	—	13,166
	$1,719,843	$15,011	$(474)	$1,734,380

[1] Time deposits in various financial institutions with maturities greater than three months that will mature within one year.

At June 30, 2015, the Company's available-for-sale securities are presented on the condensed consolidated balance sheets as short-term investments of $969.0 million and long-term investments of $898.0 million. At March 31, 2015, the Company's available-for-sale securities are presented on the condensed consolidated balance sheets as short-term investments of $1,351.1 million and long-term investments of $383.3 million.

At March 31, 2015, the Company's marketable equity securities consisted of an investment in Hua Hong Semiconductor Limited (Hua Hong), which effected its initial public offering on the Hong Kong stock exchange on October 15, 2014. This investment was previously classified as a non-marketable cost-method investment, and had a carrying value of $3.6 million. The Company sold all remaining shares of Hua Hong in the three months ended June 30, 2015.

The Company sold available-for-sale investments for proceeds of $89.2 million and $144.0 million during the three months ended June 30, 2015 and June 30, 2014, respectively. During the three months ended June 30, 2015, the Company had net realized gains of $14.0 million from sales of available-for-sale marketable equity and debt securities. The Company had no material realized gains from the sale of available-for-sale securities during the three months ended June 30, 2014. The Company determines the cost of an investment sold on an average cost basis at the

individual security level for sales from multiple lots. For all other sales, the Company uses an adjusted cost basis at the individual security level.

The following tables show all investments in an unrealized loss position for which an other-than-temporary impairment has not been recognized and the related gross unrealized losses and fair value, aggregated by investment category and the length of time that the individual securities have been in a continuous unrealized loss position (amounts in thousands):

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	June 30, 2015					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Government agency bonds	$442,847	$(1,061)	$14,911	$(89)	$457,758	$(1,150)
Municipal bonds	37,104	(765)	—	—	37,104	(765)
Corporate bonds and debt	424,510	(1,088)	28,059	(83)	452,569	(1,171)
	$904,461	$(2,914)	$42,970	$(172)	$947,431	$(3,086)

	March 31, 2015					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Government agency bonds	$162,948	$(142)	$29,942	$(58)	$192,890	$(200)
Municipal bonds	13,318	(9)	—	—	13,318	(9)
Corporate bonds and debt	163,095	(219)	19,021	(46)	182,116	(265)
	$339,361	$(370)	$48,963	$(104)	$388,324	$(474)

Management does not believe any of the unrealized losses represent an other-than-temporary impairment based on its evaluation of available evidence as of June 30, 2015 and the Company's intent is to hold these investments until these assets are no longer impaired, except for certain auction rate securities (ARS). For those debt securities not scheduled to mature until after June 30, 2016, such recovery is not anticipated to occur in the next year and these investments have been classified as long-term investments on the condensed consolidated balance sheet.

The amortized cost and estimated fair value of the available-for-sale securities at June 30, 2015, by contractual maturity, excluding corporate debt of $6.2 million, which has no contractual maturity, are shown below (amounts in thousands). Expected maturities can differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties, and the Company views its available-for-sale securities as available for current operations.

	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale				
Due in one year or less	$269,962	$295	$(78)	$270,179
Due after one year and through five years	1,485,199	1,357	(2,190)	1,484,366
Due after five years and through ten years	97,285	—	(818)	96,467
Due after ten years	9,825	—	—	9,825
	$1,862,271	$1,652	$(3,086)	$1,860,837

(7) Fair Value Measurements

Accounting rules for fair value clarify that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, the Company utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

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Level 1- Observable inputs such as quoted prices in active markets;
Level 2- Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
Level 3- Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Marketable Debt Instruments

Marketable debt instruments include instruments such as corporate bonds and debt, government agency bonds, bank deposits, municipal bonds, and money market mutual funds. When the Company uses observable market prices for identical securities that are traded in less active markets, the Company classifies its marketable debt instruments as Level 2. When observable market prices for identical securities are not available, the Company prices its marketable debt instruments using non-binding market consensus prices that are corroborated with observable market data; quoted market prices for similar instruments; or pricing models, such as a discounted cash flow model, with all significant inputs derived from or corroborated with observable market data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers or brokers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs and, to a lesser degree, unobservable market inputs. The Company corroborates non-binding market consensus prices with observable market data using statistical models when observable market data exists. The discounted cash flow model uses observable market inputs, such as LIBOR-based yield curves, currency spot and forward rates, and credit ratings.

Derivatives

The Company's derivative assets and liabilities include interest rate swaps that are classified as Level 2 as the Company uses inputs other than quoted prices that are observable for the assets or liabilities. The Level 2 derivative assets and liabilities are primarily valued using standard calculations and models that use readily observable market data as their basis.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis at June 30, 2015 are as follows (amounts in thousands):

	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Balance
Assets				
Cash and cash equivalents:				
Money market mutual funds	$217,606	$—	$—	$217,606
Deposit accounts	—	345,941	—	345,941
Short-term investments:				
Corporate bonds and debt	—	611,880	—	611,880
Government agency bonds	—	351,247	—	351,247
Municipal bonds	—	5,876	—	5,876
Long-term investments:				
Corporate bonds and debt	—	399,740	6,190	405,930

Government agency bonds	—	447,760	—	447,760
Municipal bonds	—	34,509	—	34,509
Auction rate securities	—	—	9,825	9,825
Total assets measured at fair value	$217,606	$2,196,953	$16,015	$2,430,574
Liabilities				
Derivative liabilities	$—	$6,042	$—	$6,042
Total liabilities measured at fair value	$—	$6,042	$—	$6,042

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Assets measured at fair value on a recurring basis at March 31, 2015 are as follows (amounts in thousands):

	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Balance
Assets				
Cash and cash equivalents:				
Money market mutual funds	$279,833	$—	$—	$279,833
Deposit accounts	—	327,982	—	327,982
Short-term investments:				
Marketable equity securities	13,166	—	—	13,166
Corporate bonds and debt	—	756,664	—	756,664
Time deposits [(1)]	—	506	—	506
Government agency bonds	—	549,737	—	549,737
Municipal bonds	—	30,981	—	30,981
Long-term investments:				
Corporate bonds and debt	—	164,075	6,190	170,265
Government agency bonds	—	192,519	—	192,519
Municipal bonds	—	10,717	—	10,717
Auction rate securities	—	—	9,825	9,825
Derivative assets	—	8,928	—	8,928
Total assets measured at fair value	$292,999	$2,042,109	$16,015	$2,351,123

[(1)] Time deposits in various financial institutions with maturities greater than three months that will mature within one year.

There were no transfers between Level 1 and Level 2 during the three-month period ended June 30, 2015 or the year ended March 31, 2015.

At June 30, 2015 and at March 31, 2015, the Company's ARS for which recent auctions were unsuccessful are made up of securities related to the insurance industry valued at $9.8 million with a par value of $22.4 million. The Company estimated the fair value of its ARS, which are classified as Level 3 securities, based on the following: (i) the underlying structure of each security; (ii) the present value of future principal and interest payments discounted at rates considered to reflect current market conditions; (iii) consideration of the probabilities of default, auction failure, or repurchase at par for each period; and (iv) estimates of the recovery rates in the event of default for each security. The significant unobservable inputs used in the fair value measurement of the ARS as of June 30, 2015 were estimated risk free discount rates, liquidity risk premium, and the liquidity horizon. The risk free discount rate applied to these securities was 2% to 2.5% adjusted for the liquidity risk premium which ranged from 9.1% to 29.5%. The anticipated liquidity horizon ranged from 7 to 10 years. A significant increase in the liquidity premium, discount rate or liquidity horizon, in isolation, would lead to a significantly lower fair value measurement. Each quarter, the Company investigates material changes in the fair value measurements of its ARS.

Assets Measured and Recorded at Fair Value on a Non-Recurring Basis

The Company's non-marketable equity, cost method investments, and non-financial assets, such as intangible assets, assets held for sale and property, plant and equipment, are recorded at fair value on a non-recurring basis. These assets are subject to fair value adjustments in certain circumstances, for example, when there is evidence of impairment.

The Company's non-marketable and cost method investments are monitored on a quarterly basis for impairment charges. The fair values of these investments have been determined as Level 3 fair value measurements because the valuations use unobservable inputs that require management's judgment due to the absence of quoted market prices. There were no impairment charges recognized on these investments during the three-month periods ended June 30, 2015 and June 30, 2014. These investments are included in other assets on the condensed consolidated balance sheet.

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The fair value measurements related to the Company's non-financial assets, such as intangible assets, assets held for sale and property, plant and equipment are based on available market prices at the measurement date based on transactions of similar assets and third-party independent appraisals, less cost to sell where appropriate. The Company classifies these measurements as Level 2.

(8) Fair Value of Financial Instruments

The carrying amount of cash equivalents approximates fair value because their maturity is less than three months. Management believes the carrying amount of the equity and cost-method investments materially approximated fair value at June 30, 2015 based upon unobservable inputs. The fair values of these investments have been determined as Level 3 fair value measurements. The fair values of the Company's line of credit borrowings are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements and approximate carrying value. Based on the borrowing rates currently available to the Company for bank loans with similar terms and average maturities, the fair value of the Company's line of credit borrowings at June 30, 2015 approximated book value and are considered Level 2 in the fair value hierarchy described in Note 7. The carrying amount of accounts receivable, accounts payable and accrued liabilities approximates fair value due to the short-term maturity of the amounts and are considered Level 2 in the fair value hierarchy. The fair value of the Company's senior subordinated convertible debentures was $1.740 billion at June 30, 2015 and $1.788 billion at March 31, 2015. The fair value of the Company's junior subordinated convertible debentures was $1.087 billion at June 30, 2015 and $1.124 billion at March 31, 2015. The fair value of the Company's senior and junior subordinated convertible debentures are based on observable market prices for these debentures, which are traded in less active markets and are therefore classified as a Level 2 fair value measurement, and exclude the impacts of derivative activity.

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(9) Accounts Receivable

Accounts receivable consists of the following (amounts in thousands):

	June 30, 2015	March 31, 2015
Trade accounts receivable	$276,087	$269,844
Other	3,535	6,714
	279,622	276,558
Less allowance for doubtful accounts	2,589	2,621
	$277,033	$273,937

(10) Inventories

The components of inventories consist of the following (amounts in thousands):

	June 30, 2015	March 31, 2015
Raw materials	$14,066	$13,263
Work in process	216,390	197,565
Finished goods	73,234	68,628
	$303,690	$279,456

Inventories are valued at the lower of cost or market using the first-in, first-out method. Inventory impairment charges establish a new cost basis for inventory and charges are not subsequently reversed to income even if circumstances later suggest that increased carrying amounts are recoverable.

(11) Assets Held for Sale

During the year ended March 31, 2015, the Company began to actively market property it acquired as part of the Supertex acquisition. In May 2015, the Company entered into an agreement to sell the property and subsequently completed the sale on July 22, 2015 for $14.3 million. As of June 30, 2015, the Company classified the assets as held for sale on its condensed consolidated balance sheet at its fair value of approximately $14.3 million, net of the estimated cost to sell of approximately $0.6 million.

(12) Property, Plant and Equipment

Property, plant and equipment consists of the following (amounts in thousands):

	June 30, 2015	March 31, 2015
Land	$55,624	$55,624
Building and building improvements	437,751	434,403
Machinery and equipment	1,598,481	1,576,074
Projects in process	86,093	76,315
	2,177,949	2,142,416
Less accumulated depreciation and amortization	1,582,702	1,560,844
	$595,247	$581,572

Depreciation expense attributed to property, plant and equipment was $24.7 million for the three months ended June 30, 2015 and $23.3 million for the three months ended June 30, 2014.

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(13) Noncontrolling Interests

The following table presents the changes in the components of noncontrolling interests for the three months ended June 30, 2015 (amounts in thousands):

	Noncontrolling Interests
Balance at March 31, 2015	$16,372
Net loss attributable to noncontrolling interests	(207)
Purchase of additional interests	(16,165)
Balance at June 30, 2015	$—

The following table presents the effect of changes in the Company's ownership interest in ISSC on the Company's stockholders' equity for the three months ended June 30, 2015 (amounts in thousands):

	Three Months Ended June 30, 2015
Net income attributable to Microchip Technology stockholders	$130,667
Decrease in paid-in capital for purchase of additional interests	(1,610)
Transfers from noncontrolling interest	(1,610)
Change from net income attributable to Microchip Technology stockholders and transfers from noncontrolling interest	$129,057

(14) Income Taxes

The provision for income taxes reflects tax on foreign earnings and federal and state tax on U.S. earnings. The Company had an effective tax rate benefit of 9.1% for the three-month period ended June 30, 2015 and an effective tax rate of 16.0% for the three-month period ended June 30, 2014. The Company's effective tax rate for three-month period ended June 30, 2015 is lower compared to the prior year primarily due to a revaluation of deferred tax liabilities. The income tax benefit realized during the three-month period ended June 30, 2015 included the reversal of a previously established valuation allowance against its U.S. deferred tax assets, as well as a revaluation of its foreign deferred tax liabilities. The Company's effective tax rate is lower than statutory rates in the U.S. due primarily to its mix of earnings in foreign jurisdictions with lower tax rates.

At June 30, 2015, the Company had $203.0 million of unrecognized tax benefits. Unrecognized tax benefits increased by $4.0 million compared to March 31, 2015 primarily as a result of the ongoing accrual for uncertain tax positions and the accrual of deficiency interest on these positions.

The Company files U.S. federal, U.S. state, and foreign income tax returns. For U.S. federal, and in general for U.S. state tax returns, the fiscal 2011 and later tax years remain open for examination by tax authorities. The U.S. Internal Revenue Service (IRS) is currently auditing Microchip's 2011 and 2012 tax years. For foreign tax returns, the Company is generally no longer subject to income tax examinations for years prior to fiscal 2007.

The Company recognizes liabilities for anticipated tax audit issues in the U.S. and other domestic and international tax jurisdictions based on its estimate of whether, and the extent to which, additional tax payments are more likely than not. The Company believes that it has appropriate support for the income tax positions taken and to be taken on its tax returns and that its accruals for tax liabilities are adequate for all open years based on an assessment of many factors including past experience and interpretations of tax laws applied to the facts of each matter.

The Company believes it maintains appropriate reserves to offset any potential income tax liabilities that may arise upon final resolution of matters for open tax years. If such reserve amounts ultimately prove to be unnecessary, the

resulting reversal of such reserves would result in tax benefits being recorded in the period the reserves are no longer deemed necessary. If such amounts prove to be less than an ultimate assessment, a future charge to expense would be recorded in the period in which the assessment is determined. Although the timing of the resolution and/or closure of audits is highly uncertain, the Company does not believe it is reasonably possible that the unrecognized tax benefits would materially change in the next 12 months.

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(15) 1.625% Senior Subordinated Convertible Debentures

In February 2015, the Company issued $1,725.0 million principal amount of 1.625% senior subordinated convertible debentures due February 15, 2025. The debentures are subordinated to the Company's senior debt, including amounts borrowed under its amended credit facility, but are senior to the Company's outstanding 2.125% junior subordinated convertible debentures. The debentures are convertible, subject to certain conditions, into cash, shares of the Company's common stock or a combination thereof, at the Company's election, at an initial base conversion rate of 14.5654 shares of common stock per $1,000 principal amount of debentures, representing an initial base conversion price of approximately $68.66 per share of common stock. As a result of cash dividends paid since the issuance of the debentures, the conversion rate has been adjusted to 14.7765 shares of common stock per $1,000 of principal amount of debentures, representing a base conversion price of approximately $67.67 per share of common stock. In addition, if at the time of conversion the applicable price of the Company's common stock exceeds the base conversion price, the conversion rate will be increased by up to an additional 7.2827 shares of common stock per $1,000 principal amount of debentures, as determined pursuant to a specified formula. As a result of cash dividends paid since the issuance of the debentures, the maximum number of additional shares that may be issued if the stock price of the Company's common stock exceeds the base conversion price has been adjusted to 7.3883 shares of common stock per $1,000 principal amount of debentures. However, in no event will the conversion rate exceed 20.3915 (adjusted to 20.6871 as a result of cash dividends paid since the issuance of the debentures) shares of common stock per $1,000 principal amount of debentures. The Company received net proceeds of approximately $1,694.7 million after deduction of issuance costs of approximately $30.3 million. The $30.3 million in issuance costs were split between a debt component of $20.4 million and an equity component of $9.9 million. The $20.4 million in debt issuance costs are recorded in other assets and are being amortized using the effective interest method over the term of the debentures.

Prior to the close of business on the business day immediately preceding November 15, 2024, the debentures will be convertible at the option of the debenture holders only upon the satisfaction of specified conditions and during certain periods. Thereafter until close of business on the second scheduled trading day immediately preceding February 15, 2025, the debentures will be convertible at the option of the debenture holders at any time regardless of these conditions. Accrued and unpaid interest will be considered fully paid upon settlement of shares.

As the debentures can be settled in cash upon conversion, for accounting purposes, the debentures were bifurcated into a liability component and an equity component, which are both initially recorded at fair value. The carrying value of the equity component at June 30, 2015 and March 31, 2015 was $564.9 million. The estimated fair value of the liability component of the debentures at the issuance date was $1,160.1 million resulting in a debt discount of $564.9 million. The unamortized debt discount was $548.8 million at June 30, 2015 and $559.3 million at March 31, 2015. The remaining period over which the unamortized debt discount will be recognized as non-cash interest expense is 9.62 years. In the three months ended June 30, 2015, the Company recognized $10.5 million in non-cash interest expense related to the amortization of the debt discount. The Company recognized $7.0 million of interest expense related to the 1.625% coupon on the debentures in the three months ended June 30, 2015. The effective interest rate of the debentures is 6.1%.

(16) 2.125% Junior Subordinated Convertible Debentures

The Company's $575.0 million principal amount of 2.125% junior subordinated convertible debentures due December 15, 2037, are subordinated in right of payment to any future senior debt of the Company and are effectively subordinated in right of payment to the liabilities of the Company's subsidiaries. The debentures are convertible, subject to certain conditions, into cash, shares of the Company's common stock or a combination thereof, at the Company's election, at an initial conversion rate of 29.2783 shares of common stock per $1,000 principal amount of

debentures, representing an initial conversion price of approximately $34.16 per share of common stock. As of June 30, 2015, the holders of the debentures had the right to convert their debentures between July 1, 2015 and September 30, 2015 because for at least 20 trading days during the 30 consecutive trading day period ending on June 30, 2015, the Company's common stock had a last reported sale price greater than 130% of the conversion price. As of June 30, 2015, a holder could realize more economic value by selling its debentures in the over the counter market than from converting its debentures. As a result of cash dividends paid since the issuance of the debentures, the conversion rate has been adjusted to 40.1485 shares of common stock per $1,000 of principal amount of debentures, representing a conversion price of approximately $24.91 per share of common stock. The if-converted value of the debentures exceed the principal amount by $519.9 million at June 30, 2015. The debentures include a contingent interest mechanism that begins in December 2017. The terms of the contingent interest include a 0.25% interest rate if the debentures are trading at less than $400 and 0.5% if the debentures are trading at greater than $1,500. Based on the current trading price of the debentures, the contingent interest rate in calendar year 2017 would be 0.5%.

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As the debentures can be settled in cash upon conversion, for accounting purposes, the debentures were bifurcated into a liability component and an equity component, which are both initially recorded at fair value. The carrying value of the equity component at June 30, 2015 and at March 31, 2015 was $411.2 million. The estimated fair value of the liability component of the debentures at the issuance date was $163.8 million, resulting in a debt discount of $411.2 million. The unamortized debt discount was $382.4 million at June 30, 2015 and $383.7 million at March 31, 2015. The remaining period over which the unamortized debt discount will be recognized as non-cash interest expense is 22.5 years. In the three months ended June 30, 2015, the Company recognized $1.3 million in non-cash interest expense related to the amortization of the debt discount. In the three months ended June 30, 2014, the Company recognized $2.4 million in non-cash interest expense related to the amortization of the debt discount. The Company recognized $3.1 million of interest expense related to the 2.125% coupon on the debentures in the three months ended June 30, 2015 compared to $6.1 million in the three months ended June 30, 2014. The Company acquired $575.0 million in aggregate principal amount of its 2.125% junior subordinated convertible debentures in the March 2015 quarter which is the primary reason for the reductions of interest expense in the three months ended June 30, 2015 compared to the prior year period. The effective interest rate of the debentures is 9.1%.

(17) Credit Facility

In February 2015, the Company amended its existing $2.0 billion credit agreement by increasing the revolving credit facility to $2.555 billion and removing the term loan portion of the agreement. The new credit agreement includes two tranches. One tranche consists of bank commitments through February 2020 and another tranche consists of bank commitments through June 2018, the maturity date of the original credit agreement. The Company's increase option was also adjusted to $300 million. The credit agreement provides for a $125 million foreign currency sublimit, a $25 million letter of credit sublimit and a $25 million swingline loan sublimit. The amended credit agreement was accounted for as a modification and as such any remaining unamortized deferred costs associated with the prior credit agreement was associated with the new credit agreement since the borrowing capacity was increased. At June 30, 2015, $497.0 million of revolving credit facility borrowings were outstanding under the credit agreement compared to $462.0 million at March 31, 2015.

The loans under the credit agreement bear interest, at the Company's option, at the base rate plus a spread of 0.25% to 1.25% or an adjusted LIBOR rate (based on one, two, three, or six-month interest periods) plus a spread of 1.25% to 2.25%, in each case with such spread being determined based on the consolidated leverage ratio for the preceding four fiscal quarters (in the case of the 2018 tranche revolving loans) or the consolidated senior leverage ratio (in the case of the 2020 tranche revolving loans). The base rate means the highest of JPMorgan Chase Bank, N.A.'s prime rate, the federal funds rate plus a margin equal to 0.50% and the adjusted LIBOR rate for a 1-month interest period plus a margin equal to 1.00%. Swingline loans accrue interest at a per annum rate based on the base rate plus the applicable margin for base rate loans. Base rate loans may only be made in U.S. dollars. The Company is also obligated to pay other customary administration fees and letter of credit fees for a credit facility of this size and type.

Interest is due and payable in arrears quarterly for loans bearing interest at the base rate and at the end of an interest period (or at each three-month interval in the case of loans with interest periods greater than three months) in the case of loans bearing interest at the adjusted LIBOR rate. Interest expense related to the credit agreement was approximately $3.6 million in the three months ended June 30, 2015 and approximately $5.0 million in the three months ended June 30, 2014. Principal, together with all accrued and unpaid interest, is due and payable on the respective tranche maturity date, which is June 27, 2018 and February 4, 2020. The weighted average interest rate on short-term borrowings outstanding at June 30, 2015 related to the credit agreement was 1.44%. The Company also pays a quarterly commitment fee on the available but unused portion of its line of credit which is calculated on the average daily available balance during the period. The Company may prepay the loans and terminate the commitments, in whole or in part, at any time without premium or penalty, subject to certain conditions including

minimum amounts in the case of commitment reductions and reimbursement of certain costs in the case of prepayments of LIBOR loans.

The Company's obligations under the credit agreement are guaranteed by certain of its subsidiaries meeting materiality thresholds set forth in the credit agreement. To secure the Company's obligations under the credit agreement, the Company and its domestic subsidiaries will be required to pledge the equity securities of certain of their respective material subsidiaries, subject to certain exceptions and limitations.

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The credit agreement contains customary affirmative and negative covenants, including covenants that limit or restrict the Company and its subsidiaries' ability to, among other things, incur subsidiary indebtedness, grant liens, merge or consolidate, dispose of assets, make investments, make acquisitions, enter into certain transactions with affiliates, pay dividends or make distributions, repurchase stock, enter into restrictive agreements and enter into sale and leaseback transactions, in each case subject to customary exceptions for a credit facility of this size and type. The Company is also required to maintain compliance with consolidated senior and total leverage ratios and a consolidated interest coverage ratio. At June 30, 2015, the Company was in compliance with these covenants.

The credit agreement includes customary events of default that include, among other things, non-payment defaults, inaccuracy of representations and warranties, covenant defaults, cross default to material indebtedness, bankruptcy and insolvency defaults, material judgment defaults, ERISA defaults and a change of control default. The occurrence of an event of default could result in the acceleration of the obligations under the credit agreement. Under certain circumstances, a default interest rate will apply on all obligations during the existence of an event of default under the credit agreement at a per annum rate equal to 2.00% above the applicable interest rate for any overdue principal and 2.00% above the rate applicable for base rate loans for any other overdue amounts.

(18) Contingencies

In the ordinary course of the Company's business, it is involved in a limited number of legal actions, both as plaintiff and defendant, and could incur uninsured liability in any one or more of them. The Company also periodically receives notifications from various third parties alleging infringement of patents, intellectual property rights or other matters. With respect to pending legal actions to which the Company is a party, although the outcomes of these actions are not generally determinable, the Company believes that the ultimate resolution of these matters will not have a material adverse effect on its financial position, cash flows or results of operations. Litigation relating to the semiconductor industry is not uncommon, and the Company is, and from time to time has been, subject to such litigation. No assurances can be given with respect to the extent or outcome of any such litigation in the future.

The Company's technology license agreements generally include an indemnification clause that indemnifies the licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark or trade secret infringement by the Company's proprietary technology. The terms of these indemnification provisions approximate the terms of the outgoing technology license agreements, which are typically perpetual unless terminated by either party for breach. The possible amount of future payments the Company could be required to make based on agreements that specify indemnification limits, if such indemnifications were required on all of these agreements, is approximately $139 million. There are some licensing agreements in place that do not specify indemnification limits. The Company had not recorded any liabilities related to these indemnification obligations as of June 30, 2015.

(19) Derivative Instruments

Freestanding Derivative Forward Contracts

Foreign Currency Exchange Rate Risk

The Company has international operations and is thus subject to foreign currency rate fluctuations. To help manage the risk of changes in foreign currency rates, the Company periodically enters into derivative contracts comprised of foreign currency forward contracts to hedge its asset and liability foreign currency exposure and a portion of its foreign currency operating expenses. Approximately 99% of the Company's sales are U.S. dollar denominated. To date, the exposure related to foreign exchange rate volatility has not been material to the Company's operating

results. As of June 30, 2015 and March 31, 2015, the Company had no foreign currency forward contracts outstanding. The Company recognized an immaterial amount of net realized gains and losses on foreign currency forward contracts in each of the three months ended June 30, 2015 and 2014. Gains and losses from changes in the fair value of these foreign currency forward contracts and foreign currency exchange rate fluctuations are credited or charged to Other Income (Expense) on the condensed consolidated statements of income. The Company does not apply hedge accounting to its foreign currency derivative instruments.

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Fair Value Hedges

For derivative instruments that are designated and qualify as fair value hedges, the gain or loss on the derivatives as well as the offsetting gain or loss on the hedged item attributable to the hedged risk are recognized in earnings. Interest rate derivative instruments designated as fair value hedges are designed to manage the exposure to interest rate movements and to reduce borrowing costs by converting fixed-rate debt into floating-rate debt. Under these agreements, the Company agrees to exchange, at specified intervals, the difference between the fixed and floating interest amounts calculated by reference to an agreed-upon notional principal amount.

In March 2015, the Company entered into ten-year fixed-to-floating interest rate swap agreements designated as fair value hedges of the changes in fair value of a portion of the Company's fixed-rate 1.625% senior subordinated convertible debentures due to changes in the LIBOR swap rate, the designated benchmark interest rate. The Company pays variable interest equal to the three-month LIBOR minus 53.6 basis points, and it receives a fixed interest rate of 1.625%. The notional amount of these contracts outstanding at June 30, 2015 and at March 31, 2015 was $431.3 million, representing 25% of the principal amount of the senior subordinated convertible debentures.

The following table summarizes the location and fair value amounts of derivative instruments reported on the condensed consolidated balance sheets (amounts in thousands):

	June 30, 2015		March 31, 2015	
Derivatives designated as hedging instruments	Other long-term liabilities	Other assets	Other long-term liabilities	Other assets
Interest rate contracts	$6,042	$—	$—	$8,928

The following table summarizes the location and amount of the gain or loss on the hedged item attributable to the changes in the LIBOR swap rate and the offsetting gain or loss on the related interest rate swap agreements for the three months ended June 30, 2015. The difference represents hedge ineffectiveness (amounts in thousands):

Income Statement Classification	Gain (Loss) on Senior Subordinated Convertible Debentures	Gain (Loss) on Interest Rate Swap
Other Income (Expense)	$14,931	$(14,971)

(20) Comprehensive Income (Loss)

The following table presents the changes in the components of accumulated other comprehensive income (AOCI) for the three months ended June 30, 2015 (amounts in thousands):

	Unrealized holding gains (losses) available-for-sale securities	Minimum pension liability	Foreign Currency	Total
Balance at March 31, 2015	$14,537	$13	$(3,474)	$11,076
Other comprehensive (loss) income before reclassifications	(2,012)	—	—	(2,012)
Amounts reclassified from accumulated other comprehensive (loss) income	(13,959)	—	—	(13,959)
Net other comprehensive (loss) income	(15,971)	—	—	(15,971)
Purchase of shares from noncontrolling interest	—	—	(276)	(276)
Balance at June 30, 2015	$(1,434)	$13	$(3,750)	$(5,171)

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The table below details where reclassifications of realized transactions out of AOCI are recorded on the condensed consolidated statements of income (amounts in thousands):

	Three Months Ended June 30,			
Description of AOCI Component	2015	2014		Related Statement of Income Line
Unrealized gains on available-for-sale securities	$13,959	$34		Other income
Taxes	—	(12	)	Provision for income taxes
Reclassification of realized transactions, net of taxes	$13,959	$22		Net income

(21) Share-Based Compensation

The following table presents the details of the Company's share-based compensation expense (amounts in thousands):

	Three Months Ended June 30,			
	2015		2014	
Cost of sales	$1,657	(1)	$2,055	(1)
Research and development	7,098		6,309	
Selling, general and administrative	5,357		4,957	
Pre-tax effect of share-based compensation	14,112		13,321	
Income tax benefit	3,532		1,420	
Net income effect of share-based compensation	$10,580		$11,901	

(1) During the three months ended June 30, 2015, $1.8 million of share-based compensation expense was capitalized to inventory and $1.7 million of previously capitalized share-based compensation expense in inventory was sold. During the three months ended June 30, 2014, $1.7 million of share-based compensation expense was capitalized to inventory and $2.1 million of previously capitalized share-based compensation expense in inventory was sold.

(22) Net Income Per Common Share Attributable to Microchip Technology Stockholders

The following table sets forth the computation of basic and diluted net income per common share attributable to Microchip Technology stockholders (in thousands, except per share amounts):

	Three Months Ended June 30,	
	2015	2014
Net income attributable to Microchip Technology	$130,667	$89,909
Weighted average common shares outstanding	202,232	200,187
Dilutive effect of stock options and RSUs	3,392	3,792
Dilutive effect of 2037 junior subordinated convertible debentures	11,143	20,548
Weighted average common and potential common shares outstanding	216,767	224,527
Basic net income per common share attributable to Microchip Technology stockholders	$0.65	$0.45
Diluted net income per common share attributable to Microchip Technology stockholders	$0.60	$0.40

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The Company computed basic earnings per common share attributable to its stockholders using net income available to common stockholders and the weighted average number of common shares outstanding during the period. The Company computed diluted earnings per common share attributable to its stockholders using net income available to stockholders and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period.

Potentially dilutive common shares from employee equity incentive plans are determined by applying the treasury stock method to the assumed exercise of outstanding stock options and the assumed vesting of outstanding RSUs.

Diluted net income per common share attributable to stockholders for the three months ended June 30, 2015 and June 30, 2014 includes 11,142,772 shares and 20,547,832 shares, respectively, issuable upon the exchange of the Company's 2.125% junior subordinated convertible debentures due December 15, 2037 (see Note 16). The debentures have no impact on diluted net income per common share unless the average price of the Company's common stock exceeds the conversion price because the principal amount of the debentures will be settled in cash upon conversion. Prior to conversion, the Company will include, in the diluted net income per common share calculation, the effect of the additional shares that may be issued when the Company's common stock price exceeds the conversion price using the treasury stock method. The weighted average conversion price per share used in calculating the dilutive effect of the convertible debt for the three-month periods ended June 30, 2015 and June 30, 2014 was $25.01 and $25.75, respectively.

There were no shares issuable upon the exchange of the Company's 1.625% senior subordinated convertible debentures due February 15, 2025 (see Note 15). The debentures have no impact on diluted net income per common share unless the average price of the Company's common stock exceeds the conversion price because the principal amount of the debentures will be settled in cash upon conversion. Prior to conversion, the Company will include, in the diluted net income per common share calculation, the effect of the additional shares that may be issued when the Company's common stock price exceeds the conversion price using the treasury stock method. The weighted average conversion price per share used in calculating the dilutive effect of the convertible debt for the three months ended June 30, 2015 was $67.95.

Weighted average common shares exclude the effect of option shares which are not dilutive. There were no antidilutive option shares for the three months ended June 30, 2015 and June 30, 2014.

(23) Dividends

A quarterly cash dividend of $0.3575 per share was paid on June 4, 2015 in the aggregate amount of $72.3 million. A quarterly cash dividend of $0.358 per share was declared on August 3, 2015 and will be paid on September 25, 2015 to stockholders of record as of September 11, 2015. The Company expects the September payment of its quarterly cash dividend to be approximately $75.7 million.

(24) Subsequent Event

On August 3, 2015, the Company completed its acquisition of Micrel Incorporated (Micrel). Under the terms of the merger agreement executed on May 7, 2015, Micrel shareholders were able to elect to receive the $14.00 per share purchase price in either cash or shares of Microchip common stock. Based on the results of the shareholder elections, the Company paid an aggregate of approximately $430 million in cash and issued an aggregate of 8,626,795 shares of its common stock to Micrel shareholders. The number of shares of the Company's common stock that a Micrel shareholder will receive is based on a conversion ratio of $14.00 divided by the average of the Company's closing stock price for the ten most recent trading days ending on the second to last trading day prior to August 3, 2015, which

is $42.888 per share.

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

This report, including "Part I – Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Part II - Item 1A Risk Factors" contains certain forward-looking statements that involve risks and uncertainties, including statements regarding our strategy, financial performance and revenue sources. We use words such as "anticipate," "believe," "plan," "expect," "future," "continue," "intend" and similar expressions to identify forward-looking statements. Our actual results could differ materially from the results anticipated in these forward-looking statements as a result of certain factors including those set forth under "Risk Factors," beginning at page 40 and elsewhere in this Form 10-Q. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements. We disclaim any obligation to update information contained in any forward-looking statement. These forward-looking statements include, without limitation, statements regarding the following:

- The effects that adverse global economic conditions and fluctuations in the global credit and equity markets may have on our financial condition and results of operations;
- The effects and amount of competitive pricing pressure on our product lines;
- Our ability to moderate future average selling price declines;
- The effect of product mix, capacity utilization, yields, fixed cost absorption, competition and economic conditions on gross margin;
- The amount of, and changes in, demand for our products and those of our customers;
- Our expectation that in the future we will acquire additional businesses that we believe will complement our existing businesses;
- Our expectation that in the future we will enter into joint development agreements or other business or strategic relationships with other companies;
- The level of orders that will be received and shipped within a quarter;
- Our expectation that our inventory levels will be up between 2 and 17 days in the September 2015 quarter compared to the June 2015 quarter and that it will allow us to maintain competitive lead times and provide strong delivery performance to our customers;
- The effect that distributor and customer inventory holding patterns will have on us;
- Our belief that customers recognize our products and brand name and use distributors as an effective supply channel;
- Anticipating increased customer requirements to meet voluntary criteria related to the reduction or elimination of substances in our products;
- Our belief that deferred cost of sales are recorded at their approximate carrying value and will have low risk of material impairment;
- Our belief that our direct sales personnel combined with our distributors provide an effective means of reaching our customer base;
- Our ability to increase the proprietary portion of our analog and interface product lines and the effect of such an increase;
- Our belief that our processes afford us both cost-effective designs in existing and derivative products and greater functionality in new product designs;
- The impact of any supply disruption we may experience;
- Our ability to effectively utilize our facilities at appropriate capacity levels and anticipated costs;
- That we adjust capacity utilization to respond to actual and anticipated business and industry-related conditions;
- That our existing facilities will provide sufficient capacity to respond to increases in demand with modest incremental capital expenditures;
- That manufacturing costs will be reduced by transition to advanced process technologies;
- Our ability to maintain manufacturing yields;

- Continuing our investments in new and enhanced products;
- The cost effectiveness of using our own assembly and test operations;
- Our anticipated level of capital expenditures;
- Our intent to repurchase the approximate number of shares we will issue in connection with our acquisition of Micrel;
- Continuation and amount of quarterly cash dividends;
- The sufficiency of our existing sources of liquidity to finance anticipated capital expenditures and otherwise meet our anticipated cash requirements, and the effects that our contractual obligations are expected to have on them;
- The impact of seasonality on our business;
- The accuracy of our estimates used in valuing employee equity awards;

- That the resolution of legal actions will not have a material effect on our business, and the accuracy of our assessment of the probability of loss and range of potential loss;
- The recoverability of our deferred tax assets;
- The adequacy of our tax reserves to offset any potential tax liabilities, having the appropriate support for our income tax positions and the accuracy of our estimated tax rate;
- Our belief that the expiration of any tax holidays will not have a material impact on our overall tax expense or effective tax rate;
- Our belief that the estimates used in preparing our consolidated financial statements are reasonable;
- Our belief that recently issued accounting pronouncements listed in this document will not have a significant impact on our consolidated financial statements;
- Our actions to vigorously and aggressively defend and protect our intellectual property on a worldwide basis;
- Our ability to obtain patents and intellectual property licenses and minimize the effects of litigation;
- The level of risk we are exposed to for product liability claims or indemnification claims;
- The effect of fluctuations in market interest rates on our income and/or cash flows;
- The effect of fluctuations in currency rates;
- Our belief that any of the unrealized losses in our investment portfolio represent an other-than-temporary impairment and that recovery is not anticipated to occur in the next year;
- That our offshore earnings are considered to be permanently reinvested offshore and that we could determine to repatriate some of our offshore earnings in future periods to fund stockholder dividends, share repurchases, acquisitions or other corporate activities;
- That a significant portion of our future cash generation will be in our foreign subsidiaries;
- Our intention to indefinitely reinvest undistributed earnings of certain non-US subsidiaries in those subsidiaries;
- Our intent to maintain a high-quality investment portfolio that preserves principal, meets liquidity needs, avoids inappropriate concentrations and delivers an appropriate yield; and
- Our ability to collect accounts receivable.

We begin our Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) with a summary of our overall business strategy to give the reader an overview of the goals of our business and the overall direction of our business and products. This is followed by a discussion of the Critical Accounting Policies and Estimates that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. We then discuss our Results of Operations for the three months ended June 30, 2015 compared to the three months ended June 30, 2014. We then provide an analysis of changes in our balance sheet and cash flows, and discuss our financial commitments in sections titled "Liquidity and Capital Resources," "Contractual Obligations" and "Off-Balance Sheet Arrangements."

Strategy

Our goal is to be a worldwide leader in providing specialized semiconductor products for a wide variety of embedded control applications. Our strategic focus is on the embedded control market, which includes microcontrollers, high-performance linear and mixed signal devices, power management and thermal management devices, connectivity devices, interface devices, Serial EEPROMs, SuperFlash memory products, our patented KeeLoq® security devices and Flash IP solutions. We provide highly cost-effective embedded control products that also offer the advantages of small size, high performance, low voltage/power operation and ease of development, enabling timely and cost-effective embedded control product integration by our customers. We license our SuperFlash technology and other technologies to wafer foundries, integrated device manufacturers and design partners throughout the world for use in the manufacture of advanced microcontroller products.

We sell our products to a broad base of domestic and international customers across a variety of industries. The principal markets that we serve include consumer, automotive, industrial, office automation and telecommunications. Our business is subject to fluctuations based on economic conditions within these markets.

Our manufacturing operations include wafer fabrication, wafer probe and assembly and test. The ownership of a substantial portion of our manufacturing resources is an important component of our business strategy, enabling us to maintain a high level of manufacturing control resulting in us being one of the lowest cost producers in the embedded control industry. By owning wafer fabrication facilities and our assembly and test operations, and by employing statistical process control techniques, we have been able to achieve and maintain high production yields. Direct control over manufacturing resources allows us to shorten our design and production cycles. This control also allows us to capture a portion of the wafer manufacturing and the assembly and test profit margin. We do outsource a significant portion of our manufacturing requirements to third parties.

We employ proprietary design and manufacturing processes in developing our embedded control products. We believe our processes afford us both cost-effective designs in existing and derivative products and greater functionality in new product designs. While many of our competitors develop and optimize separate processes for their logic and memory product lines, we use a common process technology for both microcontroller and non-volatile memory products. This allows us to more fully leverage our process research and development costs and to deliver new products to market more rapidly. Our engineers utilize advanced computer-aided design (CAD) tools and software to perform circuit design, simulation and layout, and our in-house photomask and wafer fabrication facilities enable us to rapidly verify design techniques by processing test wafers quickly and efficiently.

We are committed to continuing our investment in new and enhanced products, including development systems, and in our design and manufacturing process technologies. We believe these investments are significant factors in maintaining our competitive position. Our current research and development activities focus on the design of new microcontrollers, digital signal controllers, memory, analog and mixed-signal products, Flash-IP systems, development systems, software and application-specific software libraries. We are also developing new design and process technologies to achieve further cost reductions and performance improvements in our products.

We market and sell our products worldwide primarily through a network of direct sales personnel and distributors. Our distributors focus primarily on servicing the product and technical support requirements of a broad base of diverse customers. We believe that our direct sales personnel combined with our distributors provide an effective means of reaching this broad and diverse customer base. Our direct sales force focuses primarily on major strategic accounts in three geographical markets: the Americas, Europe and Asia. We currently maintain sales and support centers in major metropolitan areas in North America, Europe and Asia. We believe that a strong technical service presence is essential to the continued development of the embedded control market. Many of our field sales engineers (FSEs), field application engineers (FAEs), and sales management personnel have technical degrees and have been previously employed in an engineering environment. We believe that the technical knowledge of our sales force is a key competitive advantage in the sale of our products. The primary mission of our FAE team is to provide technical assistance to strategic accounts and to conduct periodic training sessions for FSEs and distributor sales teams. FAEs also frequently conduct technical seminars for our customers in major cities around the world, and work closely with our distributors to provide technical assistance and end-user support.

See "Our operating results are impacted by both seasonality and the wide fluctuations of supply and demand in the semiconductor industry," on page 42 for discussion of the impact of seasonality on our business.

Critical Accounting Policies and Estimates

General

Our discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. We review the accounting policies we use in reporting our financial results on a regular basis. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, business combinations, share-based compensation, inventories, income taxes, senior and junior subordinated convertible debentures and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Our results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. We review these

estimates and judgments on an ongoing basis. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements. We also have other policies that we consider key accounting policies, such as our policy regarding revenue recognition to original equipment manufacturers (OEMs); however, we do not believe these policies require us to make estimates or judgments that are as difficult or subjective as our policies described below.

Revenue Recognition - Distributors

Our distributors worldwide generally have broad price protection and product return rights, so we defer revenue recognition until the distributor sells the product to their customer. Revenue is recognized when the distributor sells the product to an end-user, at which time the sales price becomes fixed or determinable. Revenue is not recognized upon shipment to our distributors since, due to discounts from list price as well as price protection rights, the sales price is not substantially fixed or determinable at that time. At the time of shipment to these distributors, we record a trade receivable for the selling

price as there is a legally enforceable right to payment, relieve inventory for the carrying value of goods shipped since legal title has passed to the distributor, and record the gross margin in deferred income on shipments to distributors on our condensed consolidated balance sheets.

Deferred income on shipments to distributors effectively represents the gross margin on the sale to the distributor; however, the amount of gross margin that we recognize in future periods could be less than the deferred margin as a result of credits granted to distributors on specifically identified products and customers to allow the distributors to earn a competitive gross margin on the sale of our products to their end customers and price protection concessions related to market pricing conditions.

We sell the majority of the items in our product catalog to our distributors worldwide at a uniform list price. However, distributors resell our products to end customers at a very broad range of individually negotiated price points. The majority of our distributors' resales require a reduction from the original list price paid. Often, under these circumstances, we remit back to the distributor a portion of their original purchase price after the resale transaction is completed in the form of a credit against the distributors' outstanding accounts receivable balance. The credits are on a per unit basis and are not given to the distributor until they provide information to us regarding the sale to their end customer. The price reductions vary significantly based on the customer, product, quantity ordered, geographic location and other factors and discounts to a price less than our cost have historically been rare. The effect of granting these credits establishes the net selling price to our distributors for the product and results in the net revenue recognized by us when the product is sold by the distributors to their end customers. Thus, a portion of the "deferred income on shipments to distributors" balance represents the amount of distributors' original purchase price that will be credited back to the distributor in the future. The wide range and variability of negotiated price concessions granted to distributors does not allow us to accurately estimate the portion of the balance in the deferred income on shipments to distributors account that will be credited back to the distributors. Therefore, we do not reduce deferred income on shipments to distributors or accounts receivable by anticipated future concessions; rather, price concessions are typically recorded against deferred income on shipments to distributors and accounts receivable when incurred, which is generally at the time the distributor sells the product. At June 30, 2015, we had approximately $259.9 million of deferred revenue and $92.4 million in deferred cost of sales recognized as $167.5 million of deferred income on shipments to distributors. At March 31, 2015, we had approximately $260.9 million of deferred revenue and $94.8 million in deferred cost of sales recognized as $166.1 million of deferred income on shipments to distributors. The deferred income on shipments to distributors that will ultimately be recognized in our income statement will be lower than the amount reflected on the balance sheet due to additional price credits to be granted to the distributors when the product is sold to their customers. These additional price credits historically have resulted in the deferred income approximating the overall gross margins that we recognize in the distribution channel of our business.

Distributor advances, reflected as a reduction of deferred income on shipments to distributors on our condensed consolidated balance sheets, totaled $113.6 million at June 30, 2015 and $116.0 million at March 31, 2015. On sales to distributors, our payment terms generally require the distributor to settle amounts owed to us for an amount in excess of their ultimate cost. The sales price to our distributors may be higher than the amount that the distributors will ultimately owe us because distributors often negotiate price reductions after purchasing product from us and such reductions are often significant. It is our practice to apply these negotiated price discounts to future purchases, requiring the distributor to settle receivable balances, on a current basis, generally within 30 days, for amounts originally invoiced. This practice has an adverse impact on the working capital of our distributors. As such, we have entered into agreements with certain distributors whereby we advance cash to the distributors to reduce the distributor's working capital requirements. These advances are reconciled at least on a quarterly basis and are estimated based on the amount of ending inventory as reported by the distributor multiplied by a negotiated percentage. Such advances have no impact on our revenue recognition or our condensed consolidated statements of

income. We process discounts taken by distributors against our deferred income on shipments to distributors' balance and true-up the advanced amounts generally after the end of each completed fiscal quarter. The terms of these advances are set forth in binding legal agreements and are unsecured, bear no interest on unsettled balances and are due upon demand. The agreements governing these advances can be canceled by us at any time.

We reduce product pricing through price protection based on market conditions, competitive considerations and other factors. Price protection is granted to distributors on the inventory they have on hand at the date the price protection is offered. When we reduce the price of our products, it allows the distributor to claim a credit against its outstanding accounts receivable balances based on the new price of the inventory it has on hand as of the date of the price reduction. There is no immediate revenue impact from the price protection, as it is reflected as a reduction of the deferred income on shipments to distributors' balance.

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Products returned by distributors and subsequently scrapped have historically been immaterial to our consolidated results of operations. We routinely evaluate the risk of impairment of the deferred cost of sales component of the deferred income on shipments to distributors account. Because of the historically immaterial amounts of inventory that have been scrapped, and historically rare instances where discounts given to a distributor result in a price less than our cost, we believe the deferred costs are recorded at their approximate carrying value.

Business Combinations

All of our business combinations are accounted for at fair value under the acquisition method of accounting. Under the acquisition method of accounting, (i) acquisition-related costs, except for those costs incurred to issue debt or equity securities, will be expensed in the period incurred; (ii) non-controlling interests will be valued at fair value at the acquisition date; (iii) in-process research and development will be recorded at fair value as an intangible asset at the acquisition date and amortized once the technology reaches technological feasibility; (iv) restructuring costs associated with a business combination will be expensed subsequent to the acquisition date; and (v) changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date will be recognized through income tax expense or directly in contributed capital. The measurement of the fair value of assets acquired and liabilities assumed requires significant judgment. The valuation of intangible assets and acquired investments, in particular, requires that we use valuation techniques such as the income approach. The income approach includes the use of a discounted cash flow model, which includes discounted cash flow scenarios and requires the following significant estimates: revenue, expenses, capital spending and other costs, and discount rates based on the respective risks of the cash flows. The valuation of non-marketable equity investments acquired also takes into account variables such as conditions reflected in the capital markets, recent financing activity by the investees, the investees' capital structure and the terms of the investees' issued interests. Under the acquisition method of accounting, the aggregate amount of consideration we pay for a company is allocated to net tangible assets and intangible assets based on their estimated fair values as of the acquisition date. The excess of the purchase price over the value of the net tangible assets and intangible assets is recorded to goodwill. On an annual basis, we test goodwill for impairment and through June 30, 2015, we have never recorded an impairment charge against our goodwill balance.

Share-based Compensation

We measure at fair value and recognize compensation expense for all share-based payment awards, including grants of employee stock options, restricted stock units (RSUs) and employee stock purchase rights, to be recognized in our financial statements based on their respective grant date fair values. Total share-based compensation during the three months ended June 30, 2015 was $14.1 million, of which $12.5 million was reflected in operating expenses. Total share-based compensation included in cost of sales during the three months ended June 30, 2015 was $1.7 million. Total share-based compensation included in our inventory balance was $4.4 million at June 30, 2015.

Determining the appropriate fair-value model and calculating the fair value of share-based awards at the date of grant requires judgment. The fair value of our RSUs is based on the fair market value of our common stock on the date of grant discounted for expected future dividends. We use the Black-Scholes option pricing model to estimate the fair value of employee stock options and rights to purchase shares under our employee stock purchase plans. Option pricing models, including the Black-Scholes model, require the use of input assumptions, including expected volatility, expected life, expected dividend rate, and expected risk-free rate of return. We use a blend of historical and implied volatility based on options freely traded in the open market as we believe this is most reflective of market conditions and a better indicator of expected volatility than using purely historical volatility. The expected life of the awards is based on historical and other economic data trended into the future. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of our awards. The dividend yield assumption is based on our history and expectation of future dividend payouts. We estimate the number of share-based awards that will be

forfeited due to employee turnover. Quarterly changes in the estimated forfeiture rate can have a significant effect on reported share-based compensation, as the impact on prior period amortization for all unvested awards is recognized in the period the forfeiture estimate is changed. If the actual forfeiture rate is higher or lower than the estimated forfeiture rate, then an adjustment is made to increase or decrease the estimated forfeiture rate, which will result in a decrease or increase to the expense recognized in our financial statements. If forfeiture adjustments are made, they would affect our gross margin, research and development expenses, and selling, general and administrative expenses. The effect of forfeiture adjustments in the first quarter of fiscal 2016 was immaterial.

We evaluate the assumptions used to value our awards on a quarterly basis. If factors change and we employ different assumptions, share-based compensation expense may differ significantly from what we have recorded in the past. If there are any modifications or cancellations of the underlying unvested securities, we may be required to accelerate, increase or cancel any remaining unearned share-based compensation expense. Future share-based compensation expense and unearned share-based compensation will increase to the extent that we grant additional equity awards to employees or we assume unvested equity awards in connection with acquisitions.

Inventories

Inventories are valued at the lower of cost or market using the first-in, first-out method. We write down our inventory for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those we projected, additional inventory write-downs may be required. Inventory impairment charges establish a new cost basis for inventory and charges are not subsequently reversed to income even if circumstances later suggest that increased carrying amounts are recoverable. In estimating our inventory obsolescence, we primarily evaluate estimates of demand over a 12-month period and record impairment charges for inventory on hand in excess of the estimated 12-month demand. Estimates for projected 12-month demand are generally based on the average shipments of the prior three-month period, which are then annualized to adjust for any potential seasonality in our business. The estimated 12-month demand is compared to our most recently developed sales forecast to further reconcile the 12-month demand estimate. Management reviews and adjusts the estimates as appropriate based on specific situations. For example, demand can be adjusted up for new products for which historic sales are not representative of future demand. Alternatively, demand can be adjusted down to the extent any existing products are being replaced or discontinued.

In periods where our production levels are substantially below our normal operating capacity, the reduced production levels of our manufacturing facilities are charged directly to cost of sales. There was no charge to cost of sales for reduced production levels in the three-month period ended June 30, 2015. Approximately $0.8 million was charged to cost of sales in the three-month period ended June 30, 2014.

Income Taxes

As part of the process of preparing our condensed consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our condensed consolidated balance sheets. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income within the relevant jurisdiction and to the extent we believe that recovery is not likely, we must establish a valuation allowance. We have provided valuation allowances for certain of our deferred tax assets, including state net operating loss carryforwards, foreign tax credits and state tax credits, where it is more likely than not that some portion, or all of such assets, will not be realized. At June 30, 2015, the valuation allowances totaled $115.3 million. Should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. At June 30, 2015, our deferred tax asset, net of valuation allowances, was $71.1 million.

Various taxing authorities in the U.S. and other countries in which we do business scrutinize the tax structures employed by businesses. Companies of our size and complexity are regularly audited by the taxing authorities in the jurisdictions in which they conduct significant operations. Microchip is currently under IRS audit for fiscal years 2011 and 2012. We recognize liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on

our estimate of whether, and the extent to which, additional tax payments are probable. We believe that we maintain adequate tax reserves to offset any potential tax liabilities that may arise upon these and other pending audits in the U.S. and other countries in which we do business. If such amounts ultimately prove to be unnecessary, the resulting reversal of such reserves would result in tax benefits being recorded in the period the reserves are no longer deemed necessary. If such amounts ultimately prove to be less than an ultimate assessment, a future charge to expense would be recorded in the period in which the assessment is determined.

Senior and Junior Subordinated Convertible Debentures

We separately account for the liability and equity components of our senior and junior subordinated convertible debentures in a manner that reflects our nonconvertible debt (unsecured debt) borrowing rate when interest cost is recognized. This results in a bifurcation of a component of the debt, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense in our condensed consolidated

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statements of income. Lastly, we include the dilutive effect of the shares of our common stock issuable upon conversion of the outstanding senior and junior subordinated convertible debentures in our diluted income per share calculation regardless of whether the market price triggers or other contingent conversion features have been met. We apply the treasury stock method as we have the intent and have adopted an accounting policy to settle the principal amount of the senior and junior subordinated convertible debentures in cash. This method results in incremental dilutive shares when the average fair value of our common stock for a reporting period exceeds the conversion prices per share which were $67.67 and $24.91 for the senior and junior subordinated convertible debentures, respectively, at June 30, 2015 and adjusts as dividends are recorded in the future.

Contingencies

In the ordinary course of our business, we are involved in a limited number of legal actions, both as plaintiff and defendant, and could incur uninsured liability in any one or more of them. We also periodically receive notifications from various third parties alleging infringement of patents, intellectual property rights or other matters. With respect to pending legal actions to which we are a party, although the outcomes of these actions are not generally determinable, we believe that the ultimate resolution of these matters will not have a material adverse effect on our financial position, cash flows or results of operations. Litigation relating to the semiconductor industry is not uncommon, and we are, and from time to time have been, subject to such litigation. No assurances can be given with respect to the extent or outcome of any such litigation in the future.

Results of Operations

The following table sets forth certain operational data as a percentage of net sales for the periods indicated:

	Three Months Ended June 30,			
	2015		2014	
Net sales	100.0	%	100.0	%
Cost of sales	42.1		42.0	
Gross profit	57.9		58.0	
Research and development	15.9		16.0	
Selling, general and administrative	12.5		13.1	
Amortization of acquired intangible assets	6.5		6.9	
Special charges, net	0.3		0.1	
Operating income	22.7	%	21.9	%

Net Sales

We operate in two industry segments and engage primarily in the design, development, manufacture and sale of semiconductor products as well as the licensing of our SuperFlash and other technologies. We sell our products to distributors and original equipment manufacturers, referred to as OEMs, in a broad range of markets, perform ongoing credit evaluations of our customers and generally require no collateral. In certain circumstances, a customer's financial condition may require collateral, and, in such cases, the collateral would be typically provided by letters of credit.

Our net sales for the quarter ended June 30, 2015 were $534.0 million, a decrease of 1.7% from the previous quarter's sales of $543.2 million, and an increase of 1.0% from net sales of $528.9 million in the quarter ended June 30, 2014. The decrease in net sales in the quarter ended June 30, 2015 over the previous quarter was due primarily to weaker general economic and semiconductor industry conditions. The increase in net sales in the three months ended June 30,

2015 compared to the three months ended June 30, 2014 was due primarily to our acquisition of ISSC and market share gains which offset weaker general economic and semiconductor industry conditions. The number of units and the average selling prices for our semiconductor products were up approximately 1% for the three months ended June 30, 2015 over the corresponding period of the previous fiscal year. The average selling prices and the unit volumes of our sales are impacted by the mix of our products sold and overall semiconductor market conditions. Key factors related to the amount of net sales during the three months ended June 30, 2015 compared to the three months ended June 30, 2014 include:

- our acquisition of a controlling interest in ISSC on July 17, 2014;
- global economic conditions in the markets we serve;
- semiconductor industry conditions;

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- our new product offerings that have increased our served available market;
- customers' increasing needs for the flexibility offered by our programmable solutions;
- inventory holding patterns of our customers;
- increasing semiconductor content in our customers' products; and
- continued market share gains in the segments of the markets we address.

Net sales by product line for the three months ended June 30, 2015 and 2014 were as follows (dollars in thousands):

	Three Months Ended June 30, (unaudited)			
	2015	%	2014	%
Microcontrollers	$348,170	65.2	$343,761	65.0
Analog, interface and mixed signal products	127,055	23.8	125,357	23.7
Memory products	31,773	5.9	33,379	6.3
Technology licensing	23,263	4.4	20,437	3.9
Other	3,691	0.7	5,942	1.1
Total sales	$			