NETGEAR, INC
Form 10-Q
May 07, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended March 31, 2013.

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No þ
The number of outstanding shares of the registrant's Common Stock, $0.001 par value, was 38,524,049 as of April 30, 2013.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	March 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$279,098	$149,032
Short-term investments	143,314	227,845
Accounts receivable, net	237,896	256,014
Inventories	158,555	174,903
Deferred income taxes	24,052	22,691
Prepaid expenses and other current assets	34,773	33,724
Total current assets	877,688	864,209
Property and equipment, net	18,387	19,025
Intangibles, net	26,079	27,621
Goodwill	100,880	100,880
Other non-current assets	22,282	22,834
Total assets	$1,045,316	$1,034,569
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$82,410	$87,310
Accrued employee compensation	14,103	18,338
Other accrued liabilities	119,587	126,255
Deferred revenue	26,998	27,645
Income taxes payable	4,667	1,382
Total current liabilities	247,765	260,930
Non-current income taxes payable	13,187	13,735
Other non-current liabilities	6,987	5,293
Total liabilities	267,939	279,958
Commitments and contingencies (Note 9)		
Stockholders’ equity:		
Common stock	39	38
Additional paid-in capital	402,050	394,427
Cumulative other comprehensive income	139	4
Retained earnings	375,149	360,142
Total stockholders’ equity	777,377	754,611
Total liabilities and stockholders’ equity	$1,045,316	$1,034,569

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

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

	Three Months Ended	
	March 31, 2013	April 1, 2012
Net revenue	$293,399	$325,620
Cost of revenue	205,662	225,771
Gross profit	87,737	99,849
Operating expenses:		
Research and development	15,338	14,121
Sales and marketing	36,389	38,970
General and administrative	12,327	10,413
Restructuring and other charges	(30)	—
Litigation reserves, net	48	151
Total operating expenses	64,072	63,655
Income from operations	23,665	36,194
Interest income	149	119
Other income (expense), net	74	(601)
Income before income taxes	23,888	35,712
Provision for income taxes	8,545	10,565
Net income	$15,343	$25,147
Net income per share:		
Basic	$0.40	$0.67
Diluted	$0.39	$0.65
Weighted average shares outstanding used to compute net income per share:		
Basic	38,433	37,796
Diluted	39,050	38,576

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

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

	Three Months Ended	
	March 31, 2013	April 1, 2012
Net income	$15,343	$25,147
Other comprehensive income (loss), before tax:		
Unrealized gain (loss) on derivative instruments	151	(56)
Unrealized loss on available-for-sale securities	(26)	(34)
Other comprehensive income (loss), before tax	125	(90)
Tax benefit related to items of other comprehensive income	10	12
Other comprehensive income (loss), net of tax	135	(78)
Comprehensive income	$15,478	$25,069

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

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

	Three Months Ended	
	March 31, 2013	April 1, 2012
Cash flows from operating activities:		
Net income	$15,343	$25,147
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,942	3,609
Purchase premium amortization on investments	373	718
Non-cash stock-based compensation	3,590	3,392
Income tax benefit associated with stock option exercises	354	937
Excess tax benefit from stock-based compensation	(354)	(910)
Deferred income taxes	(1,015)	(477)
Changes in assets and liabilities:		
Accounts receivable	18,118	12,099
Inventories	16,348	29,410
Prepaid expenses and other assets	(671)	3,273
Accounts payable	(4,901)	(37,751)
Accrued employee compensation	(4,235)	(9,121)
Other accrued liabilities	(6,869)	(4,079)
Deferred revenue	1,317	(14,937)
Income taxes payable	2,737	1,482
Net cash provided by operating activities	45,077	12,792
Cash flows from investing activities:		
Purchases of short-term investments	(20,022)	(108,517)
Proceeds from sales and maturities of short-term investments	104,154	32,400
Purchase of property and equipment	(2,761)	(1,462)
Payments made in connection with business acquisitions, net of cash acquired	—	(500)
Net cash provided by (used in) investing activities	81,371	(78,079)
Cash flows from financing activities:		
Purchase and retirement of common stock	(336)	(596)
Proceeds from exercise of stock options	2,547	4,378
Proceeds from issuance of common stock under employee stock purchase plan	1,053	955
Excess tax benefit from stock-based compensation	354	910
Net cash provided by financing activities	3,618	5,647
Net increase (decrease) in cash and cash equivalents	130,066	(59,640)
Cash and cash equivalents, at beginning of period	149,032	208,898
Cash and cash equivalents, at end of period	$279,098	$149,258

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

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

NETGEAR, Inc. (“NETGEAR” or the “Company”) was incorporated in Delaware in January 1996. The Company is a global networking company that delivers innovative products to consumers, businesses and service providers. For consumers, the Company makes high performance, dependable and easy-to-use home networking, storage and digital media products to connect people with the Internet and their content and devices. For businesses, the Company provides networking, storage and security solutions without the cost and complexity of Big IT. The Company also supplies leading service providers with made-to-order and retail proven, whole home networking solutions for sale to their customers. The Company’s products are built on a variety of proven technologies such as wireless, Ethernet and powerline, with a focus on reliability and ease-of-use. The Company sells products primarily through a global sales channel network, which includes traditional retailers, online retailers, wholesale distributors, direct market resellers ("DMRs"), value added resellers ("VARs"), and broadband service providers.

The accompanying unaudited condensed consolidated financial statements include the accounts of NETGEAR, Inc., and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated in consolidation. The balance sheet dated December 31, 2012, has been derived from audited financial statements at such date. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company’s financial position, results of operations, comprehensive income and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

The Company’s fiscal year begins on January 1 of the year stated and ends on December 31 of the same year. The Company reports its interim results on a fiscal quarter basis rather than on a calendar quarter basis. Under the fiscal quarter basis, each of the first three fiscal quarters ends on the Sunday closest to the calendar quarter end, with the fourth quarter ending on December 31.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of revenues and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

2. Summary of Significant Accounting Policies

The Company’s significant accounting policies are disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012. The Company’s significant accounting policies have not materially changed during the three months ended March 31, 2013.

Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2011-11 ("ASU 2011-01") , "Balance Sheet," which requires the disclosure of the effect or potential effect of offsetting arrangements on a company's financial position as well as enhanced disclosure of the rights of setoff associated with a company's recognized assets and liabilities. In January 2013, the FASB ASU 2013-01, which provides clarification on the scope of ASU 2011-11. ASU 2011-11 and ASU 2013-01 are effective for fiscal years beginning on or after January 1, 2013 and interim periods within those annual periods. Since the adoption of the authoritative guidance only required additional disclosures, it did not have an impact on the Company's financial position, results of operations or cash flows.

In February 2013, the FASB issued ASU 2013-02 "Comprehensive Income," which amends Topic 220 to improve the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 is effective for reporting periods beginning after December 15, 2012. Since the adoption of the authoritative guidance only required additional disclosures, it did not have an impact on the Company's financial position, results of operations or cash flows.

In February 2013, the FASB issued ASU 2013-04, “Liabilities,” which provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date, with the exception of obligations already addressed within existing US GAAP guidance. ASU 2013-04 is effective for reporting periods beginning after December 15, 2013. The Company will adopt this standard in the first quarter of 2014 and it does not expect the adoption to have a significant impact on its financial position, results of operations or cash flows.

In March 2013, the FASB issued ASU 2013-05, "Foreign Currency Matters," which provides the standards for parent's accounting for the cumulative translation adjustment upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. ASU 2013-05 is effective for reporting periods beginning after December 15, 2013. The Company will adopt this standard in the first quarter of 2014 and it does not expect the adoption to have a significant impact on its financial position, results of operations or cash flows.

3. Business Acquisitions

AVAAK, Inc.

On July 2, 2012, the Company acquired 100% of the voting equity interests of AVAAK, Inc. (“AVAAK”), a privately-held company that developed wire-free video networking products for a total purchase consideration of $24.0 million in cash. The Company believes the acquisition will bolster its retail business unit product offerings and expand its presence into the smart home market. The Company paid $21.6 million of the aggregate purchase price in the third quarter of 2012, and expects to pay the remaining $2.4 million, less amounts used to satisfy certain claims, twelve months after the closing of the acquisition.

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

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

Net tangible assets acquired (liabilities assumed)	$ 172
Deferred tax assets, net	5,937
Intangible assets, net	6,000
Goodwill	11,895
Total consideration	$ 24,004

The estimation of fair values for tangible assets and intangible assets acquired and liabilities assumed was subject to estimates, assumptions and other uncertainties, and it is possible that the allocation of the purchase consideration reflected in the foregoing table may change.

None of the goodwill recognized related to AVAAK is deductible for income tax purposes. The goodwill recognized, which was assigned to the Company's retail business unit, is primarily attributable to expected synergies resulting from the acquisition.

In connection with the acquisition, the Company recorded $5.9 million of deferred tax assets net of deferred tax liabilities. The deferred tax assets arise from the tax benefit of the estimated net operating losses as of the date of the acquisition after consideration of limitations on the use under U.S. Internal Revenue Code section 382. The deferred tax assets are reduced by deferred tax liabilities recorded for the book basis in intangible assets and in-process research and development ("IPR&D") for which the Company has no tax basis.

The Company designated $2.3 million of the acquired intangible assets as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 14.0%. The acquired existing technology is being amortized over its estimated useful life of five years.

The Company designated $0.3 million of the acquired intangible assets as customer relationships. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to existing customer relationships and discounted at 14.0%. The acquired customer relationships are being amortized over an estimated useful life of five years.

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

The Company designated $1.4 million of the acquired intangible assets as trade name and trademarks. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to existing trade name and trademarks and discounted at 16.0%. The acquired trade name and trademarks are being amortized over an estimated useful life of five years.
In addition, $2.0 million of the consideration paid represents the fair value of acquired IPR&D projects. The IPR&D acquired is considered indefinite lived intangible assets until research and development efforts associated with the projects are completed or abandoned. The most significant of the acquired IPR&D projects relate to camera technology and applications. As of March 31, 2013, all the acquired IPR&D has been reclassified to definite intangibles and they are being amortized over an estimated useful life of four years.
Firetide, Inc.
On June 4, 2012, the Company acquired certain intellectual property of Firetide, Inc. (“Firetide”) for an aggregate purchase price of $7.2 million in cash. The acquisition included intangible assets that existed at the closing date, including IP contracts, technology assets, business technology, and goodwill. The Company believes the acquisition will bolster its wireless product offerings in its commercial business unit and strengthen its market position in the small to medium size campus wireless LAN market. The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting.
The Company paid $6.6 million of the aggregate purchase price in the second quarter of 2012, and expects to pay the remaining $0.6 million, less amounts used to satisfy certain claims, twelve months after the closing of the acquisition. The ongoing costs of developing these assets subsequent to the date of acquisition have been included in the consolidated financial statements since the date of acquisition. The historical results of operations related to the acquired assets prior to the acquisition were not material to the Company’s results of operations.
The allocation of the purchase price was as follows (in thousands):

Intangible assets, net	$4,159
Goodwill	3,041
Total consideration	$7,200

The estimation of fair values for intangible assets acquired was subject to estimates, assumptions and other uncertainties, and it is possible that the allocation of the purchase consideration reflected in the foregoing table may change.

Of the $3.0 million of goodwill recorded on the acquisition of Firetide, approximately $1.6 million and $3.0 million are deductible for U.S. federal and state income tax purposes, respectively. The goodwill recognized, which was assigned to the Company's commercial business unit, is primarily attributable to expected synergies of Firetide.
The Company designated the 4.2 million in acquired intangible assets as technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 22.0%. The acquired existing technology is being amortized over its estimated useful life of five years.

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

4. Balance Sheet Components (in thousands)

Short-Term Investments

	As of March 31, 2013				December 31, 2012			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. Treasuries	$140,508	$19	$—	$140,527	$225,016	$48	$(2)	$225,062
Certificates of Deposits	2,787	—	—	2,787	2,783	—	—	2,783
Total	$143,295	$19	$—	$143,314	$227,799	$48	$(2)	$227,845

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

Cost Method Investments

As of March 31, 2013 and December 31, 2012, the carrying value of the Company's cost method investments was $1.3 million. These investments are included in other non-current assets in the consolidated balance sheets and are carried at cost, adjusted for any impairment, because the Company does not have a controlling interest and does not have the ability to exercise significant influence over these companies. The Company monitors these investments for impairment on a quarterly basis, and adjusts carrying value for any impairment charges recognized. There were no impairments recognized in the three months ended March 31, 2013 and April 1, 2012. Realized gains and losses on these investments are reported in other income (expense), net in the consolidated statements of operations.

Accounts receivable, net

	As of March 31, 2013	December 31, 2012
Gross accounts receivable	$259,070	$276,084
Allowance for doubtful accounts	(1,256)	(1,256)
Allowance for sales returns	(17,532)	(17,031)
Allowance for price protection	(2,386)	(1,783)
Total allowances	(21,174)	(20,070)
Total accounts receivable, net	$237,896	$256,014

Inventories

	As of March 31, 2013	December 31, 2012
Raw materials	$7,295	$4,447

Finished goods	151,260	170,456
Total inventories	$158,555	$174,903

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

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

Property and equipment, net

	As of March 31, 2013	December 31, 2012
Computer equipment	$7,422	$7,290
Furniture, fixtures and leasehold improvements	12,789	12,761
Software	22,233	21,521
Machinery and equipment	33,669	31,694
Construction in progress	232	385
Total property and equipment, gross	76,345	73,651
Accumulated depreciation and amortization	(57,958)	(54,626)
Total property and equipment, net	$18,387	$19,025

Depreciation expense was $3.4 million and $2.6 million for the three months ended March 31, 2013 and April 1, 2012, respectively.

Intangibles, net

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

	Gross	Accumulated Amortization	Net
March 31, 2013			
Technology	$33,259	$(22,852)	$10,407
Customer contracts and relationships	16,000	(3,806)	12,194
Other	6,870	(3,392)	3,478
Finite-lived intangibles, net	$56,129	$(30,050)	$26,079

	Gross	Accumulated Amortization	Net
December 31, 2012			
Technology	$32,259	$(22,065)	$10,194
Customer contracts and relationships	16,000	(3,301)	12,699
Other	6,870	(3,142)	3,728
Finite-lived intangibles, net	55,129	(28,508)	26,621
Indefinite-lived intangible assets	1,000	—	1,000
Total purchased intangible assets, net	$56,129	$(28,508)	$27,621

All of the IPR&D assets as of December 31, 2012 were acquired in connection with the Company's acquisition of AVAAK. IPR&D assets represent IPR&D projects that have not reached technical feasibility and are required to be classified as indefinite-lived assets until the successful completion or abandonment of the associated research and development efforts. Accordingly, during the development period after the date of acquisition, these assets will not be amortized. When the asset reaches technical feasibility, the Company will determine the useful life of the asset, reclassify the asset out of IPR&D, and begin amortization. Development costs incurred after acquisition on acquired

IPR&D projects are expensed as incurred. As of March 31, 2013, the remaining $1.0 million of the IPR&D at December 31, 2012 had reached technical feasibility and as a result, was reclassified from IPR&D to technology.

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

Amortization of purchased intangible assets was $1.5 million and $1.0 million for the three months ended March 31, 2013 and April 1, 2012, respectively. No impairment charges were recorded in the three months ended March 31, 2013, and April 1, 2012.

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

Year Ending December 31	Amount
2013 (remaining nine months)	$4,363
2014	5,589
2015	4,972
2016	4,610
2017	3,025
Thereafter	3,520
Total expected amortization expense	$26,079

Goodwill

	As of March 31, 2013	December 31, 2012
Retail	$45,441	$45,441
Commercial	35,084	35,084
Service Provider	20,355	20,355
Total	$100,880	$100,880

There were no impairments to goodwill during the three months ended March 31, 2013 and April 1, 2012.

Other non-current assets

	As of March 31, 2013	December 31, 2012
Non-current deferred income taxes	$16,510	$16,856
Cost method investment	1,322	1,322
Other	4,450	4,656
Total other non-current assets	$22,282	$22,834

Other accrued liabilities

	As of March 31, 2013	December 31, 2012
Sales and marketing programs	$40,257	$43,652
Warranty obligation	45,876	46,659
Freight	4,601	4,457

Other	28,853	31,487
Total other accrued liabilities	$119,587	$126,255

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5. Product Warranties

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

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

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

	Three Months Ended	
	March 31, 2013	April 1, 2012
Balance as of beginning of the period	$46,659	$44,846
Provision for warranty liability made during the period	16,375	12,956
Settlements made during the period	(17,158)	(15,773)
Balance at end of period	$45,876	$42,029

6. Derivative Financial Instruments

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

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

The Company may choose not to hedge certain foreign exchange exposures for a variety of reasons, including, but not limited to, immateriality, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign exchange rates. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments in accordance with the authoritative guidance for derivatives and hedging. The Company records all derivatives on the balance sheet at fair value. The effective portions of cash flow hedges are recorded in other comprehensive income until the hedged item is recognized in earnings. Derivatives that are not designated as hedging instruments and the ineffective portions of its designated hedges are adjusted to fair value through earnings in other income (expense), net in the unaudited condensed consolidated statement of operations.

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

The fair values of the Company's derivative instruments and the line items on the unaudited condensed consolidated balance sheet to which they were recorded as of March 31, 2013, and December 31, 2012, are summarized as follows (in thousands):

Derivative Assets	Balance Sheet Location	Fair Value at March 31, 2013	Balance Sheet Location	Fair Value at December 31, 2012
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	$967	Prepaid expenses and other current assets	$1,142
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	149	Prepaid expenses and other current assets	2
Total		$1,116		$1,144

Derivative Liabilities	Balance Sheet Location	Fair Value at March 31, 2013	Balance Sheet Location	Fair Value at December 31, 2012
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	$(449)	Other accrued liabilities	$(1,616)
Derivative liabilities designated as hedging instruments	Other accrued liabilities	(54)	Other accrued liabilities	(3)
Total		$(503)		$(1,619)

For details of the Company's fair value measurements, see Note 13, Fair Value of Financial Instruments.

Offsetting Derivative Assets and Liabilities

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

The following tables set forth the offsetting of derivative assets as of March 31, 2013 and December 31, 2012 (in thousands):

As of March 31, 2013				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount

		Sheets				
Barclays	$1,009	$—	$1,009	$(503)	$—	$506
Wells Fargo Bank	107	—	107	—	—	107
Total	$1,116	$—	$1,116	$(503)	$—	$613

As of December 31, 2012	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
				Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$1,107	$—	$1,107	$(1,107)	$—	$—
Wells Fargo Bank	37	—	37	(37)	—	—
Total	$1,144	$—	$1,144	$(1,144)	$—	$—

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

The following tables set forth the offsetting of derivative liabilities as of March 31, 2013 and December 31, 2012 (in thousands):

				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
As of March 31, 2013	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$503	$—	$503	$(503)	$—	$—
Wells Fargo Bank	—	—	—	—	—	—
Total	$503	$—	$503	$(503)	$—	$—

				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
As of December 31, 2012	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
Barclays	$1,401	$—	$1,401	$(1,107)	$—	$294
Wells Fargo Bank	218	—	218	(37)	—	181
Total	$1,619	$—	$1,619	$(1,144)	$—	$475

Cash flow hedges

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

The Company expects to reclassify to earnings all of the amounts recorded in other comprehensive income ("OCI") associated with its cash flow hedges over the next 12 months. OCI associated with cash flow hedges of foreign currency revenue is recognized as a component of net revenue in the same period as the related revenue is recognized.

OCI associated with cash flow hedges of foreign currency costs of revenue and operating expenses are recognized as a component of cost of revenue and operating expense in the same period as the related costs of revenue and operating expenses are recognized.

Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur within the designated hedge period or if not recognized within 60 days following the end of the hedge period. Deferred gains and losses in other comprehensive income associated with such derivative instruments are reclassified immediately into earnings through other income and expense. Any subsequent changes in fair value of such derivative instruments also are reflected in current earnings unless they are re-designated as hedges of other transactions. The Company did not recognize any material net gains or losses related to the loss of hedge designation on discontinued cash flow hedges during the three months ended March 31, 2013, and April 1, 2012.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The effects of the Company’s derivative instruments on OCI and the unaudited condensed consolidated statement of operations for the three months ended March 31, 2013, and April 1, 2012, are summarized as follows (in thousands):

	Three Months Ended March 31, 2013			
Derivatives Designated as Hedging Instruments	Gain or (Loss) Recognized in OCI - Effective Portion (a)	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion (a)	Locat