

NETGEAR, INC
Form 10-Q
May 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended March 30, 2014.

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

For the transition period from _____ to _____

Commission file number: 000-50350

NETGEAR, Inc.

(Exact name of registrant as specified in its charter)

Delaware 77-0419172
(State or other jurisdiction of (IRS Employer
incorporation or organization) Identification No.)

350 East Plumeria Drive, 95134
San Jose, California (Zip Code)
(Address of principal executive offices)

(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 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 No

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

Large Accelerated filer Accelerated filer
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 No

The number of outstanding shares of the registrant's Common Stock, \$0.001 par value, was 36,509,142 as of April 29, 2014.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

NETGEAR, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	March 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$129,656	\$143,009
Short-term investments	110,605	105,145
Accounts receivable, net	291,251	266,484
Inventories	201,630	224,456
Deferred income taxes	28,515	27,239
Prepaid expenses and other current assets	37,047	33,778
Total current assets	798,704	800,111
Property and equipment, net	26,005	27,194
Intangibles, net	79,649	84,118
Goodwill	155,916	155,916
Other non-current assets	29,822	26,591
Total assets	\$1,090,096	\$1,093,930
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$96,285	\$114,531
Accrued employee compensation	18,534	16,551
Other accrued liabilities	141,052	143,218
Deferred revenue	30,096	24,496
Income taxes payable	1,744	1,287
Total current liabilities	287,711	300,083
Non-current income taxes payable	13,917	13,804
Other non-current liabilities	6,053	6,260
Total liabilities	307,681	320,147
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Common stock	37	37
Additional paid-in capital	432,231	421,901
Cumulative other comprehensive (loss) income	(132	) 69
Retained earnings	350,279	351,776
Total stockholders' equity	782,415	773,783
Total liabilities and stockholders' equity	\$1,090,096	\$1,093,930

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

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NETGEAR, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Three Months Ended	
	March 30, 2014	March 31, 2013
Net revenue	\$349,391	\$293,399
Cost of revenue	251,466	205,662
Gross profit	97,925	87,737
Operating expenses:		
Research and development	22,181	15,338
Sales and marketing	39,911	36,389
General and administrative	11,375	12,327
Restructuring and other charges	842	(30
Litigation reserves, net	117	48
Total operating expenses	74,426	64,072
Income from operations	23,499	23,665
Interest income	57	149
Other (expense) income, net	(108	) 74
Income before income taxes	23,448	23,888
Provision for income taxes	9,037	8,545
Net income	\$14,411	\$15,343
Net income per share:		
Basic	\$0.39	\$0.40
Diluted	\$0.39	\$0.39
Weighted average shares outstanding used to compute net income per share:		
Basic	36,630	38,433
Diluted	37,305	39,050

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 30, 2014	March 31, 2013
Net income	\$ 14,411	\$ 15,343
Other comprehensive (loss) income, before tax:		
Unrealized (loss) gain on derivative instruments	(205	) 151
Unrealized gain (loss) on available-for-sale securities	7	(26
Other comprehensive (loss) income, before tax	(198	) 125
Tax (expense) benefit related to items of other comprehensive income	(3	) 10
Other comprehensive (loss) income, net of tax	(201	) 135
Comprehensive income	\$ 14,210	\$ 15,478

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 30, 2014	March 31, 2013
Cash flows from operating activities:		
Net income	\$14,411	\$15,343
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,743	4,942
Purchase premium amortization/discount accretion on investments, net	93	373
Non-cash stock-based compensation	5,130	3,590
Income tax benefit associated with stock option exercises	(314	) 354
Excess tax benefit from stock-based compensation	(153	) (354
Deferred income taxes	(671	) (1,015
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(24,854	) 18,118
Inventories	22,826	16,348
Prepaid expenses and other assets	(7,179	) (671
Accounts payable	(18,245	) (4,901
Accrued employee compensation	1,983	(4,235
Other accrued liabilities	(2,422	) (6,869
Deferred revenue	5,637	1,317
Income taxes payable	569	2,737
Net cash provided by operating activities	5,554	45,077
Cash flows from investing activities:		
Purchases of short-term investments	(59,958	) (20,022
Proceeds from sales and maturities of short-term investments	54,500	104,154
Purchase of property and equipment	(3,085	) (2,761
Net cash (used in) provided by investing activities	(8,543	) 81,371
Cash flows from financing activities:		
Purchase and retirement of treasury stock	(15,908	) (336
Proceeds from exercise of stock options	4,063	2,547
Proceeds from issuance of common stock under employee stock purchase plan	1,328	1,053
Excess tax benefit from stock-based compensation	153	354
Net cash (used in) provided by financing activities	(10,364	) 3,618
Net (decrease) increase in cash and cash equivalents	(13,353	) 130,066
Cash and cash equivalents, at beginning of period	143,009	149,032
Cash and cash equivalents, at end of period	\$129,656	\$279,098

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

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

NETGEAR, Inc. ("NETGEAR" or the "Company") was incorporated in Delaware in January 1996. The Company is a global networking company that delivers innovative products to consumers, businesses and service providers. The Company's products are built on a variety of proven technologies such as wireless, Ethernet and powerline, with a focus on reliability and ease-of-use. The product line consists of wired and wireless devices that enable networking, broadband access and network connectivity. These products are available in multiple configurations to address the needs of the end-users in each geographic region in which the Company's products are sold.

The accompanying unaudited condensed consolidated financial statements include the accounts of NETGEAR, Inc., and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated in consolidation. The balance sheet dated December 31, 2013 has been derived from audited financial statements at such date. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company's financial position, results of operations, comprehensive income and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of revenues and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three months ended March 30, 2014 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, 2013. The Company's significant accounting policies have not materially changed during the three months ended March 30, 2014.

Recent Accounting Pronouncements

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 has adopted this standard in the first quarter of 2014 and it does not have a significant impact on its financial position, results of operations or cash flows.

In July 2013, the FASB issued ASU 2013-11, "Income Taxes," which provides explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward or a tax credit

carryforward exists. Under the new standard update, the Company's unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward or a tax credit carryforward. ASU 2013-11 is effective for the Company beginning in the first quarter fiscal 2014 and applied prospectively or retroactively with early adoption permitted. The Company adopted ASU 2013-11 during the three months ended December 31, 2013 on a prospective basis. The change did not have a significant impact on the Company's financial position, results of operations or cash flows.

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. Business Acquisitions

Arada Systems, Inc.

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

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

The fair values for tangible and intangible assets acquired and liabilities assumed were based on estimates of their fair values as of the acquisition date. These estimates are subject to revision, which may result in adjustments to the values presented above. We expect to finalize these amounts within twelve months from the acquisition date.

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

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

AirCard Division of Sierra Wireless, Inc.

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

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

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

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

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

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

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

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

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

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

The Company acquired \$9.5 million in in-process research and development ("IPR&D") projects. The value was calculated based on the present value of future estimated cash flows discounted at 13.0%, derived from projections of future revenues attributable to the assets, expected economic life of the assets, and royalty rates. The IPR&D acquired is considered indefinite lived intangible assets until research and development efforts associated with the projects are completed or abandoned. The most significant of the acquired IPR&D projects relate to multimode LTE technologies, Mobile Hot Spot, USB dongle, and Module form factors. As of March 30, 2014, \$7.4 million of the acquired IPR&D has reached technical feasibility and was reclassified to definite-lived intangibles and with an estimated useful life of four years. In addition, the Company recorded an impairment charge of \$2.0 million in the third quarter of 2013, related to the abandonment of certain IPR&D projects acquired. The Company expects to complete the remaining \$0.1 million in IPR&D projects, at an estimated cost of \$0.2 million, by the third quarter of 2014.

Pro forma financial information

The unaudited pro forma financial information in the table below summarizes the combined results of our operations and those of AirCard for the periods shown as though the acquisition of AirCard occurred as of the beginning of the fiscal year 2012. The pro forma financial information for the periods presented includes the accounting effects of the business combination, including adjustments to the amortization of intangible assets, fair value of acquired inventory, acquisition-related costs, integration expenses and related tax effects of these adjustments, where applicable. This information is for informational purposes only, is subject to a number of estimates, assumptions and other

uncertainties, and may not be indicative of the results of operations that would have been achieved if the acquisition had taken place at January 1, 2012.

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The unaudited pro forma financial information is as follows:

	Three Months Ended March 31, 2013 (in millions)
Revenue	\$ 338
Net income	\$ 15

4. Balance Sheet Components (in thousands)

Available-For-Sale Short-Term Investments

	As of March 30, 2014				December 31, 2013			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. Treasuries	\$ 109,946	\$ 13	\$—	\$ 109,959	\$ 104,595	\$ 7	\$(1)	\$ 104,601
Certificates of Deposits	174	—	—	174	159	—	—	159
Total	\$ 110,120	\$ 13	\$—	\$ 110,133	\$ 104,754	\$ 7	\$(1)	\$ 104,760

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

Cost Method Investments

As of March 30, 2014 and December 31, 2013, the carrying value of the Company's cost method investments was \$1.3 million. These investments are included in other non-current assets in the 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 30, 2014 and March 31, 2013. Realized gains and losses on these investments are reported in other income, net in the consolidated statements of operations.

Accounts receivable, net

	As of March 30, 2014	December 31, 2013
Gross accounts receivable	\$ 314,432	\$ 289,479
Allowance for doubtful accounts	(1,255)	(1,255)
Allowance for sales returns	(18,550)	(17,467)
Allowance for price protection	(3,376)	(4,273)
Total allowances	(23,181)	(22,995)

Total accounts receivable, net	\$291,251	\$266,484
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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Inventories

	As of March 30, 2014	December 31, 2013
Raw materials	\$6,591	\$8,676
Work in process	5,244	6,233
Finished goods	189,795	209,547
Total inventories	\$201,630	\$224,456

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

Property and equipment, net

	As of March 30, 2014	December 31, 2013
Computer equipment	\$8,728	\$8,527
Furniture, fixtures and leasehold improvements	14,169	14,019
Software	25,875	25,722
Machinery and equipment	53,270	50,656
Construction in progress	12	21
Total property and equipment, gross	102,054	98,945
Accumulated depreciation and amortization	(76,049)	(71,751)
Total property and equipment, net	\$26,005	\$27,194

Depreciation and amortization expense pertaining to property and equipment was \$4.3 million and \$3.4 million for the three months ended March 30, 2014 and March 31, 2013, respectively.

Intangibles, net

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

	Gross	Accumulated Amortization	Net
March 30, 2014			
Technology	\$60,999	\$(32,026)	\$28,973
Customer contracts and relationships	56,500	(10,892)	45,608
Other	10,545	(5,577)	4,968
Finite-lived intangibles, net	128,044	(48,495)	79,549
Indefinite-lived intangible assets	100	—	100
Total purchased intangible assets, net	\$128,144	\$(48,495)	\$79,649

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

As of March 30, 2014, the Company had \$0.1 million in indefinite-lived intangible assets. This balance relates to the remaining IPR&D assets acquired in connection with the Company's acquisition of AirCard. 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.

Amortization of purchased intangible assets was \$4.5 million and \$1.5 million for the three months ended March 30, 2014 and March 31, 2013, respectively.

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

Year Ending December 31	Amount
2014 (remaining nine months)	\$13,406
2015	17,258
2016	16,896
2017	11,361
2018	7,859
Thereafter	12,769
Total expected amortization expense	\$79,549

Goodwill

The changes in the carrying amount of goodwill during the three months ended March 30, 2014 are as follows:

	Retail	Commercial	Service Provider	Total
Goodwill at December 31, 2013	\$45,441	\$36,279	\$74,196	\$155,916
Goodwill acquired during the period	—	—	—	—
Goodwill at March 30, 2014	\$45,441	\$36,279	\$74,196	\$155,916

There were no impairments to goodwill during three months ended March 30, 2014 and March 31, 2013.

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Other non-current assets

	As of March 30, 2014	December 31, 2013
Non-current deferred income taxes	\$ 19,630	\$ 20,235
Cost method investment	1,322	1,322
Other	8,870	5,034
Total other non-current assets	\$ 29,822	\$ 26,591

Other accrued liabilities

	As of March 30, 2014	December 31, 2013
Sales and marketing programs	\$ 50,870	\$ 47,941
Warranty obligation	45,403	48,754
Freight	5,777	5,790
Other	39,002	40,733
Total other accrued liabilities	\$ 141,052	\$ 143,218

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 30, 2014	March 31, 2013
Balance as of beginning of the period	\$ 48,754	\$ 46,659
Provision for warranty liability made during the period	14,158	16,375
Settlements made during the period	(17,509)	(17,158)
Balance at end of period	\$ 45,403	\$ 45,876

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

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NETGEAR, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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, net in the unaudited condensed consolidated statement of operations.

The fair values of the Company's derivative instruments and the line items on the unaudited condensed consolidated balance sheet to which they were recorded as of March 30, 2014, and December 31, 2013, are summarized as follows (in thousands):