NETGEAR, INC
Form 10-Q
August 04, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the quarterly period ended July 2, 2017.

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from to

Commission file number: 000-50350
NETGEAR, Inc.
(Exact name of registrant as specified in its charter)

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

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No x

The number of outstanding shares of the registrant’s Common Stock, $0.001 par value, was 31,604,537 as of July 28, 2017.

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

	As of July 2, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$190,676	$ 240,468
Short-term investments	114,847	125,514
Accounts receivable, net	304,588	313,839
Inventories	263,773	247,862
Prepaid expenses and other current assets	27,705	35,102
Total current assets	901,589	962,785
Property and equipment, net	18,829	19,473
Intangibles, net	30,215	37,899
Goodwill	85,463	85,463
Other non-current assets	79,493	78,836
Total assets	$1,115,589	$ 1,184,456
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$72,886	$ 112,436
Accrued employee compensation	24,017	33,096
Other accrued liabilities	173,714	170,674
Deferred revenue	36,533	35,301
Income taxes payable	—	5,146
Total current liabilities	307,150	356,653
Non-current income taxes payable	15,721	15,119
Other non-current liabilities	16,796	15,865
Total liabilities	339,667	387,637
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock	32	33
Additional paid-in capital	584,097	566,307
Accumulated other comprehensive income (loss)	(4,810)	1,938
Retained earnings	196,603	228,541
Total stockholders' equity	775,922	796,819
Total liabilities and stockholders' equity	$1,115,589	$ 1,184,456

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

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

	Three Months Ended		Six Months Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Net revenue	$330,723	$311,655	$654,380	$621,911
Cost of revenue	238,787	213,867	465,512	423,558
Gross profit	91,936	97,788	188,868	198,353
Operating expenses:				
Research and development	23,357	21,804	46,040	43,941
Sales and marketing	36,461	36,089	74,690	73,366
General and administrative	12,950	13,035	26,144	25,884
Restructuring and other charges	22	1,311	59	3,989
Litigation reserves, net	53	35	53	45
Total operating expenses	72,843	72,274	146,986	147,225
Income from operations	19,093	25,514	41,882	51,128
Interest income	482	279	887	513
Other income (expense), net	383	(332)	718	(698)
Income before income taxes	19,958	25,461	43,487	50,943
Provision for income taxes	5,376	9,427	12,911	18,320
Net income	$14,582	$16,034	$30,576	$32,623
Net income per share:				
Basic	$0.45	$0.49	$0.94	$1.00
Diluted	$0.44	$0.48	$0.91	$0.98
Weighted average shares used to compute net income per share:				
Basic	32,352	32,639	32,650	32,578
Diluted	33,116	33,493	33,656	33,390

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

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

	Three Months Ended		Six Months Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Net income	$14,582	$16,034	$30,576	$32,623
Other comprehensive income (loss), before tax:				
Unrealized gains (losses) on derivative instruments	(6,003)	511	(7,700)	(36)
Unrealized gains (losses) on available-for-sale securities	(27)	46	(82)	147
Other comprehensive income (loss), before tax	(6,030)	557	(7,782)	111
Tax benefit related to derivative instruments	809	—	1,005	—
Tax benefit (provision) related to available-for-sale securities	9	(17)	29	(55)
Other comprehensive income (loss), net of tax	(5,212)	540	(6,748)	56
Comprehensive income	$9,370	$16,574	$23,828	$32,679

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

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

	Six Months Ended July 2, 2017	July 3, 2016
Cash flows from operating activities:		
Net income	$ 30,576	$ 32,623
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,224	16,887
Purchase premium amortization/discount accretion on investments, net	100	56
Non-cash stock-based compensation	10,829	9,430
Income tax impact associated with stock option exercises	—	768
Deferred income taxes	1,788	3,857
Changes in assets and liabilities:		
Accounts receivable	9,252	60,092
Inventories	(15,911)	5,277
Prepaid expenses and other assets	5,519	3,066
Accounts payable	(39,283)	(9,866)
Accrued employee compensation	(9,079)	3,349
Other accrued liabilities	(1,322)	(34,091)
Deferred revenue	1,232	136
Income taxes payable	(4,544)	(1,482)
Net cash provided by operating activities	3,381	90,102
Cash flows from investing activities:		
Purchases of short-term investments	(56,876)	(80,254)
Proceeds from maturities of short-term investments	67,648	50,147
Purchase of property and equipment	(6,162)	(5,060)
Cost method investment	(1,400)	—
Payments made in connection with business acquisition, net of cash acquired	(737)	—

Net cash provided by (used in) investing activities	2,473		(35,167	)
Cash flows from financing activities:				
Repurchases of common stock	(56,631	)	(23,252	)
Restricted stock unit withholdings	(5,649	)	(3,915	)
Proceeds from exercise of stock options	3,972		14,653	
Proceeds from issuance of common stock under employee stock purchase plan	2,662		1,645	
Net cash used in financing activities	(55,646	)	(10,869	)
Net increase (decrease) in cash and cash equivalents	(49,792	)	44,066	
Cash and cash equivalents, at beginning of period	240,468		181,945	
Cash and cash equivalents, at end of period	$ 190,676		$ 226,011	

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 company that delivers innovative networking and Internet connected products to consumers and growing businesses. The Company's products are built on a variety of proven technologies such as wireless (WiFi and LTE), Ethernet and powerline, with a focus on reliability and ease-of-use. The product line consists of devices that create and extend wired and wireless networks as well as devices that provide a special function and attach to the network, such as IP security cameras and home automation devices and services. These products are available in multiple configurations to address the changing needs of the customers 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, 2016 has been derived from audited financial statements at such date. Accordingly, these unaudited condensed consolidated financial statements do not include all of the information and footnotes typically found in the audited consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company’s financial position, results of operations, comprehensive income and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2016.
The Company’s fiscal year begins on January 1 of the year stated and ends on December 31 of the same year. The Company reports its interim results on a fiscal quarter basis rather than on a calendar quarter basis. Under the fiscal quarter basis, each of the first three fiscal quarters ends on the Sunday closest to the calendar quarter end, with the fourth quarter ending on December 31.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of net revenue and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the six months ended July 2, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017 or any future period.

Reclassification

In the first quarter of fiscal 2017, the Company reorganized its operating segment structure resulting in a change to its reportable segments. This change primarily impacted Goodwill in Note 4, Balance Sheet Components and Note 11, Segment Information. The prior-year segment financial information has been reclassified to conform to the current-year presentation. None of the changes impact previously reported consolidated net revenue, income from operations, net income per share, total assets, or stockholders’ equity. Refer to Note 11, Segment Information, for a further discussion of the segment reorganization. Additionally, in the first quarter of fiscal 2017, upon adoption of ASU 2016-09, the Company elected to apply the presentation requirements for cash flows related to excess tax benefits retrospectively to all periods presented. Refer to recently adopted accounting pronouncement under Note 2, Summary of Significant Accounting Policies, for a further discussion of the impact from the adoption of ASU 2016-09.

Note 2. Summary of Significant Accounting Policies

The Company’s significant accounting policies are disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. The Company’s significant accounting policies have not materially changed during the six months ended July 2, 2017.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Recent accounting pronouncements

Accounting Pronouncement Recently Adopted

In March 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting" (Topic 718), which simplifies the accounting for share-based payment transactions. The new guidance requires excess tax benefits and tax deficiencies to be recorded in the income statement when stock awards vest or are settled. In addition, cash flows related to excess tax benefits will no longer be separately classified as an inflow from financing activities with a corresponding outflow from operating activities but will be classified along with other income tax cash flows as an operating activity. The standard also allows the entity to repurchase more of an employee’s vesting shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made to tax authorities on an employee’s behalf for withheld shares should be presented as a financing activity on the cash flows statement, and provides an accounting policy election to account for forfeitures as they occur. The new guidance became effective for the Company in the first quarter of fiscal 2017.

Upon adoption on January 1, 2017, the Company prospectively recorded all excess tax benefits and tax deficiencies arising from stock awards vesting or settlement as income tax expense or benefit rather than in equity. For the three and six months ended July 2, 2017, the impact of the adoption was the recognition of $1.0 million and $1.8 million, respectively, excess tax benefits as a component of the provision for income taxes. The Company elected to account for forfeitures as they occur, rather than estimating expected forfeitures, which resulted in net cumulative-effect adjustment of $0.2 million decrease to retained earnings as of January 1, 2017. The Company elected to apply the presentation requirements for cash flows related to excess tax benefits retrospectively to all periods presented, which resulted in an increase to both net cash provided by operating activities and net cash used in financing activities of $1.4 million for the six months ended July 3, 2016, respectively, on the unaudited condensed consolidated statements of cash flows. The presentation requirement for cash flows related to employee taxes paid for withheld shares had no impact to any of the periods presented on the consolidated statements of cash flows since the Company has historically been presented such cash flows as a financing activity.

Accounting Pronouncements Not Yet Effective

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" (Topic 606), which was further updated in March, April, May and December 2016. The guidance in this update supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition". Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also specifies the accounting for some costs to obtain or fulfill a contract with a customer. An entity should apply the amendments in the update either retrospectively to each prior reporting period presented (full retrospective method) or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application (modified retrospective method). On July 9, 2015, the FASB concluded to delay the effective date of the new revenue standard by one year. ASU 2014-09 is effective for the Company beginning in the first quarter of fiscal 2018 and early adoption is permitted.

The Company anticipates adopting the new standard effective January 1, 2018. Although the Company is still in the process of evaluating the impact of the new standard on its financial statements, at this stage of the process, it does not believe the adoption of ASU 2014-09 will have a significant impact on the amount or timing of its revenues. The Company has identified major revenue streams, performed an analysis of a sample of contracts to evaluate the impact of the standard, and begun the drafting of its accounting policies and evaluating the new disclosure requirements. To date, the Company believes it will be impacted by the requirement of the new standard to estimate for yet to be committed sales incentives at the time revenue is recognized. Under Topic 605, these incentives are recognized as a reduction of revenue at the later of when the related revenue is recognized or when the program is offered to the channel partner. Applying Topic 606, where customary business practice of providing such incentives is determined, there is a timing difference and will require the Company upon adoption to record an estimate of yet to be committed future sales incentives with respect to revenue already recognized. The actual impact upon adoption will be based on open contracts existing at December 31, 2017 and is subject to the finalization of its transition method. In addition, the Company has determined that the presentation of certain reserve balances currently shown net within accounts receivable will be presented as refund liabilities within current liabilities upon adoption. The Company expects to complete the assessment process, including selecting a transition method for adoption, by the end of the third quarter of fiscal 2017, and to complete the implementation process, including adding procedures and evaluating necessary disclosures, prior to the first quarter of fiscal 2018.

In January 2016, the FASB issued ASU 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities" (Subtopic 825-10), which addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. This guidance also clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets. ASU 2016-01 is effective for the Company in the first quarter of fiscal 2018 and early adoption is permitted. The Company does not plan to early adopt the guidance and is currently evaluating the impact the update will have on its financial position, results of operations and cash flows and related disclosures.

In February 2016, FASB issued ASU 2016-02, "Leases" (Topic 842), which requires lessees to recognize on the balance sheets a right-of-use asset, representing its right to use the underlying asset for the lease term, and a corresponding lease liability for all leases with terms greater than twelve months. The liability will be equal to the present value of lease payments while the right-of-use asset will be based on the liability, subject to adjustment, such as for initial direct costs. In addition, ASU 2016-02 expands the disclosure requirements for lessees. Upon adoption, the Company will be required to record a lease asset and lease liability related to its operating leases. ASU 2016-02 will be applied using a modified retrospective transition method and is effective for the Company in the first quarter fiscal 2019, with early adoption permitted. The Company does not plan to early adopt the guidance and is currently evaluating the impact the update will have on its financial position, results of operations and cash flows and related disclosures.

In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments" (Topic 326), which replaces the incurred-loss impairment methodology and requires immediate recognition of estimated credit losses expected to occur for most financial assets, including trade receivables. Credit losses on available-for-sale debt securities with unrealized losses will be recognized as allowances for credit losses limited to the amount by which fair value is below amortized cost. ASU 2016-13 is effective for the Company beginning in the first quarter of 2020 and early adoption is permitted. The Company continues to assess the potential impact of the new guidance, but does not expect it to have material impacts on its financial position, results of operations or cash flows.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory" (Topic 740), which requires the recognition of the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. This removes the exception to postpone recognition until the asset has been sold to an outside party. ASU 2016-16 is effective for the Company in the first quarter of fiscal 2018 and early adoption is permitted. The Company is currently evaluating what impact, if any, the adoption of this guidance will have on its financial position, results of operations and cash flows.

In January 2017, the FASB issued ASU 2017-01, "Business Combinations: Clarifying the Definition of a Business" (Topic 805), which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business. ASU 2017-01 is effective for the Company in the first quarter of fiscal 2018 and early adoption is permitted. The guidance should be applied prospectively to any transactions occurring on or after the adoption date. The Company does not expect it to have material impacts on its financial position, results of operations or cash flows.

In January 2017, the FASB issued ASU 2017-04, "Intangibles-Goodwill and Other: Simplifying the Test for Goodwill Impairment" (Topic 350), which simplifies the subsequent measurement of goodwill by removing Step 2 of goodwill impairment test that requires the determination of the fair value of individual assets and liabilities of a reporting unit.

The new guidance requires goodwill impairment to be measured as the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. ASU 2017-04 will be applied prospectively and is effective for the Company in the first quarter of fiscal 2020, with early adoption permitted. The Company does not expect it to have material impacts on its financial position, results of operations or cash flows.

In May 2017, the FASB issued ASU 2017-09, "Compensation—Stock Compensation: Scope of Modification Accounting" (Topic 718), which clarifies when changes to the terms or conditions of a share-based payment award must by accounted for as modifications. Under the new guidance, an entity will not apply modification accounting if the award's fair value, vesting conditions and classification are the same immediately before and after the change. ASU 2017-09 is effective for the Company in the first quarter of fiscal 2018 and early adoption is permitted. The guidance should be applied prospectively to award modified on or after the adoption date. The Company does not expect it to have material impacts on its financial position, results of operations or cash flows.

Note 3. Business Acquisition

Placemeter, Inc.

On November 30, 2016, the Company acquired Placemeter, Inc. ("Placemeter"), an industry leader in computer vision analytics, for total purchase consideration of $9.6 million. The Company believes that Placemeter's engineering talent will add value to NETGEAR's Arlo smart security team, and that their proprietary computer vision algorithms will help to build video analytics solutions for the Arlo platform.

The Company paid $8.8 million of the aggregate purchase price in the fourth quarter of 2016 and paid the remaining $0.8 million in the first quarter of fiscal 2017. The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting. The results of Placemeter have been included in the unaudited condensed consolidated financial statements since the date of acquisition. Proforma 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):

Cash and cash equivalents	$8
Accounts receivable, net	11
Prepaid expenses and other current assets	130
Property and equipment, net	83
Intangibles, net	6,000
Goodwill	3,742
Accounts payable	(40)
Other accrued liabilities	(74)
Deferred tax liabilities, net	(308)
Total purchase price	$9,552

The $3.7 million of goodwill recorded on the acquisition of Placemeter is not deductible for U.S. federal or U.S. state income tax purposes. The goodwill recognized, which was assigned to the Company's former retail segment upon acquisition and was allocated to the Arlo segment under its current reporting structure, is primarily attributable to expected synergies resulting from the acquisition.

In connection with the acquisition, the Company recorded $0.3 million of deferred tax liabilities net of deferred tax assets. The deferred tax liabilities were recorded for the book basis of intangible assets for which the Company has no tax basis. The deferred tax liabilities are reduced by the tax benefit of the 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 Company designated $5.5 million of the acquired intangibles as software technology and a further $0.2 million of the acquired intangibles as database. The valuations were arrived at using the replacement cost method, with consideration having been given to the estimated time, investment and resources required to recreate the acquired intangibles. A discount rate of 15.0% was used in the valuation of each intangible. The acquired intangibles are being amortized over an estimated useful life of four years.

The Company designated $0.3 million of the acquired intangibles 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 20.0%. The acquired agreements are being amortized over an estimated useful life of three years.

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

Note 4. Balance Sheet Components

Available-for-sale short-term investments

	As of July 2, 2017				December 31, 2016			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
	(In thousands)							
U.S. treasuries	$112,987	$ —	$ (113)	$112,874	$123,869	$ 9	$ (40)	$123,838
Certificates of deposit	158	—	—	158	148	—	—	148
Total	$113,145	$ —	$ (113)	$113,032	$124,017	$ 9	$ (40)	$123,986

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

Accounts receivable, net

	As of July 2, 2017	December 31, 2016
	(In thousands)	
Gross accounts receivable	$323,291	$ 333,080
Allowance for doubtful accounts	(1,256)	(1,255)
Allowance for sales returns	(15,029)	(13,506)
Allowance for price protection	(2,418)	(4,480)
Total allowances	(18,703)	(19,241)
Total accounts receivable, net	$304,588	$ 313,839

Inventories

	As of July 2, 2017	December 31, 2016
	(In thousands)	
Raw materials	$3,691	$ 4,596
Work in process	5	—
Finished goods	260,077	243,266
Total inventories	$263,773	$ 247,862

The Company records provisions for excess and obsolete inventory based on assumptions about future demand and market conditions. 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 July 2, 2017	As of December 31, 2016
	(In thousands)	
Computer equipment	$10,174	$ 10,557
Furniture, fixtures and leasehold improvements	21,324	20,827
Software	28,789	28,663
Machinery and equipment	57,073	63,446
Total property and equipment, gross	117,360	123,493
Accumulated depreciation and amortization	(98,531)	(104,020)
Total property and equipment, net	$18,829	$ 19,473

Depreciation and amortization expense pertaining to property and equipment was $3.1 million and $6.5 million for the three and six months ended July 2, 2017, respectively, and $4.2 million and $8.1 million for the three and six months ended July 3, 2016, respectively.

Intangibles, net

	As of July 2, 2017		
	Gross	Accumulated Amortization	Net
	(In thousands)		
Technology	$66,599	$ (60,920)	$5,679
Customer contracts and relationships	56,500	(33,918)	22,582
Other	11,045	(9,091)	1,954
Total intangibles, net	$134,144	$ (103,929)	$30,215

	As of December 31, 2016		
	Gross	Accumulated Amortization	Net
	(In thousands)		
Technology	$66,599	$ (57,381)	$9,218
Customer contracts and relationships	56,500	(30,375)	26,125
Other	11,045	(8,489)	2,556
Total intangibles, net	$134,144	$ (96,245)	$37,899

Amortization of intangibles was $3.2 million and $7.7 million for the three and six months ended July 2, 2017, respectively, and $4.3 million and $8.5 million for the three and six months ended July 3, 2016, respectively.

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

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

	As of July 2, 2017
	(In thousands)
2017 (remaining six months)	$ 5,227
2018	9,396
2019	7,544
2020	6,622
2021	1,413
Thereafter	13
Total estimated amortization expense	$ 30,215

Goodwill

As discussed in Note 11, Segment Information, during the first quarter of fiscal 2017, the Company's Chief Operating Decision Maker requested changes in the information that he regularly reviews for purposes of allocating resources and assessing performance. With these changes, the Company revised its reportable segments. Beginning fiscal 2017, the Company operates and reports in three segments: Arlo, Connected Home, and Small and Medium Business ("SMB"). Goodwill was reallocated to the reportable segments using a relative fair value approach. As a result, the Company completed assessments of any potential goodwill impairment for all reportable segments immediately prior to and after the reallocation and determined that no impairment existed.

The carrying amount of goodwill under these segments during the six months ended July 2, 2017 are as follows:

	Arlo	Connected Home	SMB	Total
	(In thousands)			
Goodwill as of January 1, 2017	$21,149	$ 28,035	$36,279	$85,463
Goodwill as of July 2, 2017	$21,149	$ 28,035	$36,279	$85,463

Other non-current assets

	As of July 2, 2017	December 31, 2016
	(In thousands)	
Non-current deferred income taxes	$70,168	$ 70,859
Other	9,325	7,977
Total other non-current assets	$79,493	$ 78,836

Other accrued liabilities

	As of	
	July 2, 2017	December 31, 2016
	(In thousands)	
Sales and marketing	$72,026	$ 74,330
Warranty obligation	60,451	58,520
Freight	5,510	8,980
Other	35,727	28,844
Total other accrued liabilities	$173,714	$ 170,674

Note 5. Derivative Financial Instruments

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

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

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

The fair values of the Company’s derivative instruments and the line items on the unaudited condensed consolidated balance sheets to which they were recorded as of July 2, 2017 and December 31, 2016 are summarized as follows:

Derivative Assets	Balance Sheet Location	Fair Value at July 2, 2017	Balance Sheet Location	Fair Value at

				December 31, 2016
		(In thousands)		(In thousands)
Derivative assets not designated as hedging instruments	Prepaid expenses and other current assets	$ 438	Prepaid expenses and other current assets	$ 5,873
Derivative assets designated as hedging instruments	Prepaid expenses and other current assets	1,237	Prepaid expenses and other current assets	2,890
Total		$ 1,675		$ 8,763

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Derivative Liabilities	Balance Sheet Location	Fair Value at July 2, 2017	Balance Sheet Location	Fair Value at December 31, 2016
		(In thousands)		(In thousands)
Derivative liabilities not designated as hedging instruments	Other accrued liabilities	$ 2,935	Other accrued liabilities	$ 1,002
Derivative liabilities designated as hedging instruments	Other accrued liabilities	6,365	Other accrued liabilities	703
Total		$ 9,300		$ 1,705

For details of the Company’s fair value measurements, see Note 12, Fair Value Measurements.

Offsetting Derivative Assets and Liabilities

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

The following tables set forth the offsetting of derivative assets as of July 2, 2017 and December 31, 2016:

				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
As of July 2, 2017	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Assets Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Pledged	Net Amount
	(In thousands)					
Bank of America	$ 1,180	$ —	$ 1,180	$ (1,180)	$ —	$ —
Wells Fargo	495	—	495	(495)	—	—
Total	$ 1,675	$ —	$ 1,675	$ (1,675)	$ —	$ —

As of December 31, 2016				Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets		
	Gross Amounts of	Gross Amounts Offset in the	Net Amounts Of Assets Presented in	Financial Instruments	Cash Collateral Pledged	Net Amount

	Recognized Assets	Condensed Consolidated Balance Sheets	the Condensed Consolidated Balance Sheets			
	(In thousands)					
J.P. Morgan Chase	$ 1,492	$ —	$ 1,492	$ (442)	$ —	$ 1,050
Wells Fargo	7,271	—	7,271	(1,263)	—	6,008
Total	$ 8,763	$ —	$ 8,763	$ (1,705)	$ —	$ 7,058

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NETGEAR, INC.
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The following tables set forth the offsetting of derivative liabilities as of July 2, 2017 and December 31, 2016:

As of July 2, 2017	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Cash Collateral Pledged	Net Amount
	(In thousands)					
Bank of America	$6,587	$ —	$ 6,587	$ (1,180)	$ —	$ 5,407
Wells Fargo	2,713	—	2,713	(495)	—	2,218
Total	$9,300	$ —	$ 9,300	$ (1,675)	$ —	$ 7,625

As of December 31, 2016	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Condensed Consolidated Balance Sheets	Net Amounts Of Liabilities Presented in the Condensed Consolidated Balance Sheets	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheets: Financial Instruments	Cash Collateral Pledged	Net Amount
	(In thousands)					
J.P. Morgan Chase	$442	$ —	$ 442	$ (442)	$ —	$ —
Wells Fargo	1,263	—	1,263	(1,263)	—	—
Total	$1,705	$ —	$ 1,705	$ (1,705)	$ —	$ —

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 five to eleven months. The Company enters into about ten forward contracts per quarter with an average size of approximately $8.0 million USD equivalent related to its cash flow hedging program.

The Company expects to reclassify to earnings all of the amounts recorded in OCI associated with its cash flow hedges over the next twelve months. OCI associated with cash flow hedges of foreign currency revenue is recognized as a component of net revenue in the same period as the related revenue is recognized. OCI associated with cash flow hedges of foreign currency costs of revenue and operating expenses are recognized as a component of cost of revenue and operating expense in the same period as the related costs of revenue and operating expenses are recognized.

Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur within the designated hedge period or if not recognized within 60 days following the end of the hedge period. Deferred gains and losses in OCI with such derivative instruments are reclassified immediately into earnings through other income (expense), net. Any subsequent changes in fair value of such derivative instruments also are reflected in current earnings unless they are re-designated as hedges of other transactions. The Company did not recognize any material net gains or losses related to the loss of hedge designation as there were no discontinued cash flow hedges during the six months ended July 2, 2017 and July 3, 2016.

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The pre-tax effects of the Company’s derivative instruments on OCI and the unaudited condensed consolidated statement of operations for the three and six months ended July 2, 2017 and July 3, 2016 are summarized as follows:

	Three Months Ended July 2, 2017				
Derivatives Designated as Hedging Instruments	Gains (Losses) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gains (Losses) Reclassified from OCI into Income - Effective Portion [1]	Location of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing
	(In thousands)				
Cash flow hedges:					
Foreign currency forward contracts	$(6,935)	Net revenue	$ (1,008)	Other income (expense), net	$ 381
Foreign currency forward contracts	—	Cost of revenue	(1)	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	77	Other income (expense), net	—
Total	$(6,935)		$ (932)		$ 381

[1] Refer to Note 9, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

	Six Months Ended July 2, 2017				
Derivatives Designated as Hedging Instruments	Gains (Losses) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gains (Losses) Reclassified from OCI into Income - Effective Portion [1]	Location of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing
	(In thousands)				
Cash flow hedges:					
Foreign currency forward contracts	$(7,052)	Net revenue	$ 1,027	Other income (expense), net	$ 668
Foreign currency forward contracts	—	Cost of revenue	(14)	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(365)	Other income (expense), net	—
Total	$(7,052)		$ 648		$ 668

[1] Refer to Note 9, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

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

	Three Months Ended July 3, 2016				
Derivatives Designated as Hedging Instruments	Gains (Losses) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gains (Losses) Reclassified from OCI into Income - Effective Portion [1]	Location of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing
	(In thousands)				
Cash flow hedges:					
Foreign currency forward contracts	$88	Net revenue	$ (407)	Other income (expense), net	$ 18
Foreign currency forward contracts	—	Cost of revenue	(2)	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	(14)	Other income (expense), net	—
Total	$88		$ (423)		$ 18

[1] Refer to Note 9, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

	Six Months Ended July 3, 2016				
Derivatives Designated as Hedging Instruments	Gains (Losses) Recognized in OCI - Effective Portion	Location of Gain (Loss) Reclassified from OCI into Income - Effective Portion	Gains (Losses) Reclassified from OCI into Income - Effective Portion [1]	Location of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing	Amount of Gains (Losses) Recognized in Income and Excluded from Effectiveness Testing
	(In thousands)				
Cash flow hedges:					
Foreign currency forward contracts	$(699)	Net revenue	$ (719)	Other income (expense), net	$ 53
Foreign currency forward contracts	—	Cost of revenue	—	Other income (expense), net	—
Foreign currency forward contracts	—	Operating expenses	56	Other income (expense), net	—
Total	$(699)		$ (663)		$ 53

[1] Refer to Note 9, Stockholders' Equity, which summarizes the accumulated other comprehensive income activity related to derivatives.

Non-designated hedges

The Company enters into non-designated hedges under the authoritative guidance for derivatives and hedging to manage the exposure of non-functional currency monetary assets and liabilities held on its financial statements to fluctuations in foreign currency exchange rates, as well as to reduce volatility in other income and expense. The non-designated hedges are generally expected to offset the changes in value of its net non-functional currency asset and liability position resulting from foreign exchange rate fluctuations. Foreign currency denominated accounts receivable and payable are hedged with non-designated hedges when the related anticipated foreign revenue and expenses are recognized in the Company’s financial statements. The Company also hedges certain non-functional currency monetary assets and liabilities that may not be incorporated into the cash flow hedge program. The Company adjusts its non-designated hedges monthly and enters into about four non-designated derivatives per quarter. The average size of its non-designated hedges is approximately $2.0