

NETGEAR, INC  
Form 10-Q  
November 09, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q**

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

For the quarterly period ended September 30, 2007.

**.. 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

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**NETGEAR, Inc.**

*(Exact name of registrant as specified in its charter)*

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**Delaware**  
*(State or other jurisdiction of*

*incorporation or organization)*

**4500 Great America Parkway,**

**Santa Clara, California**  
*(Address of principal executive offices)*

**77-0419172**  
*(IRS Employer*

*Identification No.)*

**95054**  
*(Zip Code)*

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(408) 907-8000

*(Registrant's telephone number including area code)*

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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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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 35,172,161 as of November 2, 2007.

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

	September 30, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 99,912	\$ 87,736
Short-term investments	77,330	109,729
Accounts receivable, net	139,968	119,601
Inventories	79,307	77,932
Deferred income taxes	12,820	13,415
Prepaid expenses and other current assets	21,744	15,946
<b>Total current assets</b>	<b>431,081</b>	<b>424,359</b>
Property and equipment, net	9,455	6,568
Intangibles, net	17,503	975
Goodwill	41,962	3,800
Other non-current assets	44	2,202
<b>Total assets</b>	<b>\$ 500,045</b>	<b>\$ 437,904</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 33,329	\$ 39,818
Accrued employee compensation	13,840	11,803
Other accrued liabilities	78,159	75,909
Deferred revenue	7,755	8,215
Income taxes payable		7,737
<b>Total current liabilities</b>	<b>133,083</b>	<b>143,482</b>
Deferred income tax liability	4,726	
Non-current income taxes payable	7,802	
<b>Total liabilities</b>	<b>145,611</b>	<b>143,482</b>
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Common stock	34	33
Additional paid-in capital	247,779	221,487
Cumulative other comprehensive gain (loss)	127	(5)
Retained earnings	106,494	72,907
<b>Total stockholders' equity</b>	<b>354,434</b>	<b>294,422</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 500,045</b>	<b>\$ 437,904</b>

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

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>	<b>October 1,</b>	<b>September 30,</b>	<b>October 1,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Net revenue	\$ 191,681	\$ 151,571	\$ 529,528	\$ 409,568
Cost of revenue (1)	127,903	101,013	349,766	269,085
<b>Gross profit</b>	<b>63,778</b>	<b>50,558</b>	<b>179,762</b>	<b>140,483</b>
Operating expenses:				
Research and development (1)	7,816	4,675	20,881	13,196
Sales and marketing (1)	30,509	23,522	86,756	66,944
General and administrative (1)	6,781	5,762	20,643	15,176
In-process research and development		2,900	4,100	2,900
Litigation reserves	202		202	
<b>Total operating expenses</b>	<b>45,308</b>	<b>36,859</b>	<b>132,582</b>	<b>98,216</b>
<b>Income from operations</b>	<b>18,470</b>	<b>13,699</b>	<b>47,180</b>	<b>42,267</b>
Interest income	1,860	1,676	6,424	5,017
Other income (expense), net	1,732	(315)	3,152	606
<b>Income before income taxes</b>	<b>22,062</b>	<b>15,060</b>	<b>56,756</b>	<b>47,890</b>
Provision for income taxes	8,796	7,080	23,336	20,207
<b>Net income</b>	<b>\$ 13,266</b>	<b>\$ 7,980</b>	<b>\$ 33,420</b>	<b>\$ 27,683</b>
<b>Net income per share:</b>				
Basic	\$ 0.38	\$ 0.24	\$ 0.96	\$ 0.83
Diluted	\$ 0.37	\$ 0.23	\$ 0.94	\$ 0.81
<b>Weighted average shares outstanding used to compute net income per share:</b>				
Basic	35,045	33,443	34,679	33,246
Diluted	35,955	34,466	35,742	34,354

(1) Stock-based compensation expense was allocated as follows:

Cost of revenue	\$ 160	\$ 118	\$ 448	\$ 311
Research and development	694	331	1,692	725
Sales and marketing	781	359	2,319	955
General and administrative	731	443	2,098	1,096

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

**Table of Contents****NETGEAR, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Nine Months Ended	
	September 30, 2007	October 1, 2006
<b>Cash flows from operating activities:</b>		
Net income	\$ 33,420	\$ 27,683
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	10,051	5,772
Accretion of purchase discounts on investments	(953)	(1,447)
Non-cash stock-based compensation	6,557	3,087
Income tax benefit associated with stock option exercises	7,915	1,540
Excess tax benefit from stock-based compensation	(6,715)	(1,217)
Deferred income taxes	1,328	(3,717)
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(19,165)	(13,511)
Inventories	2,129	(25,900)
Prepaid expenses and other assets	(5,758)	(9,093)
Accounts payable	(7,186)	(7,816)
Accrued employee compensation	1,641	1,149
Other accrued liabilities	1,151	(3,063)
Deferred revenue	(480)	8,228
Income taxes payable	311	1,245
Net cash provided by (used in) operating activities	24,246	(17,060)
<b>Cash flows from investing activities:</b>		
Purchases of short-term investments	(75,670)	(122,010)
Proceeds from sale of short-term investments	109,235	99,116
Purchase of property and equipment	(6,639)	(5,431)
Payments made in connection with business acquisition, net of cash acquired	(57,443)	(7,600)
Net cash used in investing activities	(30,517)	(35,925)
<b>Cash flows from financing activities:</b>		
Purchase and retirement of treasury stock	(88)	
Proceeds from exercise of stock options	10,614	3,646
Proceeds from issuance of common stock under employee stock purchase plan	1,206	1,100
Excess tax benefit from stock-based compensation	6,715	1,217
Net cash provided by financing activities	18,447	5,963
Net increase (decrease) in cash and cash equivalents	12,176	(47,022)
Cash and cash equivalents, at beginning of period	87,736	90,002
Cash and cash equivalents, at end of period	\$ 99,912	\$ 42,980

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 Summary of Significant Accounting Policies**

NETGEAR, Inc. was incorporated in Delaware in January 1996. NETGEAR, Inc. together with its subsidiaries (collectively, NETGEAR or the Company) designs, develops and markets networking products that address the specific needs of small businesses and homes, enabling users to share Internet access, peripherals, files and digital content and applications among multiple networked devices. The Company's products include Ethernet networking products, broadband access products and wireless networking connectivity products that are sold worldwide through distributors, traditional retailers, online retailers, direct market resellers, or DMRs, value added resellers, or 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 at December 31, 2006 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 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, 2006.

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 the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates and operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Other than the Company's accounting policy relating to income taxes presented below, the Company's significant accounting policies have not materially changed during the nine months ended September 30, 2007.

*Income Taxes*

The Company accounts for income taxes under an asset and liability approach. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year. In addition, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences resulting from different treatments for tax versus accounting of certain items, such as accruals and allowances not currently deductible for tax purposes. The Company must then assess the likelihood that the Company's deferred tax assets will be recovered from future taxable income and to the extent the Company believes that recovery is not more likely than not, the Company must establish a valuation allowance.

As discussed in Note 9, effective January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). In the ordinary course of business there is inherent uncertainty in assessing the Company's income tax positions. The Company assesses its tax positions and records benefits for all years subject to examination based on management's evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where it is more likely than not that a tax benefit will be sustained, the Company records the largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more likely than not that a tax benefit will be sustained, no tax benefit has been recorded in the financial statements. Where applicable, associated interest and penalties have also been recognized as a component of income tax expense.



**Table of Contents****2. Recent Accounting Pronouncements**

In September 2006, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements ( SFAS 157 ), which defines fair value, establishes guidelines for measuring fair value, and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 157 on the consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 also amends certain provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting SFAS 159 on the consolidated financial statements.

**3. Business Acquisition**

On May 16, 2007, the Company completed the acquisition of 100% of the outstanding shares of Infrant Technologies, Inc. ( Infrant ), a developer of network attached storage products. The Company believes the acquisition will accelerate the Company s participation in the expanding market for network attached storage. The aggregate purchase price was \$60 million, paid in cash. Infrant shareholders may receive a total additional payout of up to \$20 million in cash over the three years following closure of the acquisition if specific revenue targets are reached. Any additional payout will primarily be accounted for as additional purchase price and will be recorded as an increase in goodwill.

The results of Infrant s operations have been included in the consolidated financial statements since the date of acquisition. The historical results of Infrant prior to the acquisition were not material to the Company s results of operations.

The accompanying condensed consolidated financial statements reflect a purchase price of approximately \$60.2 million, consisting of cash, and other costs directly related to the acquisition as follows (in thousands):

Purchase price	\$ 60,000
Direct acquisition costs	229
<b>Total consideration</b>	<b>\$ 60,229</b>

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In accordance with the purchase method of accounting, the Company allocated the total purchase price to tangible assets, liabilities and identifiable intangible assets based on their estimated fair values. Goodwill was recorded based on the residual purchase price after allocating the purchase price to the fair market value of tangible and intangible assets acquired less liabilities assumed. Goodwill arises as a result of, among other factors, future unidentified new products and new technologies as well as the implicit value of future cost savings as a result of the combining of entities. Purchased intangibles are amortized on a straight-line basis over their respective estimated useful lives. The total allocation of the purchase price is as follows (in thousands):

	<b>Fair Value on May 16, 2007</b>
Cash and cash equivalents	\$ 2,787
Accounts receivable, net	1,202
Inventories	3,504
Deferred income taxes	667
Prepaid expenses and other current assets	36
Property and equipment, net	128
Intangibles, net	22,700
Goodwill	38,160
Accounts payable	(697)
Accrued employee compensation	(396)
Other accrued liabilities	(1,019)
Deferred revenue	(20)
Income taxes payable	(9)
Deferred income tax liability	(6,814)
<b>Total purchase price allocation</b>	<b>\$ 60,229</b>

The goodwill of \$38.2 million recorded on the acquisition of Infrant is not deductible for income tax purposes.

A total of \$4.1 million of the \$22.7 million in acquired intangible assets was designated as in-process research and development ( in-process R&D ). In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist. The Company acquired three in-process R&D projects. Two projects involve development of new products in the ReadyNAS desktop product category, and one project involves development of a higher end version of a product currently selling in the ReadyNAS rack mount product category. These three projects required further research and development to determine technical feasibility and commercial viability. The fair value assigned to in-process R&D was determined using the income approach, under which the Company considered the importance of products under development to the Company's overall development plans, estimated the costs to develop the purchased in-process R&D into commercially viable products, estimated the resulting net cash flows from the products when completed and discounted the net cash flows to their present values. The Company used discount rates ranging from 36% to 38% in the present value calculations, which was derived from a weighted-average cost of capital analysis, adjusted to reflect additional risks related to the products' development and success as well as the products' stage of completion. The estimates used in valuing in-process R&D were based upon assumptions believed to be reasonable but which are inherently uncertain and unpredictable. These assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur. Accordingly, actual results may vary from the projected results.

A total of \$10.8 million of the \$22.7 million in acquired intangible assets was designated as existing technology. The value was calculated based on the present value of the future estimated cash flows derived from projections of future revenue attributable to existing technology. This \$10.8 million will be amortized over its estimated useful life of four years.

A total of \$5.2 million of the \$22.7 million in acquired intangible assets was designated as core technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated royalty savings attributable to the core technology. This \$5.2 million will be amortized over its estimated useful life of four years.

A total of \$2.6 million of the \$22.7 million in acquired intangible assets was designated as trademarks. The value was calculated based on the present value of the future estimated cash flows derived from estimated royalty savings attributable to the trademarks. This \$2.6 million will be amortized over its estimated useful life of six years.



**Table of Contents****4. Stock-based Compensation**

The Company grants options and restricted stock units from the 2006 Long Term Incentive Plan, under which awards may be granted to all employees. In addition, the Company's stock option program includes the 2003 Stock Plan, from which the Company does not currently grant awards, but may choose to do so. Award vesting periods for these plans are generally four years. As of September 30, 2007, 888,530 shares were reserved for future grants under these plans.

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

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option valuation model and the weighted average assumptions in the following table. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk free interest rate is based on the implied yield currently available on U.S. Treasury securities with an equivalent remaining term. Expected volatility is based on a combination of the historical volatility of the Company's stock as well as the historical volatility of certain of the Company's industry peers' stock:

	Stock Options Three Months Ended		Stock Options Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Expected life (in years)	4.5	4.9	4.5	4.9
Risk-free interest rate	4.54%	4.88%	4.60%	4.89%
Expected volatility	52%	59%	54%	61%
Dividend yield				

As of September 30, 2007, \$20.8 million of total unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 1.59 years. Additionally, \$3.2 million of total unrecognized compensation cost related to non-vested restricted stock awards, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 1.38 years.

**Table of Contents****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 repair or 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 contract manufacturers, in certain cases the Company has recourse to the contract manufacturer for replacement or credit for the defective products. The Company gives consideration to amounts recoverable from its contract manufacturers in determining its warranty liability. The Company assesses the adequacy of its warranty liability every quarter and, as necessary, makes adjustments to the liability. Changes in the Company's warranty liability, which is included as a component of "Other accrued liabilities" in the condensed consolidated balance sheets, are as follows (in thousands):

	<b>Nine Months Ended</b>	
	<b>September 30, 2007</b>	<b>October 1, 2006</b>
Balance as of beginning of the period	\$ 21,299	\$ 11,845
Provision for warranty liability made during the period	29,579	28,322
Warranty obligation assumed in acquisition	432	
Settlements made during the period	(28,312)	(25,182)
<b>Balance at end of period</b>	<b>\$ 22,998</b>	<b>\$ 14,985</b>

**6. Shipping and Handling Fees and Costs**

The Company includes shipping and handling fees billed to customers in net revenue. Shipping and handling costs associated with inbound freight are included in cost of revenue. Shipping and handling costs associated with outbound freight are included in sales and marketing expenses and totaled \$2.9 million for the three months ended September 30, 2007, \$2.1 million for the three months ended October 1, 2006, \$8.7 million for the nine months ended September 30, 2007, and \$6.4 million for the nine months ended October 1, 2006.

**7. Balance Sheet Components**

Accounts receivable, net:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
	<b>(In thousands)</b>	
Gross accounts receivable	\$ 151,881	\$ 132,651
Less: Allowance for doubtful accounts	(1,844)	(1,727)
Allowance for sales returns	(8,291)	(8,129)
Allowance for price protection	(1,778)	(3,194)
<b>Total allowances</b>	<b>(11,913)</b>	<b>(13,050)</b>
Accounts receivable, net	\$ 139,968	\$ 119,601





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Inventories:

	September 30, 2007	December 31, 2006
	(In thousands)	
Raw materials	\$ 323	\$
Work in process		
Finished goods	78,984	77,932
Total	\$ 79,307	\$ 77,932

Other accrued liabilities:

	September 30, 2007	December 31, 2006
	(In thousands)	
Sales and marketing programs	\$ 35,275	\$ 38,058
Warranty obligation	22,998	21,299
Freight	4,083	4,073
Other	15,803	12,479
Other accrued liabilities	\$ 78,159	\$ 75,909

**8. Net Income Per Share**

Basic net income per share is computed by dividing the net income for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of shares of common stock and potentially dilutive common stock outstanding during the period. Potentially dilutive common shares include outstanding stock options and unvested restricted stock awards, which are reflected in diluted net income per share by application of the treasury stock method. Under the treasury stock method, the amount that the employee must pay for exercising stock options, the amount of stock-based compensation cost for future services that the Company has not yet recognized, and the amount of tax benefit that would be recorded in additional paid-in capital upon exercise are assumed to be used to repurchase shares.

Net income per share for the three and nine months ended September 30, 2007 and October 1, 2006 are as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Net income	\$ 13,266	\$ 7,980	\$ 33,420	\$ 27,683
Weighted average shares outstanding:				
Basic	35,045	33,443	34,679	33,246
Dilutive potential common shares	910	1,023	1,063	1,108
Total diluted	35,955	34,466	35,742	34,354
Basic net income per share	\$ 0.38	\$ 0.24	\$ 0.96	\$ 0.83

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Diluted net income per share	\$ 0.37	\$ 0.23	\$ 0.94	\$ 0.81
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Weighted average stock options and unvested restricted stock awards to purchase 1,053,881 and 909,999 shares of the Company's stock for the three and nine months ended September 30, 2007, respectively, and 996,002 and 639,641 shares for the three and nine months ended October 1, 2006, respectively, were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive.

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**9. Income taxes**

The effective tax rate was 39.9% and 41.1% for the three and nine months ended September 30, 2007, respectively. The effective tax rate was 47.0% and 42.2% for the three and nine months ended October 1, 2006, respectively. The decrease in the effective tax rate for the three months ended September 30, 2007 compared to the three months ended October 1, 2006 was primarily caused by certain non-recurring charges related to the acquisition of SkipJam Corp. ( SkipJam ) incurred during the three months ended October 1, 2006 that were non-deductible for tax purposes.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of adoption, the Company recognized a decrease in income tax liabilities of approximately \$255,000 and a corresponding increase in retained earnings as of January 1, 2007. As of the date of adoption, the Company had gross unrecognized tax benefits of \$5.6 million and accrued interest expense of \$294,000. The total amount of tax and accrued interest as of January 1, 2007 that, if recognized, would affect the effective tax rate was \$2.6 million and \$177,000, respectively. Consistent with the provisions of FIN 48, the Company reclassified \$5.9 million of current income tax liabilities resulting in a \$4.9 million increase to non-current income taxes payable and \$1.0 million decrease to non-current deferred tax assets. The Company recognizes interest and penalties accrued related to unrecognized tax benefits in income tax expense. As of September 30, 2007, the liability for unrecognized tax benefits, net of federal impacts on state tax issues, is \$7.8 million. No unrecognized tax benefit is expected to be paid within one year, nor can the Company make a reliable estimate when cash settlement with a taxing authority may occur.

For the three and nine month period ended September 30, 2007, the increase in unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$1.6 million and \$4.8 million, respectively. The increase in accrued interest expense for the same period was \$61,000 and \$183,000, respectively.

The Company conducts business globally and, as a result, the Company and its subsidiaries or branches file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business the Company is subject to examination by taxing authorities throughout the world, including such major jurisdictions as the United States and Ireland. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations for years before 2002.

During the three months ended September 30, 2007, the federal statute of limitations for the Company's 2003 tax year closed. An immaterial amount of income tax liabilities related to issues considered effectively settled with respect to the 2003 tax year was released during the three months ended September 30, 2007.

**10. Segment Information, Operations by Geographic Area and Significant Customers**

Operating segments are components of an enterprise about which separate financial information is available and is regularly evaluated by management, namely the chief operating decision maker of an organization, in order to determine operating and resource allocation decisions. By this definition, the Company operates in one business segment, which comprises the development, marketing and sale of networking products for the small business and home markets. The Company's headquarters and a significant portion of its operations are located in the United States. The Company also conducts sales, marketing, customer service activities and certain distribution center activities through several small sales offices in Europe, Middle-East and Africa ( EMEA ) and Asia as well as outsourced distribution centers.

For reporting purposes revenue is attributed to each geography based on the geographic location of the customer. Net revenue by geography comprises gross revenue less such items as end-user customer rebates and other sales incentives deemed to be a reduction of net revenue per Emerging Issues Task Force ( EITF ) Issue No. 01-9, sales returns and price protection.

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Net revenue by geographic location is as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
North America	\$ 76,357	\$ 56,119	\$ 204,203	\$ 169,026
United Kingdom	46,770	45,142	143,108	94,275
EMEA (excluding U.K.)	48,779	36,498	130,148	103,996
Asia Pacific and rest of the world	19,775	13,812	52,069	42,271
	\$ 191,681	\$ 151,571	\$ 529,528	\$ 409,568

Long-lived assets, comprising fixed assets, are reported based on the location of the asset. Long-lived assets by geographic location are as follows (in thousands):

	September 30, 2007	December 31, 2006
North America	\$ 7,529	\$ 4,878
EMEA	521	592
Asia Pacific and rest of the world	1,405	1,098
	\$ 9,455	\$ 6,568

Significant customers are as follows (as a percentage of net revenue):

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Ingram Micro, Inc.	19%	18%	18%	20%
Tech Data Corporation	14%	15%	14%	16%
All others individually less than 10% of net revenue	67%	67%	68%	64%
	100%	100%	100%	100%

**11. Commitments and Contingencies*****Litigation and Other Legal Matters******NETGEAR v. CSIRO***

In May 2005, the Company filed a complaint for declaratory relief against the Commonwealth Scientific and Industrial Research Organization (CSIRO), in the San Jose division of the United States District Court, Northern District of California. The complaint alleges that the claims of CSIRO's U.S. Patent No. 5,487,069 are invalid and not infringed by any of the Company's products. CSIRO had asserted that the Company's wireless networking products implementing the IEEE 802.11a and 802.11g wireless LAN standards infringe its patent. In July 2006, United States Court of Appeals for the Federal Circuit affirmed the District Court's decision to deny CSIRO's motion to dismiss the action under the Foreign Sovereign Immunities Act. In September 2006, the Federal Circuit denied CSIRO's request for a rehearing en banc. CSIRO filed a response to the complaint in September 2006. In December 2006, the District Court granted CSIRO's motion to transfer the case to the Eastern District of Texas, where CSIRO had brought and won a similar lawsuit against Buffalo Technology (USA), Inc. which Buffalo is currently appealing. This action is in the discovery phase. A court-mandated mediation has been scheduled for the latter part of November 2007.

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### *SercoNet v. NETGEAR*

In May 2006, a lawsuit was filed against the Company by SercoNet, Ltd. ( SercoNet ), a manufacturer of computer networking products organized under the laws of Israel, in the United States District Court for the Southern District of New York. SercoNet

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alleges that the Company infringes U.S. Patent Nos. 5,841,360; 6,480,510; 6,970,538; 7,016,368; and 7,035,280. SercoNet has accused the Company of infringement with respect to certain of the Company's switches, routers, modems, adapters, power line products and wireless access points. In July 2006, the court granted the Company's motion to transfer the action to the Northern District of California. This action is in the discovery phase. In the second quarter of 2007, the court held a claim construction hearing whereby each side presented its interpretation of the claims in the patents being litigated. The court issued its claim construction rulings in the third quarter of 2007. In October 2007, without admitting any patent infringement, wrongdoing or violation of law and to avoid the distraction and expense of continued litigation, the Company agreed to settle the litigation. In exchange for a payment of \$850,000, the Company will receive a fully paid perpetual license to the SercoNet patents asserted in the lawsuit. Based on the historical and estimated projected future unit sales of the Company's products that are alleged to infringe the asserted patents, the Company allocated \$202,000 of the settlement cost towards product shipments prior to the settlement, which the Company recorded as a litigation settlement expense in the three months ended September 30, 2007. Additionally, the Company will allocate \$648,000 of the settlement cost to prepaid royalties which will be recognized as a component of cost of revenue as the related products are sold.

*Linex Technologies v. NETGEAR*

In June 2007, a lawsuit was filed against the Company by Linex Technologies, Inc. ( Linex ), a patent holding company organized under the laws of Delaware, in the U.S. District Court, Eastern District of Texas. Linex alleges that the Company infringes U.S. Patent No. 6,757,322. Linex has accused certain of the Company's wireless networking products incorporating multiple input/multiple output (MIMO) technology. Linex has also sued 14 other technology companies alleging similar claims of patent infringement. The Company filed its answer in the third quarter of 2007.

*Wi-Lan Inc. v. NETGEAR*

In October 2007, a lawsuit was filed against the Company by Wi-Lan Inc. ( Wi-Lan ), a patent holding company existing under the laws of Canada, in the U.S. District Court, Eastern District of Texas. Wi-Lan alleges that the Company infringes U.S. Patent Nos. 5,282,222, RE37,802 and 5,956,323. Wi-Lan has accused the Company's wireless products compliant with the IEEE 802.11 standards and ADSL products compliant with the ITU G.992 standards. Wi-Lan has also sued 21 other technology companies alleging similar claims of patent infringement. The Company is in the process of assessing the claims asserted by Wi-Lan.

*IP Indemnification Claims*

In addition, in its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers (the Indemnified Parties ) for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties that are asserted against the Indemnified Parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is generally unlimited. From time to time, the Company receives requests for indemnity and may choose to assume the defense of such litigation asserted against the Indemnified Parties.

In December 2005, the Company received a request for indemnification from Charter Communications, Inc. ( Charter ), a direct customer, related to a lawsuit filed in the U.S. District Court, Eastern District of Texas, by Hybrid Patents, Inc. ( Hybrid ), a patent holding company. Hybrid alleges that Charter infringes U.S. Patent Nos. 5,586,121, 5,818,845, 6,104,727 and Re. 35,774. Hybrid alleges that products implementing the Data Over Cable Service Interface Specification (DOCSIS) standard, which are supplied to Charter by, among others, the Company, infringes these patents. In the third quarter of 2006, the Company together with a number of other equipment suppliers to Charter assumed the defense of the litigation. In the second quarter of 2007, a jury found that the Hybrid patents were not infringed by Charter. Hybrid has filed similar lawsuits in the same jurisdiction against Comcast Corporation, Comcast of Dallas, LP, Time Warner Cable, Inc. and Cox Communications, Inc., all of whom are also customers of the Company.

In June 2006, the Company received a request for indemnification from Charter and Charter Communications Operating, LLC, related to a lawsuit filed in the U.S. District Court, Eastern District of Texas, by Rembrandt Technologies, L.P. ( Rembrandt ), a patent holding company. Rembrandt alleges that Charter infringes U.S. Patent Nos. 5,243,627, 5,852,631, 5,719,858 and 4,937,819. Rembrandt alleges that products implementing the DOCSIS standard, which are supplied to Charter by, among others, the Company, infringes these patents. Rembrandt has also filed a similar lawsuit in the same jurisdiction against Comcast Corporation, Comcast Cable Communications, LLC and Comcast of Plano, LP.

With respect to all of the above described claims against the Company, or filed by the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of



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significant operational resources. Were an unfavorable outcome to occur, there exists the possibility it would have a material adverse impact on the Company's financial position and results of operations for the period in which the unfavorable outcome occurs or becomes probable. In addition, the Company is subject to legal proceedings, claims and litigation arising in the ordinary course of business, including litigation related to intellectual property and employment matters.

While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

### ***Environmental Regulation***

The European Union ( EU ) has enacted the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods, including home and small business networking products, financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. The deadline for the individual member states of the EU to enact the directive in their respective countries was August 13, 2004 (such legislation, together with the directive, the WEEE Legislation ). Producers participating in the market are financially responsible for implementing these responsibilities under the WEEE Legislation beginning in August 2005. Similar WEEE Legislation has been or may be enacted in other jurisdictions, including in the United States, Canada, Mexico, China and Japan. The Company adopted FASB Staff Position ( FSP ) SFAS No. 143-1, Accounting for Electronic Equipment Waste Obligations , in the third quarter of fiscal 2005 and has determined that its effect did not have a material impact on its consolidated results of operations and financial position for the three and nine months ended September 30, 2007 and the three and nine months ended October 1, 2006. The Company is continuing to evaluate the impact of the WEEE Legislation and similar legislation in other jurisdictions as individual countries issue their implementation guidance.

Additionally, the EU has enacted the Restriction of Hazardous Substances Directive ( RoHS Legislation ). The RoHS Legislation, along with similar legislation in China, prohibits the use of certain substances, including mercury and lead, in certain products put on the market after July 1, 2006. The Company believes it has met the requirements of the RoHS Legislation.

### ***Employment Agreements***

The Company has signed various employment agreements with key executives pursuant to which if their employment is terminated without cause, the employees are entitled to receive their base salary (and commission or bonus, as applicable) for 52 weeks (for the Chief Executive Officer) and up to 26 weeks (for other key executives). Such employees will continue to have stock options vest for up to a one year period following the termination. If the termination, without cause, occurs within one year of a change in control, the officer is entitled to two years acceleration of any unvested portion of his or her stock options.

### ***Leases***

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

### ***Guarantees and Indemnifications***

The Company has entered into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31 to 45 days prior to the expected shipment date. Orders are non-cancelable within 30 days prior to the expected shipment date. At September 30, 2007, the Company had \$65.5 million in non-cancelable purchase commitments with suppliers. The Company expects to sell all products for which it has committed purchases from suppliers.

The Company, as permitted under Delaware law and in accordance with its Bylaws, indemnifies its officers and directors for certain events or occurrences, subject to certain limits, while the officer or director is or was serving at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential future indemnification is unlimited; however, the Company has a Director and Officer Insurance Policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the fair value of these indemnification agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2007.





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In its sales agreements, the Company typically agrees to indemnify its direct customers, distributors and resellers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. The Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2007.

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations** **Forward-looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, the words believes, anticipates, plans, expects, intends and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a discrepancy include, but are not limited to, those discussed in Part II Item 1A Risk Factors and Liquidity and Capital Resources below. All forward-looking statements in this document are based on information available to us as of the date hereof and we assume no obligation to update any such forward-looking statements. The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and the accompanying notes contained in this quarterly report. Unless expressly stated or the context otherwise requires, the terms we, our, us and NETGEAR refer to NETGEAR, Inc. and its subsidiaries.*

#### **Overview**

We design, develop and market innovative networking products that address the specific needs of small business and home users. We define small business as a business with fewer than 250 employees. We are focused on satisfying the ease-of-use, reliability, performance and affordability requirements of these users. Our product offerings enable users to share Internet access, peripherals, files, digital multimedia content and applications among multiple networked devices and other Internet-enabled devices.

Our product line consists of wired and wireless devices that enable Ethernet networking, broadband access and network connectivity. These products are available in multiple configurations to address the needs of our end-users in each geographic region in which our products are sold.

We sell our networking products through multiple sales channels worldwide, including traditional retailers, online retailers, wholesale distributors, direct market resellers ( DMRs ), value added resellers ( VARs ), and broadband service providers. Our retail channel includes traditional retail locations domestically and internationally, such as Best Buy, Circuit City, CompUSA, Fry's Electronics, Radio Shack, Staples, Argos (U.K.), Dixons (U.K.), PC World (U.K.), MediaMarkt (Germany, Austria) and FNAC (France). Online retailers include Amazon.com, Newegg.com and Buy.com. Our DMRs include Dell, CDW Corporation, Insight Corporation and PC Connection in domestic markets and Misco throughout Europe. In addition, we also sell our products through broadband service providers, such as multiple system operators in domestic markets and cable and DSL operators internationally. Some of these retailers and resellers purchase directly from us while most are fulfilled through wholesale distributors around the world. A substantial portion of our net revenue to date has been derived from a limited number of wholesale distributors, the largest of which are Ingram Micro Inc. and Tech Data Corporation. We expect that these wholesale distributors will continue to contribute a significant percentage of our net revenue for the foreseeable future.

Our net revenue grew 26.5% from the three months ended October 1, 2006 to the three months ended September 30, 2007. The increase in net revenue was primarily attributable to increased shipments in our small business switches and hubs product category as well as sales of our ReadyNAS products, which were acquired in connection with our acquisition of Infrant Technologies, Inc. ( Infrant ). We have also experienced growth in our home wireless product category.

The small business and home networking markets are intensely competitive and subject to rapid technological change. We expect our competition to continue to intensify. We believe that the principal competitive factors in the small business and home markets for networking products include product breadth, size and scope of the sales channel, brand name, timeliness of new product introductions, product performance, features, functionality and reliability, ease-of-installation, maintenance and use, and customer service and support. To remain competitive, we believe we must invest significant resources in developing new products, enhancing our current products, expanding our channels and maintaining customer satisfaction worldwide.



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Our gross margin decreased to 33.3% for the three months ended September 30, 2007, from 33.4% for the three months ended October 1, 2006. This decrease was primarily attributable to higher warranty costs associated with end-user warranty returns as well as amortization expense related to certain intangible assets acquired in connection with the Infranet acquisition. Operating expenses for the three months ended September 30, 2007 were \$45.3 million, or 23.7% of net revenue, compared to \$36.9 million, or 24.4% of net revenue, for the three months ended October 1, 2006. This increase was primarily attributable to a \$5.3 million increase in salary and other employee related expenses.

Net income increased \$5.3 million, or 66.2%, to \$13.3 million for the three months ended September 30, 2007, from \$8.0 million for the three months ended October 1, 2006. This increase was primarily attributable to an increase in gross profit of \$13.2 million, an increase in interest income of \$184,000 and an increase in other income of \$2.0 million. These increases were partially offset by an increase in operating expenses of \$8.4 million and an increase in the provision for income taxes of \$1.7 million.

**Results of Operations**

The following table sets forth the consolidated statements of operations and the percentage change for the three and nine months ended September 30, 2007, with the comparable reporting period in the preceding year.

	Three Months Ended			Nine Months Ended		
	September 30, 2007 (In thousands, except percentage data)	Percentage Change	October 1, 2006	September 30, 2007 (In thousands, except percentage data)	Percentage Change	October 1, 2006
Net revenue	\$ 191,681	26.5%	\$ 151,571	\$ 529,528	29.3%	\$ 409,568
Cost of revenue	127,903	26.6	101,013	349,766	30.0	269,085
Gross profit	63,778	26.1	50,558	179,762	28.0	140,483
Operating expenses:						
Research and development	7,816	67.2	4,675	20,881	58.2	13,196
Sales and marketing	30,509	29.7	23,522	86,756	29.6	66,944
General and administrative	6,781	17.7	5,762	20,643	36.0	15,176
In-process research and development		(100.0)	2,900	4,100	41.4	2,900
Litigation reserves	202	**		202	**	
Total operating expenses	45,308	22.9	36,859	132,582	35.0	98,216
Income from operations	18,470	34.8	13,699	47,180	11.6	42,267
Interest income	1,860	11.0	1,676	6,424	28.0	5,017
Other income (expense), net	1,732	**	(315)	3,152	420.1	606
Income before income taxes	22,062	46.5	15,060	56,756	18.5	47,890
Provision for income taxes	8,796	24.2	7,080	23,336	15.5	20,207
Net income	\$ 13,266	66.2%	\$ 7,980	\$ 33,420	20.7%	\$ 27,683

\*\* Percentage change not meaningful as prior year basis is zero or a negative amount.

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The following table sets forth the condensed consolidated statements of operations, expressed as a percentage of net revenue, for the periods indicated:

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Net revenue	100%	100%	100%	100%
Cost of revenue	66.7	66.6	66.1	65.7
Gross margin	33.3	33.4	33.9	34.3
Operating expenses:				
Research and development	4.1	3.1	3.9	3.2
Sales and marketing	15.9	15.6	16.4	16.4
General and administrative	3.6	3.8	3.9	3.7
In-process research and development	0.0	1.9	0.8	0.7
Litigation reserves	0.1	0.0	0.0	0.0
Total operating expenses	23.7	24.4	25.0	24.0
Income from operations	9.6	9.0	8.9	10.3
Interest income	1.0	1.1	1.2	1.2
Other income (expense), net	0.9	(0.2)	0.6	0.2
Income before income taxes	11.5	9.9	10.7	11.7
Provision for income taxes	4.6	4.6	4.4	4.9
Net income	6.9%	5.3%	6.3%	6.8%

**Three Months Ended September 30, 2007 Compared to Three Months Ended October 1, 2006****Net Revenue**

	Three Months Ended		
	September 30, 2007	Percentage Change	October 1, 2006
Net revenue	\$ 191,681	26.5%	\$ 151,571

(In thousands, except percentage data)

Our net revenue consists of gross product shipments, less allowances for estimated returns for stock rotation and warranty, price protection, end-user customer rebates and other sales incentives deemed to be a reduction of net revenue per EITF Issue No. 01-9 and net changes in deferred revenue.

Net revenue increased \$40.1 million, or 26.5%, to \$191.7 million for the three months ended September 30, 2007, from \$151.6 million for the three months ended October 1, 2006. The increase in net revenue was primarily attributable to increased shipments in our small business switches and hubs product category as well as sales of our ReadyNAS products, which were acquired in connection with our acquisition of Infrant. We have also experienced growth in our home wireless product category.

In the three months ended September 30, 2007, net revenue generated within North America, Europe, Middle-East and Africa ( EMEA ) and Asia Pacific was 39.8%, 49.9% and 10.3%, respectively, of our total net revenue. The comparable net revenue for the three months ended October 1, 2006 was 37.0%, 53.9% and 9.1%, respectively, of our total net revenue. The increase in net revenue over the prior year comparable quarter for

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each region was 36.1%, 17.0% and 43.2%, respectively. The North America increase in net revenue was primarily attributable to increased sales of cable gateways to service providers as well as increased sales of switch and ReadyNAS products. The EMEA increase in net revenue was driven by strong sales of switch products.

**Table of Contents****Cost of Revenue and Gross Margin**

	September 30, 2007	Three Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
Cost of revenue	\$ 127,903	26.6%	\$ 101,013
Gross margin percentage		33.3%	33.4%

Cost of revenue consists primarily of the following: the cost of finished products from our third party contract manufacturers; overhead costs including purchasing, product planning, inventory control, warehousing and distribution logistics; inbound freight; warranty costs associated with returned goods; write-downs for excess and obsolete inventory, and amortization expense of certain acquired intangibles. We outsource our manufacturing, warehousing and distribution logistics. We believe this outsourcing strategy allows us to better manage our product costs and gross margin. Our gross margin can be affected by a number of factors, including sales returns, changes in net revenues due to changes in average selling prices, end-user customer rebates and other sales incentives, and changes in our cost of goods sold due to fluctuations in prices paid for components, net of vendor rebates, warranty and overhead costs, inbound freight, conversion costs, and charges for excess or obsolete inventory and transitions from older to newer products.

Cost of revenue increased \$26.9 million, or 26.6%, to \$127.9 million for the three months ended September 30, 2007, from \$101.0 million for the three months ended October 1, 2006. In addition, our gross margin decreased to 33.3% for the three months ended September 30, 2007, from 33.4% for the three months ended October 1, 2006. In the three months ended September 30, 2007, we amortized \$1.1 million in intangibles related to our recent acquisition of Infrant, which resulted in lower gross margins. Additionally, we incurred higher warranty costs associated with end-user warranty returns. These negative margin impacts were partially mitigated by certain gross margin improvements. We experienced relatively lower inbound freight costs, as we were able to shift the mix of inbound shipments from our suppliers from more costly air freight to lower cost sea freight, and experienced lower excess inventory expense. Additionally, we experienced lower sales returns and price protection expense in the three months ended September 30, 2007.

**Operating Expenses****Research and Development**

	September 30, 2007	Three Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
Research and development expense	\$ 7,816	67.2%	\$ 4,675
Percentage of net revenue		4.1%	3.1%

Research and development expenses consist primarily of personnel expenses, payments to suppliers for design services, tooling design costs, safety and regulatory testing, product certification expenditures to qualify our products for sale into specific markets, prototypes and other consulting fees. Research and development expenses are recognized as they are incurred. We have invested in building our research and development organization to enhance our ability to introduce innovative and easy to use products. We expect to continue to add additional employees in our research and development department. In the future, we believe that research and development expenses will increase in absolute dollars as we expand into new networking product technologies and broaden our core competencies.

Research and development expenses increased \$3.1 million, or 67.2%, to \$7.8 million for the three months ended September 30, 2007, from \$4.7 million for the three months ended October 1, 2006. The increase was primarily attributable to increased salary, related payroll and other employee expenses of \$1.8 million resulting from research and development related headcount growth. Included in the \$1.8 million was \$725,000 of incremental headcount expenses related to the acquisition of Infrant. Employee headcount increased by 96% to 112 employees as of September 30, 2007 as compared to 57 employees as of October 1, 2006, partially due to 26 employees obtained from the acquisition of Infrant. Rent and facilities expenses also increased \$106,000 related to

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the Infranet acquisition and additional lab and infrastructure investments in our China Engineering Center. Non-recurring engineering costs increased \$409,000 primarily attributable to incremental product development projects. Furthermore, IT infrastructure costs allocated to research and development increased \$303,000 as a result of additional investments in software and systems in 2007. Additionally, stock-based compensation expense increased \$363,000 to \$694,000 for the three months ended September 30, 2007, from \$331,000 for the three months ended October 1, 2006.

**Sales and Marketing**

	September 30, 2007	Three Months Ended Percentage Change	October 1, 2006
(In thousands, except percentage data)			
Sales and marketing expense	\$ 30,509	29.7%	\$ 23,522
Percentage of net revenue	15.9%		15.6%

Sales and marketing expenses consist primarily of advertising, trade shows, corporate communications and other marketing expenses, product marketing expenses, outbound freight costs, personnel expenses for sales and marketing staff and technical support expenses. We believe that maintaining and building brand awareness is key to both net revenue growth and maintaining our gross margin. We also believe that maintaining widely available and high quality technical support is key to building and maintaining brand awareness. Accordingly, we expect sales and marketing expenses to increase in absolute dollars in the future, related to the planned growth of our business.

Sales and marketing expenses increased \$7.0 million, or 29.7%, to \$30.5 million for the three months ended September 30, 2007, from \$23.5 million for the three months ended October 1, 2006. Of this increase, \$2.9 million was attributable to increased salary, related payroll and other employee expenses as a result of sales and marketing related headcount growth. Employee headcount increased by 36% to 258 employees as of September 30, 2007 as compared to 190 employees as of October 1, 2006. More specifically, 60 of the 68 incremental employees related to expansion in EMEA and Asia Pacific. Outside service fees related to customer service and technical support also increased by \$939,000, in support of higher call volumes related to increased units sold and geographic expansion. Information technology ( IT ) infrastructure costs allocated to sales and marketing increased \$485,000 as a result of additional investments in software and systems in 2007. We have continued to expand our geographic market presence with investments in sales resources, and incurred a \$948,000 increase in advertising, travel, and promotion expenses related to expanded marketing activities. Furthermore, outbound freight increased \$755,000, reflecting our higher sales volume. Additionally, stock-based compensation expense increased \$422,000 to \$781,000 for the three months ended September 30, 2007, from \$359,000 for the three months ended October 1, 2006.

**General and Administrative**

	September 30, 2007	Three Months Ended Percentage Change	October 1, 2006
(In thousands, except percentage data)			
General and administrative expense	\$ 6,781	17.7%	\$ 5,762
Percentage of net revenue	3.5%		3.8%

General and administrative expenses consist of salaries and related expenses for executive, finance and accounting, human resources, professional fees, allowance for doubtful accounts and other corporate expenses. We expect a modest increase in general and administrative costs in absolute dollars related to the growth of the business.

General and administrative expenses increased \$1.0 million, or 17.7%, to \$6.8 million for the three months ended September 30, 2007, from \$5.8 million for the three months ended October 1, 2006. The increase was primarily attributable to increased salary, related payroll and other employee expenses of \$621,000 due to an increase in general and administrative related headcount and increases in compensation for existing employees. Employee headcount increased by 12% to 73 employees as of September 30, 2007 as compared to 65 employees as of October 1, 2006. We also incurred an \$870,000 increase in fees for outside professional services. Additionally, stock-based compensation expense increased \$288,000 to \$731,000 for the three months ended September 30, 2007, from \$443,000 for the three months ended October 1, 2006. Partially offsetting these increases were higher IT and facilities allocations to the other lines of businesses, due to the relatively higher headcount growth in sales and marketing as well as research and development.





**Table of Contents*****Litigation Reserves***

During the three months ended September 30, 2007, we recorded an expense of \$202,000 for costs related to the settlement of the *SercoNet v. NETGEAR* lawsuit. For a detailed discussion of our litigation matters, please see Note 11 of the Notes to Unaudited Condensed Consolidated Financial Statements.

***Interest Income and Other Income (Expense), net***

	<b>Three Months Ended</b>	
	<b>September 30,</b>	<b>October 1,</b>
	<b>2007</b>	<b>2006</b>
	<b>(In thousands)</b>	
Interest income	\$ 1,860	\$ 1,676
Other income (expense), net	1,732	(315)
<b>Total interest income and other income (expense)</b>	<b>\$ 3,592</b>	<b>\$ 1,361</b>

Interest income represents amounts earned on our cash, cash equivalents and short-term investments. Other income (expense), net primarily represents net gains and losses on transactions denominated in foreign currencies and other miscellaneous expenses.

Interest income increased \$184,000, or 11.0%, to \$1.9 million for the three months ended September 30, 2007, from \$1.7 million for the three months ended October 1, 2006. The increase in interest income was primarily attributable to an increase in the average interest rate earned in the three months ended September 30, 2007 as compared to the three months ended October 1, 2006.

Other income (expense), net, increased \$2.0 million to an income of \$1.7 million for the three months ended September 30, 2007, from an expense of \$315,000 for the three months ended October 1, 2006. The income of \$1.7 million was primarily attributable to a foreign exchange gain experienced in the three months ended September 30, 2007 due to the weakening of the U.S. dollar against the euro, British pound and Australian dollar in that period. The expense of \$315,000 in the three months ended October 1, 2006 was primarily attributable to a foreign exchange loss due to the strengthening of the U.S. dollar against the euro and British pound in that period.

***Provision for Income Taxes***

The provision for income taxes increased \$1.7 million, or 24.2%, to \$8.8 million for the three months ended September 30, 2007, from \$7.1 million for the three months ended October 1, 2006. The effective tax rate was approximately 39.9% for the three months ended September 30, 2007 and approximately 47.0% for the three months ended October 1, 2006. The decrease in the effective tax rate for the three months ended September 30, 2007 as compared to the three months ended October 1, 2006 was primarily caused by a non-recurring non-deductible in-process research and development ( in-process R&D ) expense related to the 2006 acquisition of SkipJam.

As described in Note 1 and Note 9 of the Notes to Unaudited Condensed Consolidated Financial Statements, we have adopted Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ) as of January 1, 2007.

***Net Income***

Net income increased \$5.3 million, or 66.2%, to \$13.3 million for the three months ended September 30, 2007, from \$8.0 million for the three months ended October 1, 2006. This increase was primarily attributable to an increase in gross profit of \$13.2 million, an increase in interest income of \$184,000 and an increase in other income of \$2.0 million. These increases were partially offset by an increase in operating expenses of \$8.4 million and an increase in the provision for income taxes of \$1.7 million.

**Table of Contents*****Nine Months Ended September 30, 2007 Compared to Nine Months Ended October 1, 2006******Net Revenue***

	September 30, 2007	Nine Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
Net revenue	\$ 529,528	29.3%	\$ 409,568

Net revenue increased \$119.9 million, or 29.3%, to \$529.5 million for the nine months ended September 30, 2007, from \$409.6 million for the nine months ended October 1, 2006. The increase in net revenue was primarily attributable to increased shipments in our gateway, small business switch and hub, and network storage product categories. This growth was most notably driven by increased sales of gateways to service providers. We have also experienced broad-based growth in sales of all small business switches as well as sales of our ReadyNAS products, which were acquired in connection with our acquisition of Infrant.

In the nine months ended September 30, 2007, net revenue generated within North America, EMEA and Asia Pacific was 38.6%, 51.6% and 9.8%, respectively, of our total net revenue. The comparable net revenue for the nine months ended October 1, 2006 was 41.3%, 48.4% and 10.3%, respectively, of our total net revenue. The increase in net revenue over the prior year comparable period for each region was 20.8%, 37.8% and 23.2%, respectively. The North America increase in net revenue was primarily attributable to increased sales of cable gateways to service providers as well as increased sales of switch and ReadyNAS products. The EMEA increase in net revenue was primarily attributable to growth in the United Kingdom, as a result of increased sales of gateways to service providers, as well as strong sales of switch products.

***Cost of Revenue and Gross Margin***

	September 30, 2007	Nine Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
Cost of revenue	\$ 349,766	30.0%	\$ 269,085
Gross margin percentage	33.9%		34.3%

Cost of revenue increased \$80.7 million, or 30.0%, to \$349.8 million for the nine months ended September 30, 2007, from \$269.1 million for the nine months ended October 1, 2006. In addition, our gross margin decreased to 33.9% for the nine months ended September 30, 2007, from 34.3% for the nine months ended October 1, 2006. We amortized \$2.1 million in intangibles related to our recent acquisitions in the nine months ended September 30, 2007, which resulted in lower gross margins. We also sold through the entire \$3.5 million in inventory acquired from Infrant, which was recorded at fair value under purchase accounting guidelines. Of this \$3.5 million, \$1.3 million represented a charge for the step-up to fair value in connection with the acquisition purchase accounting. Additionally, we incurred higher warranty costs associated with end-user warranty returns. These negative margin impacts were partially mitigated by certain gross margin improvements. We experienced relatively lower inbound freight costs, as we were able to shift the mix of inbound shipments from our suppliers from more costly air freight to lower cost sea freight, and we experienced lower excess inventory expense. Additionally, we experienced lower sales returns and price protection expense in the nine months ended September 30, 2007.

**Table of Contents****Operating Expenses****Research and Development**

	September 30, 2007	Nine Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
Research and development expense	\$ 20,881	58.2%	\$ 13,196
Percentage of net revenue		3.9%	3.2%

Research and development expenses increased \$7.7 million, or 58.2%, to \$20.9 million for the nine months ended September 30, 2007, from \$13.2 million for the nine months ended October 1, 2006. The increase was primarily attributable to increased salary, related payroll and other employee expenses of \$4.6 million resulting from research and development related headcount growth. Included in the \$4.6 million was \$564,000 related to incremental retention bonuses for certain employees associated with the acquisition of SkipJam and \$1.1 million of incremental headcount expenses related to the acquisition of Infrant. Employee headcount increased by 96% to 112 employees as of September 30, 2007 as compared to 57 employees as of October 1, 2006, partially due to 26 employees obtained from the acquisition of Infrant. Rent and facilities expenses increased \$516,000 related to the Infrant acquisition and additional lab and infrastructure investments in our China Engineering Center. Non-recurring engineering costs increased \$507,000 primarily attributable to incremental product development projects. Furthermore, IT infrastructure costs allocated to research and development increased \$746,000 as a result of additional investments in software and systems in 2007. Additionally, stock-based compensation expense increased \$967,000 to \$1.7 million for the nine months ended September 30, 2007, from \$725,000 for the nine months ended October 1, 2006.

**Sales and Marketing**

	September 30, 2007	Nine Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
Sales and marketing expense	\$ 86,756	29.6%	\$ 66,944
Percentage of net revenue		16.4%	16.4%

Sales and marketing expenses increased \$19.9 million, or 29.6%, to \$86.8 million for the nine months ended September 30, 2007, from \$66.9 million for the nine months ended October 1, 2006. Of this increase, \$8.3 million was attributable to increased salary, related payroll and other employee expenses as a result of sales and marketing related headcount growth. Employee headcount increased by 36% to 258 employees as of September 30, 2007 as compared to 190 employees as of October 1, 2006. More specifically, 60 of the 68 incremental employees related to expansion in EMEA and Asia Pacific. Outside service fees related to customer service and technical support also increased by \$2.6 million, in support of higher call volumes related to increased units sold and geographic expansion. Outbound freight increased \$2.2 million, reflecting our higher sales volume. We have continued to expand our geographic market presence with investments in sales resources, and incurred a \$2.7 million increase in advertising, travel and promotion expenses related to expanded marketing activities. Furthermore, IT infrastructure costs allocated to sales and marketing increased \$1.6 million as a result of additional investments in software and systems in 2007. Additionally, stock-based compensation expense increased \$1.4 million to \$2.3 million for the nine months ended September 30, 2007, from \$955,000 for the nine months ended October 1, 2006.

**Table of Contents****General and Administrative**

	September 30, 2007	Nine Months Ended Percentage Change	October 1, 2006
	(In thousands, except percentage data)		
General and administrative expense	\$ 20,643	36.0%	\$ 15,176
Percentage of net revenue	3.9%		3.7%

General and administrative expenses increased \$5.4 million, or 36.0%, to \$20.6 million for the nine months ended September 30, 2007, from \$15.2 million for the nine months ended October 1, 2006. The increase was primarily attributable to increased salary, related payroll and other employee expenses of \$2.6 million primarily attributable to an increase in general and administrative related headcount and increases in compensation for existing employees. Employee headcount increased by 12% to 73 employees as of September 30, 2007 compared to 65 employees as of October 1, 2006. We also incurred a \$2.9 million increase in fees for outside professional services. Additionally, stock-based compensation expense increased \$1.0 million to \$2.1 million for the nine months ended September 30, 2007, from \$1.1 million for the nine months ended October 1, 2006. Partially offsetting these increases were higher IT and facilities allocations to the other lines of businesses, due to the relatively higher headcount growth in sales and marketing as well as research and development.

**In-process Research and Development**

During the nine months ended September 30, 2007, we expensed \$4.1 million for in-process R&D related to intangible assets purchased in our acquisition of Infrant. See Note 3 of the Notes to Unaudited Condensed Consolidated Financial Statements for additional information regarding this acquisition. In-process R&D was expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist. We acquired three in-process R&D projects. Two projects involve development of new products in the ReadyNAS desktop product category, and one project involves development of a higher end version of a product currently selling in the ReadyNAS rack mount product category.

To date, there have been no significant differences between the actual and estimated results of the in-process R&D projects. We estimate that we will incur costs of approximately \$1.0 million to complete the projects, of which approximately \$419,000 was incurred through September 30, 2007. We expect to complete and begin benefitting from the three projects in early 2008.

The development of the acquired technology remains a significant risk due to factors including the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for new products and competitive threats. The nature of the efforts to develop these technologies into commercially viable products consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring these products to market in a timely manner could result in loss of market share or a lost opportunity to capitalize on emerging markets and could have a material adverse impact on our business and operating results.

**Litigation Reserves**

During the nine months ended September 30, 2007, we recorded an expense of \$202,000 for costs related to the settlement of the *SercoNet v. NETGEAR* lawsuit. For a detailed discussion of our litigation matters, please see Note 11 of the Notes to Unaudited Condensed Consolidated Financial Statements.

**Table of Contents****Interest Income and Other Income**

	Nine Months Ended	
	September 30, 2007	October 1, 2006
	(In thousands)	
Interest income	\$ 6,424	\$ 5,017
Other income, net	3,152	606
<b>Total interest income and other income</b>	<b>\$ 9,576</b>	<b>\$ 5,623</b>

Interest income increased \$1.4 million, or 28.0%, to \$6.4 million for the nine months ended September 30, 2007, from \$5.0 million for the nine months ended October 1, 2006. The increase in interest income was primarily attributable to an increase in the average interest rate earned in the first nine months of 2007 as compared to the first nine months of 2006.

Other income increased \$2.6 million, or 420.1%, to \$3.2 million for the nine months ended September 30, 2007, from \$606,000 for the nine months ended October 1, 2006. The increase in other income was primarily attributable to foreign exchange gains experienced due to the continued weakening of the U.S. dollar against the euro, British pound and Australian dollar in the nine months ended September 30, 2007.

**Provision for Income Taxes**

The provision for income taxes increased \$3.1 million, or 15.5%, to \$23.3 million for the nine months ended September 30, 2007, from \$20.2 million for the nine months ended October 1, 2006. The effective tax rate was approximately 41.1% for the nine months ended September 30, 2007 and approximately 42.2% for the nine months ended October 1, 2006.

As described in Note 1 and Note 9 of the Notes to Unaudited Condensed Consolidated Financial Statements, we have adopted FIN 48 as of January 1, 2007.

**Net Income**

Net income increased \$5.7 million, or 20.7%, to \$33.4 million for the nine months ended September 30, 2007, from \$27.7 million for the nine months ended October 1, 2006. This increase was primarily attributable to an increase in gross profit of \$39.3 million, an increase in interest income of \$1.4 million and an increase in other income of \$2.6 million. These increases were partially offset by an increase in operating expenses of \$34.4 million and an increase in the provision for income taxes of \$3.1 million.

**Liquidity and Capital Resources**

As of September 30, 2007, we had cash, cash equivalents and short-term investments totaling \$177.2 million. Short-term investments accounted for \$77.3 million of this balance.

Our cash and cash equivalents balance increased from \$87.7 million as of December 31, 2006 to \$99.9 million as of September 30, 2007. Operating activities during the nine months ended September 30, 2007 provided cash of \$24.2 million. Investing activities during the nine months ended September 30, 2007 used \$30.5 million, primarily for the payment, excluding cash acquired, made in connection with the acquisition of Infrant for \$60.0 million and purchases of property and equipment amounting to \$6.6 million, partially offset by net proceeds from the sale of short-term investments of \$33.6 million. During the nine months ended September 30, 2007, financing activities provided \$18.4 million, resulting from the issuance of common stock related to stock option exercises and our employee stock purchase program, as well as the excess tax benefit from exercise of stock options.

Our days sales outstanding remained unchanged at 66 days as of December 31, 2006 and September 30, 2007.

Our accounts payable decreased from \$39.8 million at December 31, 2006 to \$33.3 million at September 30, 2007. The decrease of \$6.5 million is primarily due to relative timing of payments.



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Inventory increased by \$1.4 million from \$77.9 million at December 31, 2006 to \$79.3 million at September 30, 2007. In the three months ended September 30, 2007 we experienced annual ending inventory turns of approximately 6.5, up from approximately 5.7 in the three months ended December 31, 2006.

We lease office space, cars and equipment under non-cancelable operating leases with various expiration dates through December 2026. The terms of certain of our facility leases provide for rental payments on a graduated scale. We recognize rent expense on a straight-line basis over the lease period, and have accrued for rent expense incurred but not paid.

We enter into various inventory-related purchase agreements with suppliers. Generally, under these agreements, 50% of the orders are cancelable by giving notice 46 to 60 days prior to the expected shipment date and 25% of orders are cancelable by giving notice 31 to 45 days prior to the expected shipment date. Orders are non-cancelable within 30 days prior to the expected shipment date. At September 30, 2007, we had approximately \$65.5 million in non-cancelable purchase commitments with suppliers. We expect to sell all products for which we have committed purchases from suppliers.

**Contractual Obligations and Off-Balance Sheet Arrangements**

The following table describes our commitments to settle contractual obligations and off-balance sheet arrangements in cash as of September 30, 2007 (in thousands):

<b>Contractual Obligations</b>	<b>Less than 1 Year</b>	<b>1 - 3 Years</b>	<b>3 - 5 Years</b>	<b>Over 5 Years</b>	<b>Total</b>
Operating leases	\$ 3,499	\$ 9,278	\$ 6,796	\$ 20,206	\$ 39,779
Purchase obligations	65,491				65,491
	\$ 68,990	\$ 9,278	\$ 6,796	\$ 20,206	\$ 105,270

As of September 30, 2007, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

Based on our current plans and market conditions, we believe that our existing cash, cash equivalents and short-term investments will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months. However, we may require or desire additional funds to support our operating expenses and capital requirements or for other purposes, such as acquisitions, and may seek to raise such additional funds through public or private equity financing or from other sources. We cannot assure you that additional financing will be available at all or that, if available, such financing will be obtainable on terms favorable to us and would not be dilutive. Our future liquidity and cash requirements will depend on numerous factors, including the introduction of new products and potential acquisitions of related businesses or technology.

Effective January 1, 2007, we adopted the provisions of FIN 48 (see Note 9 of the Notes to Unaudited Condensed Consolidated Financial Statements). As of September 30, 2007, the liability for unrecognized tax benefits, net of federal impacts on state tax issues, is \$7.8 million. None is expected to be paid within one year, nor can we make a reliable estimate when cash settlement with a taxing authority may occur.

**Critical Accounting Policies and Estimates**

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2006. Other than our accounting policy relating to income taxes presented in Note 1 of the Notes to Unaudited Condensed Consolidated Financial Statements, our critical accounting policies have not materially changed during the nine months ended September 30, 2007.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We do not use derivative financial instruments in our investment portfolio. We have an investment portfolio of fixed income securities that are classified as available-for-sale securities. These securities, like all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. We attempt to limit this exposure by investing primarily in short-term securities. Due to the short duration and conservative nature of our investment portfolio a movement of 10% by market interest rates would not have a material impact on our operating results and the total value of the portfolio over the next fiscal year.





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We are exposed to risks associated with foreign exchange rate fluctuations due to our international manufacturing and sales activities. We generally have not hedged currency exposures. These exposures may change over time as business practices evolve and could negatively impact our operating results and financial condition. In the second quarter of 2005 we began to invoice some of our international customers in foreign currencies including but not limited to, the euro, British pound, Japanese yen and the Australian dollar. As the customers that are currently invoiced in local currency become a larger percentage of our business, or to the extent we begin to bill additional customers in foreign currencies, the impact of fluctuations in foreign exchange rates could have a more significant impact on our results of operations. For those customers in our international markets that we continue to sell to in U.S. dollars, an increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore reduce the demand for our products. Such a decline in the demand could reduce sales and negatively impact our operating results. Certain operating expenses of our foreign operations require payment in the local currencies. As of September 30, 2007, we had net receivables in various local currencies. A hypothetical 10% movement in foreign exchange rates would result in an after-tax positive or negative impact of \$2.7 million to net income at September 30, 2007. For the three months ended September 30, 2007, 31% of total net revenue was earned in currency other than U.S. dollars.

**Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of our chief executive officer and our chief accounting officer, the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our chief executive officer and our chief accounting officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures.

*Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. We are aware that any system of controls, however well designed and operated, can only provide reasonable, and not absolute, assurance that the objectives of the system are met, and that maintenance of disclosure controls and procedures is an ongoing process that may change over time.

**PART II: OTHER INFORMATION****Item 1. Legal Proceedings**

The information set forth under Note 11 of the Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item 1 of this report, is incorporated herein by reference. For an additional discussion of certain risks associated with legal proceedings, see the section entitled Risk Factors in Item 1A of this report.

**Item 1A. Risk Factors**

*Investing in our common stock involves a high degree of risk. The risks described below are not exhaustive of the risks that might affect our business. Other risks, including those we currently deem immaterial, may also impact our business. Any of the following risks could materially adversely affect our business operations, results of operations and financial condition and could result in a significant decline in our stock price.*

**We expect our operating results to fluctuate on a quarterly and annual basis, which could cause our stock price to fluctuate or decline.**

Our operating results are difficult to predict and may fluctuate substantially from quarter-to-quarter or year-to-year for a variety of reasons, many of which are beyond our control. If our actual revenue were to fall below our estimates or the expectations of public market analysts or investors, our quarterly and annual results would be negatively impacted and the price of our stock could decline. Other factors that could affect our quarterly and annual operating results include those listed in this risk factors section of this Quarterly Report on Form 10-Q and others such as:

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changes in the pricing policies of or the introduction of new products by us or our competitors;

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changes in the terms of our contracts with customers or suppliers that cause us to incur additional expenses or assume additional liabilities;

slow or negative growth in the networking product, personal computer, Internet infrastructure, home electronics and related technology markets, as well as decreased demand for Internet access;

changes in or consolidation of our sales channels and wholesale distributor relationships or failure to manage our sales channel inventory and warehousing requirements;

delay or failure to fulfill orders for our products on a timely basis;

our inability to accurately forecast product demand;

unfavorable level of inventory and turns;

unanticipated shift in overall product mix from higher to lower margin products that would adversely impact our margins;

delays in the introduction of new products by us or market acceptance of these products;

an increase in price protection claims, redemptions of marketing rebates, product warranty returns or allowance for doubtful accounts;

challenges associated with integrating acquisitions that we make;

operational disruptions, such as transportation delays or failure of our order processing system, particularly if they occur at the end of a fiscal quarter;

seasonal patterns of higher sales during the second half of our fiscal year, particularly retail-related sales in our fourth quarter;

delay or failure of our service provider customers to purchase at the volumes that we forecast;

foreign currency exchange rate fluctuations in the jurisdictions where we transact sales in local currency;

bad debt exposure as we expand into new international markets; and

changes in accounting rules, such as recording expenses for employee stock option grants.

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As a result, period-to-period comparisons of our operating results may not be meaningful, and you should not rely on them as an indication of our future performance. In addition, our future operating results may fall below the expectations of public market analysts or investors. In this event, our stock price could decline significantly.

**Some of our competitors have substantially greater resources than we do, and to be competitive we may be required to lower our prices or increase our sales and marketing expenses, which could result in reduced margins and loss of market share.**

We compete in a rapidly evolving and highly competitive market, and we expect competition to intensify. Our principal competitors in the small business market include 3Com Corporation, Allied Telesyn International, Dell Computer Corporation, D-Link Systems, Inc., Hewlett-Packard Company, Huawei Technologies Co., Ltd., the Linksys division of Cisco Systems and Nortel Networks. Our principal competitors in the home market include Belkin Corporation, D-Link and the Linksys division of Cisco Systems. Our principal competitors in the broadband service provider market include ARRIS International, Inc., Motorola, Inc., Sagem Corporation, Scientific Atlanta, a Cisco company, ZyXEL Communications Corporation, Thomson Corporation and 2Wire, Inc. Other current and potential competitors include numerous local vendors such as Siemens Corporation and AVM in Europe, Corega International SA, Melco Inc., Buffalo Technology in Japan and TP-Link in China. Our potential competitors also include consumer electronics vendors who could integrate networking capabilities into their line of products, and our channel customers who may decide to offer self-branded networking products. We also face competition from service providers who may bundle a free networking device with their broadband service offering, which would reduce our sales if we are not the supplier of choice to those service providers.

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Many of our existing and potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers, and exert more influence on the sales channel than we can. We anticipate that current and potential competitors will also intensify their efforts to penetrate our target markets. These competitors may have more advanced technology, more extensive distribution channels, stronger brand names, greater access to shelf space in retail locations, bigger promotional budgets and larger customer bases than we do. These companies could devote more capital resources to develop, manufacture and market competing products than we could. If any of these companies are successful in competing against us, our sales could decline, our margins could be negatively impacted and we could lose market share, any of which could seriously harm our business and results of operations.

**If we do not effectively manage our sales channel inventory and product mix, we may incur costs associated with excess inventory, or lose sales from having too few products.**

If we are unable to properly monitor, control and manage our sales channel inventory and maintain an appropriate level and mix of products with our wholesale distributors and within our sales channel, we may incur increased and unexpected costs associated with this inventory. We generally allow wholesale distributors and traditional retailers to return a limited amount of our products in exchange for other products. Under our price protection policy, if we reduce the list price of a product, we are often required to issue a credit in an amount equal to the reduction for each of the products held in inventory by our wholesale distributors and retailers. If our wholesale distributors and retailers are unable to sell their inventory in a timely manner, we might lower the price of the products, or these parties may exchange the products for newer products. Also, during the transition from an existing product to a new replacement product, we must accurately predict the demand for the existing and the new product.

If we improperly forecast demand for our products we could end up with too many products and be unable to sell the excess inventory in a timely manner, if at all, or, alternatively we could end up with too few products and not be able to satisfy demand. This problem is exacerbated because we attempt to closely match inventory levels with product demand leaving limited margin for error. If these events occur, we could incur increased expenses associated with writing off excessive or obsolete inventory or lose sales or have to ship products by air freight to meet immediate demand incurring incremental freight costs above the costs of transporting product via boat, a preferred method, and suffering a corresponding decline in gross margins.

**We are currently involved in various litigation matters and may in the future become involved in additional litigation, including litigation regarding intellectual property rights, which could be costly and subject us to significant liability.**

The networking industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding infringement of patents, trade secrets and other intellectual property rights. In particular, leading companies in the data communications markets, some of which are competitors, have extensive patent portfolios with respect to networking technology. From time to time, third parties, including these leading companies, have asserted and may continue to assert exclusive patent, copyright, trademark and other intellectual property rights against us demanding license or royalty payments or seeking payment for damages, injunctive relief and other available legal remedies through litigation. These include third parties who claim to own patents or other intellectual property that cover industry standards that our products comply with. If we are unable to resolve these matters or obtain licenses on acceptable or commercially reasonable terms, we could be sued or we may be forced to initiate litigation to protect our rights. The cost of any necessary licenses could significantly harm our business, operating results and financial condition. Also, at any time, any of these companies, or any other third party could initiate litigation against us, or we may be forced to initiate litigation against them, which could divert management attention, be costly to defend or prosecute, prevent us from using or selling the challenged technology, require us to design around the challenged technology and cause the price of our stock to decline. In addition, third parties, some of whom are potential competitors, have initiated and may continue to initiate litigation against our manufacturers, suppliers, members of our sales channel or our service provider customers, alleging infringement of their proprietary rights with respect to existing or future products. In the event successful claims of infringement are brought by third parties, and we are unable to obtain licenses or independently develop alternative technology on a timely basis, we may be subject to indemnification obligations, be unable to offer competitive products, or be subject to increased expenses. Finally, consumer class-action lawsuits related to the marketing and performance of our home networking products have been asserted and may in the future be asserted against us. For additional information regarding certain of the lawsuits in which we are involved, see Item 1, Legal Proceedings, contained in Part II of this report. If we do not resolve these claims on a favorable basis, our business, operating results and financial condition could be significantly harmed.

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**The average selling prices of our products typically decrease rapidly over the sales cycle of the product, which may negatively affect our gross margins.**

Our products typically experience price erosion, a fairly rapid reduction in the average selling prices over their respective sales cycles. In order to sell products that have a falling average selling price and maintain margins at the same time, we need to continually reduce product and manufacturing costs. To manage manufacturing costs, we must collaborate with our third party manufacturers to engineer the most cost-effective design for our products. In addition, we must carefully manage the price paid for components used in our products. We must also successfully manage our freight and inventory costs to reduce overall product costs. We also need to continually introduce new products with higher sales prices and gross margins in order to maintain our overall gross margins. If we are unable to manage the cost of older products or successfully introduce new products with higher gross margins, our net revenue and overall gross margin would likely decline.

**Our future success is dependent on the growth in personal computer sales and the acceptance of networking products in the small business and home markets into which we sell substantially all of our products. If the acceptance of networking products in these markets does not continue to grow, we will be unable to increase or sustain our net revenue, and our business will be severely harmed.**

We believe that growth in the small business market will depend, in significant part, on the growth of the number of personal computers purchased by these end-users and the demand for sharing data intensive applications, such as large graphic files. We believe that acceptance of networking products in the home will depend upon the availability of affordable broadband Internet access and increased demand for wireless products. Unless these markets continue to grow, our business will be unable to expand, which could cause the value of our stock to decline. Moreover, if networking functions are integrated more directly into personal computers and other Internet-enabled devices, such as electronic gaming platforms or personal video recorders, and these devices do not rely upon external network-enabling devices, sales of our products could suffer. In addition, if the small business or home markets experience a recession or other cyclical effects that diminish or delay networking expenditures, our business growth and profits would be severely limited, and our business could be more severely harmed than those companies that primarily sell to large business customers.

**If we fail to continue to introduce new products that achieve broad market acceptance on a timely basis, we will not be able to compete effectively and we will be unable to increase or maintain net revenue and gross margins.**

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop and introduce new products that achieve broad market acceptance in the small business and home markets. Our future success will depend in large part upon our ability to identify demand trends in the small business and home markets and quickly develop, manufacture and sell products that satisfy these demands in a cost effective manner. Successfully predicting demand trends is difficult, and it is very difficult to predict the effect introducing a new product will have on existing product sales. We will also need to respond effectively to new product announcements by our competitors by quickly introducing competitive products.

We have experienced delays and quality issues in releasing new products in the past, which resulted in lower quarterly net revenue than expected. In addition, we have experienced, and may in the future experience, product introductions that fall short of our projected rates of market adoption. Any future delays in product development and introduction or product introductions that do not meet broad market acceptance could result in:

loss of or delay in revenue and loss of market share;

negative publicity and damage to our reputation and brand;

a decline in the average selling price of our products;

adverse reactions in our sales channel, such as reduced shelf space, reduced online product visibility, or loss of sales channel; and

increased levels of product returns.



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**We depend substantially on our sales channel, and our failure to maintain and expand our sales channel would result in lower sales and reduced net revenue.**

To maintain and grow our market share, net revenue and brand, we must maintain and expand our sales channel. We sell our products through our sales channel, which consists of traditional retailers, online retailers, DMRs, VARs, and broadband service providers. Some of these entities purchase our products through our wholesale distributors. We generally have no minimum purchase commitments or long-term contracts with any of these third parties.

Traditional retailers have limited shelf space and promotional budgets, and competition is intense for these resources. If the networking sector does not experience sufficient growth, retailers may choose to allocate more shelf space to other consumer product sectors. A competitor with more extensive product lines and stronger brand identity, such as Cisco Systems, may have greater bargaining power with these retailers. Any reduction in available shelf space or increased competition for such shelf space would require us to increase our marketing expenditures simply to maintain current levels of retail shelf space, which would harm our operating margin. The recent trend in the consolidation of online retailers and DMR channels has resulted in intensified competition for preferred product placement, such as product placement on an online retailer's Internet home page. Expanding our presence in the VAR channel may be difficult and expensive. We compete with established companies that have longer operating histories and longstanding relationships with VARs that we would find highly desirable as sales channel partners. We have limited experience selling to broadband service providers. Penetrating service provider accounts typically involves a long sales cycle and the challenge of displacing incumbent suppliers with established relationships and field-deployed products. If we were unable to maintain and expand our sales channel, our growth would be limited and our business would be harmed.

We must also continuously monitor and evaluate emerging sales channels. If we fail to establish a presence in an important developing sales channel, our business could be harmed.

**If we fail to successfully overcome the challenges associated with profitably growing our broadband service provider sales channel, our net revenue and gross profit will be negatively impacted.**

We sell a substantial portion of our products through broadband service providers worldwide. We face a number of challenges associated with penetrating, marketing and selling to the broadband service provider channel that differ from what we have traditionally faced with the other channels. These challenges include a longer sales cycle, more stringent product testing and validation requirements, a higher level of customer service and support demands, requirements that suppliers take on a larger share of risks, competition from established suppliers, pricing pressure resulting in lower gross margins, and our general inexperience in selling to service providers. Orders from service providers generally tend to be large but sporadic, which causes our revenues from them to fluctuate wildly and challenges our ability to accurately forecast demand from them. Even if we are selected as a supplier, typically a service provider will also designate a second source supplier, which over time will reduce the aggregate orders that we receive from that service provider. If we were to lose a service provider customer for any reason, we may experience a material and immediate reduction in forecasted revenue that may cause us to be below our net revenue and operating margin guidance for a particular period of time and therefore adversely affect our stock price. In addition, service providers may choose to prioritize the implementation of other technologies or the roll out of other services than home networking. Any slowdown in the general economy, over capacity, consolidation among service providers, regulatory developments and constraint on capital expenditures could result in reduced demand from service providers and therefore adversely affect our sales to them. If we do not successfully overcome these challenges, we will not be able to profitably grow our service provider sales channel and our growth will be slowed.

**If our products contain defects or errors, we could incur significant unexpected expenses, experience product returns and lost sales, experience product recalls, suffer damage to our brand and reputation, and be subject to product liability or other claims.**

Our products are complex and may contain defects, errors or failures, particularly when first introduced or when new versions are released. The industry standards upon which many of our products are based are also complex, experience change over time and may be interpreted in different manners. Some errors and defects may be discovered only after a product has been installed and used by the end-user. If our products contain defects or errors, or are found to be noncompliant with industry standards, we could experience decreased sales and increased product returns, loss of customers and market share, and increased service, warranty and insurance costs. In addition, our reputation and brand could be damaged, and we could face legal claims regarding our products. A successful product liability or other claim could result in negative publicity and harm our reputation, result in unexpected expenses and adversely impact our operating results.

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### **We obtain several key components from limited or sole sources, and if these sources fail to satisfy our supply requirements, we may lose sales and experience increased component costs.**

Any shortage or delay in the supply of key product components would harm our ability to meet scheduled product deliveries. Many of the semiconductors used in our products are specifically designed for use in our products and are obtained from sole source suppliers on a purchase order basis. In addition, some components that are used in all our products are obtained from limited sources. These components include connector jacks, plastic casings and physical layer transceivers. We also obtain switching fabric semiconductors, which are used in our Ethernet switches and Internet gateway products, and wireless local area network chipsets, which are used in all of our wireless products, from a limited number of suppliers. Semiconductor suppliers have experienced and continue to experience component shortages themselves, such as with substrates used in manufacturing chipsets, which in turn adversely impact our ability to procure semiconductors from them. Our contract manufacturers generally purchase these components on our behalf on a purchase order basis, and we do not have any contractual commitments or guaranteed supply arrangements with our suppliers. If demand for a specific component increases, we may not be able to obtain an adequate number of that component in a timely manner. In addition, if our suppliers experience financial or other difficulties or if worldwide demand for the components they provide increases significantly, the availability of these components could be limited. It could be difficult, costly and time consuming to obtain alternative sources for these components, or to change product designs to make use of alternative components. In addition, difficulties in transitioning from an existing supplier to a new supplier could create delays in component availability that would have a significant impact on our ability to fulfill orders for our products. If we are unable to obtain a sufficient supply of components, or if we experience any interruption in the supply of components, our product shipments could be reduced or delayed. This would affect our ability to meet scheduled product deliveries, damage our brand and reputation in the market, and cause us to lose market share.

### **We are exposed to adverse currency exchange rate fluctuations in jurisdictions where we transact in local currency, which could harm our financial results and cash flows.**

Although a significant portion of our international sales are currently invoiced in United States dollars, we have implemented and continue to implement for certain countries both invoicing and payment in foreign currencies. Recently, we have experienced currency exchange gains; however, our exposure to adverse foreign currency rate fluctuations will likely increase. We currently do not engage in any currency hedging transactions. Moreover, the costs of doing business abroad may increase as a result of adverse exchange rate fluctuations. For example, if the United States dollar declined in value relative to a local currency, we could be required to pay more in U.S. dollar terms for our expenditures in that market, including salaries, commissions, local operations and marketing expenses, each of which is paid in local currency. In addition, we may lose customers if exchange rate fluctuations, currency devaluations or economic crises increase the local currency prices of our products or reduce our customers' ability to purchase products.

### **Rising oil prices, unfavorable economic conditions, particularly in Western Europe, and turmoil in the international geopolitical environment may adversely affect our operating results.**

We derive a significant percentage of our revenues from international sales, and a deterioration in global economic and market conditions, particularly in Western Europe, may result in reduced product demand, increased price competition and higher excess inventory levels. Turmoil in the global geopolitical environment, including the ongoing tensions in Iraq and the Middle East, has pressured and continue to pressure global economies. In addition, rising oil prices may result in a reduction in consumer spending and an increase in freight costs to us. If the global economic climate does not improve, our business and operating results will be harmed.

### **If disruptions in our transportation network occur or our shipping costs substantially increase, we may be unable to sell or timely deliver our products and our operating expenses could increase.**

We are highly dependent upon the transportation systems we use to ship our products, including surface and air freight. Our attempts to closely match our inventory levels to our product demand intensify the need for our transportation systems to function effectively and without delay. On a quarterly basis, our shipping volume also tends to steadily increase as the quarter progresses, which means that any disruption in our transportation network in the latter half of a quarter will have a more material effect on our business than at the beginning of a quarter.

The transportation network is subject to disruption or congestion from a variety of causes, including labor disputes or port strikes, acts of war or terrorism, natural disasters and congestion resulting from higher shipping volumes. Labor disputes among freight carriers and at ports of entry are common, especially in Europe, and we expect labor unrest and its effects on shipping our products to be a continuing challenge for us. Since September 11, 2001, the rate of inspection of international freight by governmental entities has



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substantially increased, and has become increasingly unpredictable. If our delivery times increase unexpectedly for these or any other reasons, our ability to deliver products on time would be materially adversely affected and result in delayed or lost revenue. In addition, if the increases in fuel prices were to continue, our transportation costs would likely further increase. Moreover, the cost of shipping our products by air freight is greater than other methods. From time to time in the past, we have shipped products using air freight to meet unexpected spikes in demand or to bring new product introductions to market quickly. If we rely more heavily upon air freight to deliver our products, our overall shipping costs will increase. A prolonged transportation disruption or a significant increase in the cost of freight could severely disrupt our business and harm our operating results.

**We rely on a limited number of wholesale distributors for most of our sales, and if they refuse to pay our requested prices or reduce their level of purchases, our net revenue could decline.**

We sell a substantial portion of our products through wholesale distributors, including Ingram Micro, Inc. and Tech Data Corporation. During the fiscal quarter ended September 30, 2007, sales to Ingram Micro and its affiliates accounted for 19% of our net revenue and sales to Tech Data and its affiliates accounted for 14% of our net revenue. We expect that a significant portion of our net revenue will continue to come from sales to a small number of wholesale distributors for the foreseeable future. In addition, because our accounts receivable are concentrated with a small group of purchasers, the failure of any of them to pay on a timely basis, or at all, would reduce our cash flow. We generally have no minimum purchase commitments or long-term contracts with any of these distributors. These purchasers could decide at any time to discontinue, decrease or delay their purchases of our products. In addition, the prices that they pay for our products are subject to negotiation and could change at any time. If any of our major wholesale distributors reduce their level of purchases or refuse to pay the prices that we set for our products, our net revenue and operating results could be harmed. If our wholesale distributors increase the size of their product orders without sufficient lead-time for us to process the order, our ability to fulfill product demands would be compromised.

**As part of growing our business, we have made and expect to continue to make acquisitions. If we fail to successfully select, execute or integrate our acquisitions, or if stock market analysts or our stockholders do not support the acquisitions that we choose to execute, then our business and operating results could be harmed and our stock price could decline.**

From time to time, we will undertake acquisitions to add new product lines and technologies, gain new sales channels or enter into new sales territories. Acquisitions involve numerous risks and challenges, including but not limited to the following:

integrating the companies, assets, systems, products, sales channels and personnel that we acquire;

growing or maintaining revenues to justify the purchase price and the increased expenses associated with acquisitions;

entering into territories or markets that we have limited or no prior experience with;

establishing or maintaining business relationships with customers, vendors and suppliers who may be new to us;

overcoming the employee, customer, vendor and supplier turnover that may occur as a result of the acquisition; and

diverting management's attention from running the day to day operations of our business.

As part of undertaking an acquisition, we may also significantly revise our capital structure or operational budget, such as issue common stock that would dilute the ownership percentage of our stockholders, assume liabilities or debt, utilize a substantial portion of our cash resources to pay for the acquisition or significantly increase operating expenses. Our acquisitions have resulted and may in the future result, in in-process research and development expenses being charged in an individual quarter, which results in variability in our quarterly earnings. In addition, our effective tax rate in any particular quarter may also be impacted by acquisitions.

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We cannot assure you that we will be successful in selecting, executing and integrating acquisitions. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. In addition, if stock market analysts or our stockholders do not support or believe in the value of the acquisitions that we choose to undertake, our stock price may decline.

**If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings.**

As a result of our acquisitions, we have significant goodwill and amortizable intangible assets recorded on our balance sheet. Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes

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in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered when determining if the carrying value of our goodwill or amortizable intangible assets may not be recoverable include market conditions, operating fundamentals, competition and general economic conditions. We may incur substantial impairment charges to earnings in our financial statements during the period should an impairment of our goodwill or amortizable intangible assets be determined resulting in an adverse impact on our results of operations.

### **Our income tax provision, liability for uncertain tax positions, and other tax reserves may be insufficient if any taxing authorities are successful in asserting tax positions that are contrary to our positions.**

Significant judgment is required to determine our provision for income taxes, liability for uncertain tax positions, and other tax reserves. In the ordinary course of our business, there may be matters for which the ultimate tax outcome is uncertain. Although we believe our approach to determining the appropriate tax treatment is reasonable, no assurance can be given that the final tax authority determination will not be materially different than that which is reflected in our income tax provision, liability for uncertain tax positions, and other tax reserves. Such differences could have a material adverse effect on our income tax provision or benefits, liability for uncertain tax positions, or other tax reserves, in the period in which such determination is made and, consequently, on our net income for such period.

From time to time, we are audited by various federal, state and local authorities regarding tax matters. Our audits are in various stages of completion; however, no outcome for a particular audit can be determined with certainty prior to the conclusion of the audit and, in some cases, appeal or litigation process. As each audit is concluded, adjustments, if any, are appropriately recorded in our financial statements in the period determined. To provide for potential tax exposures, we maintain a liability for uncertain tax positions in accordance with FIN 48. However, if these accrued liabilities and/or reserves are insufficient upon completion of any audit process, there could be an adverse impact on our financial position and results of operations.

### **We depend on a limited number of third party contract manufacturers for substantially all of our manufacturing needs. If these contract manufacturers experience any delay, disruption or quality control problems in their operations, we could lose market share and our brand may suffer.**

All of our products are manufactured, assembled, tested and generally packaged by a limited number of original design manufacturers ( ODMs ) and original equipment manufacturers ( OEMs ). We rely on our contract manufacturers to procure components and, in some cases, subcontract engineering work. Some of our products are manufactured by a single contract manufacturer. We do not have any long-term contracts with any of our third party contract manufacturers. Some of these third party contract manufacturers produce products for our competitors. The loss of the services of any of our primary third party contract manufacturers could cause a significant disruption in operations and delays in product shipments. Qualifying a new contract manufacturer and commencing volume production is expensive and time consuming.

Our reliance on third party contract manufacturers also exposes us to the following risks over which we have limited control:

unexpected increases in manufacturing and repair costs;

inability to control the quality of finished products;

inability to control delivery schedules; and

potential lack of adequate capacity to manufacture all or a part of the products we require.

All of our products must satisfy safety and regulatory standards and some of our products must also receive government certifications. Our ODM and OEM contract manufacturers are primarily responsible for obtaining most regulatory approvals for our products. If our ODMs and OEMs fail to obtain timely domestic or foreign regulatory approvals or certificates, we would be unable to sell our products and our sales and profitability could be reduced, our relationships with our sales channel could be harmed, and our reputation and brand would suffer.

### **If we are unable to provide our third party contract manufacturers a timely and accurate forecast of our component and material requirements, we may experience delays in the manufacturing of our products and the costs of our products may increase.**



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We provide our third party contract manufacturers with a rolling forecast of demand, which they use to determine our material and component requirements. Lead times for ordering materials and components vary significantly and depend on various factors, such as the specific supplier, contract terms and demand and supply for a component at a given time. Some of our components have long lead times, such as wireless local area network chipsets, switching fabric chips, physical layer transceivers, connector jacks and metal and plastic enclosures. If our forecasts are not timely provided or are less than our actual requirements, our contract manufacturers may be unable to manufacture products in a timely manner. If our forecasts are too high, our contract manufacturers will be unable to use the components they have purchased on our behalf. The cost of the components used in our products tends to drop rapidly as volumes increase and the technologies mature. Therefore, if our contract manufacturers are unable to promptly use components purchased on our behalf, our cost of producing products may be higher than our competitors due to an oversupply of higher-priced components. Moreover, if they are unable to use components ordered at our direction, we will need to reimburse them for any losses they incur.

### **We rely upon third parties for technology that is critical to our products, and if we are unable to continue to use this technology and future technology, our ability to develop, sell, maintain and support technologically advanced products would be limited.**

We rely on third parties to obtain non-exclusive patented hardware and software license rights in technologies that are incorporated into and necessary for the operation and functionality of most of our products. In these cases, because the intellectual property we license is available from third parties, barriers to entry may be lower than if we owned exclusive rights to the technology we license and use. On the other hand, if a competitor or potential competitor enters into an exclusive arrangement with any of our key third party technology providers, or if any of these providers unilaterally decide not to do business with us for any reason, our ability to develop and sell products containing that technology would be severely limited. If we are shipping products which contain third party technology that we subsequently lose the right to license, then we will not be able to continue to offer or support those products. Our licenses often require royalty payments or other consideration to third parties. Our success will depend in part on our continued ability to have access to these technologies, and we do not know whether these third party technologies will continue to be licensed to us on commercially acceptable terms or at all. If we are unable to license the necessary technology, we may be forced to acquire or develop alternative technology of lower quality or performance standards. This would limit and delay our ability to offer new or competitive products and increase our costs of production. As a result, our margins, market share, and operating results could be significantly harmed.

We also utilize third party software development companies to develop, customize, maintain and support software that is incorporated into our products. If these companies fail to timely deliver or continuously maintain and support the software that we require of them, we may experience delays in releasing new products or difficulties with supporting existing products and customers.

### **If we are unable to secure and protect our intellectual property rights, our ability to compete could be harmed.**

We rely upon third parties for a substantial portion of the intellectual property we use in our products. At the same time, we rely on a combination of copyright, trademark, patent and trade secret laws, nondisclosure agreements with employees, consultants and suppliers and other contractual provisions to establish, maintain and protect our intellectual property rights. Despite efforts to protect our intellectual property, unauthorized third parties may attempt to design around, copy aspects of our product design or obtain and use technology or other intellectual property associated with our products. For example, one of our primary intellectual property assets is the NETGEAR name, trademark and logo. We may be unable to stop third parties from adopting similar names, trademarks and logos, especially in those international markets where our intellectual property rights may be less protected. Furthermore, our competitors may independently develop similar technology or design around our intellectual property. Our inability to secure and protect our intellectual property rights could significantly harm our brand and business, operating results and financial condition.

### **Our sales and operations in international markets expose us to operational, financial and regulatory risks.**

International sales comprise a significant amount of our overall net revenue. International sales were 62% of overall net revenue in fiscal 2006. We anticipate that international sales may grow as a percentage of net revenue. We have committed resources to expanding our international operations and sales channels and these efforts may not be successful. International operations are subject to a number of other risks, including:

political and economic instability, international terrorism and anti-American sentiment, particularly in emerging markets;

preference for locally branded products, and laws and business practices favoring local competition;





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exchange rate fluctuations;

increased difficulty in managing inventory;

delayed revenue recognition;

less effective protection of intellectual property;

stringent consumer protection and product compliance regulations, including but not limited to the recently enacted Restriction of Hazardous Substances directive and the Waste Electrical and Electronic Equipment directive in Europe, that may vary from country to country and that are costly to comply with; and

difficulties and costs of staffing and managing foreign operations.

**We intend to expand our operations and infrastructure, which may strain our operations and increase our operating expenses.**

We intend to expand our operations and pursue market opportunities domestically and internationally to grow our sales. We expect that this attempted expansion will strain our existing management information systems, and operational and financial controls. In addition, if we continue to grow, our expenditures will likely be significantly higher than our historical costs. We may not be able to install adequate controls in an efficient and timely manner as our business grows, and our current systems may not be adequate to support our future operations. The difficulties associated with installing and implementing these new systems, procedures and controls may place a significant burden on our management, operational and financial resources. In addition, if we grow internationally, we will have to expand and enhance our communications infrastructure. If we fail to continue to improve our management information systems, procedures and financial controls or encounter unexpected difficulties during expansion, our business could be harmed.

**If the redemption rate for our end-user promotional programs is higher than we estimate, then our net revenue and gross margin will be negatively affected.**

From time to time we offer promotional incentives, including cash rebates, to encourage end-users to purchase certain of our products. Purchasers must follow specific and stringent guidelines to redeem these incentives or rebates. Often qualified purchasers choose not to apply for the incentives or fail to follow the required redemption guidelines, resulting in an incentive redemption rate of less than 100%. Based on historical data, we estimate an incentive redemption rate for our promotional programs. If the actual redemption rate is higher than our estimated rate, then our net revenue and gross margin will be negatively affected.

**We are required to evaluate our internal control under Section 404 of the Sarbanes-Oxley Act of 2002 and any adverse results from such evaluation could impact investor confidence in the reliability of our internal controls over financial reporting.**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to furnish a report by our management on our internal control over financial reporting. Such report must contain among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management.

We will continue to perform the system and process documentation and evaluation needed to comply with Section 404, which is both costly and challenging. During this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we will be unable to assert such internal control is effective. If we are unable to assert that our internal control over financial reporting is effective as of the end of a fiscal year or if our independent registered public accounting firm is unable to express an opinion on the effectiveness of our internal control over financial reporting, we could lose investor confidence in the accuracy and completeness of our financial reports, which may have an adverse effect on our stock price.

**We are continuing to implement our international reorganization, which is straining our resources and increasing our operating expenses.**

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We have been reorganizing our foreign subsidiaries and entities to better manage and optimize our international operations. Our implementation of this project requires substantial efforts by our staff and is resulting in increased staffing requirements and related expenses. Failure to successfully execute the reorganization or other factors outside of our control could negatively impact the timing and extent of any benefit we receive from the reorganization.

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**We are currently implementing new financial, demand planning and operational management systems, and problems with the design or implementation of these systems could interfere with our business and operations.**

We recently initiated a project to upgrade our financial and enterprise resource planning systems. We have invested, and will continue to invest, significant capital and human resources in their design and implementation, which may be disruptive to our underlying business. If we experience any disruptions or delays in their implementation, our ability to fulfill customer orders, bill and track our customers, fulfill contractual obligations, accurately report our financials and otherwise run our business could be adversely affected. Even if we do not encounter these adverse effects, the design and implementation of the new systems may be much more costly than we anticipated. If we are unable to successfully design and implement the new IT systems as planned, our financial position, results of operations and cash flows could be negatively impacted.

**Our stock price may be volatile and your investment in our common stock could suffer a decline in value.**

With the continuing uncertainty about economic conditions in the United States, there has been significant volatility in the market price and trading volume of securities of technology and other companies, which may be unrelated to the financial performance of these companies. These broad market fluctuations may negatively affect the market price of our common stock.

Some specific factors that may have a significant effect on our common stock market price include:

actual or anticipated fluctuations in our operating results or our competitors' operating results;

actual or anticipated changes in the growth rate of the general networking sector, our growth rates or our competitors' growth rates;

conditions in the financial markets in general or changes in general economic conditions;

interest rate or currency exchange rate fluctuations;

our ability to raise additional capital; and

changes in stock market analyst recommendations regarding our common stock, other comparable companies or our industry generally.

**Natural disasters, mischievous actions or terrorist attacks could delay our ability to receive or ship our products, or otherwise disrupt our business.**

Our corporate headquarters are located in Northern California and one of our warehouses is located in Southern California, regions known for seismic activity. In addition, substantially all of our manufacturing occurs in two geographically concentrated areas in mainland China, where disruptions from natural disasters, health epidemics and political, social and economic instability may affect the region. If our manufacturers or warehousing facilities are disrupted or destroyed, we would be unable to distribute our products on a timely basis, which could harm our business. Moreover, if our computer information systems or communication systems, or those of our vendors or customers, are subject to disruptive hacker attacks or other disruptions, our business could suffer. We have not established a formal disaster recovery plan. Our back-up operations may be inadequate and our business interruption insurance may not be enough to compensate us for any losses that may occur. A significant business interruption could result in losses or damages and harm our business. For example, much of our order fulfillment process is automated and the order information is stored on our servers. If our computer systems and servers go down even for a short period at the end of a fiscal quarter, our ability to recognize revenue would be delayed until we were again able to process and ship our orders, which could cause our stock price to decline significantly.

**If we lose the services of our Chairman and Chief Executive Officer, Patrick C.S. Lo, or our other key personnel, we may not be able to execute our business strategy effectively.**

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Our future success depends in large part upon the continued services of our key technical, sales, marketing and senior management personnel. In particular, the services of Patrick C.S. Lo, our Chairman and Chief Executive Officer, who has led our company since its inception, are very important to our business. In November 2006, Jonathan R. Mather, our former Executive Vice President and Chief Financial Officer, left the company to pursue other opportunities, and we are still in the process of searching for his replacement. We do not maintain any key person life insurance policies. The loss of any of our senior management or other key research, development, sales or marketing personnel, particularly if lost to competitors, could harm our ability to implement our business strategy and respond to the rapidly changing needs of the small business and home markets.

**Item 6. Exhibits****Exhibit**

<b>Number</b>	<b>Description</b>
10.41	Separation Agreement and Release, dated as of August 29, 2007, by and between NETGEAR, Inc. and Deborah A. Williams (1)
10.42	Office Lease, dated as of September 25, 2007, by and between NETGEAR, Inc. and BRE/Plumeria, LLC (2)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
32.1	Section 1350 Certification of Principal Executive Officer
32.2	Section 1350 Certification of Principal Financial Officer

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- (1) Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on August 30, 2007 with the Securities and Exchange Commission.
- (2) Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on September 27, 2007 with the Securities and Exchange Commission.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NETGEAR, INC.  
Registrant

*/s/ CHRISTINE M. GORJANC*  
Christine M. Gorjanc  
*Chief Accounting Officer*  
(Principal Financial and Accounting Officer)

Date: November 9, 2007

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