NETGEAR, INC
Form 10-Q
November 13, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended October 1, 2006.

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

For the transition period from to

Commission file number: 000-50350

NETGEAR, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0419172**
(State or other jurisdiction of incorporation or organization)	*(IRS Employer Identification No.)*
4500 Great America Parkway, Santa Clara, California	**95054**
(Address of principal executive offices)	*(Zip Code)*

(408) 907-8000

(Registrant s telephone number including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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 o Accelerated Filer þ Non-Accelerated Filer o

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

The number of outstanding shares of the registrant s Common Stock, $0.001 par value, was 33,729,992 as of November 3, 2006.

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PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements***

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

	October 1, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 42,980	$ 90,002
Short-term investments	108,106	83,654
Accounts receivable, net	117,780	104,269
Inventories	77,773	51,873
Deferred income taxes	13,880	11,503
Prepaid expenses and other current assets	18,506	9,408
Total current assets	379,025	350,709
Property and equipment, net	7,311	4,702
Intangibles, net	1,050	
Goodwill	3,805	558
Non-current deferred income taxes	2,235	328
Total assets	$ 393,426	$ 356,297
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 31,096	$ 38,912
Accrued employee compensation	8,892	7,743
Other accrued liabilities	63,349	66,279
Deferred revenue	12,532	4,304
Income taxes payable	4,300	3,055
Total current liabilities	120,169	120,293
Deferred income tax liability	429	
Total liabilities	120,598	120,293
Commitments and contingencies (Note 8)		
Stockholders equity:		
Common stock	33	33
Additional paid-in capital	213,317	204,754
Deferred stock-based compensation		(468)
Cumulative other comprehensive income (loss)	20	(90)
Retained earnings	59,458	31,775
Total stockholders equity	272,828	236,004

Total liabilities and stockholders equity	$ 393,426	$ 356,297

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

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

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Net revenue	$ 151,571	$ 111,317	$ 409,568	$ 327,845
Cost of revenue (1)	101,013	72,218	269,085	214,264
Gross profit	50,558	39,099	140,483	113,581
Operating expenses:				
Research and development (1)	4,675	3,414	13,196	9,611
Sales and marketing (1)	23,522	18,199	66,944	53,575
General and administrative (1)	5,762	3,579	15,176	11,149
In-process research and development	2,900		2,900	
Litigation reserves		600		600
Total operating expenses	36,859	25,792	98,216	74,935
Income from operations	13,699	13,307	42,267	38,646
Interest income	1,676	1,093	5,017	2,761
Other income (expense), net	(315)	(314)	606	(1,148)
Income before income taxes	15,060	14,086	47,890	40,259
Provision for income taxes	7,080	5,492	20,207	15,504
Net income	$ 7,980	$ 8,594	$ 27,683	$ 24,755
Net income per share:				
Basic	$ 0.24	$ 0.26	$ 0.83	$ 0.77
Diluted	$ 0.23	$ 0.25	$ 0.81	$ 0.73
Weighted average shares outstanding used to compute net income per share:				
Basic	33,443	32,697	33,246	32,160
Diluted	34,466	34,314	34,354	33,805

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

Cost of revenue	$ 118	$ 37	$ 311	$ 113
Research and development	331	72	725	225
Sales and marketing	359	57	955	330
General and administrative	443	45	1,096	228

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

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

	Nine Months Ended	
	October 1, 2006	October 2, 2005
Cash flows from operating activities:		
Net income	$ 27,683	$ 24,755
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,772	2,324
Accretion of purchase discounts on investments	(1,447)	(1,017)
Non-cash stock-based compensation	3,087	896
Income tax benefit associated with stock option exercises	1,540	6,785
Excess tax benefit from stock-based compensation	(1,217)	
Deferred income taxes	(3,717)	(638)
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(13,511)	(7,329)
Inventories	(25,900)	6,685
Prepaid expenses and other current assets	(9,093)	(1,718)
Accounts payable	(7,816)	(28,445)
Accrued employee compensation	1,149	2,138
Other accrued liabilities	(3,063)	1,812
Deferred revenue	8,228	2,597
Income taxes payable	1,245	(3,361)
Net cash provided by (used in) operating activities	(17,060)	5,484
Cash flows from investing activities:		
Purchases of short-term investments	(122,010)	(88,381)
Proceeds from sale of short-term investments	99,116	81,611
Purchase of property and equipment	(5,431)	(3,400)
Payments made in connection with business acquisition	(7,600)	
Net cash used in investing activities	(35,925)	(10,170)
Cash flows from financing activities:		
Proceeds from exercise of stock options	3,646	7,836
Proceeds from issuance of common stock under employee stock purchase plan	1,100	1,036
Excess tax benefit from stock-based compensation	1,217	
Net cash provided by financing activities	5,963	8,872
Net increase (decrease) in cash and cash equivalents	(47,022)	4,186
Cash and cash equivalents, at beginning of period	90,002	65,052
Cash and cash equivalents, at end of period	$ 42,980	$ 69,238

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 personal computers. The Company s products include Ethernet networking products, broadband access products, and wireless networking connectivity products that are sold worldwide through distributors, traditional retailers, on-line retailers, direct marketing 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, 2005 has been derived from audited financial statements at such date. In the opinion of management, the 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, 2005. Certain reclassifications have been made to prior period reported amounts to conform to the current period presentation. These changes had no impact on stockholders equity, previously reported net income or the net change in cash and cash equivalents.

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 October 1, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

Cash and cash equivalents

The Company considers all highly liquid investments with a maturity at the time of purchase of three months or less to be cash equivalents. The Company deposits cash and cash equivalents with high credit quality financial institutions.

Short-term investments

Short-term investments comprise marketable securities that consist of government securities with an original maturity or a remaining maturity at the time of purchase, of greater than three months and less than twelve months. All marketable securities are held in the Company s name with two high quality financial institutions, who act as the Company s custodians and investment managers. All of the Company s marketable securities are classified as available-for-sale securities in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 115, Accounting For Certain Investments in Debt and Equity Securities and are carried at fair value with unrealized gains and losses reported as a separate component of stockholders equity.

Certain risks and uncertainties

The Company s products are concentrated in the networking industry, which is characterized by rapid technological advances, changes in customer requirements and evolving regulatory requirements and industry standards. The success of the Company depends on management s ability to anticipate and/or to respond quickly and adequately to technological developments in its industry, changes in customer requirements, or changes in regulatory requirements

or industry standards. Any significant delays in the development or introduction of products could have a material adverse effect on the Company s business and operating results.

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The Company relies on a limited number of third parties to manufacture all of its products. If any of the Company s third party manufacturers cannot or will not manufacture its products in required volumes, on a cost-effective basis, in a timely manner, or at all, the Company will have to secure additional manufacturing capacity. Any interruption or delay in manufacturing could have a material adverse effect on the Company s business and operating results.

Concentration of credit risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash and cash equivalents, short-term investments and accounts receivable. The Company believes that there is minimal credit risk associated with the investment of its cash and cash equivalents and short-term investments, due to the high quality financial institutions which manage the Company s investments and the restrictions placed on the type of investment that can be entered into under the Company s investment policy.

The Company s customers are primarily distributors, retailers and broadband service providers who sell the products to a large group of end users. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of the Company s customers to make required payments. The Company regularly performs credit evaluations of the Company s customers financial condition and considers factors such as historical experience, credit quality, age of the accounts receivable balances, and geographic or country-specific risks and economic conditions that may affect customers ability to pay. The allowance for doubtful accounts is reviewed monthly and adjusted if necessary based on management s assessments of customers ability to pay. If the financial condition of customers should deteriorate, additional allowances may be required, which could have an adverse impact on operating expenses.

Fair value of financial instruments

The carrying amounts of the Company s financial instruments, including cash and cash equivalents, accounts receivable, prepaid expenses, accounts payable, accrued employee compensation and other accrued liabilities approximate their fair values due to their short maturities.

Inventories

Inventories consist primarily of finished goods which are valued at the lower of cost or market, cost being determined using the first-in, first-out method. The Company writes down its inventories based on estimated excess and obsolete inventories determined primarily by future demand forecasts. At the point of loss recognition, a new, lower cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Property and equipment

Property and equipment are stated at historical cost, less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets as follows:

Computer equipment	2 years
Furniture and fixtures	5 years
Software	2-5 years
Machinery and equipment	1-3 years
Leasehold improvements	Shorter of the lease term or 5 years

The Company accounts for impairment of property and equipment in accordance with SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset exceeds its estimated undiscounted future net cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. The carrying value of the asset is reviewed on a regular basis for the existence of facts, both internal and external, that may suggest impairment.

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Goodwill

The Company applies SFAS No. 142, Goodwill and Other Intangible Assets and performs an annual impairment test. For purposes of impairment testing, the Company has determined that it has only one reporting unit. The identification and measurement of goodwill impairment involves the estimation of the fair value of the Company. The estimates of fair value of the Company are based on the best information available as of the date of the assessment, which primarily includes the Company s market capitalization and incorporates management assumptions about expected future cash flows.

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 writedown 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 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):

	Nine Months Ended	
	October 1, 2006	October 2, 2005
Balance as of beginning of the period	$ 11,845	$ 10,766
Provision for warranty liability for sales made during the period	28,322	16,220
Settlements made during the period	(25,182)	(17,350)
Balance at end of period	$ 14,985	$ 9,636

Revenue recognition

Revenue from product sales is recognized at the time the product is shipped provided that persuasive evidence of an arrangement exists, title and risk of loss has transferred to the customer, the selling price is fixed or determinable and collection of the related receivable is reasonably assured. Currently, for some of the Company s international customers, title passes to the customer upon delivery to the port or country of destination or upon their receipt of the product, and for selected retailers in the United States to whom the Company sells directly, title passes to the customer upon their receipt of the product or upon the customer s resale of the product. At the end of each fiscal quarter, the Company estimates and defers revenue related to product where title has not transferred. The revenue continues to be deferred until such time that the title passes to the customer.

In addition to warranty-related returns, certain distributors and retailers generally have the right to return product for stock rotation purposes. Every quarter, stock rotation rights are generally limited to 10% of invoiced sales to the distributor or retailer in the prior quarter. Upon shipment of the product, the Company reduces revenue for an estimate of potential future product warranty and stock rotation returns related to the current period product revenue. Management analyzes historical returns, channel inventory levels, current economic trends and changes in customer

demand for the Company s products when evaluating the adequacy of the allowance for sales returns, namely warranty and stock rotation returns. Revenue on shipments is also reduced for estimated price protection and sales incentives deemed to be contra-revenue under Emerging Issues Task Force (EITF) Issue No. 01-9.

The Company records estimated reductions to revenues for end-user customer rebates at the later of when the related revenue is recognized or when the program is offered to the end consumer. 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, the Company estimates rebate redemption rates for its promotional programs and records such amounts as a reduction to revenue.

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Sales incentives

Sales incentives provided to customers are accounted for in accordance with EITF Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer or Reseller of the Vendor s Products . Under these guidelines, the Company accrues for sales incentives as a marketing expense if it receives an identifiable benefit in exchange and can reasonably estimate the fair value of the identifiable benefit received; otherwise, it is recorded as a reduction to revenues. As a consequence, the Company records a substantial portion of its channel marketing costs as a reduction of revenue.

Shipping and handling fees and costs

In September 2000, the EITF issued EITF Issue No. 00-10, Accounting for Shipping and Handling Fees and Costs. EITF Issue No. 00-10 requires shipping and handling fees billed to customers to be classified as revenue and shipping and handling costs to be either classified as cost of revenue or disclosed in the notes to the consolidated financial statements. 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. In cases where the Company gives a freight allowance to the purchaser for their own inbound freight costs, such costs are appropriately recorded as a reduction in net revenue. Shipping and handling costs associated with outbound freight are included in sales and marketing expenses and totaled $2.1 million for the three months ended October 1, 2006, $2.1 million for the three months ended October 2, 2005, $6.4 million for the nine months ended October 1, 2006, and $5.3 million for the nine months ended October 2, 2005.

Research and development

Costs incurred in the research and development of new products are charged to expense as incurred.

Advertising costs

Advertising costs are expensed as incurred.

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. These differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. 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.

The Company assesses the probability of adverse outcomes from tax examinations regularly to determine the adequacy of the Company s income tax liability. If the Company ultimately determines that payment of these amounts is unnecessary, the Company reverses the liability and recognizes a tax benefit during the period in which the Company determines that the liability is no longer necessary. The Company records an additional charge in the Company s provision for taxes in the period in which the Company determines that the recorded tax liability is less than the Company expects the ultimate assessment to be.

Computation of net income per share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the additional dilution from potential issuances of common stock, such as stock issuable pursuant to the exercise of stock options and awards. Potentially dilutive shares are excluded from the computation of diluted net income per share when their effect is anti-dilutive.

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Stock-based compensation

Effective January 1, 2006, NETGEAR adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), using the modified prospective transition method and therefore has not restated results for prior periods. Under this transition method, stock-based compensation expense for the first nine months of fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123). Stock-based compensation expense for all stock-based compensation awards granted on or after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is generally the option vesting term of four years. Prior to the adoption of SFAS 123R, the Company recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). In March 2005, the Securities and Exchange Commission (the SEC) issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC s interpretation of SFAS 123R and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R. See Note 4 for a further discussion on stock-based compensation.

Comprehensive income

Under SFAS 130, Reporting Comprehensive Income, the Company is required to display comprehensive income and its components as part of the financial statements.

Foreign currency translation

The Company s functional currency is the U.S. dollar for all of its international subsidiaries. Foreign currency transactions of international subsidiaries are remeasured into U.S. dollars at the end-of-period exchange rates for monetary assets and liabilities, and historical exchange rates for nonmonetary assets. Expenses are remeasured at average exchange rates in effect during each period, except for expenses related to non-monetary assets, which are remeasured at historical exchange rates. Revenue is remeasured at the daily rate in effect as of the date the order ships.

2. Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in income tax positions. FIN 48 requires that the Company recognize in the consolidated financial statements the impact of a tax position that is more likely than not to be sustained upon examination based on the technical merits of the position. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adopting FIN 48 on the consolidated financial statements.

In June 2006, the EITF reached a consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) (EITF 06-3). EITF 06-3 provides that the presentation of taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer on either a gross basis (included in revenues and costs) or on a net basis (excluded from revenues) is an accounting policy decision that should be disclosed. EITF 06-3 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adopting EITF 06-3 on the consolidated financial statements.

In September 2006, the FASB issued 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 September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 requires that registrants quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in a misstated amount that, when all relevant quantitative and qualitative factors are considered, is

material. SAB 108 is effective for fiscal years beginning after November 15, 2006, and is not expected to have a material impact on the Company s consolidated financial statements.

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3. Business Acquisition

On August 1, 2006, the Company completed the acquisition of SkipJam Corp. (SkipJam), a developer of integrated software for home entertainment and control. The Company believes the acquisition enhances its strategically important digital home entertainment and control business by strengthening the Company s ability to expand its multimedia product portfolio. The aggregate purchase price was $7.6 million, paid in cash.

The results of SkipJam s operations have been included in the consolidated financial statements since the date of acquisition. The historical results of SkipJam 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 $7.7 million, consisting of cash, and other costs directly related to the acquisition as follows (in thousands):

Purchase price	$ 7,600
Direct acquisition costs	133
Total consideration	$ 7,733

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. The excess of purchase price over the aggregate fair values was recorded as goodwill. The fair values assigned to identifiable intangible assets acquired were estimated with the assistance of an independent valuation firm. Purchased intangibles are amortized on a straight-line basis over their respective useful lives. The total preliminary allocation of the purchase price is as follows (in thousands):

	Fair Value on August 1, 2006
Prepaid expenses and other current assets	$ 6
Intangibles	4,000
Goodwill	3,247
Non-current deferred income taxes	909
Deferred income tax liability	(429)
Total purchase price allocation	$ 7,733

$2.9 million of the $4.0 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 only one in-process R&D project, which is related to the development of a multimedia product that has not reached technological feasibility and has no alternative use.

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 a discount rate of 35% 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.

To date, there have been no significant differences between the actual and estimated results of the in-process R&D project. The Company estimates that it will incur costs of approximately $465,000 to complete the project, of which approximately $200,000 was incurred through October 1, 2006. The Company expects to complete the project by December 2006 and to benefit from the in-process R&D project in fiscal 2007.

$1.0 million of the $4.0 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 $1.0 million will be amortized over its four year useful life.

The remaining acquired intangible assets consist of non-competition agreements of $100,000, with a 2 year useful life. None of the goodwill recorded as part of the SkipJam acquisition will be deductible for income tax purposes.

As part of the acquisition, the Company has also agreed to pay up to $1.4 million in cash contingent on the continued employment of certain SkipJam employees with the Company. These payments will be recorded as compensation expense over a two-year period. During the three and nine months ended October 1, 2006, the Company recorded $156,000 of additional compensation expense pursuant to this agreement.

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4. Stock-based Compensation

At October 1, 2006, the Company had four stock-based employee compensation plans as described below. The total compensation expense related to these plans was approximately $1.3 million and $3.1 million, respectively, for the three and nine months ended October 1, 2006. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of APB 25. Accordingly, the Company generally recognized compensation expense only when it granted options with a discounted exercise price. Any resulting compensation expense was recognized ratably over the associated service period, which was generally the option vesting term.

Prior to January 1, 2006, the Company provided pro forma disclosure amounts in accordance with SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), as if the fair value method defined by SFAS 123 had been applied to its stock-based compensation.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition method and therefore has not restated prior periods results. Under this transition method, stock-based compensation expense for the first nine months of fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Stock-based compensation expense for the first nine months of fiscal 2006 also includes stock-based compensation awards granted after January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

The Company recognizes these compensation costs net of the estimated forfeitures on a straight-line basis over the requisite service period of the award, which is generally the option vesting term of four years. The Company estimated the forfeiture rate for the first nine months of fiscal 2006 based on its historical experience during the preceding five fiscal years.

As a result of adopting SFAS 123R, the Company s income before income taxes for the three and nine months ended October 1, 2006 was $1.1 million and $2.7 million lower, respectively, and net income for the three and nine months ended October 1, 2006 was $818,000 and $1.9 million lower, respectively, than if the Company had continued to account for stock-based compensation under APB 25. The impact on basic and diluted earnings per share for the three months ended October 1, 2006 was $0.02 and $0.03 per share, respectively. The impact on basic and diluted earnings per share for the nine months ended October 1, 2006 was $0.06 and $0.05 per share, respectively. Total stock-based compensation cost capitalized in inventory was less than $0.1 million for the three months ended October 1, 2006.

In addition, prior to the adoption of SFAS 123R, the Company presented the excess tax benefit of stock option exercises as operating cash flows. Upon the adoption of SFAS 123R, as if windfall tax benefits (the tax deductions in excess of the compensation cost that would increase the pool of windfall tax benefits) are classified as financing cash flows, with the remaining excess tax benefit classified as operating cash flows. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Prior period cash flows are not reclassified to reflect this new requirement. In addition, total cash flow is not impacted as a result of this new requirement.

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The pro forma table below reflects net earnings and basic and diluted net earnings per share for the three and nine months ended October 2, 2005, had the Company applied the fair value recognition provisions of SFAS 123, as follows (in thousands, except per share data):

	Three Months Ended October 2, 2005	Nine Months Ended October 2, 2005
Net income, as reported	$ 8,594	$ 24,755
Add:		
Employee stock-based compensation included in reported net income	211	896
Less:		
Total employee stock-based compensation determined under fair value method, net of taxes (1)	(1,301)	(6,609)
Adjusted net income	$ 7,504	$ 19,042
Basic net income per share:		
As reported	$ 0.26	$ 0.77
Pro forma	$ 0.23	$ 0.59
Diluted net income per share:		
As reported	$ 0.25	$ 0.73
Pro forma	$ 0.22	$ 0.56

(1) Of the 58,800 and 846,700 options granted during the three and nine months ended October 2, 2005, respectively, 58,800 and 666,750 were sales-restricted options that vested immediately on grant, respectively. These options had a fair value of $491,000 and $3.8 million, net

of taxes,
respectively.

As of October 1, 2006, the Company has the following share-based compensation plans:

2000 Stock Option Plan

In April 2000, the Company adopted the 2000 Stock Option Plan (the 2000 Plan). The 2000 Plan provides for the granting of stock options to employees and consultants of the Company. Options granted under the 2000 Plan may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options (NSO) may be granted to Company employees, directors and consultants. 7,350,000 shares of Common Stock have been reserved for issuance under the 2000 Plan.

Options under the 2000 Plan may be granted for periods of up to ten years and at prices no less than the estimated fair value of the shares on the date of grant as determined by the Board of Directors, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than the estimated fair value of the shares on the date of grant and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. To date, options granted generally vest over four years.

2003 Stock Plan

In April 2003, the Company adopted the 2003 Stock Plan (the 2003 Plan). The 2003 Plan provides for the granting of stock options to employees and consultants of the Company. Options granted under the 2003 Plan may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options (NSO) may be granted to Company employees, directors and consultants. The Company has reserved 750,000 shares of Common Stock plus any shares which were reserved but not issued under the 2000 Plan as of the date of the approval of the 2003 Plan. The number of shares which were reserved but not issued under the 2000 Plan that were transferred to the Company s 2003 Plan were 615,290, which when combined with the shares reserved for the Company s 2003 Plan give a total of 1,365,290 shares reserved under the Company s 2003 Plan as of the date of transfer. Any options cancelled under either the 2000 Plan or the 2003 Plan are returned to the pool available for grant. As of October 1, 2006, 92,927 shares were reserved for future grants under the Company s 2003 Plan.

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Options under the 2003 Plan may be granted for periods of up to ten years and at prices no less than the estimated fair value of the common stock on the date of grant as determined by the closing sales price for such stock as quoted on any established stock exchange or a national market system, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than the estimated fair value of the shares on the date of grant and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. To date, options granted generally vest over four years, the first tranche at the end of twelve months and the remaining shares underlying the option vesting monthly over the remaining three years. In fiscal 2005, certain options granted under the 2003 Plan immediately vested and were exercisable on the date of grant, and the shares underlying such options were subject to a resale restriction which expires at a rate of 25% per year.

2006 Long Term Incentive Plan

In April 2006, the Company adopted the 2006 Long Term Incentive Plan (the 2006 Plan), which was approved by the Company s stockholders at the 2006 Annual Meeting of Stockholders on May 23, 2006. The 2006 Plan provides for the granting of stock options, stock appreciation rights, restricted stock, performance awards and other stock awards, to eligible directors, employees and consultants of the Company. The Company has reserved 2,500,000 shares of Common Stock for issuance under the 2006 Plan. Any options cancelled under the 2006 Plan are returned to the pool available for grant. As of October 1, 2006, 2,046,050 shares were reserved for future grants under the 2006 Plan.

Options granted under the 2006 Plan may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to Company employees (including officers and directors who are also employees). Nonqualified stock options (NSO) may be granted to Company employees, directors and consultants. Options may be granted for periods of up to ten years and at prices no less than the estimated fair value of the common stock on the date of grant as determined by the closing sales price for such stock as quoted on any established stock exchange or a national market system, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than the estimated fair value of the shares on the date of grant and (ii) the exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. Options granted under the 2006 Plan generally vest over four years, the first tranche at the end of twelve months and the remaining shares underlying the option vesting monthly over the remaining three years.

Stock Appreciation Rights may be granted under the 2006 Plan subject to the terms specified by the plan administrator, provided that the term of any such right may not exceed ten (10) years from the date of grant. The exercise price generally cannot be less than the fair market value of NETGEAR s common stock on the date the stock appreciation right is granted.

Restricted stock awards may be granted under the 2006 Plan subject to the terms specified by the plan administrator. The period over which any restricted award may fully vest is generally no less than three (3) years. Restricted stock awards are nonvested stock awards that may include grants of restricted stock or grants of restricted stock units. Restricted stock awards are independent of option grants and are generally subject to forfeiture if employment terminates prior to the release of the restrictions. During that period, ownership of the shares cannot be transferred. Restricted stock has the same voting rights as other common stock and is considered to be currently issued and outstanding. Restricted stock units do not have the voting rights of common stock, and the shares underlying the restricted stock units are not considered issued and outstanding. The Company expenses the cost of the restricted stock awards, which is determined to be the fair market value of the shares at the date of grant, ratably over the period during which the restrictions lapse.

Performance awards may be in the form of performance shares or performance units. A performance share means an award denominated in shares of Company common stock and a performance unit means an award denominated in units having a dollar value or other currency, as determined by the Committee. The plan administrator will determine the number of performance awards that will be granted and will establish the performance goals and other conditions for payment of such performance awards. The period of measuring the achievement of performance goals will be a minimum of twelve (12) months.

Other stock-based awards may be granted under the 2006 Plan subject to the terms specified by the plan administrator. Other stock-based awards may include dividend equivalents, restricted stock awards, or amounts which are equivalent to all or a portion of any federal, state, local, domestic or foreign taxes relating to an award, and may be

payable in shares, cash, other securities or any other form of property as the plan administrator may determine.

In the event of a change in control of the Company, all awards under the 2006 Plan vest and all outstanding performance shares and performance units will be paid out upon transfer.

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Employee Stock Purchase Plan

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. Prior to January 1, 2006, employees were able to purchase stock semi-annually at a price equal to 85% of the fair market value at certain plan-defined dates. As of January 1, 2006, the Company changed the ESPP such that employees will purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date. Since the price of the shares is now determined at the purchase date and there is no longer a look-back period, the Company recognizes the expense based on the 15% discount at purchase. For the three and nine months ended October 1, 2006, ESPP compensation expense was $55,000 and $160,000, respectively.

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		ESPP
	Three Months Ended		Three Months Ended
	October 1, 2006	October 2, 2005	October 2, 2005
Expected life (in years)	4.9	4.0	0.5
Risk-free interest rate	4.88%	3.96%	3.21%
Expected volatility	59%	54%	54%
Dividend yield			
Weighted average fair value of grants	$10.44	$9.18	$ 5.75

	Stock Options		ESPP
	Nine Months Ended		Nine Months Ended
	October 1, 2006	October 2, 2005	October 2, 2005
Expected life (in years)	4.9	4.0	0.5
Risk-free interest rate	4.89%	3.68%	2.93%
Expected volatility	61%	56%	54%
Dividend yield			
Weighted average fair value of grants	$11.50	$7.55	$ 5.21

Options outstanding under the stock option plans as of December 31, 2005 and changes during the nine months ended October 1, 2006 were as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2005	3,673,687	$10.49		

Options granted	777,950	20.57		
Options exercised	(459,792)	7.93		
Options cancelled	(77,310)	16.54		
Options outstanding at October 1, 2006	3,914,535	$12.68	6.82	$ 49,635
Options exercisable at October 1, 2006	2,842,678	$10.44	5.96	$ 29,690

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The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company s closing stock price on the last trading day of the third quarter of fiscal 2006 and the exercise price, multiplied by the number of shares underlying the in-the-money options) that would have been received by the option holders had all option holders exercised their options on October 1, 2006. This amount changes based on the fair market value of the Company s stock. Total intrinsic value of options exercised for the three and nine months ended October 1, 2006 was $1.2 million and $6.4 million, respectively. Total fair value of options expensed for the three and nine months ended October 1, 2006 was $855,000 and $2.1 million, net of tax, respectively.

As of October 1, 2006, $9.7 million of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted-average period of 1.64 years.

Cash received from option exercises and purchases under the ESPP for the three and nine months ended October 1, 2006 was $578,000 and $4.7 million, respectively. The actual excess tax benefit recognized for the tax deduction arising from the exercise of stock-based compensation awards for the three and nine months ended October 1, 2006 totaled $341,000 and $1.5 million, respectively.

Nonvested restricted stock awards as of October 1, 2006 and changes during the nine months ended October 1, 2006 were as follows:

	Shares	Weighted Average Grant Date Fair Value
Nonvested outstanding at December 31, 2005		$
Granted	70,000	22.68
Exercised		
Cancelled		
Nonvested outstanding at October 1, 2006	70,000	$22.68

As of October 1, 2006, $1.2 million of total unrecognized compensation cost related to nonvested restricted stock awards is expected to be recognized over a weighted-average period of 1.29 years.

5. Balance Sheet Components

Accounts receivable, net:

	October 1, 2006	December 31, 2005
	(In thousands)	
Gross accounts receivable	$ 128,862	$ 113,005
Less: Allowance for doubtful accounts	(1,683)	(1,295)
Allowance for sales returns	(7,274)	(5,985)
Allowance for price protection	(2,125)	(1,456)
Total allowances	(11,082)	(8,736)
Accounts receivable, net	$ 117,780	$ 104,269

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Inventories:

	October 1, 2006	December 31, 2005
	(In thousands)	
Finished goods	$ 77,773	$ 51,873

Other accrued liabilities:

	October 1, 2006	December 31, 2005
	(In thousands)	
Sales and marketing programs	$ 31,178	$ 39,126
Warranty obligation	14,985	11,845
Outsourced engineering costs	1,648	1,732
Freight	4,394	5,814
Other	11,144	7,762
Other accrued liabilities	$ 63,349	$ 66,279

6. Net Income Per Share

Basic Earnings Per Share (EPS) is computed by dividing net income (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Basic EPS excludes the dilutive effect of stock options. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased using the proceeds from the assumed exercise of stock options.

Net income per share for the three and nine months ended October 1, 2006 and October 2, 2005 are as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Net income	$ 7,980	$ 8,594	$ 27,683	$ 24,755
Weighted average shares outstanding:				
Basic	33,443	32,697	33,246	32,160
Options and awards	1,023	1,617	1,108	1,645
Total diluted	34,466	34,314	34,354	33,805
Basic net income per share	$ 0.24	$ 0.26	$ 0.83	$ 0.77
Diluted net income per share	$ 0.23	$ 0.25	$ 0.81	$ 0.73

Anti-dilutive outstanding common stock options amounting to 996,002 and zero were excluded from the weighted average shares outstanding for the three months ended October 1, 2006 and October 2, 2005, respectively, and

639,641 and 78,777 were excluded from the weighted average shares outstanding for the nine months ended October 1, 2006 and October 2, 2005, respectively.

7. 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. NETGEAR 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.

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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 EITF Issue No. 01-9, sales returns and price protection, which reduce gross revenue. In 2005, the Company refined its methodology for these items to allocate them on a specific identification basis to the geography to which they relate. Previously such amounts were allocated based on each geography s gross revenue as a percentage of total gross revenue. Geographic revenue information for the three months ended October 2, 2005 has been revised to be consistent and comparable with the presentation of geographic revenue for the three months ended October 1, 2006. For the three months ended October 2, 2005, this revision resulted in decreases in previously reported amounts in the United States of $5.4 million, and increases in the United Kingdom of $1.0 million, Germany of $723,000, EMEA (excluding UK and Germany) of $1.9 million, and Asia Pacific and rest of the world of $1.8 million. For the nine months ended October 2, 2005, this revision resulted in decreases in previously reported amounts in the United States of $18.5 million, and increases in the United Kingdom of $5.4 million, Germany of $2.1 million, EMEA (excluding UK and Germany) of $5.3 million, and Asia Pacific and rest of the world of $5.7 million.

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

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
United States	$ 56,119	$ 53,627	$ 169,026	$ 146,796
United Kingdom	45,142	17,655	94,275	57,695
Germany	14,997	11,931	41,759	37,136
EMEA (excluding UK and Germany)	21,501	15,590	62,237	47,019
Asia Pacific and rest of the world	13,812	12,514	42,271	39,199
	$ 151,571	$ 111,317	$ 409,568	$ 327,845

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):

	October 1, 2006	October 2, 2005
United States	$ 3,362	$ 4,309
EMEA	555	49
Asia Pacific and rest of the world	3,394	297
	$ 7,311	$ 4,655

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

	Three Months Ended		Nine Months Ended	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Ingram Micro, Inc.	18%	24%	20%	27%
Tech Data Corporation	15%	17%	16%	17%
British Sky Broadcasting	12%	0%	7%	0%
All others individually less than 10% of net revenue	55%	59%	57%	56%

	100%	100%	100%	100%

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8. Commitments and Contingencies

Purchase Commitments

The Company enters 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 October 1, 2006, the Company had approximately $60.2 million in non-cancelable purchase commitments with suppliers.

Indemnification

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 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 Director and Officer insurance that limits its exposure and enables it to recover a portion of any future amounts paid. To date the Company has not received any claims. As a result, the Company believes the fair value of these indemnification agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of October 1, 2006.

In its sales agreements, the Company typically agrees to indemnify its 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 that it has recourse to its suppliers and vendors in the event amounts are required to be paid to settle lawsuits. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of October 1, 2006.

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, CSIRO filed an answer to the complaint, and a motion to transfer the case from the Northern District of California to the Eastern District of Texas. This action is in the preliminary motion stages and no trial date has been set.

SercoNet v. NETGEAR

In May 2006, a lawsuit was filed against the Company by SercoNet, Ltd., 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 alleges that the Company infringes U.S. Patents Nos. 5,841,360; 6,480,510; 6,970,538; 7,016,368; and 7,035,280. SercoNet has accused certain of the Company s switches, routers, modems, adapters, powerline products, and wireless access points of infringement. 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 preliminary motion stages and no trial date has been set.

These 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 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 all of the foregoing 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.

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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 networking products for home and small business users. We define small business as a business with fewer than 250 employees. We are focused on satisfying the ease-of-use, quality, 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 personal computers, or PCs, and other Internet-enabled devices.

Our product line consists of switches, adapters, and 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.

Our products are sold through multiple sales channels worldwide, including traditional retailers, online retailers, direct market resellers, or DMRs, value added resellers, or VARs, and, broadband service providers. Our retail channel includes traditional retail locations domestically and internationally, such as Best Buy, Circuit City, CompUSA, Costco, 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 Comcast, Charter Communications and Time-Warner Cable, in domestic markets and British Sky Broadcasting (UK), AOL (UK), Telewest/NTL (UK), Tele Denmark, and Telstra (Australia) 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 36.2% from the quarter ended October 2, 2005 to the quarter ended October 1, 2006. The increase in net revenue was especially attributable to increased shipments of our products in our broadband and home networking product categories. This growth was most notably driven by increased sales of broadband gateways to carriers and service providers, especially in the United Kingdom. We have also experienced continued growth in our RangeMax line of wireless routers and gateways.

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.

Our gross margin decreased to 33.4% for the quarter ended October 1, 2006, from 35.1% for the quarter ended October 2, 2005. This decrease was due primarily to a shift in product mix and to a lesser extent increased warranty and sales returns costs. Operating expenses for the quarter ended October 1, 2006 were $36.9 million or 24.4% of net revenue compared to $25.8 million or 23.1% of net revenue for the quarter ended October 2, 2005, in part due to acquired in-process research and development.

Net income decreased $614,000, or 7.1%, to $8.0 million for the quarter ended October 1, 2006, from $8.6 million for the quarter ended October 2, 2005. This decrease was primarily due to an increase in operating expenses of $11.1 million, including $2.9 million in acquired in-process research and development, and an increase in provision for income taxes of $1.6 million, partially offset by an increase in gross profit of $11.5 million and an increase in interest income of $583,000.

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Results of Operations

The following table sets forth the consolidated statements of operations and the percentage change for the three and nine months ended October 1, 2006, with the comparable reporting period in the preceding year.

	Three Months Ended			Nine Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)			(In thousands, except percentage data)		
Net revenue	$ 151,571	36.2%	$ 111,317	$ 409,568	24.9%	$ 327,845
Cost of revenue	101,013	39.9	72,218	269,085	25.6	214,264
Gross profit	50,558	29.3	39,099	140,483	23.7	113,581
Operating expenses:						
Research and development	4,675	36.9	3,414	13,196	37.3	9,611
Sales and marketing	23,522	29.2	18,199	66,944	25.0	53,575
General and administrative	5,762	61.0	3,579	15,176	36.1	11,149
In-process research and development	2,900	**		2,900	**	
Litigation reserves		(100.0)	600		(100.0)	600
Total operating expenses	36,859	42.9	25,792	98,216	31.1	74,935
Income from operations	13,699	2.9	13,307	42,267	9.4	38,646
Interest income	1,676	53.3	1,093	5,017	81.7	2,761
Other income (expense), net	(315)	0.3	(314)	606	**	(1,148)
Income before income taxes	15,060	6.9	14,086	47,890	19.0	40,259
Provision for income taxes	7,080	28.9	5,492	20,207	30.3	15,504
Net income	$ 7,980	(7.1%)	$ 8,594	$ 27,683	11.8%	$ 24,755

** Percentage change not meaningful as prior period 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	
	October 1, 2006	October 2, 2005	October 1, 2006	October 2, 2005
Net revenue	100%	100%	100%	100%
Cost of revenue	66.6	64.9	65.7	65.4
Gross margin	33.4	35.1	34.3	34.6
Operating expenses:				
Research and development	3.1	3.1	3.2	2.9
Sales and marketing	15.6	16.3	16.4	16.3
General and administrative	3.8	3.2	3.7	3.4
In-process research and development	1.9	0.0	0.7	0.0
Litigation reserves	0.0	0.5	0.0	0.2
Total operating expenses	24.4	23.1	24.0	22.8
Income from operations	9.0	12.0	10.3	11.8
Interest income	1.1	1.0	1.2	0.8
Other income (expense), net	(0.2)	(0.3)	0.2	(0.3)
Income before income taxes	9.9	12.7	11.7	12.3
Provision for income taxes	4.6	5.0	4.9	4.7
Net income	5.3%	7.7%	6.8%	7.6%

Quarter Ended October 1, 2006 Compared to Quarter Ended October 2, 2005

Net Revenue

	Three Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Net revenue	$151,571	36.2%	$111,317

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 $40.3 million, or 36.2%, to $151.6 million for the quarter ended October 1, 2006, from $111.3 million for the quarter ended October 2, 2005. The increase in net revenue was especially attributable to increased shipments of our products in our broadband and home networking product categories. This growth was most notably driven by increased sales of broadband gateways to carriers and service providers, especially in the United Kingdom. We have also experienced continued growth in our RangeMax line of wireless routers and gateways.

Marketing expenses that are classified as contra-revenue grew at a slower rate than overall gross sales, which further contributed to the increased net revenue. This is primarily due to increased sales in the carrier and service provider markets, which typically entails less marketing spending. This favorable net revenue impact was partially offset by an increase in historical experience of sales returns.

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In the quarter ended October 1, 2006, net revenue generated within North America, Europe, Middle-East and Africa (EMEA) and Asia Pacific was 37.0%, 53.9% and 9.1%, respectively, of our total net revenue. The comparable net revenue for the quarter ended October 2, 2005 was 48.2%, 40.6% and 11.2%, respectively, of our total net revenue. The increase in net revenue over the prior year comparable quarter for each region was 4.6%, 80.7% and 10.4%, respectively. The EMEA increase was especially attributable to growth in the United Kingdom, as sales of wireless broadband internet gateways to carriers in that market grew. The Asia Pacific increase was primarily due to expanded presence in new markets.

Cost of Revenue and Gross Margin

	Three Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Cost of revenue	$101,013	39.9%	$72,218
Gross margin percentage	33.4%		35.1%

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; freight; and warranty costs associated with returned goods and write-downs for excess and obsolete inventory. 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, freight-in, conversion costs, and charges for excess or obsolete inventory and transitions from older to newer products.

Cost of revenue increased $28.8 million, or 39.9%, to $101.0 million for the quarter ended October 1, 2006, from $72.2 million for the quarter ended October 2, 2005. In addition, our gross margin decreased to 33.4% for the quarter ended October 1, 2006, from 35.1% for the quarter ended October 2, 2005. This 1.7 point decrease was due primarily to a shift in product mix. Our growth came primarily from increased sales of products carrying lower gross margins to carriers and service providers. We also experienced increased warranty and sales returns costs, as well as higher costs related to inventory reserves and devaluation. This decrease was partially mitigated by certain gross margin improvements. Marketing expenses grew at a relatively slower rate than overall net revenue, resulting in a margin benefit. Additionally, we experienced decreased price protection claims, as well as relatively lower freight and overhead costs.

Operating Expenses

Research and Development

	Three Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Research and development expense	$4,675	36.9%	$3,414
Percentage of net revenue	3.1%		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, enhance the ease-of-use of our products,

and broaden our core competencies.

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Research and development expenses increased $1.3 million, or 36.9%, to $4.7 million for the quarter ended October 1, 2006, from $3.4 million for the quarter ended October 2, 2005. The increase was primarily due to higher salary and related payroll expenses of $583,000 resulting from research and development related headcount growth, including $156,000 related to retention bonuses for certain employees associated with the acquisition of SkipJam Corp. (SkipJam). Employee headcount increased by 8% to 57 employees as of October 1, 2006 as compared to 53 employees as of October 2, 2005 due to employees obtained from the acquisition of SkipJam. The increase was also attributable to an increase of $213,000 in certification, tooling, and other development costs related to new product introductions and existing product redesigns. Additionally, stock-based compensation expense increased $259,000 to $331,000 for the quarter ended October 1, 2006, from $72,000 for the quarter ended October 2, 2005, as a result of the adoption of SFAS 123R.

Sales and Marketing

	Three Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Sales and marketing expense	$23,522	29.2%	$18,199
Percentage of net revenue	15.6%		16.3%

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 $5.3 million, or 29.2%, to $23.5 million for the quarter ended October 1, 2006, from $18.2 million for the quarter ended October 2, 2005. Of this increase, $2.8 million was due to increased salary and payroll related expenses as a result of sales and marketing related headcount growth. Employee headcount increased from 146 employees as of October 2, 2005 to 190 employees as of October 1, 2006. More specifically, 26 of the 44 incremental employees relate to expansion in EMEA and Asia Pacific, where sales and marketing employee headcount grew 38% and 15%, respectively. We have continued to expand our geographic market presence with investments in sales resources, and incurred an $813,000 increase in advertising, travel, and promotion expenses related to expanded marketing activities. Outside service fees related to customer service and technical support also increased by $974,000, in support of higher call volumes related to increased units sold. Additionally, stock-based compensation expense increased $302,000 to $359,000 for the quarter ended October 1, 2006, from $57,000 for the quarter ended October 2, 2005, as a result of the adoption of SFAS 123R.

General and Administrative

	Three Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
General and administrative expense	$5,762	61.0%	$3,579
Percentage of net revenue	3.8%		3.2%

General and administrative expenses consist of salaries and related expenses for executive, finance and accounting, human resources, professional fees, allowance for bad debts, and other corporate expenses. We expect general and administrative costs to increase in absolute dollars related to the growth of the business as well as to fund the continued expansion of our Ireland-based international operations center throughout 2006 to support our growing international business.

General and administrative expenses increased $2.2 million, or 61.0%, to $5.8 million for the quarter ended October 1, 2006, from $3.6 million for the quarter ended October 2, 2005. The increase was primarily due to higher salary and payroll related expenses of $794,000 due to an increase in general and administrative related headcount. Employee headcount increased by 27% to 65 employees as of October 1, 2006 compared to 51 employees as of October 2, 2005. We also incurred a $615,000 increase in fees for outside

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professional services, which was in part related to an increase in IT consulting costs, outside tax preparation costs and general legal expenses. Facility costs in part due to our new office in Ireland also increased by $225,000. Additionally, stock-based compensation expense increased $398,000 to $443,000 for the quarter ended October 1, 2006, from $45,000 for the quarter ended October 2, 2005, as a result of the adoption of SFAS 123R.

In-process Research and Development

During the quarter ended October 1, 2006, we expensed $2.9 million for in-process research and development related to intangible assets purchased in our acquisition of SkipJam. See Note 3 for additional information regarding the acquisition. In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist. We acquired only one in-process R&D project, which is related to the development of a multimedia product that has not reached technological feasibility and has no alternative use.

To date, there have been no significant differences between the actual and estimated results of the in-process R&D project. We estimate that we will incur costs of approximately $465,000 to complete the project, of which approximately $200,000 was incurred through October 1, 2006. We expect to complete the project by December 2006 and to benefit from the in-process R&D project in fiscal 2007.

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 quarter ended October 2, 2005, we recorded a reserve of $600,000 for the estimated costs of adjudication or settlement of a matter which was subsequently settled.

Interest Income and Other Expense, Net

	Three Months Ended	
	October 1, 2006	October 2, 2005
	(In thousands)	
Interest income	$ 1,676	$ 1,093
Other expense, net	(315)	(314)
Total interest income and other income (expense)	$ 1,361	$ 779

Interest income represents amounts earned on our cash, cash equivalents and short-term investments.

Other income (expense), net, primarily represents gains and losses on transactions denominated in foreign currencies and other miscellaneous expenses.

Interest income increased $583,000, or 53.3%, to $1.7 million for the quarter ended October 1, 2006, from $1.1 million for the quarter ended October 2, 2005. The increase in interest income was due to an increase in the average interest rate earned in the third quarter of 2006 as compared to the third quarter of 2005.

Other expense, net, increased $1,000 to $315,000 for the quarter ended October 1, 2006, from $314,000 for the quarter ended October 2, 2005. The expense in both quarters was primarily attributable to foreign exchange losses experienced due to the strengthening of the U.S. dollar against the Euro and Great Britain Pound.

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Provision for Income Taxes

The provision for income taxes increased $1.6 million, to $7.1 million for the quarter ended October 1, 2006, from $5.5 million for the quarter ended October 2, 2005. The effective tax rate was approximately 47.0% for the quarter ended October 1, 2006 and approximately 39.0% for the quarter ended October 2, 2005. The effective tax rate for both periods differed from our statutory rate of approximately 35% due to non-deductible stock-based compensation, state taxes, and other non-deductible expenses. The effective tax rate for the quarter ended October 1, 2006 was also impacted by a non-deductible charge pertaining to in-process research and development as a result of the acquisition of SkipJam.

Net Income

Net income decreased $614,000, or 7.1%, to $8.0 million for the quarter ended October 1, 2006, from $8.6 million for the quarter ended October 2, 2005. This decrease was primarily due to an increase in operating expenses of $11.1 million, including $2.9 million in acquired in-process research and development, and an increase in provision for income taxes of $1.6 million, partially offset by an increase in gross profit of $11.5 million and an increase in interest income of $583,000.

Nine Months Ended October 1, 2006 Compared to Nine Months Ended October 2, 2005

Net Revenue

	Nine Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Net revenue	$409,568	24.9%	$327,845

Net revenue increased $81.8 million, or 24.9%, to $409.6 million for the nine months ended October 1, 2006, from $327.8 million for the nine months ended October 2, 2005. The increase in net revenue was especially attributable to increased shipments of our products in our broadband and home networking product categories. This growth was most notably driven by increased sales of broadband gateways to carriers and service providers, especially in the United Kingdom. We have also experienced growth in our RangeMax line of wireless routers and gateways, as well as continued strength in G and Super G routers and gateways. Increased sales of new products such as our Storage Central and our Powerline products also contributed significantly to home network revenue growth.

Marketing expenses that are classified as contra-revenue grew at a slower rate than overall gross sales, which further contributed to the increased net revenue. This is primarily due to increased sales in the carrier and service provider markets, which typically entails less marketing spending. This favorable net revenue impact was partially offset by an increase in historical experience of warranty and sales returns.

In the nine months ended October 1, 2006, net revenue generated within North America, EMEA and Asia Pacific was 41.3%, 48.4% and 10.3%, respectively, of our total net revenue. The comparable net revenue for the nine months ended October 2, 2005 was 44.8%, 43.3% and 11.9%, respectively, of our total net revenue. The increase in net revenue over the prior year comparable nine months for each region was 15.1%, 39.8% and 7.8%, respectively. The EMEA increase was especially attributable to growth in the United Kingdom, as sales of wireless broadband internet gateways to carriers in that market grew. Additionally, EMEA sales grew significantly in the Benelux region. The Asia Pacific increase was primarily due to expanded presence in new markets.

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Cost of Revenue and Gross Margin

	Nine Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Cost of revenue	$269,085	25.6%	$214,264
Gross margin percentage	34.3%		34.6%

Cost of revenue increased $54.8 million, or 25.6%, to $269.1 million for the nine months ended October 1, 2006, from $214.3 million for the nine months ended October 2, 2005. In addition, our gross margin decreased to 34.3% for the nine months ended October 1, 2006, from 34.6% for the nine months ended October 2, 2005. This 0.3 point decrease was due primarily to a shift in product mix. Our growth came primarily from increased sales of products carrying lower gross margins to carriers and service providers. We also experienced increased warranty and sales returns costs, as well as higher costs related to inventory reserves and devaluation. This decrease was partially mitigated by certain gross margin improvements. Marketing expenses grew at a relatively slower rate than overall net revenue, resulting in a margin benefit. Additionally, we experienced decreased price protection claims, as well as relatively lower overhead costs.

Operating Expenses

Research and Development

	Nine Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Research and development expense	$13,196	37.3%	$9,611
Percentage of net revenue	3.2%		2.9%

Research and development expenses increased $3.6 million, or 37.3%, to $13.2 million for the nine months ended October 1, 2006, from $9.6 million for the nine months ended October 2, 2005. The increase was primarily due to a $1.4 million increase in certification, tooling, and other development costs related to new product introductions and existing product redesigns. The increase was also attributable to increased salary and related payroll expenses of $1.3 million resulting from research and development related headcount growth. Employee headcount increased by 8% to 57 employees as of October 1, 2006 as compared to 53 employees as of October 2, 2005 due to employees obtained from the acquisition of SkipJam. Additionally, stock-based compensation expense increased $500,000 to $725,000 for the nine months ended October 1, 2006, from $225,000 for the nine months ended October 2, 2005, as a result of the adoption of SFAS 123R.

Sales and Marketing

	Nine Months Ended		
	October 1, 2006	Percentage Change	October 2, 2005
	(In thousands, except percentage data)		
Sales and marketing expense	$66,944	25.0%	$53,575
Percentage of net revenue	16.4%		16.3%

Sales and marketing expenses increased $13.3 million, or 25.0%, to $66.9 million for the nine months ended October 1, 2006, from $53.6 million for the nine months ended October 2, 2005. Of this increase, $5.7 million was due to increased salary and payroll related expenses as a result of sales and marketing related headcount growth. Employee headcount increased from 146 employees as of October 2, 2005 to 190 employees as of October 1, 2006. More specifically, 26 of the 44 incremental employees relate to expansion in EMEA and Asia Pacific, where sales and marketing employee headcount grew 38% and 15%, respectively. We have continued to expand our geographic

market presence with investments in sales resources. In addition, outside service fees related to customer service and technical support increased by $3.3 million, in support of higher call volumes related to increased units sold. Outbound

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freight also increased $1.2 million, reflecting our higher sales volume. We also incurred a $1.4 million increase in advertising, travel, and promotion expenses. Additionally, stock-based compensation expense increased $625,000 to $955,000 for the nine months ended October 1, 2006, from $330,000 for the nine months ended October 2, 2005, as a result of the adoption of SFAS 123R.

General and Administrative

	Nine Months Ended		
	October 1, 2006	**Percentage Change**	**October 2, 2005**
	(In thousands, except percentage data)		
General and administrative expense	$15,176	36.1%	$11,149
Percentage of net revenue	3.7%		3.4%

General and administrative expenses increased $4.1 million, or 36.1%, to $15.2 million for the nine months ended October 1, 2006, from $11.1 million for the nine months ended October 2, 2005. The increase was primarily due to higher salary and payroll related expenses of $2.1 million due to an increase in general and administrative related headcount, particularly in the finance area to support an increase in transactional processing due to increased revenue. Employee headcount increased by 27% to 65 employees as of October 1, 2006 compared to 51 employees as of October 2, 2005. We also incurred a $714,000 increase in fees for outside professional services, which was in part related to an increase in IT and tax consulting costs. Facility costs in part due to our new office in Ireland also increased by $481,000. Additionally, stock-based compensation expense increased $868,000 to $1.1 million for the nine months ended October 1, 2006, from $228,000 for the nine months ended October 2, 2005, as a result of the adoption of SFAS 123R.

In-process Research and Development

During the nine months ended October 1, 2006, we expensed $2.9 million for in-process research and development related to intangible assets purchased in our acquisition of SkipJam. See Note 3 for additional information regarding the acquisition. In-process R&D is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist. We acquired only one in-process R&D project, which is related to the development of a multimedia product that has not reached technological feasibility and has no alternative use.

To date, there have been no significant differences between the actual and estimated results of the in-process R&D project. We estimate that we will incur costs of approximately $465,000 to complete the project, of which approximately $200,000 was incurred through October 1, 2006. We expect to complete the project by December 2006 and to benefit from the in-process R&D project in fiscal 2007.

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 October 2, 2005, we recorded a reserve of $600,000 for the estimated costs of adjudication or settlement of a matter which was subsequently settled.

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Interest Income and Other Income (Expense), Net

	Nine Months Ended	
	October 1, 2006	October 2, 2005
	(In thousands)	
Interest income	$ 5,017	$ 2,761
Other income (expense), net	606	(1,148)
Total interest income and other income (expense)	$ 5,623	$ 1,613

Interest income increased $2.2 million, or 81.7%, to $5.0 million for the nine months ended October 1, 2006, from $2.8 million for the nine months ended October 2, 2005. The increase in interest income was a result of an increase in the average balance of cash, cash equivalents and short-term investments, as well as an increase in the average interest rate earned in the first nine months of 2006 as compared to the first nine months of 2005.

Other income (expense), net, increased $1.7 million to income of $606,000 for the nine months ended October 1, 2006, from an expense of $1.1 million for the nine months ended October 2, 2005. The income of $606,000 was primarily attributable to a foreign exchange gain experienced in the nine months ended October 1, 2006 due to the weakening of the U.S. dollar against the Euro and Great Britain Pound. The expense of $1.1 million was primarily attributable to a foreign exchange loss experienced in the nine months ended October 2, 2005 due to the strengthening of the U.S. dollar against the Euro and Great Britain Pound.

Provision for Income Taxes

The provision for income taxes increased $4.7 million, to $20.2 million for the nine months ended October 1, 2006, from $15.5 million for the nine months ended October 2, 2005. The effective tax rate was approximately 42.2% for the nine months ended October 1, 2006 and approximately 38.5% for the nine months ended October 2, 2005. The effective tax rate for both periods differed from our statutory rate of approximately 35% due to non-deductible stock-based compensation, state taxes, and other non-deductible expenses. The effective tax rate for the nine months ended October 1, 2006 was also impacted by a non-deductible charge pertaining to in-process research and development as a result of the acquisition of SkipJam.

Net Income

Net income increased $2.9 million, or 11.8%, to $27.7 million for the nine months ended October 1, 2006, from $24.8 million for the nine months ended October 2, 2005. This increase was primarily due to an increase in gross profit of $26.9 million, an increase in interest income of $2.2 million, and an increase in other income of $1.7 million, partially offset by an increase in operating expenses of $23.3 million, including $2.9 million in acquired in-process research and development, and an increase in provision for income taxes of $4.7 million.

Liquidity and Capital Resources

As of October 1, 2006, we had cash, cash equivalents and short-term investments totaling $151.1 million. Short-term investments accounted for $108.1 million of this balance.

Our cash and cash equivalents balance decreased from $90.0 million as of December 31, 2005 to $43.0 million as of October 1, 2006. Operating activities during the nine months ended October 1, 2006 used cash of $17.1 million, which primarily consisted of inventory purchases. Investing activities during the nine months ended October 1, 2006 used $35.9 million primarily for the net purchase of short-term investments of $22.9 million, payments made in connection with our acquisition of SkipJam of $7.6 million, and purchases of property and equipment amounting to $5.4 million. During the nine months ended October 1, 2006, financing activities provided $6.0 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 decreased from 77 days as of December 31, 2005 to 71 days as of October 1, 2006.

Our accounts payable decreased from $38.9 million at December 31, 2005 to $31.1 million at October 1, 2006. The decrease of $7.8 million is due to the timing of purchases and our decision to take advantage of favorable discounts upon prompt payment.

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Inventory increased by $25.9 million from $51.9 million at December 31, 2005 to $77.8 million at October 1, 2006. In the quarter ended October 1, 2006 we experienced annual ending inventory turns of approximately 5.2, down from approximately 6.5 in the quarter ended December 31, 2005.

We lease office space and equipment under non-cancelable operating leases with various expiration dates through April 2011. 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 October 1, 2006, we had approximately $60.2 million in non-cancelable purchase commitments with 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 October 1, 2006 (in thousands):

Contractual Obligations	Less than 1 Year	1 3 Years	3 5 Years	Total
Operating leases	$ 2,236	$ 1,886	$ 207	$ 4,329
Purchase obligations	60,174			60,174
	$ 62,410	$ 1,886	$ 207	$ 64,503

As of October 1, 2006, 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.

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, 2005. Other than the stock-based compensation accounting policy below, our critical accounting policies have not materially changed during the nine months ended October 1, 2006.

Stock-based compensation

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition method and therefore have not restated results for prior periods. Under this transition method, stock-based compensation expense for the first nine months of fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Stock-based compensation expense for all stock-based compensation awards granted on or after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. We recognize these compensation costs on a straight-line basis over the requisite service period of the award, which is generally the option vesting term of four years. Prior to the adoption of SFAS 123R, we recognized stock-based compensation expense in accordance with APB 25. In March 2005, the SEC issued SAB 107 regarding the SEC s interpretation of SFAS 123R and the valuation of share-based payments for public companies. We have applied the provisions of SAB 107 in our adoption of SFAS 123R.

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Determining the appropriate fair value model and calculating the fair value of stock-based compensation awards requires the input of highly subjective assumptions, including the expected life of the stock-based compensation awards and stock price volatility. The assumptions used in calculating the fair value of stock-based compensation awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 4 of the notes to unaudited condensed consolidated financial statements in the Form 10-Q for a further discussion on stock-based compensation.

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.

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, Great Britain 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 October 1, 2006, 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 $3.2 million to net income at October 1, 2006.

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 financial 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 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 financial 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 Securities Exchange Act of 1934 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.

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PART II: OTHER INFORMATION

Item 1. ***Legal Proceedings***

NETGEAR v. CSIRO

In May 2005, we 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 our products. CSIRO had asserted that our 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, CSIRO filed an answer to the complaint, and a motion to transfer the case from the Northern District of California to the Eastern District of Texas. This action is in the preliminary motion stages and no trial date has been set.

SercoNet v. NETGEAR

In May 2006, a lawsuit was filed against us by SercoNet, Ltd., 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 alleges that we infringe U.S. Patents Nos. 5,841,360; 6,480,510; 6,970,538; 7,016,368; and 7,035,280. SercoNet has accused certain of our switches, routers, modems, adapters, powerline products, and wireless access points of infringement. In July 2006, the court granted our motion to transfer the action to the Northern District of California. This action is in the preliminary motion stages and no trial date has been set.

These claims against us, or filed by us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, and result in the diversion of significant operational resources. Were an unfavorable outcome to occur, there exists the possibility it would have a material adverse impact on our financial position and results of operations for the period in which the unfavorable outcome occurs or becomes probable.

In addition, we are 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 all of the foregoing matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

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 Form 10-Q and others such as:

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

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our inability to accurately forecast product demand;

our inventory level and turns;

unanticipated shift in overall product mix from higher to lower margin products which 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;

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;

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.

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 advertising expenditures or other 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, 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 AARIS Group, Inc., Motorola, Inc., Scientific Atlanta, a Cisco company, Thomson Corporation and Terayon Communications Systems, 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.

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

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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 or members of our sales channel, 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. If we do not resolve these claims on a favorable basis, our business, operating results and financial condition could be significantly harmed.

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 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

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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 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.

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, on-line 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. A competitor with more extensive product lines and stronger brand identity, such as Cisco Systems, may have greater bargaining power with these retailers. The competition for retail shelf space may increase, which would require us to increase our marketing expenditures simply to maintain current levels of retail shelf space. 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. 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 overcome successfully the challenges associated with profitably growing our broadband service provider sales channel, our net revenue and gross profit will be negatively impacted.

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We face a number of challenges associated with penetrating 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, competition from established suppliers, pricing pressure resulting in lower gross margins, and our general inexperience in selling to service providers. Orders from service providers are large but sporadic, which results in our carrier revenues fluctuating and challenges our ability to forecast accurately demand from service providers. 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.

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 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 the majority 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 losses, and our exposure to losses in foreign currency transactions 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.

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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, have 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 EMEA, 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 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 recent 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 October 1, 2006, sales to Ingram Micro and its affiliates accounted for 18% of our net revenue and sales to Tech Data and its affiliates accounted for 15% 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.

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.

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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. Such report must also contain a statement that our independent registered public accounting firm has issued an audit report on management s assessment of such internal controls.

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 attest that our management s report is fairly stated or they are 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 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, or ODMs, and original equipment manufacturers, or 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 an 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.

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 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

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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 over supply 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 our products. 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. 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 56% of overall net revenue in fiscal 2005. 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;
- exchange rate fluctuations;
- increased difficulty in managing inventory;

delayed revenue recognition;

less effective protection of intellectual property;

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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, or WEEE 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.

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

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. As part of the reorganization, we have been implementing new information technology systems, including new forecasting and order processing systems. If we fail to successfully and timely integrate these new systems, we will suffer disruptions to our operations. Any unanticipated interruptions in our business operations as a result of implementing these changes that could result in loss or delay in revenue causing an adverse effect on our financial results.

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 our growth rates or our competitors growth rates;

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

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

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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.

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 April 2006, Jonathan R. Mather, our Executive Vice President and Chief Financial Officer, informed us of his intent to leave the company to pursue other opportunities. Mr. Mather s departure is tentatively scheduled for the end of November 2006. If we are unable to timely hire a replacement Chief Financial Officer prior to Mr. Mather s planned departure, we may not be able to ensure a smooth transition. All of our executive officers or key employees are at will employees, and 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 Number	**Description**
2.1	Agreement and Plan of Merger, dated as of July 26, 2006, by and among NETGEAR, Inc., SKJM Holdings Corporation, SkipJam Corp., Michael Spilo, Jonathan Daub, Francis Refol, Dennis Aldover and Zhicheng Qiu (1)
10.35	Employment Agreement, effective as of September 5, 2006, by and between NETGEAR, Inc. and Deborah Williams (2)
10.36	Relocation Agreement, effective as of September 5, 2006, by and between NETGEAR, Inc. and Deborah Williams (3)
10.37	Employment Agreement, effective as of September 7, 2006, by and between NETGEAR, Inc. and Thomas Holt (4)
10.38	Relocation Agreement, effective as of September 7, 2006, by and between NETGEAR, Inc. and Thomas Holt (5)
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

(1)

Incorporated by reference to Exhibit 2.1 of the Company s Current Report on Form 8-K filed on July 27, 2006 with the Securities and Exchange Commission.

(2) Incorporated by reference to Exhibit 99.1 of the Company s Current Report on Form 8-K filed on September 11, 2006 with the Securities and Exchange Commission.

(3) Incorporated by reference to Exhibit 99.2 of the Company s Current Report on Form 8-K filed on September 11, 2006 with the Securities and Exchange Commission.

(4) Incorporated by reference to Exhibit 99.3 of the Company s Current Report on Form 8-K filed on September 11, 2006 with the Securities and Exchange Commission.

(5) Incorporated by reference to Exhibit 99.4 of the Company s Current Report on Form 8-K filed on September 11, 2006 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/ JONATHAN R. MATHER
Jonathan R. Mather
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: November 13, 2006

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