NETGEAR INC
Form 10-Q
August 11, 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 July 2, 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 £

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

Large Accelerated Filer £ Accelerated Filer þ Non-Accelerated Filer £

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

The number of outstanding shares of the registrant s Common Stock, $0.001 par value, was 33,409,993 as of August 4, 2006.

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PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements***

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

	July 2, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 51,620	$ 90,002
Short-term investments	107,260	83,654
Accounts receivable, net	105,993	104,269
Inventories	69,322	51,873
Deferred income taxes	11,599	11,503
Prepaid expenses and other current assets	13,657	9,408
Total current assets	359,451	350,709
Property and equipment, net	6,826	4,702
Goodwill	558	558
Other non-current assets	1,025	328
Total assets	$ 367,860	$ 356,297
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 33,263	$ 38,912
Accrued employee compensation	7,675	7,743
Other accrued liabilities	56,054	66,279
Deferred revenue	6,882	4,304
Income taxes payable	1,131	3,055
Total current liabilities	105,005	120,293
Commitments and contingencies (Note 7)		
Stockholders equity:		
Common stock	33	33
Additional paid-in capital	211,489	204,754
Deferred stock-based compensation		(468)
Cumulative other comprehensive loss	(145)	(90)
Retained earnings	51,478	31,775
Total stockholders equity	262,855	236,004
Total liabilities and stockholders equity	$ 367,860	$ 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		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Net revenue	$ 130,738	$ 107,576	$ 257,997	$ 216,528
Cost of revenue (1)	85,361	68,975	168,072	142,046
Gross profit	45,377	38,601	89,925	74,482
Operating expenses:				
Research and development (1)	3,989	3,280	8,521	6,197
Sales and marketing (1)	22,740	18,298	43,422	35,376
General and administrative (1)	4,991	3,895	9,414	7,570
Total operating expenses	31,720	25,473	61,357	49,143
Income from operations	13,657	13,128	28,568	25,339
Interest income	1,739	897	3,341	1,668
Other income (expense)	852	(780)	921	(834)
Income before income taxes	16,248	13,245	32,830	26,173
Provision for income taxes	6,413	4,944	13,127	10,012
Net income	$ 9,835	$ 8,301	$ 19,703	$ 16,161
Net income per share:				
Basic	$ 0.30	$ 0.26	$ 0.59	$ 0.51
Diluted	$ 0.29	$ 0.25	$ 0.57	$ 0.48
Weighted average shares outstanding used to compute net income per share:				
Basic	33,251	32,146	33,147	31,901
Diluted	34,484	33,716	34,293	33,480
(1) Stock-based compensation expense was allocated as follows:				
Cost of revenue	$ 102	$ 38	$ 193	$ 76
Research and development	193	73	394	153
Sales and marketing	303	124	596	273
General and administrative	413	89	653	183

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

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

	Six Months Ended	
	July 2, 2006	**July 3, 2005**
Cash flows from operating activities:		
Net income	$ 19,703	$ 16,161
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,656	1,559
Accretion of purchase discounts on investments	(872)	(691)
Non-cash stock-based compensation	1,836	685
Income tax benefit associated with stock option exercises	1,199	4,272
Excess tax benefit from stock-based compensation	(998)	
Deferred income taxes	(593)	(948)
Changes in assets and liabilities:		
Accounts receivable	(1,724)	4,221
Inventories	(17,449)	9,451
Prepaid expenses and other current assets	(4,249)	624
Accounts payable	(5,649)	(30,314)
Accrued employee compensation	(68)	449
Other accrued liabilities	(10,225)	(1,342)
Deferred revenue	2,578	529
Income taxes payable	(1,924)	(2,741)
Net cash provided by (used in) operating activities	(16,779)	1,915
Cash flows from investing activities:		
Purchases of short-term investments	(87,638)	(53,912)
Proceeds from sale of short-term investments	64,850	56,813
Purchase of property and equipment	(3,781)	(2,312)
Payments made in connection with business acquisition	(200)	
Net cash provided by (used in) in investing activities	(26,769)	589
Cash flows from financing activities:		
Proceeds from exercise of stock options	3,068	5,660
Proceeds from issuance of common stock under employee stock purchase plan	1,100	1,036
Excess tax benefit from stock-based compensation	998	
Net cash provided by financing activities	5,166	6,696
Net increase (decrease) in cash and cash equivalents	(38,382)	9,200
Cash and cash equivalents, at beginning of period	90,002	65,052
Cash and cash equivalents, at end of period	$ 51,620	$ 74,252

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

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 six months ended July 2, 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.

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 future warranty obligations. The warranties are generally for one or more years from the date of purchase by the end user. The Company s liability under these warranties is to provide a replacement product or issue a credit to the customer when a valid claim is received. Because the Company s products are manufactured by a contract manufacturer, in most cases the Company has recourse to the contract manufacturer for replacement or credit for the defective products. The Company accounts for warranty returns similar to stock rotation returns. That is, revenue on shipments is reduced for estimated returns for product under warranty. Factors that affect the Company s warranty liability include the number of installed units, historical experience and management s judgment regarding anticipated rates of warranty claims. The Company assesses the adequacy of its warranty liability every quarter and makes adjustments to the liability if necessary. 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):

	Six Months Ended	
	July 2, 2006	**July 3, 2005**
Balance as of beginning of the period	$ 11,845	$ 10,766
Provision for warranty liability for sales made during the period	17,273	10,368
Settlements made during the period	(15,965)	(11,011)
Balance at end of period	$ 13,153	$ 10,123

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.

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 $2.2 million for the three months ended July 2, 2006, $1.7 million for the three months ended July 3, 2005, $4.3 million for the six months ended July 2, 2006, and $3.1 million for the six months ended July 3, 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. Potentially dilutive shares are excluded from the computation of diluted net income per share when their effect is anti-dilutive.

Stock-based Compensation

Effective January 1, 2006, NETGEAR adopted the fair value recognition provisions of Statement of Financial Accounting Standards (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 six 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 3 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.

3. Stock-based Compensation

At July 2, 2006, the Company had four stock-based employee compensation plans as described below. The total compensation expense related to these plans was approximately $1.0 million and $1.8 million, respectively, for the three and six months ended July 2, 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 six 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 six 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 forfeiture rate 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 six 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 six months ended July 2, 2006 was $860,000 and $1.5 million lower, respectively, and net income for the three and six months ended July 2, 2006 was $531,000 and $1.1 million lower, respectively, than if the Company had continued to account for stock-based compensation under APB 25. The impact on both basic and diluted earnings per share for the three months ended July 2, 2006 was $0.01 per share, and the impact on both basic and diluted earnings per share for the six months ended July 2, 2006 was $0.04 per share. Total stock-based compensation cost capitalized in inventory was less than $0.1 million for the three months ended July 2, 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.

The pro forma table below reflects net earnings and basic and diluted net earnings per share for the three and six months ended July 3, 2005, had the Company applied the fair value recognition provisions of SFAS 123, as follows (in thousands, except per share data):

	Three Months Ended July 3, 2005	Six Months Ended July 3, 2005
Net income, as reported	$ 8,301	$ 16,161
Add:		
Employee stock-based compensation included in reported net income	324	685
Less:		
Total employee stock-based compensation determined under fair value method, net of taxes (1)	(1,606)	(5,309)
Adjusted net income	$ 7,019	$ 11,537
Basic net income per share:		
As reported	$ 0.26	$ 0.51
Pro forma	$ 0.22	$ 0.36
Diluted net income per share:		
As reported	$ 0.25	$ 0.48
Pro forma	$ 0.21	$ 0.34

(1) Of the 192,300 and 787,900 options granted during the three and six months ended July 3, 2005, respectively, 92,300 and 607,950 were sales-restricted options that vested immediately on grant, respectively.

These options had a fair value of $633,000 and $3.3 million, net of taxes, respectively.

As of July 2, 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 July 2, 2006, 65,091 shares were reserved for future grants under the Company s 2003 Plan.

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 July 2, 2006, 2,098,750 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

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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.

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 six months ended July 2, 2006, ESPP compensation expense was $33,000 and $105,000, 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 the rate on a U.S. Treasury bill or bond that approximates the expected life of the option. Expected volatility is based on both 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**
	July 2, 2006	**July 3, 2005**	**July 3, 2005**
Expected life (in years)	5.0	4.0	0.5
Risk-free interest rate	4.96%	3.73%	3.21%
Expected volatility	61%	58%	54%
Dividend yield			
Weighted average fair value of grants	$12.66	$8.41	$ 5.75

	Stock Options		**ESPP**
	Six Months Ended		**Six Months Ended**
	July 2, 2006	**July 3, 2005**	**July 3, 2005**