COGNEX CORP
Form 10-Q
October 27, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
(Mark One)

[X]	Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 28, 2014 or
[ ]	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 001-34218
COGNEX CORPORATION
(Exact name of registrant as specified in its charter)

Massachusetts	04-2713778
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

One Vision Drive
Natick, Massachusetts 01760-2059
(508) 650-3000
(Address, including zip code, and telephone number, including area code, of principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes X No

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

Large accelerated filer	X	Accelerated filer
Non-accelerated filer		Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No X

As of September 28, 2014, there were 87,045,169 shares of Common Stock, $.002 par value per share, of the registrant outstanding.

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COGNEX CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Three-months Ended		Nine-months Ended	
	September 28, 2014 (unaudited)	September 29, 2013	September 28, 2014 (unaudited)	September 29, 2013
Revenue				
Product	$158,631	$83,464	$345,142	$237,834
Service	10,725	7,324	23,945	20,356
	169,356	90,788	369,087	258,190
Cost of revenue				
Product	37,825	18,132	77,689	52,506
Service	6,502	3,216	13,512	9,415
	44,327	21,348	91,201	61,921
Gross margin				
Product	120,806	65,332	267,453	185,328
Service	4,223	4,108	10,433	10,941
	125,029	69,440	277,886	196,269
Research, development, and engineering expenses	18,542	12,184	44,666	35,392
Selling, general, and administrative expenses	47,059	33,877	120,627	99,344
Operating income	59,428	23,379	112,593	61,533
Foreign currency gain (loss)	716	(442)	510	(303)
Investment income	776	937	2,364	2,103
Other income (expense)	202	(166)	(146)	(306)
Income before income tax expense	61,122	23,708	115,321	63,027
Income tax expense	10,722	2,981	20,467	9,897
Net income	$50,400	$20,727	$94,854	$53,130
Earnings per weighted-average common and common-equivalent share:				
Basic	$0.58	$0.24	$1.09	$0.61
Diluted	$0.57	$0.23	$1.06	$0.59
Weighted-average common and common-equivalent shares outstanding:				
Basic	86,963	87,339	86,875	87,578
Diluted	89,167	89,359	89,145	89,450

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

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COGNEX CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Three-months Ended		Nine-months Ended	
	September 28, 2014	September 29, 2013	September 28, 2014	September 29, 2013
	(unaudited)		(unaudited)	
Net income	$50,400	$20,727	$94,854	$53,130
Other comprehensive income (loss), net of tax:				
Cash flow hedges:				
Change in net unrealized gain (loss), net of tax of $4 and $0 in the three-month periods and net of tax of ($2) and $0 in the nine-month periods, respectively	62	—	(173)	—
Reclassification adjustments for loss (gain) included in net income	44	—	101	—
Net change related to cash flow hedges	106	—	(72)	—
Available-for-sale investments:				
Change in net unrealized gain (loss), net of tax of ($49) and $152 in the three-month periods and net of tax of $133 and ($124) in the nine-month periods, respectively	(120)	764	1,441	(342)
Reclassification adjustments for loss (gain) included in net income	(45)	(20)	(651)	(103)
Net change related to available-for-sale investments	(165)	744	790	(445)
Currency translation adjustments:				
Change in currency translation adjustments, net of tax of $441 and $302 in the three-month periods and net of tax of $501 and $121 in the nine-month periods, respectively	(4,540)	1,626	(4,639)	(181)
Net change related to currency translation adjustments	(4,540)	1,626	(4,639)	(181)
Other comprehensive income (loss), net of tax	(4,599)	2,370	(3,921)	(626)
Total comprehensive income	$45,801	$23,097	$90,933	$52,504

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

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COGNEX CORPORATION
CONSOLIDATED BALANCE SHEETS
(In thousands)

	September 28, 2014 (unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$38,179	$40,644
Short-term investments	49,758	184,822
Accounts receivable, less reserves of $1,184 and $1,354 in 2014 and 2013, respectively	99,949	53,015
Inventories	31,210	25,694
Unbilled revenue	13,292	1,793
Deferred income taxes	8,329	7,611
Prepaid expenses and other current assets	17,032	18,472
Total current assets	257,749	332,051
Long-term investments	409,283	229,655
Property, plant, and equipment, net	39,318	37,136
Deferred income taxes	14,846	12,307
Intangible assets, net	11,789	14,723
Goodwill	81,689	81,689
Other assets	1,728	2,138
	$816,402	$709,699
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$13,302	$9,487
Accrued expenses	39,503	34,331
Accrued income taxes	1,450	1,263
Deferred revenue	24,253	15,941
Total current liabilities	78,508	61,022
Reserve for income taxes	3,942	4,765
Commitments and contingencies (Note 8)		
Shareholders' equity:		
Common stock, $.002 par value –		
Authorized: 140,000 shares, issued and outstanding: 87,045 and 86,831 shares in 2014 and 2013, respectively	174	174
Additional paid-in capital	245,687	211,440
Retained earnings	521,845	462,131
Accumulated other comprehensive loss, net of tax	(33,754)	(29,833)
Total shareholders' equity	733,952	643,912
	$816,402	$709,699

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

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COGNEX CORPORATION
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine-months Ended	
	September 28, 2014	September 29, 2013
	(unaudited)	
Cash flows from operating activities:		
Net income	$94,854	$53,130
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation expense	11,258	8,299
Depreciation of property, plant, and equipment	6,194	5,389
Amortization of intangible assets	2,934	2,880
Amortization of discounts or premiums on investments	1,596	1,996
Realized gain on sale of investments	(651)	(103)
Net unrealized loss on trading securities	—	267
Tax effect of stock option exercises	(7,178)	(6,584)
Change in deferred income taxes	(2,959)	216
Change in operating assets and liabilities:		
Accounts receivable	(51,961)	(7,010)
Unbilled revenue	(12,234)	(1,862)
Inventories	(6,555)	(1,342)
Deferred revenue	9,453	(1,143)
Accrued income taxes	7,331	5,651
Accrued expenses	6,221	2,486
Other	4,684	(3,035)
Net cash provided by operating activities	62,987	59,235
Cash flows from investing activities:		
Purchases of investments	(283,982)	(251,033)
Maturities and sales of investments	239,396	178,372
Purchases of property, plant, and equipment	(9,078)	(6,152)
Net cash used in investing activities	(53,664)	(78,813)
Cash flows from financing activities:		
Issuance of common stock under stock option plans	15,651	25,990
Repurchase of common stock	(35,140)	(28,059)
Tax effect of stock option exercises	7,178	6,584
Net cash provided by (used in) financing activities	(12,311)	4,515
Effect of foreign exchange rate changes on cash and cash equivalents	523	349
Net change in cash and cash equivalents	(2,465)	(14,714)
Cash and cash equivalents at beginning of period	40,644	45,160
Cash and cash equivalents at end of period	$38,179	$30,446

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

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COGNEX CORPORATION
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(In thousands)

	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	Total Shareholders'
	Shares	Par Value	Capital	Earnings	Loss	Equity
Balance as of December 31, 2013	86,831	$174	$211,440	$462,131	$(29,833)	$643,912
Issuance of common stock under stock plans	1,146		15,651			15,651
Repurchase of common stock	(932)			(35,140)		(35,140)
Stock-based compensation expense			11,258			11,258
Excess tax benefit from stock option exercises			7,178			7,178
Tax benefit for research and development credits as a result of stock option accounting			160			160
Net income				94,854		94,854
Net unrealized loss on cash flow hedges, net of tax of $2					(173)	(173)
Reclassification of net realized loss on cash flow hedges					101	101
Net unrealized gain on available-for-sale investments, net of tax of $133					1,441	1,441
Reclassification of net realized gain on the sale of available-for-sale investments					(651)	(651)
Foreign currency translation adjustment, net of tax of $501					(4,639)	(4,639)
Balance as of September 28, 2014 (unaudited)	87,045	$174	$245,687	$521,845	$(33,754)	$733,952

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

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COGNEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
NOTE 1: Summary of Significant Accounting Policies
As permitted by the rules of the Securities and Exchange Commission applicable to Quarterly Reports on Form 10-Q, these notes are condensed and do not contain all disclosures required by generally accepted accounting principles (GAAP). Reference should be made to the consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.
In the opinion of the management of Cognex Corporation (the “Company”), the accompanying consolidated unaudited financial statements contain all adjustments, consisting of normal, recurring adjustments and financial statement reclassifications, necessary to present fairly the Company’s financial position as of September 28, 2014, and the results of its operations for the three-month and nine-month periods ended September 28, 2014 and September 29, 2013, and changes in shareholders’ equity, comprehensive income, and cash flows for the periods presented.
The results disclosed in the Consolidated Statements of Operations for the three-month and nine-month periods ended September 28, 2014 are not necessarily indicative of the results to be expected for the full year.
NOTE 2: New Pronouncements
Accounting Standards Update (ASU) 2014-08, “Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360) - Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity”
ASU 2014-08 defines a discontinued operation as a component or group of components that is disposed of or is classified as held for sale and represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results. A strategic shift could include a disposal of (1) a major geographical area of operations, (2) a major line of business, (3) a major equity method investment, or (4) other major parts of an entity. In addition, having significant continuing involvement with a component after a disposal or failing to eliminate the operations or cash flows of a disposed component from an entity’s ongoing operations will no longer preclude presentation as a discontinued operation. The ASU will require new disclosures related to discontinued operations and to disposals of individually significant components that do not qualify as discontinued operations. The guidance in ASU 2014-08 applies prospectively to new disposals of components and new classifications as held for sale beginning in 2015 for most entities, with early adoption allowed. Management is in the process of evaluating the impact of this update.
Accounting Standards Update (ASU) 2014-09, “Revenue from Contracts with Customers”
The amendments in ASU 2014-09 will supersede and replace all currently existing U.S. GAAP, including industry-specific revenue recognition guidance, with a single, principle-based revenue recognition framework. The concept guiding this new model is that revenue recognition will depict transfer of control to the customer in an amount that reflects consideration to which an entity expects to be entitled. The core principles supporting this framework include (1) identifying the contract with a customer, (2) identifying separate performance obligations within the contract, (3) determining the transaction price, (4) allocating the transaction price to the performance obligations, and (5) recognizing revenue. This new framework will require entities to apply significantly more judgment. This increase in management judgment will require expanded disclosure on estimation methods, inputs, and assumptions for revenue recognition. The guidance in ASU 2014-09 is effective for public companies for annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. Management is in the process of evaluating the impact of this update.
Accounting Standards Update (ASU) 2014-15, "Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern"
ASU 2014-15 requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date of issuance of the entity's financial statements. The entity must provide certain disclosures if "conditions or events raise substantial doubt about the entity's ability to continue as a going concern." The ASU will require management to disclose principal conditions or events contributing to the "doubt" to continue as a going concern, as well as management's evaluations and plans to try to alleviate these uncertainties. The guidance in ASU 2014-15 applies to all entities and is effective for annual periods beginning after December 15, 2015, and interim periods thereafter. Early adoption is permitted. Given the Company's financial condition,

management does not expect ASU 2014-15 to have a significant impact on our disclosures.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 3: Fair Value Measurements
Financial Assets and Liabilities that are Measured at Fair Value on a Recurring Basis
The following table summarizes the financial assets and liabilities required to be measured at fair value on a recurring basis as of September 28, 2014 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets:		
Money market instruments	$568	$—
Corporate bonds	—	255,268
Treasury bills	—	102,674
Asset-backed securities	—	65,130
Sovereign bonds	—	19,234
Municipal bonds	—	9,014
Agency bonds	—	5,765
Cash flow hedge forward contracts	—	133
Economic hedge forward contracts	—	9
Liabilities:		
Cash flow hedge forward contracts	—	105
Economic hedge forward contracts	—	9

The Company’s money market instruments are reported at fair value based upon the daily market price for identical assets in active markets, and are therefore classified as Level 1.
The Company’s debt securities and forward contracts are reported at fair value based upon model-driven valuations in which all significant inputs are observable or can be derived from or corroborated by observable market data for substantially the full term of the asset or liability, and are therefore classified as Level 2. Management is responsible for estimating the fair value of these financial assets and liabilities, and in doing so, considers valuations provided by a large, third-party pricing service. For debt securities, this service maintains regular contact with market makers, brokers, dealers, and analysts to gather information on market movement, direction, trends, and other specific data. They use this information to structure yield curves for various types of debt securities and arrive at the daily valuations. The Company's forward contracts are typically traded or executed in over-the-counter markets with a high degree of pricing transparency. The market participants are generally large commercial banks.
The Company did not record an other-than-temporary impairment of these financial assets or liabilities during the nine-month period ended September 28, 2014.
Financial Assets that are Measured at Fair Value on a Non-recurring Basis
The Company has an interest in a limited partnership, which is accounted for using the cost method and is required to be measured at fair value on a non-recurring basis. Management is responsible for estimating the fair value of this investment, and in doing so, considers valuations of the partnership’s investments as determined by the General Partner. Publicly-traded investments in active markets are reported at the market closing price less a discount, as appropriate, to reflect restricted marketability. Fair value for private investments for which observable market prices in active markets do not exist is based upon the best information available including the value of a recent financing, reference to observable valuation measures for comparable companies (such as revenue multiples), public or private transactions (such as the sale of a comparable company), and valuations for publicly-traded comparable companies. The valuations also incorporate the General Partner’s own judgment and close familiarity with the business activities of each portfolio company. Significant increases or decreases in any of these inputs in isolation may result in a significantly lower or higher fair value measurement. The portfolio consists of securities of public and private companies, and consequently, inputs used in the fair value calculation are classified as Level 3. The Company did not

record an other-than-temporary impairment of this asset during the nine-month period ended September 28, 2014.

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Non-financial Assets that are Measured at Fair Value on a Non-recurring Basis
Non-financial assets such as goodwill, intangible assets, and property, plant, and equipment are required to be measured at fair value only when an impairment loss is recognized. The Company did not record an impairment charge related to these assets during the nine-month period ended September 28, 2014.
NOTE 4: Cash, Cash Equivalents, and Investments
Cash, cash equivalents, and investments consisted of the following (in thousands):

	September 28, 2014	December 31, 2013
Cash	$37,611	$40,124
Money market instruments	568	520
Cash and cash equivalents	38,179	40,644
Corporate bonds	45,889	109,040
Municipal bonds	1,971	9,276
Sovereign bonds	1,709	11,448
Asset-backed securities	189	53,559
Agency bonds	—	1,499
Short-term investments	49,758	184,822
Corporate bonds	209,379	109,909
Treasury bills	102,674	73,666
Asset-backed securities	64,941	21,820
Sovereign bonds	17,525	16,385
Municipal bonds	7,043	5,919
Agency bonds	5,765	—
Limited partnership interest	1,956	1,956
Long-term investments	409,283	229,655
	$497,220	$455,121

The Company’s investment portfolio includes corporate bonds, municipal bonds, sovereign bonds, asset-backed securities, treasury bills, and agency bonds. Corporate bonds consist of debt securities issued by both domestic and foreign companies; municipal bonds consist of debt securities issued by state and local government entities; sovereign bonds consist of direct debt issued by foreign governments; asset-backed securities consist of debt securities collateralized by pools of receivables or loans with credit enhancement; treasury bills consist of debt securities issued by both the U.S. and foreign governments; and agency bonds consist of domestic or foreign obligations of government agencies and government sponsored enterprises that have government backing.

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COGNEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table summarizes the Company's available-for-sale investments as of September 28, 2014 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Short-term:				
Corporate bonds	$45,785	$106	$(2)	$45,889
Municipal bonds	1,970	1	—	1,971
Sovereign bonds	1,704	5	—	1,709
Asset-backed securities	189	—	—	189
Long-term:				
Corporate bonds	208,585	936	(142)	209,379
Treasury bills	102,685	18	(29)	102,674
Asset-backed securities	64,936	42	(37)	64,941
Sovereign bonds	17,516	21	(12)	17,525
Municipal bonds	6,989	54	—	7,043
Agency bonds	5,771	—	(6)	5,765
	$456,130	$1,183	$(228)	$457,085

The following table summarizes the Company's gross unrealized losses and fair values for available-for-sale investments in an unrealized loss position as of September 28, 2014 (in thousands):

	Unrealized Loss Position For:					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Treasury bills	$67,615	$(29)	$—	$—	$67,615	$(29)
Corporate bonds	59,613	(143)	1,709	(1)	61,322	(144)
Asset-backed securities	18,415	(24)	4,654	(13)	23,069	(37)
Agency bonds	5,765	(6)	—	—	5,765	(6)
Sovereign bonds	5,153	(12)	—	—	5,153	(12)
	$156,561	$(214)	$6,363	$(14)	$162,924	$(228)

As of September 28, 2014, the Company did not recognize an other-than-temporary impairment of these investments. In its evaluation, management considered the type of security, the credit rating of the security, the length of time the security has been in a loss position, the size of the loss position, our intent and ability to hold the security to expected recovery of value, and other meaningful information. The Company does not intend to sell, and is unlikely to be required to sell, any of these available-for-sale investments before its effective maturity or market price recovery.

The Company recorded gross realized gains and gross realized losses on the sale of investments totaling $66,000 and $21,000, respectively, during the three-month period ended September 28, 2014 and $32,000 and $12,000, respectively, during the three-month period ended September 29, 2013. The Company recorded gross realized gains and gross realized losses on the sale of investments totaling $695,000 and $44,000, respectively, during the nine-month period ended September 28, 2014 and $182,000 and $79,000, respectively, during the nine-month period ended September 29, 2013. These gains and losses are included in "Investment income" on the Consolidated Statements of Operations.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the effective maturity dates of the Company's available-for-sale investments as of September 28, 2014 (in thousands):

	1 Year or Less	1-2 Years	2-3 Years	3-4 Years	4-5 Years	5-8 Years	Total
Corporate bonds	$45,889	$68,817	$102,268	$18,128	$20,166	$—	$255,268
Treasury bills	—	90,210	12,464	—	—	—	102,674
Asset-backed securities	189	9,677	15,262	24,657	10,822	4,523	65,130
Sovereign bonds	1,709	12,372	5,153	—	—	—	19,234
Municipal bonds	1,971	2,965	3,574	504	—	—	9,014
Agency bonds	—	1,500	4,265	—	—	—	5,765
	$49,758	$185,541	$142,986	$43,289	$30,988	$4,523	$457,085

The Company is a Limited Partner in Venrock Associates III, L.P. (Venrock), a venture capital fund. The Company has committed to a total investment in the limited partnership of up to $20,500,000, with an expiration date of December 31, 2015. As of September 28, 2014, the Company contributed $19,886,000 to the partnership. The remaining commitment of $614,000 can be called by Venrock at any time before December 31, 2015. Distributions and contributions are at the discretion of Venrock's management. No contributions were made and no distributions were received during the nine-month period ended September 28, 2014.

NOTE 5: Inventories

Inventories consisted of the following (in thousands):

	September 28, 2014	December 31, 2013
Raw materials	$19,175	$13,101
Work-in-process	5,750	4,472
Finished goods	6,285	8,121
	$31,210	$25,694

NOTE 6: Intangible Assets and Goodwill

The Company evaluates the possible impairment of goodwill and other intangible assets whenever events or circumstances indicate that the carrying value of these assets may not be recoverable. No triggering event occurred in the nine-month period ended September 28, 2014 that would indicate a potential impairment of goodwill or other intangible assets.

NOTE 7: Warranty Obligations

The Company records the estimated cost of fulfilling product warranties at the time of sale based upon historical costs to fulfill claims. Obligations may also be recorded subsequent to the time of sale whenever specific events or circumstances impacting product quality become known that would not have been taken into account using historical data. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers and third-party contract manufacturers, the Company's warranty obligation is affected by product failure rates, material usage, and service delivery costs incurred in correcting a product failure. An adverse change in any of these factors may result in the need for additional warranty provisions. Warranty obligations are included in "Accrued expenses" on the Consolidated Balance Sheets.

The changes in the warranty obligations were as follows (in thousands):

Balance as of December 31, 2013	$3,016
Provisions for warranties issued during the period	4,012
Fulfillment of warranty obligations	(2,512)
Foreign exchange rate changes	(218)
Balance as of September 28, 2014	$4,298

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COGNEX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 8: Contingencies
In May 2008, the Company filed a complaint against MvTec Software GmbH, MvTec LLC, and Fuji America Corporation in the United States District Court for the District of Massachusetts alleging infringement of certain patents owned by the Company. In May 2014, the parties mutually agreed to dismiss this action with prejudice. This matter is now closed.
In May 2009, the Company pre-filed a complaint with the United States International Trade Commission (ITC) pursuant to Section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. §1337, against MvTec Software GmbH, MvTec LLC, Fuji America, and several other respondents alleging unfair methods of competition and unfair acts in the unlawful importation into the United States, sale for importation, or sale within the United States after importation. By this filing, the Company requested the ITC to investigate the Company’s contention that certain machine vision software, machine vision systems, and products containing the same infringe, and respondents directly infringe and/or actively induce and/or contribute to the infringement in the United States, of one or more of the Company’s U.S. patents. In September 2009, the Company reached a settlement with two of the respondents, and in December 2009, the Company reached a settlement with five additional respondents. In March 2010, the Company reached a settlement with respondent Fuji Machine Manufacturing Co., Ltd. and its subsidiary Fuji America Corporation. These settlements did not have a material impact on the Company’s financial results. An ITC hearing was held in May 2010. In July 2010, the Administrative Law Judge issued an initial determination finding two of the Company’s patents invalid and that respondents did not infringe the patents-at-issue. In September 2010, the ITC issued a notice that it would review the initial determination of the Administrative Law Judge. The ITC issued its Final Determination in November 2010 in which it determined to modify-in-part and affirm-in-part the Administrative Law Judge’s determination, and terminate the investigation with a finding of no violation of Section 337 of the Tariff Act of 1930 (as amended 19 U.S.C. §1337). The Company filed an appeal of the decision with the United States Court of Appeals for the Federal Circuit. An oral hearing before the United States Court of Appeals occurred in February 2012. In December 2013, the Federal Circuit affirmed the ITC’s finding of non-infringement, and therefore did not also need to address the ITC’s finding regarding validity. This matter is now closed.
In March 2013, the Company filed a lawsuit against Microscan Systems, Inc. (“Microscan”) and Code Corporation in the United States District Court for the Southern District of New York alleging that Microscan’s Mobile Hawk handheld imager infringes U.S. Patent 7,874,487 owned by the Company (the “'487 patent”). The lawsuit sought to prohibit Code Corporation from manufacturing the product, and Microscan from selling and distributing the product. The Company also sought monetary damages resulting from the alleged infringement. Late in the day on April 30, 2014, the jury found that Microscan willfully infringed the ‘487 patent and awarded Cognex $2.6M in damages. Following the verdict, Microscan filed motions requesting judgment as a matter of law on the issues of infringement, invalidity and willfulness, as well as a motion to dismiss for lack of standing. The Company filed motions seeking treble damages (based on the finding of willfulness), attorneys’ fees as an exceptional case, and a permanent injunction against future infringement of the ‘487 patent and the import, manufacture and/or sale of Microscan’s Mobile Hawk product within the U.S. In June 2014, final briefs were filed and the court issued an order denying all of Microscan’s motions and the Company’s motion for treble damages, while granting the Company’s motion for permanent injunction (limited to enjoining future infringement of the ‘487 patent and the import, manufacture and/or sale of infringing versions of Microscan’s Mobile Hawk product within the U.S.) and the Company’s motion for attorneys’ fees, in part, pending a determination thereof following submission of supplemental briefs by both parties. In July 2014, Microscan filed a Notice of Appeal with the Federal Circuit appealing all orders, findings, and/or conclusions of the District Court that were adverse to Microscan. In August 2014, the Company filed a Notice of Appeal with the Federal Circuit appealing the order granting summary judgment that claims 23, 28, and 29 of the ’487 patent are invalid. Also in August 2014, the Federal Circuit consolidated Microscan’s appeal and the Company’s appeal. The District Court stayed the decision with regard to the Company’s request for attorney’s fees until the appeal at the Federal Circuit is concluded.

In August 2014, Microscan filed a lawsuit against the Company in the United States District Court for the Southern District of New York alleging that the Company's DataMan® 8500 handheld imager infringes U.S. Patent 6,352,204 (the "'204 patent"). The lawsuit sought to prohibit the Company from manufacturing, selling, and distributing the DataMan® 8500 product. Microscan also sought monetary damages resulting from the alleged infringement. In September 2014, the Company filed an Answer to the Complaint denying all allegations and asserting in a counterclaim that the '204 patent is invalid. In October 2014, the Company filed an Amended Answer further explaining its counterclaim of invalidity. Also in October 2014, Microscan filed an Amended Complaint alleging that the Company's DataMan® 7500 and DataMan® 8600 also infringe the '204 patent. The Company subsequently responded in October 2014 with its Answer to the Amended Complaint. This matter is ongoing.

The Company cannot predict the outcome of the above-referenced pending matter and an adverse resolution of this lawsuit could have a material adverse effect on the Company's financial position, liquidity, results of operations, and/or indemnification obligations. In addition, various other claims and legal proceedings generally incidental to the normal course of business are pending or threatened on behalf of or against the Company. While we cannot predict the outcome of these incidental matters, we believe that any liability arising from them will not have a material adverse effect on our financial position, liquidity, or results of operations.

NOTE 9: Guarantees

In the ordinary course of business, the Company enters into guarantee contracts with certain customers, generally in the Company's Surface Inspection Systems Division (SISD) business. These guarantees represent standby letters of credit (LOC) which can be grouped into three categories: (1) bank guarantees which may require the Company to return a customer's initial payment if the Company cannot deliver the order; (2) warranty bonds which may require the Company to resolve warranty issues within a specified time period; and (3) performance bonds which include a combination of the above two options. The type of LOC is generally determined based upon customer request and the guarantee amount represents the maximum potential amount of future payments. All of the Company's LOCs are with the same counterparty and they do not contain any recourse provisions or collateral obligations.

The following table details the letters of credit outstanding as of September 28, 2014:

Type	Guarantee Amount (in thousands)	Guarantee Due Date
Bank guarantees	$989	Various from October 2014 to August 2016
Warranty bonds	807	Various from October 2014 to August 2016
Performance bonds	392	Various from December 2014 to December 2017
	$2,188	

The Company evaluates losses for guarantees under accounting for contingencies. The Company considers such factors as the degree of probability that the Company would be required to satisfy the guarantee and the ability to make a reasonable estimate of the loss. To date, the Company has not incurred any losses as a result of these obligations, and therefore, has not recorded any liability related to such obligation in its financial statements. The fair value of the Company's outstanding guarantees is immaterial for all periods presented.

NOTE 10: Indemnification Provisions

Except as limited by Massachusetts law, the by-laws of the Company require it to indemnify certain current or former directors, officers, and employees of the Company against expenses incurred by them in connection with each proceeding in which he or she is involved as a result of serving or having served in certain capacities. Indemnification is not available with respect to a proceeding as to which it has been adjudicated that the person did not act in good faith in the reasonable belief that the action was in the best interests of the Company. The maximum potential amount of future payments the Company could be required to make under these provisions is unlimited. The Company has never incurred significant costs related to these indemnification provisions. As a result, the Company believes the estimated fair value of these provisions is minimal.

In the ordinary course of business, the Company may accept standard limited indemnification provisions in connection with the sale of its products, whereby it indemnifies its customers for certain direct damages incurred in connection with third-party patent or other intellectual property infringement claims with respect to the use of the Company's products. The term of these indemnification provisions generally coincides with the customer's use of the Company's products. The maximum potential amount of future payments the Company could be required to make under these provisions is generally subject to fixed monetary limits. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification provisions. As a result, the Company believes the estimated fair value of these provisions is minimal.

In the ordinary course of business, the Company also accepts limited indemnification provisions from time to time, whereby it indemnifies customers for certain direct damages incurred in connection with bodily injury and property damage arising from the installation of the Company's products. The term of these indemnification provisions generally coincides with the period of installation. The maximum potential amount of future payments the Company could be required to make under these provisions is generally limited and is likely recoverable under the Company's insurance policies. As a result of this coverage, and the fact that the Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification provisions, the Company believes the estimated fair value of these provisions is minimal.

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NOTE 11: Derivative Instruments
The Company is exposed to certain risks relating to its ongoing business operations including foreign currency exchange rate risk and interest rate risk. The Company currently mitigates certain foreign currency exchange rate risks with derivative instruments. The Company does not currently manage its interest rate risk with derivative instruments.
The Company faces exposure to foreign currency exchange rate fluctuations, as a significant portion of its revenues, expenses, assets, and liabilities are denominated in currencies other than the functional currencies of the Company's subsidiaries or the reporting currency of the Company, which is the U.S. Dollar. The Company faces two types of foreign currency exchange rate exposures:

- Transactional currency/functional currency exchange rate exposures from transactions that are denominated in currencies other than the functional currency of the subsidiary. These transaction gains and losses are reported in "Foreign currency gain (loss)" on the Consolidated Statements of Operations.
- Functional currency/reporting currency exchange rate exposures from the revaluation of the assets and liabilities of our foreign subsidiaries, whose functional currency is generally their local currency, to the Company's reporting currency, which is the U.S. Dollar. These translation gains and losses are reported in "Accumulated other comprehensive loss" on the Consolidated Balance Sheets and also on the Consolidated Statements of Comprehensive Income.

The Company's foreign currency risk management strategy is principally designed to mitigate the potential financial impact of changes in the value of transactions and balances denominated in foreign currencies resulting from changes in foreign currency exchange rates. Currently, the Company enters into two types of hedges to manage this risk. The first are economic hedges which utilize foreign currency forward contracts with maturities of up to 45 days to manage the exposure to fluctuations in foreign currency exchange rates arising primarily from foreign-denominated receivables and payables. The gains and losses on these derivatives are largely offset by changes in the fair value of the assets and liabilities being hedged. The second are cash flow hedges which utilize foreign currency forward contracts with maturities of up to 18 months to hedge specific forecasted transactions of the Company's foreign subsidiaries with the goal of protecting our budgeted revenues and expenses against foreign currency exchange rate changes compared to our budgeted rates.
The Company had the following outstanding forward contracts that were entered into to mitigate foreign currency exchange rate risk (in thousands):

	As of September 28, 2014		As of December 31, 2013	
Currency	Notional Value	USD Equivalent	Notional Value	USD Equivalent
Derivatives Designated as Hedging Instruments:				
Japanese Yen	665,000	$6,059	625,000	$6,122
Hungarian Forint	604,000	2,479	570,175	2,603
Singapore Dollar	3,225	2,450	2,867	2,346
British Pound	750	1,177	613	1,010
Canadian Dollar	1,173	1,069	985	932
Derivatives Not Designated as Hedging Instruments:				
Japanese Yen	885,000	$8,128	294,500	$2,797
British Pound	1,375	2,244	1,100	1,820
Taiwanese Dollar	32,500	1,078	27,000	908
Korean Won	925,000	887	650,000	620
Singapore Dollar	1,200	946	—	—
Hungarian Forint	225,000	919	123,000	568
Euro	—	—	2,828	3,887
Chinese Renminbi	—	—	9,000	1,467
Brazilian Real	—	—	250	106

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Information regarding the fair value of the outstanding forward contracts was as follows (in thousands):

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Location	Fair Value September 28, 2014	December 31, 2013	Balance Sheet Location	Fair Value September 28, 2014	December 31, 2013
Derivatives Designated as Hedging Instruments:						
Cash flow hedge forward contracts	Prepaid expenses and other current assets	$133	$204	Accrued expenses	$105	$98
Derivatives Not Designated as Hedging Instruments:						
Economic hedge forward contracts	Prepaid expenses and other current assets	$9	$6	Accrued expenses	$9	$24

The table below details the gross activity for all derivative assets and liabilities which were presented on a net basis on the Consolidated Balance Sheets due to the right of offset with each counterparty (in thousands):

Asset Derivatives			Liability Derivatives		
	September 28, 2014	December 31, 2013		September 28, 2014	December 31, 2013
Gross amounts of recognized assets	$142	$210	Gross amounts of recognized liabilities	$120	$122
Gross amounts offset	—				