UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 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 December 31, 2010

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 0000-26251

NETSCOUT SYSTEMS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**04-2837575**
(State or Other Jurisdiction of	**(IRS Employer**
Incorporation or Organization)	**Identification No.)**

310 Littleton Road, Westford, MA 01886

(978) 614-4000

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) YES ¨ 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	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	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

The number of shares outstanding of the registrant s common stock, par value $0.001 per share, as of February 4, 2011 was 42,231,880.

Table of Contents

NETSCOUT SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTER ENDED DECEMBER 31, 2010

TABLE OF CONTENTS

PART I: FINANCIAL INFORMATION		
Item 1.	***Unaudited Financial Statements:***	
	Condensed Consolidated Balance Sheets: As of December 31, 2010 and March 31, 2010	3
	Condensed Consolidated Statements of Operations: For the three and nine months ended December 31, 2010 and December 31, 2009	4
	Condensed Consolidated Statements of Cash Flows: For the nine months ended December 31, 2010 and December 31, 2009	5
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	***Management s Discussion and Analysis of Financial Condition and Results of Operations***	17
Item 3.	***Quantitative and Qualitative Disclosures About Market Risk***	33
Item 4.	***Controls and Procedures***	34
PART II: OTHER INFORMATION		
Item 1A.	***Risk Factors***	35
Item 2.	***Unregistered Sales of Equity Securities and Use of Proceeds***	35
Item 6.	***Exhibits***	35
SIGNATURES		36
EXHIBIT INDEX		37

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. Unaudited Financial Statements

NetScout Systems, Inc.

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)

(Unaudited)

	December 31, 2010	March 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 121,482	$ 63,322
Marketable securities	64,407	69,875
Accounts receivable, net of allowance for doubtful accounts of $344 and $427 at December 31, 2010 and March 31, 2010, respectively	56,792	65,556
Inventories	8,948	9,181
Prepaid income taxes		2,730
Deferred income taxes	2,614	2,698
Prepaid expenses and other current assets	4,800	5,422
Total current assets	**259,043**	**218,784**
Fixed assets, net	12,359	12,773
Goodwill	128,177	128,177
Acquired intangible assets, net	49,158	53,573
Deferred income taxes	29,670	30,062
Long-term marketable securities	24,341	37,354
Other assets	1,660	1,878
Total assets	**$ 504,408**	**$ 482,601**
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 5,521	$ 7,307
Accrued compensation	19,203	19,806
Accrued other	5,096	5,051
Income taxes payable	1,652	
Current portion of long-term debt	15,000	11,250
Deferred revenue	80,384	84,196
Total current liabilities	**126,856**	**127,610**
Other long-term liabilities	1,166	551
Accrued long-term retirement benefits	1,803	1,645
Long-term deferred revenue	13,980	17,846
Long-term debt, net of current portion	56,856	68,106
Total liabilities	**200,661**	**215,758**

Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.001 par value: 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2010 and March 31, 2010		
Common stock, $0.001 par value: 150,000,000 shares authorized; 46,930,395 and 46,490,166 shares issued and 42,182,406 and 41,769,680 shares outstanding at December 31, 2010 and March 31, 2010, respectively	47	46
Additional paid-in capital	219,298	209,146
Accumulated other comprehensive loss	(1,112)	(1,817)
Treasury stock at cost, 4,748,087 and 4,720,584 shares at December 31, 2010 and March 31, 2010, respectively	(32,139)	(31,691)
Retained earnings	117,653	91,159
Total stockholders equity	**303,747**	**266,843**
Total liabilities and stockholders equity	**$ 504,408**	**$ 482,601**

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

Table of Contents

NetScout Systems, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009	Nine Months Ended December 31, 2010	Nine Months Ended December 31, 2009
Revenue:				
Product	$ 43,016	$ 40,774	$ 114,289	$ 99,796
Service	33,320	29,941	98,271	88,672
Total revenue	76,336	70,715	212,560	188,468
Cost of revenue:				
Product	10,343	9,924	28,002	25,472
Service	5,749	5,481	16,972	14,974
Total cost of revenue	16,092	15,405	44,974	40,446
Gross profit	60,244	55,310	167,586	148,022
Operating expenses:				
Research and development	10,145	9,181	29,734	27,069
Sales and marketing	27,022	26,328	77,832	69,806
General and administrative	6,356	5,475	17,478	15,309
Amortization of acquired intangible assets	476	490	1,430	1,471
Total operating expenses	43,999	41,474	126,474	113,655
Income from operations	16,245	13,836	41,112	34,367
Interest and other income (expense), net:				
Interest income	210	109	587	527
Interest expense	(599)	(873)	(1,879)	(2,828)
Other income (expense), net	(3)	(98)	(2)	5
Total interest and other income (expense), net	(392)	(862)	(1,294)	(2,296)
Income before income tax expense	15,853	12,974	39,818	32,071
Income tax expense	4,752	4,433	13,324	11,207
Net income	$ 11,101	$ 8,541	$ 26,494	$ 20,864
Basic net income per share	$ 0.26	$ 0.21	$ 0.63	$ 0.52
Diluted net income per share	$ 0.26	$ 0.20	$ 0.62	$ 0.50
Weighted average common shares outstanding used in computing:				
Net income per share - basic	42,105	40,684	41,946	40,463
Net income per share - diluted	43,173	42,041	42,836	41,657

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

Table of Contents

NetScout Systems, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended December 31, 2010	Nine Months Ended December 31, 2009
Cash flows from operating activities:		
Net income	$ 26,494	$ 20,864
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	10,369	10,867
Loss on disposal of fixed assets	91	247
Share-based compensation expense associated with equity awards	4,139	3,774
Deferred income taxes	(73)	2,328
Changes in assets and liabilities		
Accounts receivable	8,764	(17,823)
Inventories	233	(1,561)
Prepaid income taxes	2,730	1,601
Prepaid expenses and other current assets	513	284
Other assets	117	40
Accounts payable	(1,786)	2,099
Accrued compensation and other expenses	491	(5,811)
Income taxes payable	1,652	4,494
Deferred revenue	(7,678)	5,746
Net cash provided by operating activities	46,056	27,149
Cash flows from investing activities:		
Purchase of marketable securities	(49,593)	(64,339)
Proceeds from maturity of marketable securities	69,161	32,968
Purchase of fixed assets	(5,530)	(4,731)
Capitalized software development costs		(408)
Net cash provided by (used in) investing activities	14,038	(36,510)
Cash flows from financing activities:		
Proceeds from the exercise of stock options	2,163	2,228
Repayment of long-term debt	(7,500)	(10,644)
Excess tax benefit from stock options exercised	3,403	2,079
Net cash used in financing activities	(1,934)	(6,337)
Net increase (decrease) in cash and cash equivalents	58,160	(15,698)
Cash and cash equivalents, beginning of period	63,322	82,222
Cash and cash equivalents, end of period	**$ 121,482**	**$ 66,524**

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

NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements as of December 31, 2010 and for the three and nine months ended December 31, 2010 and 2009 have been prepared by NetScout Systems, Inc., or NetScout or the Company, in accordance with generally accepted accounting principles, or GAAP, for interim financial reports and the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared under generally accepted accounting principles have been condensed or omitted pursuant to such regulations. In the opinion of the Company s management, the unaudited interim consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the Company s financial position, results of operations and cash flows. The results of operations for the three and nine months ended December 31, 2010 and 2009 are not necessarily indicative of the results of operations for the year ending March 31, 2011. The balance sheet at March 31, 2010 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2010, as filed with the Securities Exchange Commission, or SEC, on May 28, 2010.

Recently Adopted Accounting Pronouncements

In October 2009, the FASB amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of industry-specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

(i) provide updated guidance on how the deliverables in a multiple deliverable arrangement should be separated, and how the consideration should be allocated;

(ii) require an entity to allocate revenue in an arrangement using its best estimate of selling prices of deliverables if a vendor does not have vendor-specific objective evidence, or VSOE, of selling price or third-party evidence of selling price; and

(iii) eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

We elected to early adopt this accounting guidance at the beginning of our first quarter of our fiscal year 2011 on a prospective basis for applicable transactions originating or materially modified after April 1, 2010. The adoption of this guidance did not have a material impact on our financial position or results of operations for the three and nine months ended December 31, 2010. The following reflects our updated policy for revenue recognition.

Product revenue consists of sales of hardware products (which include embedded software that works together with the hardware to deliver the product s essential functionality), licensing of software products, and sale of hardware bundled with a software license. Product revenue is recognized upon shipment, provided that evidence of an arrangement exists, title and risk of loss have passed to the customer, fees are fixed or determinable and collection of the related receivable is probable. Because many of our solutions are comprised of both hardware and more than incidental software components, we recognize our revenue in accordance with authoritative guidance on both hardware and software revenue recognition.

6

Table of Contents

Service revenue consists primarily of fees from customer support agreements, consulting and training. The Company generally provides software and hardware support as part of product sales. Revenue related to the initial bundled software and hardware support is recognized ratably over the support period. In addition, customers can elect to purchase extended support agreements for periods after the initial software warranty expiration, typically for 12-month periods. Revenue from customer support agreements is recognized ratably over the support period. Revenue from consulting and training services is recognized as the work is performed.

Multi-element arrangements are concurrent customer purchases of a combination of product and service offerings that may be delivered at various points in time. For multi-element arrangements comprised only of hardware products and related services, the total transaction revenue is allocated to the multiple elements based on each element s relative fair value compared to the total fair value of all the elements. Each element s relative fair value is based on management s best estimate of selling price paid by customers based on the element s historical pricing. Sales of all products and services are reviewed quarterly and best estimate of selling price for each element is updated, when appropriate, to ensure that it reflects recent pricing experience.

For multi-element arrangements comprised only of software products and related services, a portion of the total purchase price is allocated to the undelivered elements, primarily support agreements and training, using vendor-specific objective evidence of fair value of the undelivered elements. The remaining portion of the total transaction value is allocated to the delivered software, referred to as the residual method. Vendor-specific objective evidence of fair value of the undelivered elements is based on the price customers pay when the element is sold separately. The separate sales of the undelivered elements is reviewed on a quarterly basis and vendor-specific objective evidence of fair value for such elements updated, when appropriate, to ensure that it reflects recent pricing experience.

For multi-element arrangements comprised of a combination of hardware and software elements, the total transaction value is bifurcated between the hardware elements and the software elements based on the relative selling prices of the hardware elements and the software elements as a group. Then, revenue for the hardware and hardware-related services is recognized following the hardware revenue recognition methodology outlined above and revenue for the software and software-related services is recognized following the residual method.

2. Concentration of Credit Risk and Significant Customers

Financial instruments, which include cash, cash equivalents, short-term marketable securities, accounts receivable and accounts payable, are stated at cost, plus accrued interest where applicable, which approximates fair value. Long-term marketable securities include auction rate securities which are currently illiquid, corporate bonds and certificates of deposit. At December 31, 2010, no one direct customer or channel partner accounted for more than 10% of the accounts receivable balance. At March 31, 2010, the Company had one customer which accounted for more than 10% of the accounts receivable balance. During the three and nine months ended December 31, 2010 and 2009, respectively, no one direct customer or indirect channel partner accounted for more than 10% of total revenue. Historically, the Company has not experienced any significant non-performance by its customers nor does the Company anticipate non-performance by its customers in the future; accordingly, the Company does not require collateral.

Table of Contents

3. Share-Based Compensation

The following is a summary of share-based compensation expense (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	2009	2010	2009
Cost of product revenue	$ 34	$ 27	$ 85	$ 84
Cost of service revenue	22	51	152	163
Research and development	368	291	1,009	911
Sales and marketing	551	493	1,623	1,594
General and administrative	485	345	1,270	1,022
Total share-based compensation expense, before income tax effect	$ 1,460	$ 1,207	$ 4,139	$ 3,774

4. Cash, Cash Equivalents and Marketable Securities

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents and those investments with original maturities greater than three months to be marketable securities. Cash equivalents, short-term marketable securities and long-term marketable securities are stated at fair value. Cash and cash equivalents consisted of money market instruments and cash maintained with various financial institutions at December 31, 2010 and March 31, 2010, respectively.

Marketable Securities

The following is a summary of marketable securities held by NetScout at December 31, 2010 classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains (Losses)	Fair Value
Type of security (see Note 5):			
U.S. government and municipal obligations	$ 27,078	$ (61)	$ 27,017
Commercial paper	19,207	1	19,208
Corporate bonds	12,933	(15)	12,918
Certificates of deposit	5,316	(52)	5,264
Total short-term marketable securities	64,534	(127)	64,407
Auction rate securities	23,760	(2,714)	21,046
Corporate bonds	3,302	(7)	3,295
Total long-term marketable securities	27,062	(2,721)	24,341
	$ 91,596	$ (2,848)	$ 88,748

Maturity dates for short-term marketable securities held at December 31, 2010 range from January 2011 to December 2011. Maturity dates for long-term marketable securities held at December 31, 2010, which consist of auction rate securities and corporate bonds, range from March 2012 to June 2038.

8

Table of Contents

The following is a summary of marketable securities held by NetScout at March 31, 2010, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains (Losses)	Fair Value
Type of security (see Note 5):			
U.S. government and municipal obligations	$ 42,026	$ 59	$ 42,085
Commercial paper	8,993		8,993
Corporate bonds	9,039	(15)	9,024
Certificates of deposit	10,761		10,761
Subtotal	70,819	44	70,863
Less: restricted investment	937	51	988
Total short-term marketable securities	69,882	(7)	69,875
Auction rate securities	32,399	(3,924)	28,475
U.S. government and municipal obligations	2,032	(4)	2,028
Corporate bonds	3,589	(2)	3,587
Certificates of deposit	3,266	(2)	3,264
Total long-term marketable securities	41,286	(3,932)	37,354
	$ 111,168	$ (3,939)	$ 107,229

Maturity dates for short-term marketable securities held at March 31, 2010 range from April 2010 to March 2011. Maturity dates for long-term marketable securities held at March 31, 2010, which consist of auction rate securities, corporate bonds and certificates of deposit, range from April 2011 to December 2039.

The Company s long-term marketable securities include investments in auction rate securities. Beginning in February 2008 and continuing through December 31, 2010, auctions have failed resulting in a lack of short-term liquidity for these securities, which has caused the Company to classify them as long-term on its consolidated balance sheet. As of December 31, 2010, the Company s auction rate securities consisted of four positions issued by municipal agencies with a total par value of $23.8 million and a current estimated market value totaling $21.0 million. As of December 31, 2010, these investments have investment grade ratings ranging from AAA to A by Standard and Poor s. These investments are collateralized by student loans with underlying support by the federal government through the Federal Family Education Loan Program and by monoline insurance companies.

During the three months ended December 31, 2010, redemptions by the issuers for certain of the Company s auction rate securities totaling $300 thousand were settled at par. During the nine months ended December 31, 2010, redemptions by the issuers for certain of the Company s auction rate securities totaling $8.6 million were settled at par.

At December 31, 2010, the Company valued its outstanding auction rate securities at fair value using a discounted cash flow model. This model estimated future interest income using maximum rate formulas applicable to each of these securities which consider historical spreads for benchmark rates included in these formulas as well as rates for U.S. Treasuries. The model then discounts the estimated future interest income using a risk based discount rate that considers known U.S. Treasury yields as of December 31, 2010, historical spreads in comparison to U.S. Treasuries, and a liquidity risk premium of 350 basis points. As these securities have retained investment grade credit ratings with Standard and Poor s, the Company has not applied a credit spread to its discount rate. The valuation also includes assumptions as to when these securities will return to liquidity, of which the weighted average period is estimated at between 52 and 55 months depending on the security being valued. This valuation resulted in a cumulative temporary decline in value of $2.7 million ($1.7 million, net of tax) as of December 31, 2010 recorded within accumulated other comprehensive income (loss) on the balance sheet. This represents an increase to the valuation reserve of $83 thousand ($52 thousand, net of tax) during the

9

Table of Contents

quarter ended December 31, 2010 reflecting changes in market interest rates used to value the securities. To the extent the Company determines that any impairment is other-than-temporary, the Company would record a charge to earnings.

The Company has the ability and intent to hold these securities until a recovery in the auction process or other liquidity event occurs. Based on the Company s current cash position, expected operating cash flows and the Company s other sources of cash, the Company does not believe that it is more likely than not that it will be required to sell the securities before a recovery in the auction process or other liquidity event occurs. Additionally, the Company believes that the present value of expected future cash flows consisting of interest payments and the return of principal is sufficient to recover the amortized cost basis of the securities and expects to collect these cash flows. Therefore, the Company does not believe that the decline in value of its auction rate securities is other than temporary, or that any portion of the temporary decline is the result of a credit loss.

Restricted Investment

NetScout had a restricted investment account related to a deferred compensation plan which was liquidated during the three months ended December 31, 2010. As of March 31, 2010, the balance of $988 thousand was included in prepaid and other current assets. As of March 31, 2010, there were unrealized gains of $51 thousand recorded as accumulated other comprehensive income (loss) related to this investment.

5. Fair Value Measurements

The Company follows the authoritative guidance for fair value measurements of its financial assets and financial liabilities.

The guidance clarifies the definition of fair value as an exit price representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. The following summarizes the three-tier value hierarchy, which prioritizes, in descending order, the inputs used in measuring fair value as follows:

Level I	Observable inputs such as quoted prices in active markets,
Level II	Inputs other than the quoted prices in active markets that are observable either directly or indirectly, and
Level III	Unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions.

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures certain financial assets and liabilities at fair value, including its marketable securities and derivative financial instruments. The Company s investment instruments, except for auction rate securities, listed below are classified within Level I of the fair value hierarchy because they are valued using quoted market prices or alternative pricing sources with reasonable levels of price transparency. The Company s derivative financial instruments consist of forward foreign exchange contracts and are classified as Level II because the fair values of these derivatives are determined using models based on market observable inputs, including spot prices for foreign currencies and credit derivatives, as well as an interest rate factor. For further information on the Company s derivative instruments refer to Note 9. The Company s auction rate securities are classified as Level III of the fair value hierarchy due to the limited market data for pricing these securities. For further information on the Company s auction rate securities refer to Note 4.

Table of Contents

The following table summarizes the valuation of the Company s marketable securities by the above levels as of December 31, 2010 (in thousands):

	Total Fair Value	Level I	Level II	Level III
ASSETS:				
Cash and cash equivalents	$ 121,482	$ 121,482	$	$
U.S. government and municipal obligations	27,017	27,017		
Commercial paper	19,208	19,208		
Corporate bonds	16,213	16,213		
Certificate of deposits	5,264	5,264		
Auction rate securities	21,046			21,046
Derivative asset	36		36	
	$ 210,266	$ 189,184	$ 36	$ 21,046
LIABILITIES:				
Derivative financial instruments	$ 95	$	$ 95	$
	$ 95	$	$ 95	$

The following table presents a reconciliation of assets classified as Level III measured at fair value using significant unobservable inputs for the three and nine months ended December 31, 2010 (in thousands):

	Three Months Ended December 31, 2010	Nine Months Ended December 31, 2010
Balance at beginning of period	$ 21,457	$ 28,475
Total gains or (losses) (realized or unrealized)		
Change in accrued interest receivable	(28)	(39)
Unrealized losses included in accumulated other comprehensive income (loss)	(115)	36
Redemptions	(300)	(8,600)
Reversal of temporary loss on redeemed securities	32	1,174
Balance at end of period	$ 21,046	$ 21,046

6. Inventories

Inventories are stated at the lower of actual cost or net realizable value. Cost is determined by using the first-in, first-out, or FIFO method. Inventories consist of the following (in thousands):

	December 31, 2010	March 31, 2010
Raw materials	$ 5,333	$ 5,184
Work in process	301	269
Finished goods	3,314	3,728

	$ 8,948	$ 9,181

7. Goodwill & Acquired Intangible Assets
Goodwill

The carrying amount of goodwill was $128.2 million as of December 31, 2010 and March 31, 2010. The Company s goodwill resulted from the acquisition of Network General Central Corporation, or Network General, in November 2007, the acquisition of substantially all of the assets of Quantiva, Inc. in April 2005 and the acquisition of NextPoint Networks, Inc. in July 2000.

Table of Contents

Acquired Intangible Assets

The net carrying amounts of acquired intangible assets were $49.2 million and $53.6 million as of December 31, 2010 and March 31, 2010, respectively. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. The Company amortizes acquired intangible assets over their estimated useful lives on a straight-line basis, except for the acquired trade name or names, which has an indefinite life and thus is not amortized. The carrying value of the indefinite lived trade name will be evaluated for potential impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired.

Acquired intangible assets consist of the following as of December 31, 2010 (in thousands):

	Cost	Accumulated Amortization	Net
Acquired software	$ 19,900	$ (12,603)	$ 7,297
Customer relationships	29,200	(5,966)	23,234
Indefinite lived trade name	18,600		18,600
Net beneficial leases	336	(309)	27
	$ 68,036	$ (18,878)	$ 49,158

Amortization of acquired software included as cost of product revenue was $995 thousand and $3.0 million for the three and nine months ended December 31, 2010, respectively. Amortization of other acquired intangible assets included as operating expense was $476 thousand and $1.4 million for the three and nine months ended December 31, 2010, respectively.

Acquired intangible assets consist of the following as of March 31, 2010 (in thousands):

	Cost	Accumulated Amortization	Net
Acquired software	$ 19,900	$ (9,618)	$ 10,282
Customer relationships	29,200	(4,553)	24,647
Indefinite lived trade name	18,600		18,600
Net beneficial leases	336	(292)	44
	$ 68,036	$ (14,463)	$ 53,573

Amortization of acquired software included as cost of product revenue was $995 thousand and $3.0 million for the three and nine months ended December 31, 2009, respectively. Amortization of other acquired intangible assets included as operating expense was $490 thousand and $1.5 million for the three and nine months ended December 31, 2009, respectively.

The following is the expected future amortization expense as of December 31, 2010 for the years ended March 31 (in thousands):

2011 (remaining three months)	$ 1,472
2012	5,885
2013	4,206
2014	1,884
2015	1,884
Thereafter	15,227
	$ 30,558

The weighted average useful life of acquired intangible assets is 11 years.

Table of Contents

8. Capitalized Software Development Costs

Net capitalized software development costs for our nGenius Service Delivery Manager product totaled $306 thousand and $408 thousand at December 31, 2010 and March 31, 2010, respectively. This product was released on June 29, 2010, and is being amortized on a straight-line basis over two years. Amortization of capitalized software development costs included as cost of product revenue was $51 thousand and $102 thousand for the three and nine months ended December 31, 2010.

9. Derivative Instruments and Hedging Activities

NetScout operates internationally and, in the normal course of business, is exposed to fluctuations in foreign currency exchange rates. The exposures result from costs that are denominated in currencies other than the U.S. dollar, primarily the Euro, British Pound, Canadian Dollar, and Indian Rupee. During the year ended March 31, 2010, the Company began managing its foreign currency transaction risk by hedging forecasted cash flows for operating expenses for up to twelve months, within specified guidelines through the use of forward contracts. The Company enters into foreign currency exchange contracts to hedge cash flow exposures from costs that are denominated in currencies other than the U.S. dollar. These hedges are designated as cash flow hedges at inception.

All of the Company s derivative instruments are utilized for risk management purposes, and the Company does not use derivatives for speculative trading purposes. As of December 31, 2010, the Company had open contracts with notional amounts totaling $10.6 million that mature over the next twelve months.

The location and amounts of derivative fair values on the condensed consolidated balance sheets as of December 31, 2010 and March 31, 2010 were as follows (in thousands):

	Balance Sheet Location	Asset Derivatives December 31, 2010	Asset Derivatives March 31, 2010	Balance Sheet Location	Liability Derivatives December 31, 2010	Liability Derivatives March 31, 2010
Derivatives Designated as Hedging Instruments:						
Forward contracts	Other current assets	$ 36	$ 94	Accrued other liabilities	$ 95	$ 359

The following table provides the effect foreign exchange forward contracts had on other comprehensive income (loss), or OCI, and results of operations as of December 31, 2010 (in thousands):

	Effective Portion			Ineffective Portion	
Derivatives in Cash Flow Hedging Relationships	**Amount of Gain or (Loss) Recognized in OCI on Derivative (a)**	**Location of Gain or (Loss) Reclassified from Accumulated OCI into Income**	**Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (b)**	**Location of Gain (Loss) Recognized in Income on Derivative**	**Amount of Gain or (Loss) Recognized in Income on Derivative (amount excluded from effectiveness Testing) (c)**
Forward contracts	$ (197)	Research and development	$ 17	Research and development	$ 11
		Sales and marketing	(432)	Sales and marketing	(1)
	$ (197)		$ (415)		$ 10

(a) The amount represents the change in fair value of derivative contracts due to changes in spot rates.

(b) The amount represents reclassification from other comprehensive income to earnings that occurs when the hedged item affects earnings.

(c) The amount represents the change in fair value of derivative contracts due to changes in the difference between the spot price and forward price that is excluded from the assessment of hedge effectiveness and therefore recognized in earnings. No amounts were recognized in income due to ineffectiveness.

Table of Contents

10. Long-term Debt

In December 2007, the Company entered into a credit facility with a syndicate of lenders led by KeyBank National Association, or KeyBank, providing a term loan of $100 million and a $10 million revolving credit facility, or the Credit Facility, pursuant to a Credit Agreement, dated as of December 21, 2007, by and among the Company, KeyBank and the other parties thereto, or the Credit Agreement. The proceeds of the $100 million term loan were used to redeem all of the Company s outstanding senior secured floating rate notes issued in connection with the acquisition of Network General on November 1, 2007. No amounts were outstanding under the revolving credit facility as of December 31, 2010.

At the Company s election, revolving loans and the term loan under the Credit Agreement bear interest at either (1) a rate per annum equal to the greater of KeyBank s prime rate or 0.5% in excess of the federal funds effective rate, or the Alternative Base Rate, or (2) the one-, two-, three-, or six-month per annum LIBOR, as selected by the Company, multiplied by the statutory reserve adjustment, collectively the Eurodollar Rate, in each case plus an applicable margin. The applicable margin varies depending on the Company s consolidated leverage ratio ranging from 175 basis points for Alternative Base Rate loans and 300 basis points for Eurodollar Rate loans if the Company s consolidated leverage ratio is 2.50 to 1.00 or higher, down to 75 basis points for Alternative Base Rate loans and 200 basis points for Eurodollar Rate loans if the Company s consolidated leverage ratio is 1.00 to 1.00 or less. The consolidated leverage ratio is the ratio of funded indebtedness to adjusted earnings before interest, taxes, depreciation and amortization, or EBITDA. For the three months ended December 31, 2010 and 2009 the term loan incurred interest at 2.750% and 3.375%, respectively. Effective September 30, 2010, the interest rate on the term loan was 2.750%, and the Company expects this to be the rate in effect until the next adjustment date of March 31, 2011.

Payments of principal on the term loan commenced on March 31, 2008, and will be made in regular quarterly installments. As of December 31, 2010, the aggregate annual repayment amounts are as follows for the years ended March 31 (in thousands):

2011 (remaining three months)	$ 3,750
2012	15,000
2013	53,106
	$ 71,856

The Credit Agreement contains financial covenants that stipulate a maximum leverage ratio of 3.00 and a minimum fixed-charge coverage ratio of 1.25. As of December 31, 2010, the Company was in compliance with all covenants. Substantially all of the Company s assets serve as collateral under the Credit Agreement. Subject to certain exceptions, the Credit Agreement contains provisions for mandatory prepayments including from (a) 100% of the net proceeds from certain asset sales by the Company and its subsidiaries, (b) 100% of the net proceeds from the issuance of debt, (c) annually, subject to the Company s leverage ratio, either 25% or 50% of the annual excess cash flow of the Company and its subsidiaries as defined in the Credit Agreement, (d) 50% of the net proceeds from the issuance of equity by the Company and its subsidiaries and (e) 100% of the net proceeds from insurance recovery and condemnation events of the Company and its subsidiaries. The Company made a $3.1 million payment during the second quarter of fiscal year 2010 as a result of the annual excess cash flow calculation based on the year ended March 31, 2009 financial results. An excess cash flow payment was not triggered for the year ended March 31, 2010. The Company may also prepay loans under the Credit Agreement, including the term loan, at any time, without penalty, subject to certain notice requirements.

11. Treasury Stock

On September 17, 2001, the Company announced an open market stock repurchase program to purchase up to one million shares of outstanding Company common stock, subject to market conditions and other factors. Any purchases under the Company s stock repurchase program may be made from time to time without

Table of Contents

prior notice. On July 26, 2006, the Company announced that it had expanded the existing open market stock repurchase program to enable the Company to purchase up to an additional three million shares of the Company s outstanding common stock, bringing the total number of shares authorized for repurchase to four million shares. Through December 31, 2010, the Company had repurchased a total of 486,794 shares of common stock through the open market stock repurchase program. The Company did not repurchase any shares during the nine months ended December 31, 2010, under the program.

In connection with the vesting and release of the restriction on previously vested shares of restricted stock, we repurchased 27,503 shares for $448 thousand related to minimum statutory tax withholding requirements on these restricted stock units during the nine months ended December 31, 2010. These repurchase transactions do not fall under the repurchase program described above, and therefore do not reduce the amount that is available for repurchase under that program.

12. Net Income Per Share

Calculations of the basic and diluted net income per share and potential common shares are as follows (in thousands, except per share data):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Basic:				
Net income	$ 11,101	$ 8,541	$ 26,494	$ 20,684
Weighted average common shares outstanding	42,105	40,684	41,946	40,463
Basic net income per share	$ 0.26	$ 0.21	$ 0.63	$ 0.52
Diluted:				
Net income	$ 11,101	$ 8,541	$ 26,494	$ 20,684
Weighted average common shares outstanding	42,105	40,684	41,946	40,463
Weighted average stock options	310	746	333	739
Weighted average restricted stock units	758	611	557	455
Diluted weighted average shares	43,173	42,041	42,836	41,657
Diluted net income per share	$ 0.26	$ 0.20	$ 0.62	$ 0.50

The following table sets forth options and restricted stock units excluded from the calculation of diluted net income per share, since their inclusion would be antidilutive (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	**2009**	**2010**	**2009**
Stock options		221	20	224
Restricted stock units		7	9	27
Total		228	29	251

Table of Contents

13. Comprehensive Income

Other comprehensive income typically consists of unrealized gains and losses on cash equivalents, marketable securities, restricted investments and hedge contracts. Comprehensive income for the three and nine months ended December 31, 2010 and 2009 is as follows (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	2009	2010	2009
Net income	$ 11,101	$ 8,541	$ 26,494	$ 20,864
Unrealized gain (loss) on cash equivalents, marketable securities and restricted investment, net of tax	(200)	(89)	571	(193)
Unrealized gain (loss) on hedge contracts, net of tax	(53)	(163)	134	(163)
Comprehensive income	$ 10,848	$ 8,289	$ 27,199	$ 20,508

14. Income Taxes

The estimated annual effective tax rate as of December 31, 2010 for fiscal year 2011 is 33.6%, compared to an estimated annual effective rate of 34.9% as of December 31, 2009 for fiscal year 2010. The decrease in our effective tax rate is primarily due the reinstatement of the federal research and development credit and an increase in our domestic production activities deduction. The federal research and development credit was re-enacted on December 17, 2010 as part of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (H.R. 4853) . The impact of this law change was accounted for during this quarter. This act retroactively extends the federal research and development credit to the beginning of calendar year 2010. The Company has recorded a rate reduction of approximately 1.2% to its estimated annual effective tax rate for fiscal year 2011. Since this legislation was retroactively reinstated to the beginning of calendar year 2010, the Company has recorded a discrete item in its year-to-date provision during the quarter for the fiscal 2010 fourth quarter benefit. Generally, the estimated annual effective tax rates differ from the statutory rates primarily due to the impact of federal and state tax credits, state taxes and the qualified production activities deduction.

Significant accounting judgments and estimates are made when determining whether it is more likely than not that the Company s deferred income tax assets will be realized. Management has concluded that deferred income tax assets do not require a valuation allowance. If these judgments and estimates prove to be materially inaccurate, a valuation allowance may be required and the Company s financial results could be materially and adversely impacted in the future. If the Company determines that it will not be able to realize some or all of its deferred income taxes in the future, an adjustment to the deferred income tax assets will be charged to income tax expense in the period such determination is made.

The Company s policy is to include interest and penalties related to unrecognized tax benefits as a component of interest expense on the condensed consolidated statements of operations. Accrued interest and penalties as of December 31, 2010 are $22 thousand.

15. Geographic Information

The Company reports revenues and income under one reportable industry segment. The Company s management assesses operating results on an aggregate basis to make decisions about the allocation of resources.

The Company manages its business in the following geographic areas: United States, Europe, Asia and Rest of World. In accordance with United States export control regulations, the Company does not sell or do business with countries subject to economic sanctions and export controls.

Table of Contents

Total revenue by geography is as follows (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	2009	2010	2009
United States	$ 52,358	$ 49,657	$ 154,941	$ 139,914
Europe	12,930	11,258	29,243	24,579
Asia	4,582	3,077	11,208	8,491
Rest of World	6,466	6,723	17,168	15,484
	$ 76,336	$ 70,715	$ 212,560	$ 188,468

The United States revenue includes sales to resellers in the United States. These resellers fulfill customer orders and may subsequently ship the Company s products to international locations. The Company reports these shipments as United States revenue since the Company ships the products to a United States location. Revenue attributable to locations outside of the United States is a result of export sales. Substantially all of the Company s identifiable assets are located in the United States.

16. Subsequent Events

The Company has evaluated subsequent events for potential recognition or disclosure in these financial statements. No material subsequent events have occurred since December 31, 2010 that required recognition or disclosure in these financial statements.

17. Recently Issued Accounting Pronouncements

Fair Value Disclosures. In January 2010, the Financial Accounting Standards Board, or FASB, issued amended standards requiring additional fair value disclosures. The amended standards require disclosures of transfers in and out of Levels I and II of the fair value hierarchy, as well as requiring gross basis disclosures for purchases, sales, issuances and settlements within the Level III reconciliation which will replace the net presentation format. Additionally, the update clarifies the requirement to determine the level of disaggregation for fair value measurement disclosures and to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements in either Level II or Level III. The Company adopted the new guidance in the fourth quarter of our fiscal year 2010, except for the gross presentation of the Level III rollforward information which is effective for fiscal years beginning after December 15, 2010 (fiscal year 2012 for the Company). Because these new standards are related primarily to disclosures, their adoption has not had and is not expected to have a significant impact on the Company s financial position or results of operations.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following information should be read in conjunction with the unaudited consolidated financial information and the notes thereto included in this Quarterly Report on Form 10-Q. In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking statements that involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. Actual events or results may differ materially due to competitive factors and other factors referred to in Part I, Item 1A. *Risk Factors* in our Annual Report on Form 10-K for our fiscal year ended March 31, 2010 and elsewhere in this Quarterly Report. These factors may cause our actual results to differ materially from any forward-looking statement.

Overview

NetScout was founded in 1984 and is headquartered in Westford, Massachusetts. We design, develop, manufacture, market, sell and support market leading unified service delivery management, service assurance

17

and application and network performance management solutions focused on assuring service delivery for the world s largest, most demanding and complex internet protocol, or IP, based service delivery environments. We manufacture and market these products in integrated hardware and software solutions that are used by commercial enterprises, large governmental agencies and telecommunication service providers worldwide. We have a single operating segment and substantially all of our identifiable assets are located in the United States.

Our operating results are influenced by a number of factors, including, but not limited to, the mix and quantity of products and services sold, pricing, costs of materials used in our products, growth in employee related costs, including commissions, and the expansion of our operations. Factors that affect our ability to maximize our operating results include, but are not limited to, our ability to introduce and enhance existing products, the marketplace acceptance of those new or enhanced products, continued expansion into international markets, development of strategic partnerships, competition, successful acquisition integration efforts and current economic conditions.

Results Overview

We saw continued strength during the nine months ending December 31, 2010, with product revenue growth of 15% and overall revenue growth of 13% compared to the prior year period driven by strength in our enterprise and service provider sectors. Gross margin remained flat at 79% for the nine months ending December 31, 2010 and 2009. While operating expenses increased on higher sales and marketing expenses and incentive compensation, we improved our operating margin to 19% for the nine months ended December 31, 2010, compared to 18% for the same period in the prior year. Net income and diluted net income per share increased 27% and 24%, respectively compared to the prior year.

We also achieved strong cash flow with cash, cash equivalents and marketable securities increasing to $210.2 million at December 31, 2010. This represents an increase of $14.2 million over the previous quarter end on September 30, 2010.

Use of Non-GAAP Financial Measures

From time to time in press releases regarding quarterly earnings, presentations and other communications, we may provide financial information determined by methods other than in accordance with generally accepted accounting principles, or GAAP. Recent non-GAAP financial measures have included non-GAAP revenue, income from operations, net income and net income per diluted share, each of which were adjusted from amounts determined based on GAAP to exclude the effect of purchase accounting adjustments to reduce to fair value acquired deferred revenue resulting from our acquisition of Network General Central Corporation, or Network General, in November 2007, and to add back the revenue impact of recently adopted accounting guidance, share-based compensation expenses, certain business development expenses and the amortization of acquired intangible assets, net of related income tax effects.

Management regularly uses supplemental non-GAAP financial measures internally to understand, manage and evaluate its business and to make operating decisions. These non-GAAP measures are among the primary factors that management uses in planning and forecasting future periods. Management believes these non-GAAP financial measures enhance the reader s overall understanding of NetScout s current financial performance and its prospects for the future by providing a higher degree of transparency for certain financial measures and providing a level of disclosure that helps investors understand how the Company plans and measures its business. We believe that providing these non-GAAP measures affords investors a view of our operating results that may be more easily compared to our peer companies and against prior periods by enabling investors to consider our operating results on both a GAAP and non-GAAP basis during periods where GAAP results were affected by non-recurring events, such as our acquisition of Network General.

These non-GAAP measures are not in accordance with GAAP, should not be considered an alternative for measures prepared in accordance with GAAP, and may have limitations in that they do not reflect all our results

Table of Contents

of operations as determined in accordance with GAAP. These non-GAAP measures should only be used to evaluate our results of operations in conjunction with the corresponding GAAP measures. The presentation of non-GAAP information is not meant to be considered superior to, in isolation from or as a substitute for results prepared in accordance with GAAP.

The following table reconciles revenue, net income and net income per share on a GAAP and non-GAAP basis for the three and nine months ended December 31, 2010 and 2009 (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2010	2009	2010	2009
GAAP revenue	$ 76,336	$ 70,715	$ 212,560	$ 188,468
Impact of new accounting guidance	(148)		(351)	
Deferred revenue fair value adjustment	10	209	123	1,205
Non-GAAP revenue	$ 76,198	$ 70,924	$ 212,332	$ 189,673
GAAP net income	$ 11,101	$ 8,541	$ 26,494	$ 20,864
Impact of new accounting guidance	(148)		(351)	
Deferred revenue fair value adjustment	10	209	123	1,205
Share based compensation expense	1,460	1,207	4,139	3,774
Amortization of acquired intangible assets	1,471	1,485	4,415	4,456
Business development expenses	623		623	
Income tax adjustments	(1,298)	(1,102)	(3,401)	(3,585)
Non-GAAP net income	$ 13,219	$ 10,340	$ 32,042	$ 26,714
GAAP diluted net income per share	$ 0.26	$ 0.20	$ 0.62	$ 0.50
Share impact of non-GAAP adjustments identified above	0.05	0.05	0.13	0.14
Non-GAAP diluted net income per share	$ 0.31	$ 0.25	$ 0.75	$ 0.64

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America consistently applied. The preparation of these consolidated financial statements requires us to make significant estimates and judgments that affect the amounts reported in our consolidated financial statements and the accompanying notes. These items are regularly monitored and analyzed by management for changes in facts and circumstances, and material changes in these estimates could occur in the future. Changes in estimates are recorded in the period in which they become known. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from our estimates.

While all of our accounting policies impact the consolidated financial statements, certain policies are viewed to be critical. Critical accounting policies are those that are both most important to the portrayal of our financial condition and results of operations and that require management s most subjective or complex judgments and estimates. We consider the following accounting policies to be critical in fully understanding and evaluating our financial results:

- cash, cash equivalents and marketable securities;

- revenue recognition;

commission expense;

Table of Contents

- uncollected deferred product revenue;
- valuation of inventories;
- valuation of goodwill and acquired intangible assets;
- capitalization of software development costs;
- derivative financial instruments;
- share-based compensation; and
- income taxes.

Please refer to the critical accounting policies set forth in our Annual Report on Form 10-K for the fiscal year ended March 31, 2010, filed with the Securities and Exchange Commission, or the SEC on May 28, 2010, for a description of all critical accounting policies.

The critical accounting policies included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2010 have not materially changed, other than the following:

The critical accounting policy entitled Revenue Recognition has been changed to reflect the adoption of new authoritative guidance for revenue arrangements with multiple deliverables during the quarter ended June 30, 2010.

The adoption of this guidance did not have a material impact on our financial position or results of operations for the three and nine months ended December 31, 2010.

Revenue Recognition

Product revenue consists of sales of our hardware products (which include embedded software that works together with the hardware to deliver the product s essential functionality), licensing of our software products, and sale of hardware bundled with a software license. Product revenue is recognized upon shipment, provided that evidence of an arrangement exists, title and risk of loss have passed to the customer, fees are fixed or determinable and collection of the related receivable is probable. Because many of our solutions are comprised of both hardware and more than incidental software components, we recognize our revenue in accordance with authoritative guidance on both hardware and software revenue recognition.

Service revenue consists primarily of fees from customer support agreements, consulting and training. We generally provide software and hardware support as part of product sales. Revenue related to the initial bundled software and hardware support is recognized ratably over the support period. In addition, customers can elect to purchase extended support agreements for periods after the initial software warranty expiration, typically for 12-month periods. Revenue from customer support agreements is recognized ratably over the support period. Revenue from consulting and training services is recognized as the work is performed.

Multi-element arrangements are concurrent customer purchases of a combination of our product and service offerings that may be delivered at various points in time. For multi-element arrangements comprised only of hardware products and related services, we allocate the total transaction revenue to the multiple elements based on each element s relative fair value compared to the total fair value of all the elements. Each element s relative fair value is based on management s best estimate of selling price paid by customers based on the element s historical pricing. We review the sales of all products and services quarterly and update, when appropriate, our best estimate of selling price for each element to ensure that it reflects our recent pricing experience.

For multi-element arrangements comprised only of software products and related services, we allocate a portion of the total purchase price to the undelivered elements, primarily support agreements and training, using vendor-specific objective evidence of fair value of the undelivered elements. The remaining portion of the total transaction value is allocated to the delivered software, referred to as the residual method. Vendor-specific objective evidence of fair value of the undelivered elements is based on the price customers pay when the element is sold separately. We review the separate sales of the undelivered elements on a quarterly basis and update, when appropriate, our vendor-specific objective evidence of fair value for such elements to ensure that it reflects our recent pricing experience.

For multi-element arrangements comprised of a combination of hardware and software elements, the total transaction value is bifurcated between the hardware elements and the software elements based on the relative selling prices of the hardware elements and the software elements as a group. Then, revenue for the hardware and hardware-related services is recognized following the hardware revenue recognition methodology outlined above and revenue for the software and software-related services is recognized following the residual method.

Three Months Ended December 31, 2010 and 2009

Revenue

Product revenue consists of sales of our hardware products and licensing of our software products. Service revenue consists of customer support agreements, consulting and training. No one customer or indirect channel partner accounted for more than 10% of our total revenue during the three months ended December 31, 2010 and 2009.

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Revenue:						
Product	$ 43,016	56%	$ 40,774	58%	$ 2,242	5%
Service	33,320	44	29,941	42	3,379	11%
Total revenue	$ 76,336	100%	$ 70,715	100%	$ 5,621	8%

Product. The 5%, or $2.2 million, increase in product revenue was due to a $7.1 million increase in our enterprise business sector, offset by a $4.8 million decrease in our service provider sector. While revenue for our service provider sector was down for the three months ended December 31, 2010 compared to the same period last year, revenue has increased $2.5 million on a fiscal year-to-date basis reflecting the uneven timing of the large orders associated with this sector. Compared to the same period in the prior year, we realized an increase of approximately 23% in the average selling price per unit of our products offset by a 17% decrease in units shipped. The increase in selling price per unit is due to a shift in product mix towards our higher capacity Infinistream products.

Service. The 11%, or $3.4 million, increase in service revenue was due in part to a $1.6 million increase in revenue from maintenance contracts due to increased renewals from a growing support base, a $1.1 million increase in revenue from post-contract customer support in connection with product revenue growth and a $405 thousand increase in other service revenue. In addition, there was a decline of $186 thousand in purchase accounting adjustments to deferred service revenue associated with our acquisition of Network General. As a result of this acquisition, acquired deferred revenue was reduced to fair value to eliminate selling profit from the contracts that were acquired from Network General. As the fair value adjusted deferred revenue has amortized over time, it comprised a smaller proportion of total maintenance revenue during the three months ended December 31, 2010. Subsequent maintenance renewal contracts are recorded at their full value and thus result in higher recorded revenue.

Table of Contents

Total product and service revenue from direct and indirect channels are as follows:

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Indirect	$ 48,607	64%	$ 41,925	59%	$ 6,682	16%
Direct	27,729	36	28,790	41	(1,061)	(4)%
Total revenue	$ 76,336	100%	$ 70,715	100%	$ 5,621	8%

The 16%, or $6.7 million, increase in indirect channel revenue is primarily the result of an increase in international sales. Sales to customers outside the United States are primarily export sales through channel partners, who are generally responsible for distributing our products and providing technical support and service to customers within their territories. Our reported international revenue does not include any revenue from sales to customers outside the United States that are shipped to our United States-based indirect channel partners. These domestic resellers fulfill customer orders based upon joint selling efforts in conjunction with our direct sales force and may subsequently ship our products to international locations; however, we report these shipments as United States revenue since we ship the products to a domestic location. The 4%, or $1.1 million, decrease in direct channel revenue is primarily the result of decreased revenue in the United States due to the decrease in volume within the quarter with our larger direct service provider customers.

Total revenue by geography is as follows:

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
United States	$ 52,358	69%	$ 49,657	70%	$ 2,701	5%
International						
Europe	12,930	17	11,258	16	1,672	15%
Asia	4,582	6	3,077	4	1,505	49%
Rest of World	6,466	8	6,723	10	(257)	(4)%
Subtotal International	23,978	31	21,058	30	2,920	14%
Total revenue	$ 76,336	100%	$ 70,715	100%	$ 5,621	8%

United States revenues increased 5%, or $2.7 million, primarily as a result of strong growth in our enterprise business sector. The 14%, or $2.9 million, increase in international revenue is due to growth in both the enterprise and the service provider sectors. We expect revenue from sales to customers outside the United States to continue to account for a significant portion of our total revenue in the future. In accordance with United States export control regulations we do not sell or do business with countries subject to economic sanctions and export controls.

Table of Contents

Cost of Revenue and Gross Profit

Cost of product revenue consists primarily of material components, manufacturing personnel expenses, media duplication, manuals, packaging materials, overhead and amortization of capitalized software and developed product technology. Cost of service revenue consists primarily of personnel, material, overhead and support costs.

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Cost of revenue						
Product	$ 10,343	14%	$ 9,924	14%	$ 419	4%
Service	5,749	8	5,481	8	268	5%
Total cost of revenue	$ 16,092	21%	$ 15,405	22%	$ 687	4%
Gross profit:						
Product $	$ 32,673	43%	$ 30,850	44%	$ 1,823	6%
Product gross profit %	76%		76%			
Service $	$ 27,571	36%	$ 24,460	35%	$ 3,111	13%
Service gross profit %	83%		82%			
Total gross profit $	$ 60,244		$ 55,310		$ 4,934	9%
Total gross profit %	79%		78%			

Product. The 4%, or $419 thousand, increase in cost of product revenue was primarily due to the 5% increase in product revenue during the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The product gross profit percentage remained flat at 76% for the three months ended December 31, 2010 and 2009, respectively. Average headcount was 29 and 27 for the three months ended December 31, 2010 and 2009, respectively.

Service. The 5%, or $268 thousand, increase in cost of service revenue was primarily due to a $201 thousand increase in employee related expenses and a $72 thousand increase in travel in our support and consulting groups. The 13%, or $3.1 million, increase in service gross profit corresponds with the 11%, or $3.4 million, increase in service revenue, offset by the 5%, or $268 thousand, increase in cost of services. The service gross profit percentage increased one point from 82% to 83% when comparing the three months ended December 31, 2010 to the three months ended December 31, 2009. Average headcount was 113 and 104 for the three months ended December 31, 2010 and 2009, respectively.

Gross profit. Our gross profit increased 9%, or $4.9 million. This increase is attributable to our increase in revenue of 8%, or $5.6 million. The net effect of the combined increases in revenue and cost of revenue was a one point increase in gross profit percentage from the three months ended December 31, 2009 to the three months ended December 31, 2010.

Table of Contents

Operating Expenses

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Research and development	$ 10,145	13%	$ 9,181	13%	$ 964	10%
Sales and marketing	27,022	36	26,328	37	694	3%
General and administrative	6,356	8	5,475	8	881	16%
Amortization of acquired intangible assets	476	1	490	1	(14)	(3%)
Total Operating Expenses	$ 43,999	58%	$ 41,474	59%	$ 2,525	6%

Research and development. Research and development expenses consist primarily of personnel expenses, fees for outside consultants, overhead and related expenses associated with the development of new products and the enhancement of existing products.

The 10%, or $964 thousand, increase in research and development expenses is primarily due to increases in incentive compensation and other employee related expenses due to an increase in headcount. Average headcount in research and development was 256 and 236 for the three months ended December 31, 2010 and 2009, respectively.

Sales and marketing. Sales and marketing expenses consist primarily of personnel expenses, including commissions, overhead and other expenses associated with selling activities and marketing programs such as trade shows, seminars, advertising, and new product launch activities.

The 3%, or $694 thousand, increase in total sales and marketing expenses was due to a $1.3 million increase in employee related expenses, a $324 thousand in increased expenses related to the NetScout user conferences and other sales meetings, $215 thousand in increased sales travel expenses due to increased headcount and international travel, $118 thousand of increased rent from international locations and $118 thousand in increased depreciation expense associated with demo units. These were offset by a $1.6 million decrease in sales commissions. The three months ended December 31, 2009 contained large sales incentive commissions which were driven by high service provider and maintenance renewal bookings. Renewal bookings are down 16% fiscal year-to-date because of last year s unusually large occurrence of early and multi-year renewals which began in the quarter ended December 31, 2009. Average headcount in sales and marketing was 316 and 293 for the three months ended December 31, 2010 and 2009, respectively.

General and administrative. General and administrative expenses consist primarily of personnel expenses for executive, financial, legal and human resource employees, overhead and other corporate expenditures.

The 16%, or $881 thousand, increase in general and administrative expenses was primarily due to a $968 thousand increase in professional services mainly due to business development costs and a $317 thousand increase in incentive compensation and other employee related expenses, partially offset by a $178 thousand decrease in allocated overhead costs due to lower facility costs and depreciation expense. Average headcount in general and administrative was 115 and 107 for the three months ended December 31, 2010 and 2009, respectively.

Amortization of acquired intangible assets. Amortization of acquired intangible assets consists primarily of amortization of customer relationships related to the acquisition of Network General.

Table of Contents

Interest and Other Income (Expense), Net. Interest and other income (expense), net includes interest earned on our cash, cash equivalents, marketable securities and restricted investments, interest expense and other non-operating gains or losses.

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Interest and other income (expense), net	$ (392)	(1)%	$ (862)	(1)%	$ 470	55%

The 55%, or $470 thousand, decrease in interest and other expense was primarily due to a $274 thousand decrease in interest expense due to a reduction in the interest rate as well as a reduction of approximately $10 million on the outstanding principal of our debt due to debt repayments. During the quarters ended December 31, 2010 and 2009, the average interest rates on our outstanding debt were 2.750% and 3.375%, respectively. Additionally, the decrease was affected by a $101 thousand increase in interest income due to an increase in market interest rates received on investments as well as a $54 thousand increase resulting from a decrease in losses on the disposal of assets.

Income Tax Expense. We estimate our income tax expense based on our estimated annual effective tax rate. The estimated annual effective tax rate as of December 31, 2010 for fiscal year 2011 is 33.6%, compared to an estimated annual effective tax rate of 34.9% as of December 31, 2009 for fiscal year 2010. The decrease in our effective tax rate is primarily due to the reinstatement of the federal research and development credit and an increase in our domestic production activities deduction. The federal research and development credit was re-enacted on December 17, 2010 as part of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (H.R. 4853) . The impact of this law change was accounted for during this quarter. This act retroactively extends the federal research and development credit to the beginning of calendar year 2010. We have recorded a rate reduction of approximately 1.2% to our estimated annual effective tax rate for fiscal year 2011. Since this legislation was retroactively reinstated to the beginning of calendar year 2010, we have recorded a discrete item in our year-to-date provision during the quarter for the fiscal 2010 fourth quarter benefit. Generally, the estimated annual effective tax rates differ from the statutory rates primarily due to the impact of federal and state tax credits, state taxes, and the qualified production activities deduction.

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Income tax expense	$ 4,752	6%	$ 4,433	6%	$ 319	7%

Net Income. Net income for the three months ended December 31, 2010 and 2009 is as follows:

	Three Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Net income	$ 11,101	15%	$ 8,541	12%	$ 2,560	30%

The $2.6 million increase in net income for the three months ended December 31, 2010 was largely attributable to the $4.9 million increase in total gross profit and a $470 thousand decrease in interest expense offset by a $2.5 million increase in operating expenses mainly due to increased employee related expenses and incentive compensation.

Table of Contents

Nine Months Ended December 31, 2010 and 2009

Revenue

Product revenue consists of sales of our hardware products and licensing of our software products. Service revenue consists of customer support agreements, consulting and training. No one direct customer or indirect channel partner accounted for more than 10% of our total revenue during the nine months ended December 31, 2010 and 2009.

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Revenue:						
Product	$ 114,289	54%	$ 99,796	53%	$ 14,493	15%
Service	98,271	46	88,672	47	9,599	11%
Total revenue	$ 212,560	100%	$ 188,468	100%	$ 24,092	13%

Product. The 15%, or $14.5 million, increase in product revenue was due to a $12.0 million increase in our enterprise business sector and a $2.5 million increase in our service provider sector. Compared to the same period in the prior year, we realized an increase of approximately 27% in the average selling price per unit of our products offset by a 7% decrease in units shipped. The increase in selling price per unit is due to a shift in product mix towards our higher capacity Infinistream products.

Service. The 11%, or $9.6 million, increase in service revenue was due in part to a $3.5 million increase in revenue from post-contract customer support in connection with product revenue growth, a $2.3 million increase in revenue from maintenance contracts due to increased renewals from a growing support base, and a $490 thousand increase in other service revenue. In addition, there was a decline of $1.1 million in purchase accounting adjustments to deferred service revenue associated with our acquisition of Network General. As a result of this acquisition, acquired deferred revenue was reduced to fair value to eliminate selling profit from the contracts that were acquired from Network General. As the fair value adjusted deferred revenue has amortized over time, it comprised a smaller proportion of total maintenance revenue during the nine months ended December 31, 2010. Subsequent maintenance renewal contracts are recorded at their full value and thus result in higher recorded revenue. We also recognized $1.4 million in training and consulting revenue during the quarter ended June 30, 2010 from non-refundable expired contracts. Prior to this quarter, the Company had not been able to demonstrate that it had fulfilled its obligations. However, during the quarter, the Company was able to demonstrate that its obligations had been fulfilled related to the non-refundable expired contracts. While the Company will continue to recognize revenue from non-refundable contracts, it does not expect the revenue in future quarters to be significant.

Total product and service revenue from direct and indirect channels are as follows:

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Indirect	$ 129,548	61%	$ 117,851	63%	$ 11,697	10%
Direct	83,012	39	70,617	37	12,395	18%
Total revenue	$ 212,560	100%	$ 188,468	100%	$ 24,092	13%

26

Table of Contents

The 10%, or $11.7 million, increase in indirect channel revenue is the result of an increase in international sales. Sales to customers outside the United States are primarily export sales through channel partners, who are generally responsible for distributing our products and providing technical support and service to customers within their territories. Our reported international revenue does not include any revenue from sales to customers outside the United States that are shipped to our United States-based indirect channel partners. These domestic resellers fulfill customer orders based upon joint selling efforts in conjunction with our direct sales force and may subsequently ship our products to international locations; however, we report these shipments as United States revenue since we ship the products to a domestic location. The 18%, or $12.4 million, increase in direct channel revenue and change in sales mix between direct and indirect is primarily the result of increased domestic revenue from our telecommunications and enterprise sectors, as well as the $1.1 million reduction in purchase accounting adjustments related to the Network General acquisition which had the effect of increasing revenue.

Total revenue by geography is as follows:

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
United States	$ 154,941	73%	$ 139,914	74%	$ 15,027	11%
International						
Europe	29,243	14	24,579	13	4,664	19%
Asia	11,208	5	8,491	5	2,717	32%
Rest of World	17,168	8	15,484	8	1,684	11%
Subtotal International	57,619	27	48,554	26	9,065	19%
Total revenue	$ 212,560	100%	$ 188,468	100%	$ 24,092	13%

United States revenues increased 11%, or $15.0 million, primarily as a result of strong growth in our enterprise sector, which includes financial services, and in our service provider sector. The 19%, or $9.1 million, increase in international revenue is also due to growth in both our enterprise and service provider sectors. We expect revenue from sales to customers outside the United States to continue to account for a significant portion of our total revenue in the future. In accordance with United States export control regulations we do not sell or do business with countries subject to economic sanctions and export controls.

Table of Contents

Cost of Revenue and Gross Profit

Cost of product revenue consists primarily of material components, personnel expenses, media duplication, manuals, packaging materials, overhead and amortization of capitalized software and developed product technology. Cost of service revenue consists primarily of personnel, material, overhead and support costs.

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Cost of revenue						
Product	$ 28,002	13%	$ 25,472	14%	$ 2,530	10%
Service	16,972	8	14,974	8	1,998	13%
Total cost of revenue	$ 44,974	21%	$ 40,446	22%	$ 4,528	11%
Gross profit:						
Product $	$ 86,287	41%	$ 74,324	39%	$ 11,963	16%
Product gross profit %	75%		74%			
Service $	$ 81,299	38%	$ 73,698	39%	$ 7,601	10%
Service gross profit %	83%		83%			
Total gross profit $	$ 167,586		$ 148,022		$ 19,564	13%
Total gross profit %	79%		79%			

Product. The 10%, or $2.5 million, increase in cost of product revenue was primarily due to the 15%, or $14.5 million increase in product revenue for the nine months ended December 31, 2010 when compared to the nine months ended December 31, 2009. Our product gross profit percentage increased by one point to 75% for the nine months ended December 31, 2010. This increase was primarily due to the realization of cost savings within our manufacturing organization. Average headcount in cost of product revenue was 29 and 27 for the nine months ended December 31, 2010 and 2009, respectively.

Service. The 13%, or $2.0 million, increase in cost of service revenue was primarily due to a $1.4 million increase in employee related expenses, a $278 thousand increase in cost of materials used to support customers under service contracts and a $285 thousand increase in travel in our support and consulting groups. The 10%, or $7.6 million, increase in service gross profit corresponds with the 11%, or $9.6 million, increase in service revenue, offset by the 13%, or $2.0 million, increase in cost of services. The service gross profit percentage remained flat at 83% for the nine months ended December 31, 2010. Average headcount in cost of service revenue was 114 and 104 for the nine months ended December 31, 2010 and 2009, respectively.

Gross profit. Our gross profit increased 13%, or $19.6 million. This increase is attributable to our increase in revenue of 13%, or $24.1 million, offset by an 11%, or $4.5 million, increase in cost of revenue. The net effect of the combined increases in revenue and cost of revenue on gross margin remained flat at 79% for both the nine months ended December 31, 2009 to the nine months ended December 31, 2010.

28

Table of Contents

Operating Expenses

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Research and development	$ 29,734	14%	$ 27,069	14%	$ 2,665	10%
Sales and marketing	77,832	37	69,806	37	8,026	11%
General and administrative	17,478	8	15,309	8	2,169	14%
Amortization of acquired intangible assets	1,430	1	1,471	1	(41)	(3%)
Total Operating Expenses	$ 126,474	60%	$ 113,655	60%	$ 12,819	11%

Research and development. Research and development expenses consist primarily of personnel expenses, including incentive compensation, fees for outside consultants, overhead and other expenses associated with the development of new products and the enhancement of existing products.

The 10%, or $2.7 million, increase in research and development expenses is primarily due to increases in incentive compensation and other employee related expenses due to an increase in headcount. Average headcount in research and development was 254 and 237 for the nine months ended December 31, 2010 and 2009, respectively.

Sales and marketing. Sales and marketing expenses consist primarily of personnel expenses, including commissions, overhead and other expenses associated with selling activities and marketing programs such as trade shows, seminars, advertising, and new product launch activities.

The 11%, or $8.0 million, increase in total sales and marketing expenses was primarily due to $1.1 million in increased sales commissions commensurate with the higher sales revenue, a $3.5 million increase in other employee related expenses resulting from increased headcount, a $928 thousand increase in travel expenses, an $889 thousand increase in recruiting fees, a $516 thousand increase in depreciation expense associated with demo units and a $688 thousand increase in expenses related to the NetScout user conferences and other sales meetings. Average headcount in sales and marketing was 312 and 297 for the nine months ended December 31, 2010 and 2009, respectively.

General and administrative. General and administrative expenses consist primarily of personnel expenses for executive, financial, legal and human resource employees, overhead and other corporate expenditures.

The 14%, or $2.2 million, increase in general and administrative expenses was primarily due to a $1.2 million increase in incentive compensation and other employee related expenses and a $1.5 million increase professional services, mainly due to business development costs. These were partially offset by a $465 thousand decrease in allocated overhead costs due to lower facility costs and depreciation expense. Average headcount in general and administrative was 112 and 109 for the nine months ended December 31, 2010 and 2009, respectively.

Amortization of acquired intangible assets. Amortization of acquired intangible assets consists primarily of amortization of customer relationships related to the acquisition of Network General.

Table of Contents

Interest and Other Income (Expense), Net. Interest and other income (expense), net includes interest earned on our cash, cash equivalents, marketable securities and restricted investments and interest expense.

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Interest and other income (expense), net	$ (1,294)	(1)%	$ (2,296)	(1)%	$ 1,002	44%

The 44%, or $1.0 million, decrease in interest and other expense was primarily due to a $949 thousand decrease in interest expense due to a reduction in the interest rate and principal amounts outstanding associated with our debt. During the nine months ended December 31, 2010 and 2009, the average interest rate on the term loan was 2.750% and 3.708%, respectively. Interest income was relatively flat compared to the prior year.

Income Tax Expense. We estimate our income tax expense based on our estimated annual effective tax rate. The estimated annual effective tax rate as of December 31, 2010 for fiscal year 2011 is 33.6%, compared to an estimated annual effective tax rate of 34.9% as of December 31, 2009 for fiscal year 2010. The decrease in our effective tax rate is primarily due to the reinstatement of the federal research and development credit and an increase in our domestic production activities deduction. The federal research and development credit was re-enacted on December 17, 2010 as part of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (H.R. 4853) . The impact of this law change was accounted for during this quarter. This act retroactively extends the federal research and development credit to the beginning of calendar year 2010. We have recorded a rate reduction of approximately 1.2% to our estimated annual effective tax rate for fiscal year 2011. Since this legislation was retroactively reinstated to the beginning of calendar year 2010, we have recorded a discrete item in our year-to-date provision during the quarter for the fiscal 2010 fourth quarter benefit. Generally, the estimated annual effective tax rates differ from the statutory rates primarily due to the impact of federal and state tax credits, tax-exempt interest income, state taxes, and qualified production activities deductions.

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Income tax expense	$ 13,324	6%	$ 11,207	6%	$ 2,117	19%

Net income. Net income for the nine months ended December 31, 2010 and 2009 is as follows:

	Nine Months Ended December 31, (Dollars in Thousands)					
	2010		2009		Change	
		% of Revenue		% of Revenue	$	%
Net income	$ 26,494	13%	$ 20,864	11%	$ 5,630	27%

The $5.6 million increase in net income for the nine months ended December 31, 2010 compared to the nine months ended December 31, 2009 was largely attributable to the $19.6 million increase in total gross profit and a $1.0 million decrease in interest expense offset by a $12.8 million increase in operating expenses mainly due to increased employee related expenses and incentive compensation.

Table of Contents

Contractual Obligations

As of December 31, 2010, we had the following contractual obligations:

Payment due by period (Dollars in thousands)

Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Short and long-term debt obligations (1)	$ 75,133	$ 16,845	$ 58,288	$	$
Unconditional purchase obligations	8,290	8,290			
Operating lease obligations (2)	37,837	3,527	6,868	6,825	20,617
Retirement obligations	5,036	1,447	2,214	593	782
Total contractual obligations	$ 126,296	$ 30,109	$ 67,370	$ 7,418	$ 21,399

(1) Includes accrued interest at an interest rate of 2.750% for our outstanding term loan at December 31, 2010.

(2) We lease facilities and certain equipment under operating lease agreements extending through September 2023 for a total of $37.8 million. Additionally, the payments due by the periods above were computed based on the terms of the renegotiated lease agreements for the Westford office, which was entered in August 2010 and the San Jose office, which was entered in September 2010.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Commitment and Contingencies

From time to time we are subject to legal proceedings and claims in the ordinary course of business. In our opinion, the amount of ultimate expense with respect to any current legal proceedings and claims, if determined adversely, will not have a significant adverse effect on our financial position or results of operations.

Liquidity and Capital Resources

Cash, cash equivalents and marketable securities consist of the following (in thousands):

	December 31, 2010	March 31, 2010
Cash and cash equivalents	$ 121,482	$ 63,322
Short-term marketable securities	64,407	69,875
Long-term marketable securities	24,341	37,354
Cash, cash equivalents and marketable securities	$ 210,230	$ 170,551

At December 31, 2010, we had a revolving credit facility with a syndicate of lenders led by KeyBank National Association, or KeyBank, which allows us to borrow up to $10 million for working capital purposes and to obtain letters of credit subject to a sublimit. Amounts outstanding under the facility bear interest at a floating interest rate dependent upon, at our election, LIBOR or KeyBank s prime rate, in each case plus a margin, and are collateralized by substantially all of our assets. Under the agreement, we are required to comply with certain financial covenants which require that we maintain minimum certain amounts of liquidity, the most restrictive of which are a minimum fixed charge coverage ratio of no less than 1.25 to 1.00 and a maximum leverage ratio of less than 3.00 to 1.00. As of December 31, 2010, we were in compliance with such covenants. As of December 31, 2010, no amounts were outstanding under the revolving credit facility.

Cash, cash equivalents, and marketable securities increased by $39.7 million from March 31, 2010 to December 31, 2010. While cash and cash equivalents increased by $58.2 million, short and long-term marketable securities decreased in total by $18.5 million.

Our long-term marketable securities include investments in auction rate securities. Beginning in February 2008 and continuing through December 31, 2010, auctions have failed resulting in a lack of short-term liquidity for these securities, which has caused us to classify them as long term on our consolidated balance sheet. As of December 31, 2010, our auction rate securities consisted of four positions issued by municipal agencies with a total par value of $23.8 million and a current estimated market value totaling $21.0 million. The auction rate securities held by NetScout at December 31, 2010 have maturity dates ranging from December 2032 through June 2038. As of December 31, 2010, these investments have investment grade ratings ranging from AAA to A. These investments are collateralized by student loans with underlying support by the federal government through the Federal Family Education Loan Program and by monoline insurance companies. We have the ability and intent to hold these securities until a recovery in the auction process or other liquidity event occurs. The fair value of these securities has been estimated by management based on the assumptions disclosed in Note 4 to our consolidated financial statements. We will continue to analyze our auction rate securities each reporting period for impairment, and we may be required to record an impairment charge in the consolidated statement of operations if the decline in fair value is determined to be other-than-temporary. The estimated fair value of our auction rate securities could change significantly based on market and economic conditions, including changes in market rates, the estimated timing until a liquidity event, the discount factor associated with illiquidity and the credit ratings of our securities. There is no assurance as to when liquidity will return to this investment class, and therefore, we continue to monitor and evaluate these securities. Based on our expected operating cash flows, and our other sources of cash, we do not expect the lack of liquidity in these investments to affect our ability to execute our current business plan.

	Nine Months Ended December 31, (Dollars in Thousands)	
	2010	**2009**
Net cash provided by operating activities	$ 46,056	$ 27,149
Net cash provided by (used in) investing activities	$ 14,038	$ (36,510)
Net cash used in financing activities	$ (1,934)	$ (6,337)

Net cash provided by operating activities

Net cash provided by operating activities amounted to $46.1 million and $27.1 million during the nine months ended December 31, 2010 and 2009, respectively. The primary sources of operating cash flow in the nine months ended December 31, 2010 included net income of $26.5 million, adjusted to exclude the effects of non-cash items of $14.5 million, including depreciation and amortization, share-based compensation expense, deferred income taxes and loss on disposal of fixed assets, an $8.8 million decrease in accounts receivable resulting from increased cash collections and decreased billings, a $2.7 million decrease in refundable income taxes and a $1.7 million increase in income taxes payable, offset by a $7.7 million decrease in deferred revenue.

Net cash provided by investing activities

Net cash provided by investing activities was $14.0 million for the nine months ended December 31, 2010. This includes the proceeds from the maturity of marketable securities due to cash management activities of $69.2 million offset by the purchase of marketable securities of $49.6 million and the purchase of fixed assets to support our infrastructure of $5.5 million.

Table of Contents

Net cash used in financing activities

Net cash used in financing activities was $1.9 million for the nine months ended December 31, 2010. The primary outflow was due to the repayment of $7.5 million of our long-term debt with KeyBank, offset by a tax benefit from stock options exercised of $3.4 million and proceeds from the exercise of stock options in the amount of $2.2 million.

Liquidity

We believe that our cash balances, short-term marketable securities classified as available-for-sale and future cash flows generated by operations will be sufficient to meet our anticipated cash needs for working capital, capital expenditures and scheduled principal and interest payments on our debt for at least the next 12 months. If demand for our product were to decrease substantially, our ability to generate cash flow sufficient for our short-term working capital and expenditure needs could be materially impacted.

Additionally, a portion of our cash may be used to acquire or invest in complementary businesses or products or to obtain the right to use complementary technologies. From time to time, in the ordinary course of business, we evaluate potential acquisitions of such businesses, products or technologies such as our acquisition of Network General. If our existing sources of liquidity are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities. The sale of additional equity or debt securities could result in additional dilution to our stockholders.

Recently Issued Accounting Pronouncements

Fair Value Disclosures. In January 2010, the Financial Accounting Standards Board, or FASB, issued amended standards requiring additional fair value disclosures. The amended standards require disclosures of transfers in and out of Levels I and II of the fair value hierarchy, as well as requiring gross basis disclosures for purchases, sales, issuances and settlements within the Level III reconciliation which will replace the net presentation format. Additionally, the update clarifies the requirement to determine the level of disaggregation for fair value measurement disclosures and to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements in either Level II or Level III. We adopted the new guidance in the fourth quarter of our fiscal year 2010, except for the gross presentation of the Level III rollforward information which is effective for fiscal years beginning after December 15, 2010 (fiscal year 2012 for NetScout). Because these new standards are related primarily to disclosures, their adoption has not had and is not expected to have a significant impact on our financial position or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market Risk. Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. Our primary market risk exposures are in the areas of illiquidity of auction rate securities, interest rate risk and foreign currency exchange rate risk. We currently do not hedge interest rate exposure, but do not believe that a fluctuation in interest rates would have a material impact on the value of our cash equivalents and marketable securities. Our long-term marketable securities, which consist primarily of auction rate securities, are stated at fair value based on risk adjusted discounted cash flow calculations. Prior to February 2008, these securities typically were stated at par value. While we continue to earn interest on auction rate securities at the maximum contractual rate, these securities are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, par value no longer approximates the estimated fair value of auction rate securities. As a result of their illiquidity, we have recorded a temporary impairment at December 31, 2010 against the carrying value of our auction rate securities.

Credit Risk. Our cash equivalents and marketable securities consist primarily of money market instruments, U.S. Treasury bills, certificates of deposit, commercial paper, corporate bonds, municipal obligations and student loan backed auction rate securities.

Table of Contents

Additional information regarding auction rate securities held by NetScout at December 31, 2010 is detailed in Note 4 to the consolidated financial statements.

At December 31, 2010 and periodically throughout the year, we have maintained cash balances in various operating accounts in excess of federally insured limits. We limit the amount of credit exposure with any one financial institution by evaluating the creditworthiness of the financial institutions with which we invest.

Interest Rate Risk. We are exposed to market risks related to fluctuations in interest rates related to our term loan with KeyBank. As of December 31, 2010, we owed $71.9 million on this loan with an interest rate of 2.750% effective September 30, 2010 through March 31, 2011, the next LIBOR reset date. A sensitivity analysis was performed on the outstanding portion of our debt obligation as of December 31, 2010. Should the current weighted average interest rate increase or decrease by 10%, the resulting annual increase or decrease to interest expense would be approximately $182 thousand as of December 31, 2010.

Foreign Currency Exchange Risk. As a result of our foreign operations, we face exposure to movements in foreign currency exchange rates, primarily the Euro, British Pound, Canadian Dollar and Indian Rupee. The current exposures arise primarily from expenses denominated in foreign currencies. NetScout currently engages in foreign currency hedging activities in order to limit these exposures.

As of December 31, 2010, we had foreign currency forward contracts with notional amounts totaling $10.6 million. The valuation of outstanding foreign currency forward contracts at December 31, 2010 resulted in a liability balance of $95 thousand, reflecting unfavorable contract rates in comparison to current market rates at this date and an asset balance of $36 thousand reflecting favorable rates in comparison to current market rates.

We do not use derivative financial instruments for speculative trading purposes. The counterparty to these forward contracts is a multinational commercial bank. We believe the risk of counterparty nonperformance is not material. However, we cannot be assured that the financial institution will not be further impacted by the negative economic environment.

Item 4. Controls and Procedures

As of December 31, 2010, NetScout, under the supervision and with the participation of our management, including the Company s principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(b) promulgated under the Securities Exchange Act of 1934, as amended, or the Exchange Act. Based upon that evaluation, our principal executive officer and principal financial officer concluded that, as of December 31, 2010, our disclosure controls and procedures were effective in ensuring that material information relating to NetScout, including its consolidated subsidiaries, required to be disclosed by NetScout in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, including ensuring that such material information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in our internal controls that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II: OTHER INFORMATION

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended March 31, 2010. The risks discussed in our Annual Report on Form 10-K could materially affect our business, financial condition and future results. There have been no material changes to those risk factors since we filed our Annual Report on Form 10-K. The risks described in our Annual Report on Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the third quarter of fiscal year 2011, the Company did not repurchase any shares of its outstanding common stock pursuant to its open market stock repurchase program further described above in Note 11 to the condensed consolidated financial statements attached hereto.

Item 6. Exhibits

(a) Exhibits

31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
32.2	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).

Table of Contents

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.

	NETSCOUT SYSTEMS, INC.
Date: February 4, 2011	/s/ Anil K. Singhal Anil K. Singhal President, Chief Executive Officer and Chairman (Principal Executive Officer)
Date: February 4, 2011	/s/ David P. Sommers David P. Sommers Senior Vice President, General Operations and Chief Financial Officer (Principal Financial Officer)
Date: February 4, 2011	/s/ Jean Bua Jean Bua Vice President, Finance and Chief Accounting Officer (Principal Accounting Officer)

36

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
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