

NETSCOUT SYSTEMS INC  
Form 10-Q  
February 01, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2012

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)

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**Delaware**  
(State or Other Jurisdiction of

**04-2837575**  
(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 ☒ 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 ☒

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 ☒

The number of shares outstanding of the registrant's common stock, par value \$0.001 per share, as of January 25, 2013 was 41,614,169.

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NETSCOUT SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTER ENDED DECEMBER 31, 2012

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	<b>December 31, 2012</b>	<b>March 31, 2012</b>
<b>Assets</b>	<b>(Unaudited)</b>	
Current assets:		
Cash and cash equivalents	\$ 90,836	\$ 117,255
Marketable securities	35,324	79,617
Accounts receivable, net of allowance for doubtful accounts of \$1,033 and \$226 at December 31, 2012 and March 31, 2012, respectively	61,908	69,795
Inventories	7,427	8,021
Prepaid income taxes	8,917	4,600
Deferred income taxes	5,664	4,237
Prepaid expenses and other current assets	9,465	6,162
Total current assets	219,541	289,687
Fixed assets, net	18,077	16,457
Goodwill	203,251	170,384
Intangible assets, net	65,433	54,685
Deferred income taxes	11,755	17,892
Long-term marketable securities	10,540	16,644
Other assets	3,523	2,008
Total assets	\$ 532,120	\$ 567,757
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 9,151	\$ 7,539
Accrued compensation	29,016	23,050
Accrued other	7,404	6,235
Current portion of contingent liabilities	4,224	3,774
Deferred revenue	90,567	93,493
Total current liabilities	140,362	134,091
Other long-term liabilities	2,044	2,347
Deferred tax liability	2,467	1,410
Accrued long-term retirement benefits	1,818	1,990
Long-term deferred revenue	22,717	18,722
Long-term debt	0	62,000
Contingent liabilities, net of current portion	2,370	4,828
Total liabilities	171,778	225,388
Commitments and contingencies (Note 12)		
Stockholders' equity:		
Preferred stock, \$0.001 par value:		
5,000,000 shares authorized; no shares issued or outstanding at December 31, 2012 and March 31, 2012	0	0
Common stock, \$0.001 par value:		
150,000,000 shares authorized; 48,887,013 and 48,185,731 shares issued and 41,604,647 and 41,814,191 shares outstanding at December 31, 2012 and March 31, 2012, respectively	49	48

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Additional paid-in capital	248,694	237,289
Accumulated other comprehensive income	1,450	212
Treasury stock at cost, 7,282,366 and 6,371,540 shares at December 31, 2012 and March 31, 2012, respectively	(76,759)	(56,032)
Retained earnings	186,908	160,852
 Total stockholders' equity	 360,342	 342,369
 Total liabilities and stockholders' equity	 \$ 532,120	 \$ 567,757

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

**Table of Contents****NetScout Systems, Inc.****Consolidated Statements of Operations****(In thousands, except per share data)****(Unaudited)**

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Revenue:				
Product	\$ 52,676	\$ 46,005	\$ 139,100	\$ 113,616
Service	38,891	37,292	113,373	105,601
Total revenue	91,567	83,297	252,473	219,217
Cost of revenue:				
Product	12,182	10,731	32,582	27,439
Service	6,982	6,508	20,386	19,273
Total cost of revenue	19,164	17,239	52,968	46,712
Gross profit	72,403	66,058	199,505	172,505
Operating expenses:				
Research and development	15,352	13,593	44,630	36,073
Sales and marketing	30,105	27,518	86,997	81,144
General and administrative	8,539	6,564	22,071	20,135
Amortization of acquired intangible assets	846	565	2,077	1,541
Restructuring charges	(1)	372	1,065	372
Total operating expenses	54,841	48,612	156,840	139,265
Income from operations	17,562	17,446	42,665	33,240
Interest and other expense, net:				
Interest income	115	104	423	304
Interest expense	(293)	(472)	(1,085)	(1,449)
Other income (expense), net	74	(150)	86	(607)
Loss on extinguishment of debt	0	(690)	0	(690)
Total interest and other expense, net	(104)	(1,208)	(576)	(2,442)
Income before income tax expense	17,458	16,238	42,089	30,798
Income tax expense	6,320	6,207	16,033	11,317
Net income	\$ 11,138	\$ 10,031	\$ 26,056	\$ 19,481
Basic net income per share	\$ 0.27	\$ 0.24	\$ 0.62	\$ 0.46
Diluted net income per share	\$ 0.26	\$ 0.24	\$ 0.62	\$ 0.46
Weighted average common shares outstanding used in computing:				
Net income per share basic	41,709	41,523	41,715	42,126
Net income per share diluted	42,298	42,303	42,364	42,815

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

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**NetScout Systems, Inc.**

**Consolidated Statements of Comprehensive Income**

**(In thousands)**

**(Unaudited)**

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Net Income	\$ 11,138	\$ 10,031	\$ 26,056	\$ 19,481
Other comprehensive income:				
Unrealized (loss) gain on cash equivalents, marketable securities and restricted investment, net of taxes (benefits) of \$0, \$0, (\$73) and (\$58)	(24)	17	97	154
Unrealized gain (loss) on hedge contracts, net of (benefits) taxes of (\$23), (\$39), \$88 and (\$241)	(38)	(68)	138	(393)
Cumulative translation adjustments	719	(936)	1,003	(936)
Other comprehensive income	657	(987)	1,238	(1,175)
Comprehensive income	\$ 11,795	\$ 9,044	\$ 27,294	\$ 18,306

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



**Table of Contents****NetScout Systems, Inc.****Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

	<b>Nine Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 26,056	\$ 19,481
Adjustments to reconcile net income to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	13,826	12,191
Loss on extinguishment of debt	0	553
Loss on disposal of fixed assets	71	149
Deal related compensation expense and accretion charges	205	0
Share-based compensation expense associated with equity awards	7,254	6,117
Net change in fair value of contingent and contractual liabilities	400	0
Deferred income taxes	6,237	3,258
Other gains	(16)	(35)
Changes in assets and liabilities		
Accounts receivable	12,130	16,189
Inventories	1,568	(2,285)
Prepaid expenses and other assets	(4,358)	(800)
Accounts payable	(3,137)	(2,752)
Accrued compensation and other expenses	6,400	(1,403)
Contingent liabilities	449	
Deferred revenue	(107)	(6,780)
Net cash provided by operating activities	66,978	43,883
<b>Cash flows from investing activities:</b>		
Purchase of marketable securities	(102,478)	(89,369)
Proceeds from maturity of marketable securities	153,046	161,365
Purchase of fixed assets	(8,312)	(7,852)
Increase in deposits	(804)	0
Acquisition of businesses, net of cash acquired	(51,273)	(46,721)
Net cash (used in) provided by investing activities	(9,821)	17,423
<b>Cash flows from financing activities:</b>		
Issuance of common stock under stock plans	516	264
Payment of contingent consideration	(3,197)	0
Treasury stock repurchases	(20,727)	(17,939)
Proceeds from issuance of long-term debt, net of issuance costs	0	60,691
Repayment of long-term debt	(62,000)	(68,106)
Excess tax benefit from share-based compensation awards	1,934	(612)
Net cash used in financing activities	(83,474)	(25,702)
Effect of exchange rate changes on cash and cash equivalents	(102)	(10)

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Net (decrease) increase in cash and cash equivalents	(26,419)	35,594
Cash and cash equivalents, beginning of period	117,255	67,168
Cash and cash equivalents, end of period	\$ 90,836	\$ 102,762

## Supplemental disclosures:

Cash paid for interest	\$ 325	\$ 1,008
Cash paid for income taxes	\$ 12,460	\$ 9,648
Non-cash transactions:		
Transfers of inventory to fixed assets	\$ 583	\$ 1,910
Additions to property, plant and equipment included in accounts payable	\$ 370	\$ 184
Contingent consideration related to acquisitions, included in contingent liabilities	\$ 0	\$ 8,000
Debt issuance costs settled through the issuance of additional debt	\$ 0	\$ 1,184
Interest settled through issuance of additional debt	\$ 0	\$ 125
Gross decrease in contractual liability relating to fair value adjustment	\$ (135)	\$ 0
Gross increase in contingent consideration liability relating to fair value adjustment	\$ 535	\$ 0
Issuance of common stock under employee stock plans	\$ 2,224	\$ 0

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

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**NetScout Systems, Inc.**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**NOTE 1 BASIS OF PRESENTATION**

The accompanying unaudited interim consolidated financial statements have been prepared by NetScout Systems, Inc., or NetScout or the Company. Certain information and footnote disclosures normally included in financial statements prepared under generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of 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 year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The results reported in these consolidated financial statements are not necessarily indicative of results that may be expected for the entire year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2012.

**Recent Accounting Pronouncements**

In July 2012, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2012-02: Testing Indefinite-Lived Intangible Assets for Impairment (ASU 2012-02). ASU 2012-02 gives entities an option to first assess qualitative factors to determine whether the existence of events and circumstances indicate that it is more likely than not that the indefinite-lived intangible asset is impaired. If based on its qualitative assessment an entity concludes that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount, quantitative impairment testing is required. However, if an entity concludes otherwise, quantitative impairment testing is not required. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 (the first quarter of fiscal year 2014 for the Company), with early adoption permitted. The company intends to early adopt this standard during the fourth quarter of its fiscal year ending March 31, 2013 for its annual impairment test. The Company does not expect that the adoption of this standard will have a material effect on its financial statements.

On April 1, 2012, the Company adopted Accounting Standards Update 2011-05: Presentation of Comprehensive Income (ASU 2011-05), which requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in equity. These consolidated financial statements include separate Consolidated Statements of Comprehensive Income.

In December 2011, the FASB issued ASU 2011-11: Balance Sheet (Topic 210), Disclosures about Offsetting Assets and Liabilities, which requires companies to disclose information about financial instruments that have been offset and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. Companies will be required to provide both net (offset amounts) and gross information in the notes to the financial statements for relevant assets and liabilities that are offset. ASU 2011-11 will be effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013 (the fourth quarter of fiscal year 2013 for the Company). The adoption of ASU 2011-11 will impact financial statement presentation only; accordingly, it will have no impact on the Company's financial condition, results of operations, or cash flows.

**NOTE 2 CONCENTRATION OF CREDIT RISK AND SIGNIFICANT CUSTOMERS**

Financial instruments, which include cash, cash equivalents, accounts receivable and accounts payable, are stated at cost, plus accrued interest where applicable, which approximates fair value. Debt is recorded at the

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amount drawn on the revolving credit facility plus interest based on floating rates reflective of changes in the market which approximates fair value.

At December 31, 2012, the Company had one direct customer which accounted for more than 10% of the accounts receivable balance, while no indirect customer accounted for more than 10% of the accounts receivable balance. At March 31, 2012, no one direct customer or indirect channel partner accounted for more than 10% of the accounts receivable balance. During the three and nine months ended December 31, 2012 and 2011, no one direct customer or indirect channel partner accounted for more than 10% of total revenue. Historically, the Company has not experienced any significant failure of its customers to meet their payment obligations nor does the Company anticipate material non-performance by its customers in the future; accordingly, the Company does not require collateral from its customers. However, if the Company's assumptions are incorrect, there could be an adverse impact on its allowance for doubtful accounts.

**NOTE 3 SHARE-BASED COMPENSATION**

The following is a summary of share-based compensation expense including restricted stock units and employee stock purchases made under our employee stock purchase plan (ESPP) based on estimated fair values within the applicable cost and expense lines identified below (in thousands):

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Cost of product revenue	\$ 61	\$ 49	\$ 176	\$ 137
Cost of service revenue	96	49	249	161
Research and development	778	600	2,164	1,702
Sales and marketing	775	775	2,301	2,152
General and administrative	754	697	2,353	1,965
	\$ 2,464	\$ 2,170	\$ 7,243	\$ 6,117

*Employee Stock Purchase Plan* The Company maintains an ESPP for all eligible employees as described in the Company's Annual Report on Form 10-K for the year ended March 31, 2012. Under the ESPP, shares of the Company's common stock may be purchased on the last day of each bi-annual offering period at 85% of the fair value on the last day of such offering period. The offering periods run from March 1 through August 30 and from September 1 through February 28 of each year. During the nine months ended December 31, 2012, employees purchased 93,661 shares under the ESPP and the fair value per share was \$23.75.

**NOTE 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 and cash equivalents consisted of money market instruments and cash maintained with various financial institutions at December 31, 2012 and March 31, 2012.

**Table of Contents****Marketable Securities**

The following is a summary of marketable securities held by NetScout at December 31, 2012 classified as short-term and long-term (in thousands):

	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Fair Value</b>
Type of security:			
U.S. government and municipal obligations	\$ 15,751	\$ 5	\$ 15,756
Commercial paper	13,587	0	13,587
Corporate bonds	3,076	0	3,076
Certificates of deposit	2,905	0	2,905
 Total short-term marketable securities	 35,319	 5	 35,324
 U.S. government and municipal obligations	 10,019	 1	 10,020
Corporate bonds	518	2	520
 Total long-term marketable securities	 10,537	 3	 10,540
 Total marketable securities	 \$ 45,856	 \$ 8	 \$ 45,864

The following is a summary of marketable securities held by NetScout at March 31, 2012, classified as short-term and long-term (in thousands):

	<b>Amortized Cost</b>	<b>Unrealized Gains (Losses)</b>	<b>Fair Value</b>
Type of security:			
U.S. government and municipal obligations	\$ 17,779	\$ 20	\$ 17,799
Commercial paper	22,469	0	22,469
Corporate bonds	18,531	(1)	18,530
Certificates of deposit	3,208	(1)	3,207
Auction rate securities	17,612	0	17,612
 Total short-term marketable securities	 79,599	 18	 79,617
 Auction rate securities	 1,651	 (190)	 1,461
U.S. government and municipal obligations	13,828	8	13,836
Corporate bonds	1,345	2	1,347
 Total long-term marketable securities	 16,824	 (180)	 16,644
 Total marketable securities	 \$ 96,423	 \$ (162)	 \$ 96,261

Contractual maturities of the Company's marketable securities held at December 31, 2012 and March 31, 2012 were as follows (in thousands):

<b>December 31, 2012</b>	<b>March 31, 2012</b>
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Available-for-sale securities:		
Due in 1 year or less	\$ 35,324	\$ 79,617
Due after 1 year through 5 years	10,540	15,183
Due after 10 years	0	1,461
	\$ 45,864	\$ 96,261

During the quarter ended June 30, 2012, redemptions for the Company's remaining auction rate securities totaling \$19.3 million were settled, \$17.6 million of which were classified as current marketable securities as of

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March 31, 2012 and another \$1.7 million classified as long-term marketable securities. As a result of the settlements, during the three months ended June 30, 2012, the Company reversed the remaining valuation reserve of \$190 thousand (\$117 thousand, net of tax) previously recorded within accumulated other comprehensive income (loss) on the balance sheet. The Company held no investments in auction rate securities at December 31, 2012.

**NOTE 5 FAIR VALUE MEASUREMENTS**

The following tables present the Company's financial assets and liabilities measured on a recurring basis using the fair value hierarchy as of December 31, 2012 and March 31, 2012. The fair value hierarchy has three levels based on the reliability of the inputs used to determine fair value. Level 1 refers to fair values determined based on quoted prices in active markets for identical assets. Level 2 refers to fair values estimated using significant other observable inputs, and Level 3 includes fair values estimated using significant non-observable inputs.

	Fair Value Measurements at December 31, 2012			
	Level 1	Level 2	Level 3	Total
<b>ASSETS:</b>				
Cash and cash equivalents	\$ 90,836	\$ 0	\$ 0	\$ 90,836
U.S. government and municipal obligations	25,776	0	0	25,776
Commercial paper	0	13,587	0	13,587
Corporate bonds	3,596	0	0	3,596
Certificate of deposits	0	2,905	0	2,905
Derivative financial instruments	0	293	0	293
	\$ 120,208	\$ 16,785	\$ 0	\$ 136,993
<b>LIABILITIES:</b>				
Contingent consideration	\$ 0	\$ 0	\$ (5,756)	\$ (5,756)
Contingent contractual non-compliance liability	0	0	(295)	(295)
Derivative financial instruments	0	(68)	0	(68)
	\$ 0	\$ (68)	\$ (6,051)	\$ (6,119)

	Fair Value Measurements at March 31, 2012			
	Level 1	Level 2	Level 3	Total
<b>ASSETS:</b>				
Cash and cash equivalents	\$ 117,255	\$ 0	\$ 0	\$ 117,255
U.S. government and municipal obligations	31,635	0	0	31,635
Commercial paper	0	22,469	0	22,469
Corporate bonds	19,877	0	0	19,877
Certificate of deposits	0	3,207	0	3,207
Auction rate securities	0	17,612	1,461	19,073
Derivative financial instruments	0	150	0	150
	\$ 168,767	\$ 43,438	\$ 1,461	\$ 213,666
<b>LIABILITIES:</b>				
Contingent consideration	\$ 0	\$ 0	\$ (8,213)	\$ (8,213)
Contingent contractual non-compliance liability	0	0	(700)	(700)
Derivative financial instruments	0	(166)	0	(166)

\$	0	\$	(166)	\$	(8,913)	\$	(9,079)
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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 marketable securities and derivative financial instruments.

The Company's Level 1 investments are classified as such because they are valued using quoted market prices or alternative pricing sources with reasonable levels of price transparency.

The Company's Level 2 investments are classified as such because fair value is being calculated using data from similar but not identical sources, or a discounted cash flow model using the contractual interest rate as compared to the underlying interest yield curve. The Company's short-term auction rate securities at March 31, 2012 were classified as Level 2 since the amounts were based upon redemption notices for an inactive market. The Company's derivative financial instruments consist of forward foreign exchange contracts and are classified as Level 2 because the fair values of these derivatives are determined using models based on market observable inputs, including spot prices for foreign currencies, as well as an interest rate factor. Commercial paper and certificate of deposits are classified as Level 2 because the Company uses market information from similar but not identical instruments and discounted cash flow models based on interest rate yield curves to determine fair value. For further information on the Company's derivative instruments refer to Note 9.

The Company's long-term auction rate securities at March 31, 2012 were classified as Level 3 in the fair value hierarchy due to the limited market data for pricing these securities and the subjective factors considered to create a liquidity discount. The Company's contingent purchase consideration and contingent contractual non-compliance liability are valued by probability weighting expected payment scenarios and then applying a discount based on the present value of the future cash flow streams. The Company has elected to account for the contractual non-compliance liability at fair value. This election has been made as both contingent liabilities are related. The fair value election created parity between the two items during the settlement period. These liabilities are classified as Level 3 because the probability weighting of future payment scenarios is based on assumptions developed by management.

The following table sets forth a reconciliation of changes in the fair value of the Company's Level 3 financial assets for the nine months ended December 31, 2012 (in thousands):

	<b>Auction Rate Securities</b>	<b>Contingent Purchase Consideration</b>	<b>Contingent Contractual Non-compliance Liability</b>
Balance at beginning of period	\$ 1,461	\$ (8,213)	\$ (700)
Change in fair value (included within research and development expense)	0	(740)	135
ARSs redeemed by issuers	(1,650)	0	0
Unrealized gains included in accumulated other comprehensive income (loss)	190	0	0
Unrealized gain (loss) included in earnings	(1)	0	0
Payments	0	3,197	270
Balance at end of period	\$ 0	\$ (5,756)	\$ (295)

The Company has updated the probabilities used in the fair value calculation of the contingent liabilities at December 31, 2012 which resulted in an additional liability of \$400 thousand included as part of earnings for the nine months ended December 31, 2012. The fair value of the contingent consideration was estimated by applying a probability based model, which utilizes significant inputs that are unobservable in the market. Key assumptions include a 3.3% discount rate, a stay period of two or three years and a percent weighted-probability of settlement of the contingent contractual non-compliance liability. Deal related compensation expense, accretion charges and changes related to settlements of contractual non-compliance liabilities for the nine months ended December 31, 2012 was \$205 thousand and was included as part of earnings.

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During the quarter ended December 31, 2012, the Level 3 liability related to the contractual non-compliance liability was paid and resulted in a \$270 thousand decrease. All amounts were accurately reflected in purchase accounting and there was no impact to earnings in the post-acquisition period.

**NOTE 6 INVENTORIES**

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

	December 31, 2012	March 31, 2012
Raw materials	\$ 1,486	\$ 4,083
Work in process	1,983	363
Finished goods	3,958	3,575
	\$ 7,427	\$ 8,021

**NOTE 7 ACQUISITIONS**

While the Company uses its best estimates and assumptions as part of the purchase price allocation process to value the assets acquired and liabilities assumed on the acquisition date, its estimates and assumptions are subject to refinement. As a result, during the preliminary purchase price allocation period, which may be up to one year from the acquisition date, the Company records adjustments to the assets acquired and liabilities assumed with a corresponding offset to goodwill. The Company records adjustments to the assets acquired and liabilities assumed subsequent to the purchase price allocation period in the Company's operating results in the period in which the adjustments were determined. The results of operations of the acquired businesses described below have been included in the Company's consolidated financial statements beginning on their respective acquisition dates unless indicated otherwise below.

***ONPATH***

On October 31, 2012, the Company acquired ONPATH Technologies, Inc. (ONPATH), an established provider of scalable packet flow switching technology for high-performance networks for the aggregation and distribution of network traffic for data, voice, video testing, monitoring, performance management and cybersecurity deployments. ONPATH's packet flow switch technology is synergistic with the Company's network monitoring switch strategy. The acquisition of the packet flow switch technology further strengthens the Company's Unified Service Delivery Management strategy by enabling scalable access to all relevant network traffic across highly distributed network environments for use by any network monitoring, performance management and security system. ONPATH's test automation technology is used to monitor networks in test environments which simulate existing and planned network environments. The results of ONPATH's operations have been included in the consolidated financial statements since October 31, 2012. The total cash transferred of \$41.0 million consisted entirely of cash consideration, of which \$8.2 million will be paid to employees and directors of ONPATH pursuant to ONPATH's transaction bonus and retention plan. Approximately \$4.0 million of the transaction bonuses are considered compensation and is therefore not included as consideration within the table below.

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The following table summarizes the allocation of the purchase price (in thousands):

Allocation of the purchase consideration:	
Current assets, including cash and cash equivalents of \$527	\$ 8,389
Fixed assets	778
Identifiable intangible assets	10,970
Goodwill	20,869
Deferred tax asset	6,330
Other assets	1,432
Total assets acquired	48,768
Current liabilities	(6,387)
Deferred revenue	(921)
Deferred income tax liabilities	(4,660)
	\$ 36,800

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill of \$17.8 million from the ONPATH acquisition will be included within the Company's existing Unified Service Delivery reporting unit and \$3.1 million will be included within the test automation reporting unit. Both reporting units resulting from the acquisition of ONPATH will be included in the Company's annual impairment review.

The fair values of intangible assets were based on valuations using an income approach, with estimates and assumptions provided by management of ONPATH and the Company. These assumptions include estimates of future revenues associated with the technology purchased as part of the acquisition and the migration of the current technology to more advanced version of the software. This fair value measurement was based on significant inputs not observable in the market and thus represents Level 3 fair value measurements. The following table reflects the fair value of the acquired identifiable intangible assets and related estimates of useful lives (in thousands):

	Fair Value	Useful Life (Years)
Developed technology	\$ 4,970	8
Customer relationships	6,000	7
	\$ 10,970	

The weighted average useful life of identifiable intangible assets acquired from ONPATH is 7.5 years. Acquired software is amortized using an accelerated amortization method. Customer relationships are amortized on a straight-line basis.

Goodwill and intangible assets recorded as part of the ONPATH acquisition are not deductible for tax purposes.

The Company notes that it acquired significant net operating losses from ONPATH. ONPATH has represented to the Company that there were no historical changes in control that would limit NetScout's ability to utilize these net operating losses in its consolidated federal return. NetScout has assumed these representations are correct per the disclosed acquisition allocation. However, NetScout is performing a detailed change in control study to ensure losses are not limited by an event other than the NetScout acquisition. The Company also notes that ONPATH did not claim research and development credits for historical tax returns. NetScout believes that certain ONPATH activities qualify for a research and development credit, and will perform analysis on the historical periods to identify and claim credits for historical research and development activities. No credit has been recorded within the acquisition allocation. Any adjustments to either of these items within one year of acquisition will be recorded against goodwill.



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On July 20, 2012 the Company acquired certain assets, technology and employees of Accanto Systems, S.r.l. (Accanto), a supplier of service assurance solutions for telecommunication service providers which enables carriers to monitor and manage the delivery of voice services over converged, next generation telecom architectures. Accanto's technology is synergistic with the Company's packet flow strategy and brings voice service monitoring capabilities for legacy environments and for next generation network voice services. The Company intends to maintain a relationship with the selling entity such that the selling entity will serve as a distributor for the Company. The results of Accanto's operations, related to those assets, technology and employees acquired, have been included in the consolidated financial statements since that date. The total purchase price of \$15.0 million consisted entirely of cash consideration. The goodwill recognized primarily relates to the value in combining Accanto's product with our customer base.

The following table summarizes the allocation of the purchase price (in thousands):

Allocation of the purchase consideration:	
Current assets	\$ 389
Fixed assets	237
Identifiable intangible assets	5,280
Goodwill	11,157
 Total assets acquired	 17,063
Current liabilities	(839)
Deferred revenue	(240)
Deferred income tax liabilities	(984)
	 \$ 15,000

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill from the Accanto acquisition will be included within the Company's Unified Service Delivery reporting unit and will be included in the Company's annual impairment review. The acquired software intangible had a tax basis of approximately \$2.1 million which carried over as part of the acquisition and will be deductible for tax purposes. Under Italian tax law the Company may choose to step up all or a portion of the basis for the remaining value of the acquired software as well as the customer relationships and goodwill by paying a substitute tax on those assets. The Company has not completed its economic analysis of this item and has until June 2013 to make an election to step up the basis in the intangibles acquired. As this election does not relate to the agreement between the Company and Accanto, it will not affect balances recorded in purchase accounting.

The fair values of intangible assets were based on valuations using an income approach, with estimates and assumptions provided by management of Accanto and the Company. These assumptions include estimates of future revenues associated with the technology purchased as part of the acquisition and the migration of the current technology to more advanced version of the software. This fair value measurement was based on significant inputs not observable in the market and thus represents Level 3 fair value measurements. The following table reflects the fair value of the acquired identifiable intangible assets and related estimates of useful lives (in thousands):

	Fair Value	Useful Life (Years)
Developed technology	\$ 3,500	8
Distributor relationships	1,780	6
	 \$ 5,280	

The weighted average useful life of identifiable intangible assets acquired from Accanto is 7.3 years. Acquired software is amortized using an accelerated amortization method. Distributor relationships are amortized on a straight-line basis.



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The Company incurred approximately \$1.3 million of acquisition-related costs related to Accanto and ONPATH which are included in general and administrative expense during the nine months ended December 31, 2012.

In the fiscal year ended March 31, 2012, the Company completed the acquisitions of Psytechnics, Ltd (Psytechnics), Fox Replay BV (Replay) and Simena, LLC (Simena) described more fully in the Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2012.

***Simena***

On November 18, 2011, the Company completed the acquisition of Simena for \$10.1 million. The purchase price is no longer preliminary.

In connection with the acquisition of Simena, the Company became obligated to pay the seller up to \$10.8 million in additional purchase consideration subject to adjustment based on the final determination of certain assets and liabilities. As a result, a majority of the changes to the value of the contingent consideration would be expected to have an offsetting impact on the recorded values of the assets and liabilities assumed as part of the transaction.

The contingent liability was recorded at its fair value of \$8.0 million at the acquisition date. The Company has re-measured the fair value at December 31, 2012 and will re-measure the fair value of the consideration at each subsequent reporting period and recognize any adjustment to fair value as part of earnings.

***Replay***

On October 3, 2011, the Company completed the acquisition of Replay for \$20.2 million.

***Psytechnics***

On April 1, 2011, the Company completed the acquisition of Psytechnics for \$17.0 million.

Goodwill resulting from the acquisitions of Psytechnics, Replay and Simena is included within the Company's Unified Service Delivery reporting unit and will be included in the Company's annual impairment review.

During the nine months ended December 31, 2012, the Company has recorded \$15.6 million of revenue directly attributable to ONPATH, Replay, Accanto and Simena within its consolidated financial statements.

The following table presents unaudited pro forma results of the historical Consolidated Statements of Operations of the Company and ONPATH, Accanto, Simena and Replay for the three and nine months ended December 31, 2012 and 2011, giving effect to the mergers as if they occurred on April 1, 2011 (in thousands, except per share data):

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Pro forma revenue	\$ 94,221	\$ 91,566	\$ 263,009	\$ 244,003
Pro forma net income	\$ 11,038	\$ 1,813	\$ 20,036	\$ 2,409
Pro forma income per share:				
Basic	\$ 0.26	\$ 0.04	\$ 0.48	\$ 0.06
Diluted	\$ 0.26	\$ 0.04	\$ 0.47	\$ 0.06
Pro forma shares outstanding				
Basic	41,709	41,523	41,715	42,126
Diluted	42,298	42,303	42,364	42,815

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The pro forma results for the three and nine months ended December 31, 2012 and 2011 primarily include adjustments for amortization of intangibles. This pro forma information does not purport to indicate the results that would have actually been obtained had the acquisitions been completed on the assumed date, or which may be realized in the future.

**NOTE 8 GOODWILL AND INTANGIBLE ASSETS****Goodwill**

The Company has two reporting units: (1) Unified Service Delivery and (2) test automation. As of December 31, 2012 and March 31, 2012, goodwill attributable to the Unified Service Delivery reporting unit was \$200.1 million and \$170.4 million, respectively and goodwill attributable to the test automation reporting unit was \$3.1 million and \$0, respectively. Goodwill is tested for impairment at a reporting unit level at least annually, or on an interim basis if an event occurs or circumstances change that would, more likely than not, reduce the fair value of the reporting segment below its carrying value. The Company will complete its annual impairment test during the quarter ended March 31, 2013.

The carrying amount of goodwill was \$203.3 million and \$170.4 million as of December 31, 2012 and March 31, 2012. The following table summarizes the changes in the carrying amount of goodwill (in thousands):

	<b>Nine Months Ended December 31, 2012</b>
Balance at March 31, 2012	\$ 170,384
Goodwill related to the acquisition of Accanto	11,157
Goodwill related to the acquisition of ONPATH	20,869
Foreign currency translation impact	841
Balance as of December 31, 2012	\$ 203,251

**Intangible Assets**

The net carrying amounts of intangible assets were \$65.4 million and \$54.7 million as of December 31, 2012 and March 31, 2012, respectively. Intangible assets acquired in a business combination are recorded under the acquisition method of accounting at their estimated fair values at the date of acquisition. The Company amortizes intangible assets over their estimated useful lives, except for the acquired trade name which resulted from the Network General acquisition, 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.

Intangible assets consist of the following as of December 31, 2012 (in thousands):