

NETSCOUT SYSTEMS INC  
Form 10-Q  
January 28, 2014  
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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, 2013

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  
(State or Other Jurisdiction of  
Incorporation or Organization)  
310 Littleton Road, Westford, MA 01886  
(978) 614-4000

04-2837575  
(IRS Employer  
Identification No.)

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 24, 2014 was 41,329,074.



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FOR THE QUARTER ENDED DECEMBER 31, 2013  
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## PART I: FINANCIAL INFORMATION

## Item 1. Unaudited Financial Statements

NetScout Systems, Inc.

Consolidated Balance Sheets

(In thousands, except share and per share data)

	December 31, 2013 (Unaudited)	March 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$88,648	\$99,930
Marketable securities	56,343	37,338
Accounts receivable, net of allowance for doubtful accounts of \$147 and \$971 at December 31, 2013 and March 31, 2013, respectively	74,263	73,900
Inventories	11,128	7,563
Deferred income taxes	9,419	9,538
Prepaid expenses and other current assets	8,800	9,043
Total current assets	248,601	237,312
Fixed assets, net	21,350	19,678
Goodwill	203,201	202,453
Intangible assets, net	59,827	63,827
Deferred income taxes	5,629	9,211
Long-term marketable securities	37,222	16,823
Other assets	2,047	2,872
Total assets	\$577,877	\$552,176
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$8,679	\$10,161
Accrued compensation	32,327	31,585
Accrued other	7,070	8,256
Income taxes payable	705	114
Deferred revenue	102,010	95,055
Total current liabilities	150,791	145,171
Other long-term liabilities	2,415	2,249
Deferred tax liability	991	941
Accrued long-term retirement benefits	1,578	1,757
Long-term deferred revenue	22,285	25,907
Contingent liabilities, net of current portion	4,219	4,248
Total liabilities	182,279	180,273
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, 2013 and March 31, 2013	0	0
Common stock, \$0.001 par value:		
150,000,000 shares authorized; 49,826,807 and 49,007,491 shares issued and 41,326,074 and 41,466,921 shares outstanding at December 31, 2013 and March 31, 2013, respectively	50	49
Additional paid-in capital	267,649	253,202

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Accumulated other comprehensive income	2,521	671
Treasury stock at cost, 8,500,733 and 7,540,570 shares at December 31, 2013 and March 31, 2013, respectively	(108,513	) (83,480 )
Retained earnings	233,891	201,461
Total stockholders' equity	395,598	371,903
Total liabilities and stockholders' equity	\$577,877	\$552,176

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

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Revenue:				
Product	\$68,561	\$52,676	\$163,895	\$139,100
Service	41,867	38,891	120,435	113,373
Total revenue	110,428	91,567	284,330	252,473
Cost of revenue:				
Product	14,534	12,182	36,117	32,582
Service	9,068	6,982	24,111	20,386
Total cost of revenue	23,602	19,164	60,228	52,968
Gross profit	86,826	72,403	224,102	199,505
Operating expenses:				
Research and development	18,348	15,352	50,951	44,630
Sales and marketing	32,425	30,105	96,184	86,997
General and administrative	7,929	8,539	22,367	22,071
Amortization of acquired intangible assets	860	846	2,571	2,077
Restructuring charges	0	(1	) 0	1,065
Total operating expenses	59,562	54,841	172,073	156,840
Income from operations	27,264	17,562	52,029	42,665
Interest and other income (expense), net:				
Interest income	66	115	210	423
Interest expense	(198	) (293	) (575	) (1,085
Other income, net	176	74	277	86
Total interest and other income (expense), net	44	(104	) (88	) (576
Income before income tax expense	27,308	17,458	51,941	42,089
Income tax expense	10,014	6,320	19,511	16,033
Net income	\$17,294	\$11,138	\$32,430	\$26,056
Basic net income per share	\$0.42	\$0.27	\$0.78	\$0.62
Diluted net income per share	\$0.41	\$0.26	\$0.77	\$0.62
Weighted average common shares outstanding used in computing:				
Net income per share - basic	41,425	41,709	41,417	41,715
Net income per share - diluted	41,884	42,298	41,969	42,364

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)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Net income	\$17,294	\$11,138	\$32,430	\$26,056
Other comprehensive income:				
Cumulative translation adjustments	405	719	1,624	1,003
Changes in market value of investments:				
Changes in unrealized gains (losses)	3	(24	) 7	97
Total net change in market value of investments	3	(24	) 7	97
Changes in market value of derivatives:				
Changes in market value of derivatives, net of taxes (benefit) of \$31, (\$17), \$35 and (\$6)	56	(29	) 55	(16
Reclassification adjustment for net (losses) gains included in net income, net of (benefits) taxes of (\$15), (\$6), \$85 and \$94	(25	) (9	) 164	154
Total net change in market value of derivatives	31	(38	) 219	138
Other comprehensive income	439	657	1,850	1,238
Comprehensive income	\$17,733	\$11,795	\$34,280	\$27,294

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

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NetScout Systems, Inc.

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended December 31,	
	2013	2012
Cash flows from operating activities:		
Net income	32,430	26,056
Adjustments to reconcile net income to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	13,774	13,826
Loss on disposal of fixed assets	38	71
Deal related compensation expense and accretion charges	114	205
Share-based compensation expense associated with equity awards	9,959	7,254
Net change in fair value of contingent and contractual liabilities	(289)	) 400
Deferred income taxes	4,259	6,237
Other gains	(69)	) (16)
Changes in assets and liabilities		
Accounts receivable	(302)	) 12,130
Inventories	(5,346)	) 1,568
Prepaid expenses and other assets	1,345	(4,358)
Accounts payable	(1,255)	) (3,137)
Accrued compensation and other expenses	2,259	6,400
Contingent liabilities	0	449
Income taxes payable	591	0
Deferred revenue	3,259	(107)
Net cash provided by operating activities	60,767	66,978
Cash flows from investing activities:		
Purchase of marketable securities	(88,802)	) (102,478)
Proceeds from maturity of marketable securities	49,405	153,046
Purchase of fixed assets	(8,709)	) (8,115)
Purchase of intangible assets	(713)	) (197)
Decrease (increase) in deposits	37	(804)
Acquisition of businesses, net of cash acquired	0	(51,273)
Net cash used in investing activities	(48,782)	) (9,821)
Cash flows from financing activities:		
Issuance of common stock under stock plans	755	516
Payment of contingent consideration	(841)	) (3,197)
Treasury stock repurchases	(25,033)	) (20,727)
Repayment of long-term debt	0	(62,000)
Excess tax benefit from share-based compensation awards	2,039	1,934
Net cash used in financing activities	(23,080)	) (83,474)
Effect of exchange rate changes on cash and cash equivalents	(187)	) (102)
Net decrease in cash and cash equivalents	(11,282)	) (26,419)
Cash and cash equivalents, beginning of period	99,930	117,255
Cash and cash equivalents, end of period	\$88,648	\$90,836
Supplemental disclosures:		
Cash paid for interest	\$0	\$325



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Cash paid for income taxes	\$12,628	\$12,460
Non-cash transactions:		
Transfers of inventory to fixed assets	\$1,781	\$583
Additions to property, plant and equipment included in accounts payable	\$233	\$370
Gross decrease in contractual liability relating to fair value adjustment	\$(148)	\$(135)
Gross (decrease) increase in contingent consideration liability relating to fair value adjustment	\$(141)	\$535
Issuance of common stock under employee stock plans	\$2,230	\$2,224

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, 2013.

**Recent Accounting Pronouncements**

In March 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2013-05 Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (ASU 2013-05). ASU 2013-05 provides guidance on releasing cumulative translation adjustments when a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or a business within a foreign entity. ASU 2013-05 is effective on a prospective basis for fiscal years and interim reporting periods within those years, beginning after December 15, 2013 (the fourth quarter of fiscal year 2014 for the Company). Early adoption is permitted. This standard is not expected to have a material impact on the Company's financial condition, results of operations, or cash flows.

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

Financial instruments that potentially subject us to concentration of credit risk consist primarily of investments, trade accounts receivable and accounts payable. Our cash, cash equivalents, and marketable securities are placed with financial institutions with high credit standings.

At December 31, 2013, the Company had no single indirect channel partner which accounted for more than 10% of the accounts receivable balance, while two direct customers accounted for more than 10% of the accounts receivable balance. At March 31, 2013, no single 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, 2013, one direct customer accounted for more than 10% of our total revenue, while no indirect channel partner accounted for more than 10% of total revenue during the three and nine months ended December 31, 2013. During the three and nine months ended December 31, 2012, 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.

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## 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):

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Cost of product revenue	\$62	\$61	\$174	\$176
Cost of service revenue	194	96	566	249
Research and development	1,157	778	3,316	2,164
Sales and marketing	944	775	2,952	2,301
General and administrative	860	754	2,951	2,353
	\$3,217	\$2,464	\$9,959	\$7,243

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, 2013. 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 31 and from September 1 through February 28 of each year. During the nine months ended December 31, 2013, employees purchased 89,765 shares under the ESPP and the value per share was \$24.84.

## 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, 2013 and March 31, 2013.

## Marketable Securities

The following is a summary of marketable securities held by NetScout at December 31, 2013 classified as short-term and long-term (in thousands):

	Amortized	Unrealized	Fair
	Cost	Gains	Value
Type of security:			
U.S. government and municipal obligations	\$39,433	\$5	\$39,438
Commercial paper	7,093	0	7,093
Corporate bonds	7,749	4	7,753
Certificates of deposit	2,059	0	2,059
Total short-term marketable securities	56,334	9	56,343
U.S. government and municipal obligations	35,147	18	35,165
Corporate bonds	2,057	0	2,057
Total long-term marketable securities	37,204	18	37,222
Total marketable securities	\$93,538	\$27	\$93,565

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The following is a summary of marketable securities held by NetScout at March 31, 2013, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains	Fair Value
Type of security:			
U.S. government and municipal obligations	\$17,416	\$11	\$17,427
Commercial paper	12,390	0	12,390
Corporate bonds	2,559	2	2,561
Certificates of deposit	4,960	0	4,960
Total short-term marketable securities	37,325	13	37,338
U.S. government and municipal obligations	14,211	7	14,218
Corporate bonds	2,605	0	2,605
Total long-term marketable securities	16,816	7	16,823
Total marketable securities	\$54,141	\$20	\$54,161

Contractual maturities of the Company's marketable securities held at December 31, 2013 and March 31, 2013 were as follows (in thousands):

	December 31, 2013	March 31, 2013
Available-for-sale securities:		
Due in 1 year or less	\$56,343	\$37,338
Due after 1 year through 5 years	37,222	16,823
	\$93,565	\$54,161

## NOTE 5 – FAIR VALUE MEASUREMENTS

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. 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, 2013 and March 31, 2013 (in thousands).

	Fair Value Measurements at December 31, 2013			
	Level 1	Level 2	Level 3	Total
<b>ASSETS:</b>				
Cash and cash equivalents	\$88,648	\$0	\$0	\$88,648
U.S. government and municipal obligations	74,603	0	0	74,603
Commercial paper	0	7,093	0	7,093
Corporate bonds	9,810	0	0	9,810
Certificate of deposits	0	2,059	0	2,059
Derivative financial instruments	0	367	0	367
	\$173,061	\$9,519	\$0	\$182,580
<b>LIABILITIES:</b>				
Contingent purchase consideration	\$0	\$0	\$(4,219)	\$(4,219)
Contingent contractual non-compliance liability	0	0	(98)	(98)
Derivative financial instruments	0	(138)	0	(138)
	\$0	\$(138)	\$(4,317)	\$(4,455)

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	Fair Value Measurements at March 31, 2013			
	Level 1	Level 2	Level 3	Total
<b>ASSETS:</b>				
Cash and cash equivalents	\$99,930	\$0	\$0	\$99,930
U.S. government and municipal obligations	31,645	0	0	31,645
Commercial paper	0	12,390	0	12,390
Corporate bonds	5,166	0	0	5,166
Certificate of deposits	0	4,960	0	4,960
Derivative financial instruments	0	71	0	71
	\$136,741	\$17,421	\$0	\$154,162
<b>LIABILITIES:</b>				
Contingent purchase consideration	\$0	\$0	\$(5,087)	\$(5,087)
Contingent contractual non-compliance liability	0	0	(246)	(246)
Derivative financial instruments	0	(249)	0	(249)
	\$0	\$(249)	\$(5,333)	\$(5,582)

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 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 and credit derivatives, 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 contingent purchase consideration and contingent contractual non-compliance liability at December 31, 2013 and March 31, 2013 were classified as Level 3 in the fair value hierarchy. They 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 liabilities for the nine months ended December 31, 2013 (in thousands):

	Contingent Purchase Consideration	Contingent Contractual Non-compliance Liability
Balance at beginning of period	\$(5,087)	\$(246)
Change in fair value (included within research and development expense)	27	148
Payments	841	0
Balance at end of period	\$(4,219)	\$(98)

The Company has updated the probabilities used in the fair value calculation of the contingent liabilities during the nine months ended December 31, 2013 which reduced the liability by \$289 thousand and is included as part of

earnings for the nine

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months ended December 31, 2013. The fair value of the contingent purchase 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 and a percent weighted-probability of the 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, 2013 were \$114 thousand and were included as part of earnings.

During the nine months ended December 31, 2013, \$841 thousand related to the acquisition of Simena, LLC (Simena) was paid to the former owner.

**NOTE 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 (FIFO) method. Inventories consist of the following (in thousands):

	December 31, 2013	March 31, 2013
Raw materials	\$6,959	\$3,986
Work in process	246	272
Finished goods	3,923	3,305
	\$11,128	\$7,563

**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 and to be 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 are 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	\$8,356	
Fixed assets	784	
Identifiable intangible assets	10,970	
Goodwill	19,897	
Deferred tax asset	7,329	
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 \$17.5 million from the ONPATH acquisition was included within the Company's existing Unified Service Delivery reporting unit and \$2.4 million was included within the Test Automation reporting unit. Both reporting units resulting from the acquisition of ONPATH were included in the Company's annual impairment review on January 31, 2013.

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, except for years):

	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 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. During the fourth quarter of the Company's fiscal year ended March 31, 2013, the Company completed a 382 study with its tax advisors and concluded that ONPATH's representations were correct. 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 in the second quarter of fiscal year 2014, performed an analysis on the historical periods to identify and claim credits for historical research and development activities. A net tax credit of \$517 thousand has been recorded within the acquisition allocation related to ONPATH's research and development activities.

Accanto

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 maintains a relationship with the selling entity such that the selling entity serves 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

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\$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 is included within the Company's Unified Service Delivery reporting unit and was 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. The remaining value of the acquired software intangible asset and the full value of the customer relationship intangible asset and goodwill is not deductible for tax purposes.

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 versions 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, except for years):

	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.

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

	Three Months Ended December 31, 2012 (unaudited)	Nine Months Ended December 31, 2012 (unaudited)
Pro forma revenue	\$94,221	\$263,009
Pro forma net income	\$11,038	\$20,036
Pro forma income per share:		
Basic	\$0.26	\$0.48
Diluted	\$0.26	\$0.47
Pro forma shares outstanding		
Basic	41,709	41,715

Diluted

42,298

42,364

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The proforma results for the three and nine months ended December 31, 2012 primarily include adjustments for amortization of intangibles. This proforma 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.

During the nine months ended December 31, 2013, the Company has recorded \$9.0 million of revenue directly attributable to ONPATH and Accanto within its consolidated financial statements.

**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, 2013 and March 31, 2013, goodwill attributable to the Unified Service Delivery reporting unit was \$200.8 million and \$199.5 million, respectively. Goodwill attributable to the Test Automation reporting unit was \$2.4 million and \$3.0 million as of December 31, 2013 and March 31, 2013, 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 unit below its carrying value.

The changes in the carrying amount of goodwill for the nine months ended December 31, 2013 are due to purchase accounting adjustments and the impact of foreign currency translation adjustments related to asset balances that are recorded in currencies other than the U.S. dollar.

The changes in the carrying amount of goodwill for the nine months ended December 31, 2013 are as follows (in thousands):

	Nine Months Ended December 31, 2013
Balance as of March 31, 2013	\$202,453
Purchase accounting adjustments	(665 )
Foreign currency translation impact	1,413
Balance as of December 31, 2013	\$203,201

**Intangible Assets**

The net carrying amounts of intangible assets were \$59.8 million and \$63.8 million as of December 31, 2013 and March 31, 2013, 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 Central Corporation (Network General) acquisition, which has an indefinite life and thus is not amortized. The carrying value of the indefinite lived trade name is evaluated for potential impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired.

During the three months ended December 31, 2013, the Company acquired certain rights to Accanto software not previously purchased as part of the acquisition transaction in fiscal year 2013 for \$500 thousand. This amount is included within developed technology as of December 31, 2013 and will be amortized using the economic benefit period over 6.3 years.

Intangible assets include an indefinite lived trade name with a carrying value of \$18.6 million and the following amortizable intangible assets as of December 31, 2013 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	\$31,603	\$(22,964 )	\$8,639
Customer relationships	38,789	(13,294 )	25,495
Distributor relationships	1,996	(480 )	1,516
Core technology	7,553	(2,389 )	5,164
Non-compete agreements	352	(264 )	88
Other	696	(371 )	325
	\$80,989	\$(39,762 )	\$41,227



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Intangible assets include an indefinite lived trade name with a carrying value of \$18.6 million and the following amortizable intangible assets as of March 31, 2013 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	\$30,848	\$(21,343)	) \$9,505
Customer relationships	38,718	(11,038)	) 27,680
Distributor relationships	1,895	(219)	) 1,676
Core technology	7,446	(1,455)	) 5,991
Non-compete agreements	334	(167)	) 167
Other	483	(275)	) 208
	\$79,724	\$(34,497)	) \$45,227

Amortization of software and core technology included as cost of product revenue was \$837 thousand and \$2.5 million for the three and nine months ended December 31, 2013, respectively. Amortization of other intangible assets included as operating expense was \$891 thousand and \$2.7 million for the three and nine months ended December 31, 2013, respectively.

Amortization of software and core technology included as cost of product revenue was \$1.0 million and \$3.9 million for the three and nine months ended December 31, 2012, respectively. Amortization of other intangible assets included as operating expense was \$906 thousand and \$2.2 million for the three and nine months ended December 31, 2012, respectively.

The following is the expected future amortization expense as of December 31, 2013 for the years ended March 31 (in thousands):

2014 (remaining three months)	\$2,052
2015	6,984
2016	6,439
2017	5,858
2018	5,078
Thereafter	14,816
	\$41,227

The weighted average amortization period of developed technology and core technology is 6.7 years. The weighted average amortization period for customer and distributor relationships is 13.3 years. The weighted average amortization period for amortizing all intangibles is 10.1 years.

**NOTE 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. The Company manages its foreign cash flow risk by hedging forecasted cash flows for operating expenses denominated in foreign currencies 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. These contracts will mature over the next twelve months and are expected to impact earnings on or before maturity.

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The notional amounts and fair values of derivative instruments in the consolidated balance sheets as of December 31, 2013 and March 31, 2013 were as follows (in thousands):

	Notional Amounts (a)		Other Current Assets		Accrued Other Liabilities	
	December 31, 2013	March 31, 2013	December 31, 2013	March 31, 2013	December 31, 2013	March 31, 2013
Derivatives Designated as Hedging Instruments:						
Forward contracts	\$15,675	\$17,071	\$367	\$71	\$138	\$249

(a) Notional amounts represent the gross contract/notional amount of the derivatives outstanding.

The following table provides the effect foreign exchange forward contracts had on other comprehensive income (loss) (OCI) and results of operations for the three months ended December 31, 2013 and 2012 (in thousands):

Derivatives in Cash Flow Hedging Relationships	Effective Portion			Ineffective Portion				
	Gain (Loss) Recognized in OCI on Derivative (a)		Gain (Loss) Reclassified from Accumulated OCI into Income (b)	Gain (Loss) Recognized in Income (Amount Excluded from Effectiveness Testing) (c)				
	December 31, 2013	December 31, 2012		December 31, 2013	December 31, 2012			
Forward contracts	\$87	\$ (46 )	Research and development Sales and marketing	\$ (109 ) 149	\$ (52 ) 67	Research and development Sales and marketing	\$ 75 3	\$ 51 (9 )
	\$87	\$ (46 )		\$ 40	\$ 15		\$ 78	\$ 42

(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 gains or losses were reclassified as a result of discontinuance of cash flow hedges.

The following table provides the effect foreign exchange forward contracts had on other comprehensive income (loss) (OCI) and results of operations for the nine months ended December 31, 2013 and 2012 (in thousands):

Derivatives in Cash Flow Hedging Relationships	Effective Portion			Ineffective Portion				
	Gain (Loss) Recognized in OCI on Derivative (a)		Gain (Loss) Reclassified from Accumulated OCI into Income (b)	Gain (Loss) Recognized in Income (Amount Excluded from Effectiveness Testing) (c)				
	December 31, 2013	December 31, 2012		December 31, 2013	December 31, 2012			
Forward contracts	\$90	\$ (22 )	Research and development Sales and marketing	\$ (293 ) 44	\$ (289 ) 41	Research and development Sales and marketing	\$ 172 (3 )	\$ 137 (4 )
	\$90	\$ (22 )		\$ (249 )	\$ (248 )		\$ 169	\$ 133

(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 gains or losses were reclassified as a result of discontinuance of cash flow hedges.

**NOTE 10 – LONG-TERM DEBT**

On October 29, 2012, the Company paid down its outstanding balance in the amount of \$62.0 million on its credit facility. As of December 31, 2013, there were no amounts outstanding under this credit facility.



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On November 22, 2011, the Company entered into a credit facility (the Credit Agreement) with a syndicate of lenders led by KeyBank National Association (KeyBank) providing the Company with a \$250 million revolving credit facility, which may be increased to \$300 million at any time up to 90 days before maturity. The revolving credit facility includes a swing line loan sub-facility of up to \$10 million and a letter of credit sub-facility of up to \$10 million. The credit facility under the Credit Agreement matures on November 21, 2016.

At the Company's election, revolving loans under the Credit Agreement bear interest at either (a) a rate per annum equal to the highest of (1) KeyBank's prime rate, (2) 0.50% in excess of the federal funds effective rate, or (3) one hundred (100.00) basis points in excess of the London Interbank Offered Rate (LIBOR) for one-month interest periods, or the Base Rate; or (b) the one-, two-, three-, or six-month per annum LIBOR, as selected by the Company, multiplied by the statutory reserve adjustment, or collectively, the Eurodollar Rate, in each case plus an applicable margin. Swing line loans will bear interest at the Base Rate plus the applicable Base Rate margin. Beginning with the delivery of the Company's financial statements for the quarter ended December 31, 2011, the applicable margin began to depend on the Company's leverage ratio, ranging from 100 basis points for Base Rate loans and 200 basis points for Eurodollar Rate loans if the Company's consolidated leverage ratio is 2.50 to 1.00 or higher, down to 25 basis points for Base Rate loans and 125 basis points for Eurodollar Rate loans if the Company's consolidated leverage ratio is 1.00 to 1.00 or less.

The Company may prepay loans under the Credit Agreement at any time, without penalty, subject to certain notice requirements. Debt is recorded at the amount drawn on the revolving credit facility plus interest based on floating rates reflective of changes in the market which approximates fair value.

The loans are guaranteed by each of the Company's domestic subsidiaries and are collateralized by all of the assets of the Company and its domestic subsidiaries, as well as 65% of the capital stock of the Company's foreign subsidiaries directly owned by the Company and its domestic subsidiaries. The Credit Agreement generally prohibits any other liens on the assets of the Company and its subsidiaries, subject to certain exceptions as described in the Credit Agreement. The Credit Agreement contains certain covenants applicable to the Company and its subsidiaries, including, without limitation, limitations on additional indebtedness, liens, various fundamental changes (including material mergers and dispositions of assets), dividends and distributions, capital expenditures, investments (including material acquisitions and investments in foreign subsidiaries), transactions with affiliates, sale-leaseback transactions, hedge agreements, payment of junior financing, material changes in business, and other limitations customary in senior secured credit facilities. In addition, the Company is required to maintain certain consolidated leverage and interest coverage ratios as well as a minimum liquidity amount. As of December 31, 2013, the Company was in compliance with all of these covenants.

**NOTE 11 – RESTRUCTURING CHARGES**

During the fiscal year ended March 31, 2013, the Company restructured part of its international sales organization related to an overlap of personnel acquired as part of the Accanto acquisition. The Company recorded \$1.2 million of restructuring charges related to severance costs.

The following table provides a summary of the activity related to these restructuring plans and the related liability included as accrued compensation on the Company's consolidated balance sheet (in thousands):

	Three Months Ended December 31, 2013	Nine Months Ended December 31, 2013
Employee Severance:		
Balance at beginning of period	\$71	\$910
Other adjustments	—	(49)
Cash payments	—	(790)
Balance as of December 31, 2013	\$71	\$71

The balance is expected to be paid in full by December 31, 2014.

**NOTE 12 – COMMITMENTS AND CONTINGENCIES**

Acquisition related – The Company recorded two contingent liabilities related to the acquisition of Simena, one relates to future consideration to be paid to the former owner which had an initial fair value of \$8.0 million at the time of acquisition and another relates to contractual non-compliance liabilities incurred by Simena with an initial fair value of \$1.6 million at the time of acquisition. At December 31, 2013, the present value of the future consideration was

\$4.2 million and the contractual non-compliance liability was \$98 thousand.

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Legal – From time to time, NetScout is subject to legal proceedings and claims in the ordinary course of business. In the opinion of management, 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 the Company’s financial condition, results of operations or cash flows.

As disclosed in Part II, Item 1, in March 2012, NetScout uncovered and investigated, and in April 2012, disclosed to the U.S. Department of Justice and the California State Attorney General potential violations of federal and California state anti-trust laws. The potential violations involve a former employee and one or more third parties in connection with sales to state governmental agencies during fiscal year 2012. The California State Attorney General is conducting an investigation into the matter. NetScout has been informed by the Department of Justice that it does not intend to take any action against NetScout. NetScout believes we did not benefit from any of the transactions uncovered and believes that the amounts involved are not material.

## NOTE 13 – 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 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, 2013, the Company had repurchased a total of 3,506,700 shares of common stock through the open market stock repurchase program. The Company repurchased 750,407 shares for \$19.7 million under the program during the nine months ended December 31, 2013.

In connection with the vesting and release of the restriction on previously vested shares of restricted stock units, the Company repurchased 209,756 shares for \$5.3 million related to minimum statutory tax withholding requirements on these restricted stock units during the nine months ended December 31, 2013. 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.

## NOTE 14 – NET INCOME PER SHARE

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Numerator:				
Net income	\$17,294	\$11,138	\$32,430	\$26,056
Denominator:				
Denominator for basic net income per share - weighted average shares outstanding	41,425	41,709	41,417	41,715
Dilutive common equivalent shares:				
Weighted average stock options	43	111	63	127
Weighted average restricted stock units	416	478	489	522
Denominator for diluted net income per share - weighted average shares outstanding	41,884	42,298	41,969	42,364
Net income per share:				
Basic net income per share	\$0.42	\$0.27	\$0.78	\$0.62
Diluted net income per share	\$0.41	\$0.26	\$0.77	\$0.62



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

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
Restricted stock units	—	43	195	283

Basic EPS is calculated by dividing net income by the weighted average number of shares outstanding during the period. Unvested restricted shares, although legally issued and outstanding, are not considered outstanding for purposes of calculating basic earnings per share. Diluted EPS is calculated by dividing net income by the weighted average number of shares outstanding plus the dilutive effect, if any, of outstanding stock options, restricted shares and restricted stock units using the treasury stock method. The calculation of the dilutive effect of outstanding equity awards under the treasury stock method includes consideration of proceeds from the assumed exercise of stock options, unrecognized compensation expense and any tax benefits as additional proceeds.

**NOTE 15 – INCOME TAXES**

Our effective income tax rates were 37.6% and 36.3% for the nine months ended December 31, 2013 and the fiscal year ended March 31, 2013, respectively. Generally, the effective tax rates differ from statutory rates due to the impact of the domestic production activities deduction, the impact of state taxes, and federal, foreign and state tax credits. The effective tax rate for the nine months ended December 31, 2013 is higher than the effective rate for our fiscal year ended March 31, 2013 primarily due to the interim accounting treatment of certain foreign losses for which no benefit can be recognized.

Our effective tax rates were 37.6% and 38.1% for the nine months ended December 31, 2013 and 2012, respectively. At this time, the effective tax rate is lower than the comparable year primarily due to the impact of the reinstatement of the research and development credit.

**NOTE 16 – SEGMENT AND GEOGRAPHIC INFORMATION**

The Company reports revenues and income under one reportable segment. The consolidated financial information is used by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company manages its business in the following geographic areas: United States, Europe, Asia and the rest of the 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.

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

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2013	2012	2013	2012
United States	\$86,747	\$66,990	\$216,364	\$188,701
Europe	12,313	12,940	33,906	31,373
Asia	4,035	4,201	14,788	12,678
Rest of the world	7,333	7,436	19,272	19,721
	\$110,428	\$91,567	\$284,330	\$252,473

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. A majority of 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.

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

In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking statements under Section 21E of the Exchange Act and other federal securities laws. These forward looking statements involve risks and uncertainties. These statements relate to future events or our future financial performance and are identified by terminology such as "may," "will," "could," "should," "expects," "plans," "intends," "seeks," "anticipates," "believes," "estimates," "potential" or "continue," or the negative of such terms or other comparable terminology. These statements are only predictions. 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, 2013 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 and application performance management solutions focused on assuring service delivery for the world's largest, most demanding and complex 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, our ability to achieve expense reductions and make structural improvements and current economic conditions.

Our key objectives have been to continue to gain market share in the wireless service provider market and to accelerate our enterprise growth by extending into the application performance management segment. A common component of both initiatives has been the acceptance of our Unified Services Delivery Management Strategy. This strategy has been bolstered by our acquisitions and integration of both voice/video and packet flow or monitoring switch technology.

During the first quarter of our fiscal year 2014, NetScout announced the release of the nGeniusONE Unified Performance Management platform. The nGeniusONE platform converges application and network performance management functionality into a single unified platform that delivers a top-down, serviced-focused perspective of performance characteristics of all infrastructure and application elements associated with service delivery.

During the first quarter of our fiscal year 2014, management performed a review of its summation of revenue by industry. As a result, we changed our method of apportioning revenue to our revenue sectors, and the categorization of certain customers to different sectors. This change in the manner of describing fluctuations by sector will not affect our total net revenues, total product and service revenues, or revenue by geography.

Results Overview

We saw continued growth during the quarter ended December 31, 2013, with product revenue growth of 30% and overall revenue growth of 21% compared to the same period in the prior year.

Our business maintained strong gross profit margins. Our gross profit for the quarter ended December 31, 2013 increased by \$14.4 million, or 20%, when compared to the quarter ended December 31, 2012. The gross profit

percentage remained flat at 79% during the quarters ended December 31, 2013 and 2012.

We continue to maintain strong liquidity. At December 31, 2013, we had cash, cash equivalents and marketable securities of \$182.2 million. This represents an increase of \$28.1 million from March 31, 2013.

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## Use of Non-GAAP Financial Measures

We supplement the generally accepted accounting principles (GAAP) financial measures we report in quarterly earnings announcements, investor presentations and other investor communications by reporting the following non-GAAP measures: non-GAAP revenue, non-GAAP net income and non-GAAP net income per diluted share. Non-GAAP revenue eliminates the GAAP effects of acquisitions by adding back revenue related to deferred revenue revaluation. Non-GAAP net income includes the foregoing adjustment and also removes inventory fair value adjustments, expenses related to the amortization of acquired intangible assets, share-based compensation, restructuring, certain expenses relating to acquisitions including compensation for post-combination services and business development charges, net of related income tax effects. Non-GAAP diluted net income per share also excludes these expenses as well as the related impact of all these adjustments on the provision for income taxes.

These non-GAAP measures are not in accordance with GAAP, should not be considered an alternative for measures prepared in accordance with GAAP (revenue, net income and diluted net income per share), and may have limitations in that they do not reflect all our results 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.

Management believes these non-GAAP financial measures enhance the reader's overall understanding of our 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 we plan and measure our 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 also enables investors to consider our operating results on both a GAAP and non-GAAP basis during and following the integration period of our acquisitions. Presenting the GAAP measures on their own may not be indicative of our core operating results. Furthermore, management believes that the presentation of non-GAAP measures when shown in conjunction with the corresponding GAAP measures provide useful information to management and investors regarding present and future business trends relating to our financial condition and results of operations.

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, 2013 and 2012 (in thousands, except for per share amounts):

	Three Months Ended		Nine Months Ended		
	December 31,		December 31,		
	2013	2012	2013	2012	
GAAP revenue	\$110,428	\$91,567	\$284,330	\$252,473	
Deferred revenue fair value adjustment	140	400	419	671	
Non-GAAP revenue	\$110,568	\$91,967	\$284,749	\$253,144	
GAAP net income	\$17,294	\$11,138	\$32,430	\$26,056	
Deferred revenue fair value adjustment	140	400	419	671	
Inventory fair value adjustment	—	249	—	249	
Share based compensation expense	3,217	2,464	9,959	7,243	
Amortization of acquired intangible assets	1,697	1,805	5,051	5,938	
Business development and integration expense	78	543	482	1,374	
Compensation for post combination services	530	1,005	1,685	1,819	
Restructuring charges	—	(1	)	—	1,065
Income tax adjustments	(1,941	) (2,257	) (6,034	) (6,498	)
Non-GAAP net income	\$21,015	\$15,346	\$43,992	\$37,917	
GAAP diluted net income per share	\$0.41	\$0.26	\$0.77	\$0.62	
	0.09	0.10	0.28	0.28	



Per share impact of non-GAAP adjustments  
identified above

Non-GAAP diluted net income per share	\$0.50	\$0.36	\$1.05	\$0.90
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## 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:

- marketable securities;
- revenue recognition;
- valuation of goodwill, intangible assets and other acquisition accounting items; and
- share-based compensation.

Please refer to the critical accounting policies set forth in our Annual Report on Form 10-K for the fiscal year ended March 31, 2013, filed with the Securities and Exchange Commission (SEC) on May 24, 2013, for a description of all of our critical accounting policies.

Three Months Ended December 31, 2013 and 2012

## 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. During the three months ended December 31, 2013, one customer accounted for more than 10% of total revenue. During the three months ended December 31, 2012, there were no customers that accounted for more than 10% of total revenue.

	Three Months Ended December 31, (Dollars in Thousands)				Change			
	2013	% of Revenue	2012	% of Revenue	\$	%		
Revenue:								
Product	\$68,561	62	% \$52,676	58	% \$15,885	30	%	
Service	41,867	38	38,891	42	2,976	8	%	
Total revenue	\$110,428	100	% \$91,567	100	% \$18,861	21	%	

Product. The 30%, or \$15.9 million, increase in product revenue was due to a \$12.3 million increase in revenue from our service provider sector, a \$2.2 million increase in our general enterprise sector and a \$1.4 million increase in our government enterprise sector.

Compared to the same period in the prior year, we realized a 30% increase in units shipped, as well as a 15% increase in the average selling price per unit of our products.

We expect continued growth in our service provider sector through the year ended March 31, 2014.

Service. The 8%, or \$3.0 million, increase in service revenue was due to a \$2.4 million increase in revenue from new maintenance contracts and renewals from a growing support base and a \$685 thousand increase in premium support contracts.



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These were partially offset by a \$96 thousand decrease in consulting revenue and an \$88 thousand decrease in training revenue. We expect single digit percentage growth in our service revenues. We expect this to be generated by product revenue growth which increases our installed base and therefore our related maintenance contracts.

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

	Three Months Ended		December 31,		Change			
	(Dollars in Thousands)							
	2013		2012		\$	%		%
		% of Revenue		% of Revenue				
Indirect	\$53,930	49	% \$47,907	52	% \$6,023	13	%	
Direct	56,498	51	43,660	48	12,838	29	%	
Total revenue	\$110,428	100	% \$91,567	100	% \$18,861	21	%	

The 13%, or \$6.0 million, increase in indirect channel revenue is the result of the increase in sales to our general enterprise sectors across all geographies. Sales to customers outside the United States are export sales typically 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 29%, or \$12.8 million, increase in direct revenue is primarily the result of increased domestic revenue from our service provider sector.

Total revenue by geography is as follows:

	Three Months Ended		December 31,		Change			
	(Dollars in Thousands)							
	2013		2012		\$	%		%
		% of Revenue		% of Revenue				
United States	\$86,747	79	% \$66,990	73	% \$19,757	29	%	
International:								
Europe	12,313	11	12,940	14	(627)	(5)	%	
Asia	4,035	4	4,201	5	(166)	(4)	%	
Rest of the world	7,333	6	7,436	8	(103)	(1)	%	
Subtotal international	23,681	21	24,577	27	(896)	(4)	%	
Total revenue	\$110,428	100	% \$91,567	100	% \$18,861	21	%	

United States revenues increased 29%, or \$19.8 million, as a result of gains within the service provider and general enterprise sectors. The 4%, or \$896 thousand, decrease in international revenue is primarily due to a decrease in our international service provider sector. 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 to, or do business with, countries subject to economic sanctions and export controls.

**Cost of Revenue and Gross Profit**

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

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	Three Months Ended December 31, (Dollars in Thousands)				Change			
	2013	% of Revenue	2012	% of Revenue	\$	%		
Cost of revenue								
Product	\$14,534	13	% \$12,182	13	% \$2,352	19	%	
Service	9,068	8	6,982	8	2,086	30	%	
Total cost of revenue	\$23,602	21	% \$19,164	21	% \$4,438	23	%	
Gross profit:								
Product \$	\$54,027	49	% \$40,494	44	% \$13,533	33	%	
Product gross profit %	79	%	77	%				
Service \$	\$32,799	30	% \$31,909	35	% \$890	3	%	
Service gross profit %	78	%	82	%				
Total gross profit \$	\$86,826		\$72,403		\$14,423	20	%	
Total gross profit %	79	%	79	%				

Product. The 19%, or \$2.4 million, increase in cost of product revenue was primarily due to the \$15.9 million, or 30%, increase in product revenue during the three months ended December 31, 2013. This was partially offset by a \$249 thousand decrease in amortization of inventory fair value adjustment resulting from a fair value adjustment to acquired inventory in the ONPATH acquisition and a \$122 thousand decrease in amortization of software and core technology included as cost of product revenue during such period. The product gross profit percentage increased by two percentage points to 79% during the three months ended December 31, 2013 as compared to the three months ended December 31, 2012. The 33%, or \$13.5 million, increase in product gross profit corresponds with the 30%, or \$15.9 million, increase in product revenue, offset by the 19%, or \$2.4 million, increase in cost of product revenue. Average headcount in manufacturing was 32 and 30 for the three months ended December 31, 2013 and 2012, respectively.

Service. The 30%, or \$2.1 million, increase in cost of service revenue was primarily due to a \$1.1 million increase in employee related expenses resulting in part from headcount to support our growing installed base. In addition, there was an \$847 thousand increase in cost of materials used to support customers under service contracts. The service gross profit percentage decreased by four percentage points to 78% for the three months ended December 31, 2013 as compared to the three months ended December 31, 2012, primarily related to the increases in cost mentioned above. The 3%, or \$890 thousand, increase in service gross profit corresponds with the 8%, or \$3.0 million, increase in service revenue, offset by the 30%, or \$2.1 million, increase in cost of services. Average service headcount was 145 and 135 for the three months ended December 31, 2013 and 2012, respectively.

Gross profit. Our gross profit increased 20%, or \$14.4 million. This increase is attributable to our increase in revenue of 21%, or \$18.9 million, partially offset by a 23%, or \$4.4 million, increase in cost of revenue. The gross profit percentage remained flat at 79% for the three months ended December 31, 2013 as compared to the three months ended December 31, 2012. Overall we expect our gross profit percentage to remain relatively flat in future periods with increased sales volumes offset by corresponding increases in product and service costs.

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## Operating Expenses

	Three Months Ended December 31, (Dollars in Thousands)				Change			
	2013	% of Revenue	2012	% of Revenue	\$	%		
Research and development	\$18,348	17	% \$15,352	17	% \$2,996	20	%	
Sales and marketing	32,425	29	30,105	33	2,320	8	%	
General and administrative	7,929	7	8,539	9	(610)	(7)	)%	
Amortization of acquired intangible assets	860	1	846	1	14	2	%	
Restructuring charges	—	—	(1)	0	1	(100)	)%	
Total operating expenses	\$59,562	54	% \$54,841	60	% \$4,721	9	%	

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 20%, or \$3.0 million, increase in research and development expenses is due to a \$2.1 million increase in employee related expenses, a \$372 thousand increase in depreciation expenses, a \$237 thousand increase in non-recurring engineering expenses, a \$147 thousand increase in temporary hire expenses and a \$133 thousand increase in computer supplies. These expenses were partially offset by a \$174 thousand decrease in deal related compensation. Average headcount in research and development was 347 and 359 for the three months ended December 31, 2013 and 2012, respectively.

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

The 8%, or \$2.3 million, increase in total sales and marketing expenses was due to a \$1.8 million increase in commissions due to higher shipments as well as an increase in anticipated higher quota attainment and special incentive programs related to the nGenius One product introduction during the three months ended December 31, 2013 compared to the three months ended December 31, 2012. In addition, there was a \$1.7 million increase in employee related expenses due to an increase in headcount and share-based compensation. These increases were partially offset by a \$583 thousand decrease in depreciation expense, a \$315 thousand decrease in sales meeting expenses and a \$268 thousand decrease in recruiting costs. Average headcount in sales and marketing was 361 and 349 for the three months ended December 31, 2013 and 2012, 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 7%, or \$610 thousand, decrease in general and administrative expenses was due to a \$540 thousand decrease in bad debt expense, a \$451 thousand decrease in business development expenses, a \$309 thousand decrease in deal related compensation, and a \$72 thousand decrease in depreciation expenses. These decreases were partially offset by an \$888 thousand increase in employee related expenses. Average headcount in general and administrative was 116 and 118 for the three months ended December 31, 2013 and 2012, respectively.

Amortization of acquired intangible assets. Amortization of acquired intangible assets consists primarily of amortization of customer relationships related to the acquisitions of ONPATH, Accanto Systems, S.r.l. (Accanto), Simena, LLC (Simena), Fox Replay BV (Replay), Psytechnics, Ltd (Psytechnics) and Network General Central Corporation (Network General).

The 2%, or \$14 thousand, increase in amortization of acquired intangible assets is due to the increase of expense recorded related to the acquisitions of ONPATH and Accanto.



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

	Three Months Ended December 31, (Dollars in Thousands)		2012		Change			
	2013	% of Revenue		% of Revenue	\$	%		
Interest and other income (expense), net	\$44	—	% \$(104	) —	% \$148	142	%	

The 142%, or \$148 thousand, increase in interest and other income was due to a \$102 thousand decrease in foreign currency exchange expense and a \$95 thousand decrease in interest expense due to the payment of our outstanding debt during the quarter ended December 31, 2012. These increases to interest and other (expense) income, net were partially offset by a \$49 thousand decrease in interest income received on investments.

Income Tax Expense. Our effective income tax rates were 36.7% and 36.2% for the three months ended December 31, 2013 and 2012, respectively. Generally, the effective tax rates differ from statutory rates due to the impact of the domestic production activities deduction, the impact of state taxes, and federal, foreign and state tax credits. At this time, the effective tax rate for the three months ended December 31, 2013 is higher than the comparable prior year period primarily due to the interim accounting treatment of certain foreign losses for which no benefit can be recognized.

	Three Months Ended December 31, (Dollars in Thousands)		2012		Change			
	2013	% of Revenue		% of Revenue	\$	%		
Income tax expense	\$10,014	9	% \$6,320	7	% \$3,694	58	%	

Nine months ended December 31, 2013 and 2012

Revenue

During the nine months ended December 31, 2013, one customer accounted for more than 10% of total revenue. During the nine months ended December 31, 2012, no customers accounted for more than 10% of total revenue.

	Nine Months Ended December 31, (Dollars in Thousands)		2012		Change			
	2013	% of Revenue		% of Revenue	\$	%		
Revenue:								
Product	\$163,895	58	% \$139,100	55	% \$24,795	18	%	
Service	120,435	42	% 113,373	45	% 7,062	6	%	
Total revenue	\$284,330	100	% \$252,473	100	% \$31,857	13	%	

Product. The 18%, or \$24.8 million, increase in product revenue was due to an \$11.4 million increase in revenue from our general enterprise sector, a \$10.9 million increase in revenue from our service provider sector and a \$2.5 million increase in revenue from our government enterprise sector. Compared to the same period in the prior year, we realized a 13% increase in units shipped and an 8% increase in the average selling price per unit of our products.

Service. The 6%, or \$7.1 million, increase in service revenue was due to a \$5.0 million increase in revenue from maintenance contracts due to increased new maintenance contracts and renewals from a growing support base and a \$2.4 million increase in premium support contracts. These were partially offset by a \$325 thousand decrease in consulting revenue and a \$138 thousand decrease in training revenue.





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

	Nine Months Ended December 31, (Dollars in Thousands)				Change			
	2013	2012	2013	2012	\$	%		
Indirect	\$142,420	\$122,708	50 %	49 %	\$19,712	16 %		%
Direct	141,910	129,765	50 %	51 %	12,145	9 %		%
Total revenue	\$284,330	\$252,473	100 %	100 %	\$31,857	13 %		%

The 16%, or \$19.7 million, increase in indirect channel revenue is the result of increases in sales to our general enterprise sectors across all geographies as well as an increase to our service provider sector domestically. Sales to customers outside the United States are export sales typically 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 9%, or \$12.1 million, increase in direct revenue is primarily the result of increased domestic revenue from our service provider customers.

Total revenue by geography is as follows:

	Nine Months Ended December 31, (Dollars in Thousands)				Change			
	2013	2012	2013	2012	\$	%		
United States	\$216,364	\$188,701	76 %	75 %	\$27,663	15 %		%
International:								
Europe	33,906	31,373	12 %	12 %	2,533	8 %		%
Asia	14,788	12,678	5 %	5 %	2,110	17 %		%
Rest of the world	19,272	19,721	7 %	8 %	(449)	(2) %		%
Subtotal international	67,966	63,772	24 %	25 %	4,194	7 %		%
Total revenue	\$284,330	\$252,473	100 %	100 %	\$31,857	13 %		%

United States revenues increased 15%, or \$27.7 million, as a result of an increase in our service provider and general enterprise sectors. The 7%, or \$4.2 million, increase in international revenue is primarily due to an increase in our general enterprise sector in Europe and Asia.

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## Cost of Revenue and Gross Profit

	Nine Months Ended December 31, (Dollars in Thousands)				Change	
	2013	% of Revenue	2012	% of Revenue	\$	%
Cost of revenue						
Product	\$36,117	13	\$32,582	13	\$3,535	11
Service	24,111	8	20,386	8	3,725	18
Total cost of revenue	\$60,228	21	\$52,968	21	\$7,260	14
Gross profit:						
Product \$	\$127,778	45	\$106,518	42	\$21,260	20
Product gross profit %	78	%	77	%		
Service \$	\$96,324	34	\$92,987	37	\$3,337	4
Service gross profit %	80	%	82	%		
Total gross profit \$	\$224,102		\$199,505		\$24,597	12
Total gross profit %	79	%	79	%		

Product. The 11%, or \$3.5 million, increase in cost of product revenue was mainly a result of the 18%, or \$24.8 million increase in product revenue. In addition, there was a \$460 thousand increase in employee related expenses due to increased headcount. These increases were partially offset by a \$1.4 million decrease in amortization of software and core technology included as cost of product revenue for the nine months ended December 31, 2013. In addition, there was a \$249 thousand decrease in amortization of inventory fair value adjustment, and a \$180 thousand decrease in obsolescence charges as we did not discontinue or make plans to discontinue, any product during the nine months ended December 31, 2013. The product gross profit percentage increased by one percentage point to 78% during the nine months ended December 31, 2013. Average headcount in manufacturing was 32 and 28 for the nine months ended December 31, 2013 and 2012, respectively.

Service. The 18%, or \$3.7 million, increase in cost of service revenue was primarily due to a \$2.5 million increase in employee related expenses resulting in part from increased headcount to support our growing installed base, as well as from increased share-based compensation. In addition, there was a \$988 thousand increase in cost of materials used to support customers under service contracts, \$306 thousand increase in software licenses, and a \$162 thousand increase in travel expenses. These increases were partially offset by a \$321 thousand decrease in consulting expenses. The service gross profit percentage decreased by two percentage points to 80% for the nine months ended December 31, 2013 when compared to the nine months ended December 31, 2012 primarily related to the increases in cost mentioned above. The 4%, or \$3.3 million, increase in service gross profit corresponds with the 6%, or \$7.1 million, increase in service revenue, partially offset by the 18%, or \$3.7 million, increase in cost of services. Average service headcount was 144 and 130 for the nine months ended December 31, 2013 and 2012, respectively.

Gross profit. Our gross profit increased 12%, or \$24.6 million. This increase is attributable to our increase in revenue of 13% or \$31.9 million, partially offset by a 14%, or \$7.3 million, increase in cost of revenue. The gross profit percentage remained flat at 79% for the nine months ended December 31, 2013 when compared to the nine months ended December 31, 2012.

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## Operating Expenses

	Nine Months Ended December 31, (Dollars in Thousands)				Change		
	2013	% of Revenue	2012	% of Revenue	\$	%	
Research and development	\$50,951	18	% \$44,630	18	% \$6,321	14	%
Sales and marketing	96,184	34	86,997	34	% 9,187	11	%
General and administrative	22,367	8	22,071	9	% 296	1	%
Amortization of acquired intangible assets	2,571	1	2,077	1	% 494	24	%
Restructuring charges	—	—	1,065	0	% (1,065 )	(100 )	%
Total operating expenses	\$172,073	61	% \$156,840	62	% \$15,233	10	%

Research and development. The 14%, or \$6.3 million, increase in research and development expenses is due to a \$4.1 million increase in employee related expenses, as a result of increased headcount and increased share-based compensation, a \$751 thousand increase in non-recurring engineering expenses, a \$635 thousand increase in depreciation expense, a \$360 thousand increase in travel expense, a \$328 thousand increase in temporary hire expenses, a \$282 thousand increase in software licenses, a \$194 thousand increase in computer supplies and a \$183 thousand increase in manufacturing supplies. These expenses were offset by a \$461 thousand decrease in deal related compensation related to the acquisition of Simena and a \$196 thousand decrease in meeting expenses. Average headcount in research and development was 353 and 331 for the nine months ended December 31, 2013 and 2012, respectively.

Sales and marketing. The 11%, or \$9.2 million, increase in total sales and marketing expenses was due to a \$3.9 million increase in employee related expenses as a result of increased headcount and share-based compensation, a \$3.8 million increase in commissions due to both higher shipments as well as an increase in anticipated higher quota attainment and special incentive programs related to the nGenius One product introduction during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012. In addition, there was an \$835 thousand increase in trade show expenses, a \$709 thousand increase related to the NetScout user conference, a \$564 thousand increase in travel expenses and a \$140 thousand increase in consulting expenses. These expenses were partially offset by a \$587 thousand decrease in sales meeting expenses and a \$427 thousand decrease in recruitment expenses. Average headcount in sales and marketing was 355 and 339 for the nine months ended December 31, 2013 and 2012, respectively.

General and administrative. The 1%, or \$296 thousand, increase in general and administrative expenses was due to a \$690 thousand increase in employee related expenses as a result of increased headcount and share-based compensation, a \$258 thousand increase in compensation for post combination services, a \$251 thousand increase in tax and accounting related services, a \$227 thousand increase in expenses for software licenses, and a \$112 thousand increase in office expenses. These increases were partially offset by an \$877 thousand decrease in business development expenses, and a \$475 thousand decrease in bad debt expense. Average headcount in general and administrative was 119 and 113 for the nine months ended December 31, 2013 and 2012, respectively.

Amortization of acquired intangible assets. Amortization of acquired intangible assets consists primarily of amortization of customer relationships related to the acquisitions of ONPATH, Accanto, Simena, Replay, Psytechnics and Network General.

The 24%, or \$494 thousand, increase in amortization of acquired intangible assets is due to the increase of expense recorded related to the acquisitions of ONPATH and Accanto.

Restructuring charges. During the quarter ended September 30, 2012, we restructured part of our international sales organization related to an overlap of personnel acquired as part of the Accanto acquisition. As a result, we recorded \$1.2 million of restructuring charges during the nine months ended December 31, 2012.



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

	Nine Months Ended December 31, (Dollars in Thousands)				Change		
	2013	% of Revenue	2012	% of Revenue	\$	%	
Interest and other (expense), net	(88	) 0	% (576	) —	% \$488	85	%

The 85%, or \$488 thousand, decrease in interest and other expense, net was due to a \$510 thousand decrease in interest expense due to the repayment of our outstanding debt during the quarter ended December 31, 2012, as well as an \$191 thousand decrease in foreign currency exchange expense. These decreases to interest and other expense, net were partially offset by a \$213 thousand decrease in interest income received on investments.

Income Tax Expense. Our effective income tax rates were 37.6% and 38.1% for the nine months ended December 31, 2013 and 2012, respectively. Generally, the effective tax rates differ from statutory rates due to the impact of the domestic production activities deduction, the impact of state taxes, and federal, foreign and state tax credits. At this time, the effective tax rate for the nine months ended December 31, 2013 is lower than the comparable prior year period primarily due to reinstatement of the research and development credit.

	Nine Months Ended December 31, (Dollars in Thousands)				Change		
	2013	% of Revenue	2012	% of Revenue	\$	%	
Income tax expense	19,511	7	% 16,033	6	% \$3,478	22	%
Off-Balance Sheet Arrangements							

As of December 31, 2013 and 2012, we did not have any off-balance sheet arrangements as defined in Regulation S-K, Item 303(a)(4)(ii).

#### Commitment and Contingencies

We account for claims and contingencies in accordance with authoritative guidance that requires us to record an estimated loss from a claim or loss contingency when information available prior to issuance of our consolidated financial statements indicates that it is probable that a liability has been incurred at the date of the consolidated financial statements and the amount of the loss can be reasonably estimated. If we determine that it is reasonably possible but not probable that an asset has been impaired or a liability has been incurred or if the amount of a probable loss cannot be reasonably estimated, then in accordance with the authoritative guidance, we disclose the amount or range of estimated loss if the amount or range of estimated loss is material. Accounting for claims and contingencies requires us to use our judgment. We consult with legal counsel on those issues related to litigation and seek input from other experts and advisors with respect to matters in the ordinary course of business. For additional information with respect to legal proceedings, refer to Part II, Item 1 “Legal Proceedings.”

We recorded two contingent liabilities related to the acquisition of Simena. One relates to future consideration to be paid to the former owner which had an initial fair value of \$8.0 million at the time of acquisition and another relates to contractual non-compliance liabilities incurred by Simena with an initial fair value of \$1.6 million at the time of acquisition. At December 31, 2013, the present value of the future consideration was \$4.2 million and the contractual non-compliance liability was \$98 thousand.

As disclosed in Part II, Item 1, in March 2012, we uncovered and investigated, and in April 2012, disclosed to the U.S. Department of Justice and the California State Attorney General potential violations of federal and California state anti-trust laws. The potential violations involve a former employee and one or more third parties in connection with sales to state governmental agencies during fiscal year 2012. The California State Attorney General is conducting an investigation into the

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matter. We have been informed by the Department of Justice that it does not intend to take any action against NetScout. We believe we did not benefit from any of the transactions uncovered and believe that the amounts involved are not material.

## Liquidity and Capital Resources

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

	December 31, 2013	March 31, 2013
Cash and cash equivalents	\$88,648	\$99,930
Short-term marketable securities	56,343	37,338
Long-term marketable securities	37,222	16,823
Cash, cash equivalents and marketable securities	\$182,213	\$154,091
Cash, cash equivalents and marketable securities		

At December 31, 2013, cash, cash equivalents and marketable securities totaled \$182.2 million, up \$28.1 million from \$154.1 million at March 31, 2013 due primarily to cash flow from operations of \$60.8 million, partially offset by \$25.0 million of cash used to repurchase shares of our common stock and \$9.4 million of cash used for capital expenditures.

Substantially all of our cash, cash equivalents and marketable securities are located in the United States. At December 31, 2013, cash and short-term and long-term investments in the United States was \$180.2 million, while cash held outside the United States was approximately \$2.0 million.

Cash and cash equivalents were impacted by the following:

	Nine months ended December 31, (Dollars in Thousands)	
	2013	2012
Net cash provided by operating activities	\$60,767	\$66,978
Net cash used in investing activities	\$(48,782	) \$(9,821 )
Net cash used in financing activities	\$(23,080	) \$(83,474 )
Net cash provided by operating activities		

Cash provided by operating activities was \$60.8 million during the nine months ended December 31, 2013, compared to \$67.0 million of cash provided by operating activities during the nine months ended December 31, 2012. This \$6.2 million decrease was due in part to accounts receivable, which had a \$12.4 million unfavorable impact in the nine months ended December 31, 2013 as compared to the nine months ended December 31, 2012. Days sales outstanding of 61 days as of the end of the third quarter of fiscal year 2014 compared to 68 days at March 31, 2013 and 61 days at the end of the third quarter of fiscal year 2013. In addition, there was a \$6.9 million decrease in cash flows from inventories related to an increase in the inventory balance as of December 31, 2013. The decreases in cash flow from accounts receivable and inventories is related to increases in those balances to support increases in sales volume. There was a \$4.1 million decrease from accrued compensation and other expenses largely due to the timing of accruals and payments for incentive compensation as a result of an increase in the payout for fiscal year 2013 incentive compensation during the nine months ended December 31, 2013 as compared to the payout for the fiscal year 2012 incentive compensation during the nine months ended December 31, 2012, partially offset by an increase from accrued commissions. Additionally, there was a \$2.0 million decrease from deferred income taxes. These decreases were partially offset by a \$6.4 million increase from net income, a \$5.7 million increase from prepaid expenses and other assets, a \$3.4 million increase from deferred revenues, a \$2.7 million increase from share-based compensation and a \$1.9 million increase from accounts payable due to timing of payments.





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## Net cash used in investing activities

	Nine months ended December 31, (Dollars in Thousands)	
	2013	2012
Cash used in investing activities included the following:		
Purchase of marketable securities	\$(88,802	) \$(102,478
Proceeds from maturity of marketable securities	49,405	153,046
Purchase of fixed assets	(8,709	) (8,115
Purchase of intangible assets	(713	) (197
Decrease (increase) in deposits	37	(804
Acquisition of businesses, net of cash acquired	—	(51,273
	\$(48,782	) \$(9,821

Cash used in investing activities was up \$39.0 million to \$48.8 million during the nine months ended December 31, 2013, compared to \$9.8 million of cash used in investing activities in the nine months ended December 31, 2012.

Our investments in property and equipment consist primarily of computer equipment, demonstration units, office equipment and facility improvements. We plan to continue to invest in capital expenditures to support our infrastructure in our fourth quarter of fiscal year 2014.

Purchases of intangible assets increased by \$516 thousand during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012. During the three months ended December 31, 2013, the Company acquired certain rights to Accanto software for \$500 thousand not previously purchased as part of the acquisition transaction in fiscal year 2013.

The net inflow related to the purchase and sales of marketable securities during the nine months ended December 31, 2013 when compared to the nine months ended December 31, 2012 was driven by the impact of a change in investment mix and the sale of securities to repay our outstanding debt during the nine months ended December 31, 2012.

## Net cash used in financing activities

	Nine months ended December 31, (Dollars in Thousands)	
	2013	2012
Cash used in financing activities included the following:		
Issuance of common stock under stock plans	\$755	\$516
Payment of contingent consideration	(841	) (3,197
Treasury stock repurchases	(25,033	) (20,727
Repayment of long-term debt	0	(62,000
Excess tax benefit from share-based compensation awards	2,039	1,934
	\$(23,080	) \$(83,474

Cash used in financing activities was down \$60.4 million to \$23.1 million during the nine months ended December 31, 2013, compared to \$83.5 million of cash used in financing activities in the nine months ended December 31, 2012.

During the quarter ended December 31, 2012, we paid down our outstanding credit facility in the amount of \$62.0 million. As of the date of this filing there are no amounts outstanding under this credit facility.

During the nine months ended December 31, 2013 and 2012, we paid \$841 thousand and \$3.2 million, respectively, related to the contingent purchase consideration for the acquisition of Simena. For additional information with respect

to the contingent purchase consideration, see Note 12 in the Notes to the Consolidated Financial Statements of this Form 10-Q.

Our Board of Directors has periodically authorized us to repurchase shares of our common stock. We are currently authorized to repurchase up to four million shares with cash from operations. During the nine months ended December 31,

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2013 and 2012, we repurchased 750,407 and 749,499 shares at a cost of \$19.7 million and \$17.0 million, respectively, under this program. Future repurchases of shares will reduce our cash balances. In addition, during the nine months ended December 31, 2013 and 2012, we had 209,756 and 161,327 shares transferred to us from employees for tax withholding at a cost of \$5.3 million and \$3.7 million, respectively.

We generated \$2.0 million and \$1.9 million during the nine months ended December 31, 2013 and 2012, respectively, of the excess tax benefits from share-based compensation awards.

Credit Facility

On November 22, 2011, we entered into a new credit facility with a syndicate of lenders led by KeyBank National Association (KeyBank) which provides us with a \$250 million revolving credit facility, which may be increased to \$300 million at any time up to 90 days before maturity. The revolving credit facility includes a swing line loan sub-facility of up to \$10 million and a letter of credit sub-facility of up to \$10 million. The credit facility matures on November 21, 2016 and is secured by substantially all of our assets. At December 31, 2013, there were no amounts outstanding under the credit facility.

Expectations for Fiscal Year 2014

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 and capital expenditures for at least the next 12 months. In addition, we expect that cash provided by operating activities for our fiscal year 2014 will be in line with cash provided in our fiscal year 2013. Capital expenditures in our fiscal year 2014 are currently anticipated to be in line with previous years' trends.

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 acquisitions of Psytechnics on April 1, 2011, Replay on October 3, 2011, Simena on November 18, 2011, certain assets, technology and employees of Accanto on July 20, 2012 and ONPATH on October 31, 2012. 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

In March 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2013-05 Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (ASU 2013-05). ASU 2013-05 provides guidance on releasing cumulative translation adjustments when a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or a business within a foreign entity. ASU 2013-05 is effective on a prospective basis for fiscal years and interim reporting periods within those years, beginning after December 15, 2013 (the fourth quarter of fiscal year 2014 for us). Early adoption is permitted. This standard is not expected to have a material impact on our financial condition, results of operations, or cash flows.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

**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 and municipal obligations.

At December 31, 2013, we 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.

**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. We currently engage in foreign currency hedging activities in order to limit these exposures. We do not use derivative financial instruments for speculative trading purposes.

As of December 31, 2013, we had foreign currency forward contracts with notional amounts totaling \$15.7 million. The valuation of outstanding foreign currency forward contracts at December 31, 2013 resulted in an asset balance of \$367 thousand, reflecting favorable rates in comparison to current market rates and a liability balance of \$138 thousand, reflecting unfavorable contract rates in comparison to current market rates at this date. As of March 31, 2013, we had foreign currency forward contracts with notional amounts totaling \$17.1 million. The valuation of outstanding foreign currency forward contracts at March 31, 2013 resulted in a liability balance of \$249 thousand, reflecting unfavorable contract rates in comparison to current market rates at this date and an asset balance of \$71 thousand reflecting favorable rates in comparison to current market rates.

Item 4. Controls and Procedures

As of December 31, 2013, 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 (Exchange Act). Based upon that evaluation, our principal executive officer and principal financial officer concluded that, as of December 31, 2013, 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.

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## PART II: OTHER INFORMATION

## Item 1. Legal Proceedings

From time to time, NetScout is subject to legal proceedings and claims in the ordinary course of business. In the opinion of management, 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 condition, results of operations or cash flows.

In March 2012, NetScout uncovered and investigated, and in April 2012, disclosed to the U.S. Department of Justice and the California State Attorney General potential violations of federal and California state anti-trust laws. The potential violations involve a former employee and one or more third parties in connection with sales to state governmental agencies during fiscal year 2012. NetScout believes it did not benefit from any of the transactions uncovered and that the amounts involved are not believed to be material. The California State Attorney General is conducting an investigation into the matter. NetScout is cooperating fully and is providing all requested information. In general, the federal and state agencies have the authority to seek fines and other remedies for anti-trust violations; however, no charges or proceedings have been initiated by any governmental agency against NetScout and we have been informed by the Department of Justice that it does not intend to take any action against NetScout.

## 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, 2013. 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

The following table provides information about purchases we made during the quarter ended December 31, 2013 of equity securities that are registered by us pursuant to Section 12 of the Exchange Act:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs
10/1/2013 - 10/31/2013	85,681	\$ 28.51	64,400	703,900
11/1/2013 - 11/30/2013	162,091	29.18	159,725	544,175
12/1/2013 - 12/31/2013	51,031	29.61	50,875	493,300
Total	298,803	\$ 29.06	275,000	493,300

We purchased an aggregate of 23,803 shares transferred to us from employees in satisfaction of minimum tax (1)withholding obligations associated with the vesting of restricted stock units during the period. These purchases reflected in the table do not reduce the maximum number of shares that may be purchased under the plan.

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Item 6. Exhibits

(a) Exhibits

10.1	+	Form of Amended and Restated Indemnification Agreement between the Company and each director and executive officer.
31.1	+	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	+	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	++	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	++	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	**	XBRL Instance Document.
101.SCH	**	XBRL Taxonomy Extension Schema Document.
101.CAL	**	XBRL Taxonomy Extension Calculation Linkbase document.
101.DEF	**	XBRL Taxonomy Extension Definition Linkbase document.
101.LAB	**	XBRL Taxonomy Extension Label Linkbase document.
101.PRE	**	XBRL Taxonomy Extension Presentation Linkbase document.

+ Filed herewith.

++ Furnished herewith.

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NETSCOUT SYSTEMS, INC.

Date: January 28, 2014

/s/ Anil K. Singhal  
Anil K. Singhal  
President, Chief Executive Officer and Chairman  
(Principal Executive Officer)

Date: January 28, 2014

/s/ Jean Bua  
Jean Bua  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)  
(Principal Accounting Officer)



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101.LAB	** XBRL Taxonomy Extension Label Linkbase document.
101.PRE	** XBRL Taxonomy Extension Presentation Linkbase document.
+	Filed herewith.
++	Furnished herewith.
**	XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.