NETSCOUT SYSTEMS INC
Form 10-Q
November 05, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2015
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 000-26251

NETSCOUT SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

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

310 Littleton Road, Westford, MA 01886
(978) 614-4000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) YES x NO ¨

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

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

The number of shares outstanding of the registrant’s common stock, par value $0.001 per share, as of October 29, 2015 was 99,131,910.

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FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2015
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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)

	September 30, 2015 (Unaudited)	March 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$215,539	$104,893
Marketable securities	103,138	101,392
Accounts receivable and unbilled costs, net of allowance for doubtful accounts of $8,984 and $173 at September 30, 2015 and March 31, 2015, respectively	165,092	82,226
Inventories	71,066	12,130
Prepaid income taxes	40,694	1,393
Deferred income taxes	29,796	21,755
Prepaid expenses and other current assets (related party balances of $53,702 and $0, respectively)	72,218	13,495
Total current assets	697,543	337,284
Fixed assets, net	60,398	23,864
Goodwill	1,702,705	197,445
Intangible assets, net	1,102,717	50,180
Deferred income taxes	412	—
Long-term marketable securities	32,708	58,572
Other assets	7,588	1,704
Total assets	$3,604,071	$669,049
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable (related party balances of $7,513 and $0, respectively)	$37,425	$13,077
Accrued compensation	73,482	36,553
Accrued other	27,660	14,474
Income taxes payable	—	107
Deferred tax liability	2,252	—
Deferred revenue and customer deposits	233,405	123,422
Total current liabilities	374,224	187,633
Other long-term liabilities	5,445	1,995
Deferred tax liability	328,010	10,639
Accrued long-term retirement benefits	28,988	1,587
Long-term deferred revenue and customer deposits	39,224	26,961
Long-term debt	250,000	—
Contingent liabilities, net of current portion	4,560	4,484
Total liabilities	1,030,451	233,299
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock, $0.001 par value:		
5,000,000 shares authorized; no shares issued or outstanding at September 30, 2015 and March 31, 2015	—	—

Common stock, $0.001 par value: 150,000,000 shares authorized; 113,858,772 and 50,812,548 shares issued and 99,131,910 and 40,807,805 shares outstanding at September 30, 2015 and March 31, 2015, respectively	114	51
Additional paid-in capital	2,619,418	298,101
Accumulated other comprehensive loss	(2,914)	(4,645)
Treasury stock at cost, 14,726,862 and 10,004,743 shares at September 30, 2015 and March 31, 2015, respectively	(354,511)	(169,516)
Retained earnings	311,513	311,759
Total stockholders' equity	2,573,620	435,750
Total liabilities and stockholders' equity	$3,604,071	$669,049

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 September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Revenue:				
Product	$174,899	$57,953	$228,492	$122,319
Service	86,211	45,646	133,361	89,132
Total revenue	261,110	103,599	361,853	211,451
Cost of revenue:				
Product (related party balances of $7,728, $0, $7,728 and $0, respectively)	75,421	12,939	87,919	26,705
Service (related party balances of $2,492, $0, $2,492 and $0, respectively)	24,766	8,656	33,564	17,486
Total cost of revenue	100,187	21,595	121,483	44,191
Gross profit	160,923	82,004	240,370	167,260
Operating expenses:				
Research and development (related party balances of $10,814, $0, $10,814 and $0, respectively)	65,896	19,241	83,954	38,008
Sales and marketing (related party balances of $9,078, $0, $9,078 and $0, respectively)	79,153	32,196	117,245	69,468
General and administrative (related party balances of $7,063, $0, $7,063 and $0, respectively)	41,301	11,067	51,400	19,820
Amortization of acquired intangible assets	9,843	856	10,652	1,718
Total operating expenses	196,193	63,360	263,251	129,014
Income (loss) from operations	(35,270)	18,644	(22,881)	38,246
Interest and other income (expense), net:				
Interest income	172	98	330	202
Interest expense	(1,786)	(196)	(1,978)	(390)
Other income (expense), net (related party balances of $383, $0, $383 and $0, respectively)	786	(445)	674	(486)
Total interest and other expense, net	(828)	(543)	(974)	(674)
Income (loss) before income tax expense (benefit)	(36,098)	18,101	(23,855)	37,572
Income tax expense (benefit)	(28,183)	6,868	(23,609)	14,863
Net income (loss)	$(7,915)	$11,233	$(246)	$22,709
Basic net income (loss) per share	$(0.09)	$0.27	$0.00	$0.55
Diluted net income (loss) per share	$(0.09)	$0.27	$0.00	$0.54
Weighted average common shares outstanding used in computing:				
Net income per share - basic	91,410	41,060	66,232	41,071
Net income per share - diluted	91,410	41,652	66,232	41,732

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

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NetScout Systems, Inc.
Consolidated Statements of Comprehensive Income (Loss)
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Net income (loss)	$(7,915)	$11,233	$(246)	$22,709
Other comprehensive income:				
Cumulative translation adjustments	(124)	(1,675)	853	(2,107)
Changes in market value of investments:				
Changes in unrealized (losses) gains	117	(23)	58	21
Total net change in market value of investments	117	(23)	58	21
Changes in market value of derivatives:				
Changes in market value of derivatives, net of benefits of ($187), ($360), ($204) and ($272)	(340)	(603)	(313)	(467)
Reclassification adjustment for net gains (losses) included in net income, net of taxes (benefits) of $177, $51, $657 and ($14)	291	81	1,133	(23)
Total net change in market value of derivatives	(49)	(522)	820	(490)
Other comprehensive income (loss)	(56)	(2,220)	1,731	(2,576)
Total comprehensive income (loss)	$(7,971)	$9,013	$1,485	$20,133

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

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NetScout Systems, Inc.
Consolidated Statements of Stockholders' Equity
(In thousands, except share data)
(Unaudited)

	Common stock		Additional Paid In Capital	Accumulated Other Comprehensive Income (Loss)	Treasury stock		Retained Earnings	Total Stockholders' Equity
	Shares	Par Value			Shares	Stated Value		
Balance, March 31, 2014	49,922,959	$50	$273,574	$2,772	8,757,175	$(117,802)	$250,567	$409,161
Net income							22,709	22,709
Unrealized net investment gains				21				21
Unrealized net gains on derivative financial instruments				(490)				(490)
Cumulative translation adjustments				(2,107)				(2,107)
Issuance of common stock pursuant to exercise of options	11,850	—	66					66
Issuance of common stock pursuant to vesting of restricted stock units	670,521	1						1
Stock-based compensation expense for restricted stock units granted to employees			7,362					7,362
Issuance of common stock under employee stock purchase plan	59,897		2,760					2,760
Repurchase of treasury stock					726,526	(30,894)		(30,894)
Tax benefits of disqualifying dispositions of incentive stock options			4,033					4,033
Balance, September 30, 2014	50,665,227	$51	$287,795	$196	9,483,701	$(148,696)	$273,276	$412,622

	Common stock	Additional Paid In	Accumulated Other	Treasury stock	Retained Earnings	Total Stockholders'

	Shares	Par Value	Capital	Comprehensive Income (Loss)	Shares	Stated Value		Equity
Balance, March 31, 2015	50,812,548	$51	$298,101	$(4,645)	10,004,743	$(169,516)	$311,759	$435,750
Net income (loss)							(246)	(246)
Unrealized net investment gains				58				58
Unrealized net gains on derivative financial instruments				820				820
Cumulative translation adjustments				853				853
Issuance of common stock pursuant to vesting of restricted stock units	463,744	1						1
Stock-based compensation expense for restricted stock units granted to employees			11,041					11,041
Issuance of common stock under employee stock purchase plan	82,836	—	3,028					3,028
Repurchase of treasury stock					4,722,119	(184,995)		(184,995)
Issuance of shares related to the acquisition of the Communications Business of Danaher	62,499,644	62	2,305,549					2,305,611
Tax benefits of disqualifying dispositions of incentive stock options			1,699					1,699
Balance, September 30, 2015	113,858,772	$114	$2,619,418	$(2,914)	14,726,862	$(354,511)	$311,513	$2,573,620

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

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

	Six Months Ended September 30, 2015	2014
Cash flows from operating activities:		
Net income (loss)	$(246)	$22,709
Adjustments to reconcile net income (loss) to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	51,797	9,753
Loss on disposal of fixed assets	222	—
Deal related compensation expense and accretion charges	6,652	76
Share-based compensation expense associated with equity awards	12,098	7,797
Net change in fair value of contingent and contractual liabilities	—	(9)
Deferred income taxes	4,166	1,760
Other losses	61	85
Changes in assets and liabilities		
Accounts receivable	52,695	10,684
Due from related party	(28,878)	—
Inventories	7,168	(2,871)
Prepaid expenses and other assets	(36,751)	(3,367)
Accounts payable	(5,012)	(1,226)
Accrued compensation and other expenses	11,855	672
Due to related party	7,513	—
Income taxes payable	(107)	(791)
Deferred revenue	(76,290)	(16,282)
Net cash provided by operating activities	6,943	28,990
Cash flows from investing activities:		
Purchase of marketable securities	(41,544)	(57,790)
Proceeds from maturity of marketable securities	65,720	36,204
Purchase of fixed assets	(9,113)	(4,016)
Purchase of intangible assets	(152)	(92)
(Increase) decrease in deposits	(1)	101
Acquisition of businesses, net of cash acquired	27,748	—
Net cash provided by (used in) investing activities	42,658	(25,593)
Cash flows from financing activities:		
Issuance of common stock under stock plans	1	67
Treasury stock repurchases	(184,995)	(30,894)
Proceeds from issuance of long-term debt, net of issuance costs	244,623	—
Excess tax benefit from share-based compensation awards	1,699	4,033
Net cash provided by (used in) financing activities	61,328	(26,794)
Effect of exchange rate changes on cash and cash equivalents	(283)	307
Net increase (decrease) in cash and cash equivalents	110,646	(23,090)
Cash and cash equivalents, beginning of period	104,893	102,076
Cash and cash equivalents, end of period	$215,539	$78,986
Supplemental disclosures:		
Non-cash transactions:		

Transfers of inventory to fixed assets	$1,688	$940
Additions to property, plant and equipment included in accounts payable	$31	$120
Debt issuance costs settled through the issuance of additional debt	$5,377	$—
Gross decrease in contractual liability relating to fair value adjustment	$—	$(49)
Gross increase in contingent consideration liability relating to fair value adjustment	$—	$40
Issuance of common stock under employee stock plans	$3,028	$2,760
Purchase consideration	$2,279,910	$—
Contingently returnable consideration	$25,701	$—

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. All significant intercompany accounts and transactions are eliminated in consolidation.

The accompanying unaudited interim consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. On July 14, 2015, we completed the acquisition of the Communications Business (the Communications Business) of Danaher Corporation (Danaher) which is more fully described in Note 7 below. This transaction was recorded using the purchase method of accounting; accordingly, the financial results of the acquisition are included in the accompanying unaudited consolidated financial statements for the periods subsequent to the acquisition.

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, 2015.

Fiscal Year End

NetScout's fiscal year ends on March 31st and the quarters end on the last calendar day of the months of June, September and December. The entities acquired as part of the Communications Business acquisition follow a 52/53 fiscal reporting calendar except for the third quarter, which ends on December 31st. The remaining fiscal periods end on every thirteenth Friday, except for its first fiscal quarter which may end on the fourteenth Friday following December 31st. The acquired entities Fiscal 2016 year will end on April 1, 2016. The Company does not adjust for the difference in fiscal periods between the acquired entities and itself, as such difference would be less than 93 days, pursuant to Regulation S-X Rule 3A-02. References herein to Fiscal 2016, 2015 and 2014 refer to the fiscal years ended March 31, 2016, 2015 and 2014, respectively.

Recent Accounting Pronouncements

In August 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2015-15,"Interest-Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-Of-Credit Arrangements and Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting" (ASU 2015-15). The guidance in the previously issued ASU 2015-03, "Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs" does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The Company adopted this standard in the second quarter of Fiscal 2016 as early adoption was permitted.

In September 2015, the FASB issued Accounting Standards Update No. 2015-16, Simplifying the Accounting for Measurement-Period Adjustments, (ASU 2015-16), which eliminates the requirement to restate prior financial statements for measurement period adjustments. The new guidance requires that the cumulative impact of a measurement period adjustment be recognized in the reporting period in which the adjustment is identified. The Company adopted this standard in the second quarter of Fiscal 2016 as early adoption was permitted.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: Topic 606 (ASU 2014-09), to supersede nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing U.S. GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. This ASU will be effective for the Company in the first quarter of its fiscal year 2019. Early adoption is not permitted. This ASU allows for either full retrospective or modified retrospective adoption. The Company is currently evaluating the impact of its pending adoption of ASU 2014-09 on its consolidated financial statements.

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. The Company's cash, cash equivalents, and marketable securities are placed with financial institutions with high credit standings.

At September 30, 2015, one direct customer accounted for more than 10% of the accounts receivable balance, while no indirect channel partners accounted for more than 10% of the accounts receivable balance. At March 31, 2015, one direct customer accounted for more than 10% of the accounts receivable balance, while no indirect channel partner accounted for more than 10% of the accounts receivable balance.

During the three and six months ended September 30, 2015, one direct customer accounted for more than 10% of the Company's total revenue, while no indirect channel partner accounted for more than 10% of total revenue. During the three months ended September 30, 2014, no direct customer or indirect channel partner accounted for more than 10% of the Company's total revenue. During the six months ended September 30, 2014, two direct customers each accounted for more than 10% of the Company's total revenue, while no indirect channel partner accounted for more than 10% of total revenue.

As disclosed parenthetically within the financial statements, the Company has a receivable from Danaher in the amount of $53.7 million that represents a concentration of credit risk at September 30, 2015.

Historically, the Company has not experienced any significant failure of its customers to meet their payment obligations nor does the Company anticipate material non-performance by its customers in the future; accordingly, the Company does not require collateral from its customers. However, if the Company’s assumptions are incorrect, there could be an adverse impact on its allowance for doubtful accounts.

NOTE 3 – SHARE-BASED COMPENSATION

The following is a summary of share-based compensation expense including restricted stock units and employee stock purchases made under the Company's 2011 Employee Stock Purchase Plan (ESPP) based on estimated fair values within the applicable cost and expense lines identified below (in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Cost of product revenue	$167	$93	$269	$153
Cost of service revenue	754	314	1,127	542
Research and development	2,572	1,490	4,062	2,516
Sales and marketing	2,240	1,235	3,643	2,198
General and administrative	1,770	1,363	2,997	2,388
	$7,503	$4,495	$12,098	$7,797

Employee Stock Purchase Plan – The Company maintains the ESPP for all eligible employees as described in the Company’s Annual Report on Form 10-K for the year ended March 31, 2015. 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 1st through August 31st and from September 1st through February 28th of each year. During the six months ended September 30, 2015, employees purchased 82,836 shares under the ESPP and the value per share was $36.55.

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 September 30, 2015 and March 31, 2015.

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Marketable Securities

The following is a summary of marketable securities held by NetScout at September 30, 2015, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains	Fair Value
Type of security:			
U.S. government and municipal obligations	$93,507	$25	$93,532
Commercial paper	2,990	—	2,990
Corporate bonds	6,614	2	6,616
Total short-term marketable securities	103,111	27	103,138
U.S. government and municipal obligations	32,664	44	32,708
Total long-term marketable securities	32,664	44	32,708
Total marketable securities	$135,775	$71	$135,846

The following is a summary of marketable securities held by NetScout at March 31, 2015, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains (Losses)	Fair Value
Type of security:			
U.S. government and municipal obligations	$88,651	$3	$88,654
Commercial paper	5,093	2	5,095
Corporate bonds	7,644	(1)	7,643
Total short-term marketable securities	101,388	4	101,392
U.S. government and municipal obligations	56,683	8	56,691
Corporate bonds	1,880	1	1,881
Total long-term marketable securities	58,563	9	58,572
Total marketable securities	$159,951	$13	$159,964

Contractual maturities of the Company’s marketable securities held at September 30, 2015 and March 31, 2015 were as follows (in thousands):

	September 30, 2015	March 31, 2015
Available-for-sale securities:		
Due in 1 year or less	$103,138	$101,392
Due after 1 year through 5 years	32,708	58,572
	$135,846	$159,964

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 at September 30, 2015 and March 31, 2015 (in thousands):

	Fair Value Measurements at September 30, 2015			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$215,539	$—	$—	$215,539
U.S. government and municipal obligations	34,084	92,156	—	126,240
Commercial paper	—	2,990	—	2,990
Corporate bonds	6,616	—	—	6,616
Derivative financial instruments	—	34	—	34
Contingently returnable consideration	$—	$—	$19,125	$19,125
	$256,239	$95,180	$19,125	$370,544
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(4,560)	$(4,560)
Derivative financial instruments	—	(416)	—	(416)
	$—	$(416)	$(4,560)	$(4,976)

	Fair Value Measurements at March 31, 2015			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$104,893	$—	$—	$104,893
U.S. government and municipal obligations	46,564	98,781	—	145,345
Commercial paper	—	5,095	—	5,095
Corporate bonds	9,524	—	—	9,524
Derivative financial instruments	—	15	—	15
	$160,981	$103,891	$—	$264,872
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(4,484)	$(4,484)
Derivative financial instruments	—	(1,664)	—	(1,664)
	$—	$(1,664)	$(4,484)	$(6,148)

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. The Company classifies municipal obligations as level 2 because the fair values are determined using quoted prices from markets the Company considers to be inactive. Commercial paper is 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 Level 3 asset and liability consist of contingently returnable consideration and contingent purchase consideration, respectively. The Company's contingently returnable consideration represents a contingent right of return from Danaher to reimburse NetScout for cash awards to be paid by NetScout to employees of the Communications Business for post-combination services on various dates through August 4, 2016 as part of the acquisition of the Communications Business. The contingently returnable consideration is classified as Level 3 because the fair value of the asset was determined using

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assumptions developed by management in determining the estimated cash award expected to be paid on August 4, 2016 after applying an assumed forfeiture rate. The contingently returnable consideration of $19.1 million, net of taxes as of September 30, 2015 is included as prepaid expenses and other current assets in Company’s consolidated balance sheet. For additional information, see Note 7 of the Company's Notes to Consolidated Financial Statements.
The following table sets forth a reconciliation of changes in the fair value of the Company’s Level 3 financial assets and liabilities for the six months ended September 30, 2015 (in thousands):

	Contingent Purchase Consideration	Contingently Returnable Consideration
Balance at beginning of period	$(4,484)	$—
Increase in fair value and accretion expense (included within research and development expense)	(76)	
Contingently returnable consideration		19,125
Balance at end of period	$(4,560)	$19,125

Deal related compensation expense and accretion charges related to the contingent consideration for the six months ended September 30, 2015 was $76 thousand and was included as part of earnings.

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):

	September 30, 2015	March 31, 2015
Raw materials	$18,868	$6,134
Work in process	1,551	17
Finished goods	50,647	5,979
	$71,066	$12,130

The Company reviews the components of its inventory on a periodic basis for excess, obsolete or impaired inventory, and records a reserve for such identified items. The inventory reserve was $16.9 million and $4.1 million at September 30, 2015 and March 31, 2015, respectively.

NOTE 7 - ACQUISITIONS

On July 14, 2015 (Closing Date), the Company completed the acquisition of the Communications Business, which included certain assets, liabilities, technology and employees within Tektronix Communications, VSS Monitoring, Arbor Networks and certain portions of the Fluke Networks Enterprise business, which excluded Danaher's data communications cable installation business and its communication service provider business. The acquisition was structured as a Reverse Morris Trust transaction (the Transaction) whereby Danaher Corporation contributed its Communications Business to a new subsidiary, Potomac Holding LLC (Newco). The total equity consideration was $2.3 billion based on issuing approximately 62.5 million new shares of NetScout common stock to the existing common unit holders of Potomac Holding LLC (Newco), based on the July 13, 2015 NetScout common stock closing share price of $36.89 per share.

The Transaction is being accounted for under the acquisition method of accounting with the operations of the Communications Business included in the Company’s operating results from the date of acquisition. The acquisition method of accounting requires, among other things, that assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The preliminary determination of the fair value of assets acquired and liabilities assumed has been recognized based on management's estimates and assumptions using the information about facts and circumstances that existed at the acquisition date.

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. Fair value estimates are based on a complex series of judgments about future events and uncertainties and rely heavily on estimates and assumptions. The judgments used to determine the estimated fair value assigned to each class of assets acquired and

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liabilities assumed, as well as asset lives, can materially impact the Company's results of operations. The finalization of the purchase accounting assessment will result in a change in the valuation of assets acquired and liabilities assumed and may have a material impact on the Company's results of operations and financial position. As a result, during the measurement 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 to reflect additional information received about facts and circumstances which existed at the date of acquisition. 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 size and breadth of the Transaction will necessitate the use of this measurement period to adequately analyze and assess a number of the factors used in establishing the fair value of certain tangible and intangible assets acquired and liabilities assumed as of the acquisition date and the related tax impacts of any changes made. Any potential adjustments made could be material in relation to the preliminary values presented below.   In connection with the Transaction, under the Employee Matters Agreement dated July 14, 2015 by and among the Company, Danaher and Newco, Danaher will fund certain contracts under which employees will provide post-combination services to the Company.

1) For any outstanding Danaher restricted stock units or stock options held by employees of the Communications Business transferred to Newco (Newco Employees) that vested from July 14, 2015 through August 4, 2015, the awards continued to vest in Danaher shares. These awards met the definition of a derivative under ASC 815 and as such, the Company determined the fair value of these awards on July 14, 2015 and recorded them separate from the business combination as prepaid compensation. The derivative was amortized into compensation expense through August 4, 2015, the post combination requisite settlement date. The total amount of compensation expense for post combination services recorded for the three and six months ended September 30, 2015 was $6.5 million.

2) All outstanding Danaher restricted stock units or stock options held by Newco Employees that were due to vest after August 4, 2015 were cancelled and replaced by NetScout with a cash retention award equal to one half of the value of the employee's cancelled Danaher equity award and up to $15 million of restricted stock units relating to shares of NetScout common stock equal to the remaining one half of the value of the employee's cancelled Danaher equity award. The restricted stock units issued are considered new share-based payment awards granted by NetScout to the former employees of Danaher. NetScout accounted for these new awards separately from the business combination. The Company recognized share-based compensation net of an estimated forfeiture rate and only recognized compensation cost for those shares expected to vest on a straight-line basis over the requisite service period of the award. The cash retention award will become payable on the August 4, 2016, subject to the employee's continued employment with NetScout through the applicable vesting date of August 4, 2016. Danaher will reimburse NetScout for the amount of the cash retention payments (net of any applicable employment taxes and deductions). The cash retention award liability will be accounted for separately from the business combination as the cash retention award is automatically forfeited upon termination of employment. NetScout will record the cash retention award liability over the period it is earned as compensation expense for post combination services. The reimbursement by Danaher to NetScout of the estimated cash retention award payment represents contingently returnable consideration, which will be accounted for separately from the business combination on the date of the acquisition. At September 30, 2015, the Company has recorded a receivable from Danaher in the amount of $8.4 million, net of tax and is included as prepaid expenses and other current assets in Company's consolidated balance sheet. At September 30, 2015, the Company has recorded a cash retention award liability of $2.6 million and is included as accrued compensation in Company's consolidated balance sheet. For the three and six months ended September 30, 2015, $2.6 million has been recorded as compensation expense for post combination services.

3) Newco Employees that were entitled to receive an incentive bonus under the Danaher annual bonus plan will receive a cash incentive bonus payment subject to the employee's continued employment with NetScout through December 31, 2015. The cash incentive bonus liability will be accounted for separately from the business combination as the cash incentive bonus is automatically forfeited upon termination of employment. NetScout will

record the liability over the period it is earned as compensation expense for post combination services. The payment of the cash retention award will be reimbursed by Danaher to NetScout, which will be accounted for separately from the business combination on the date of the acquisition. At September 30, 2015, the Company has recorded a receivable due from Danaher in the amount of $5.8 million, net of tax and is included as prepaid expenses and other current assets in Company's consolidated balance sheet. At September 30, 2015, the Company has recorded a cash incentive bonus liability of $4.1 million and is included as accrued compensation in the Company's consolidated balance sheet. For the three and six months ended September 30, 2015, $4.1 million has been recorded as compensation expense for post combination services.

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4) Certain Newco Employees will receive cash retention payments subject to the employee's continued employment with NetScout through October 16, 2015, ninety (90) days after the close of the acquisition. The cash retention payment liability will be accounted for separately from the business combination as the cash retention payment is automatically forfeited upon termination of employment. NetScout will record the liability over the period it is earned as compensation expense for post combination services. The payment of the cash retention award will be reimbursed by Danaher to NetScout, which will be accounted for separately from the business combination on the date of the acquisition. At September 30, 2015, the Company has recorded a receivable due from Danaher in the amount of $5.0 million, net of tax and is included as prepaid expenses and other current assets in Company's consolidated balance sheet. At September 30, 2015, the Company has recorded a cash retention payment liability of $6.7 million and is included as accrued compensation in Company's consolidated balance sheet. For the three and six months ended September 30, 2015, $6.7 million has been recorded as compensation expense for post combination services.

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

Purchase Price allocation:		
Total equity consideration	$2,305,611	(1)
Less: Equity consideration for replacement awards	(25,701	)(2)
Less: Delayed close entities	(5,700	)(3)
Estimated Purchase Price	2,274,210	
Estimated fair value of assets acquired and liabilities assumed:		
Cash	27,748	
Accounts receivable	135,322	
Inventories	80,320	
Prepaid expenses and other assets	7,220	
Property, plant and equipment	36,539	
Deferred income taxes	13,067	
Intangible assets	1,080,700	
Other assets	897	
Accounts payable	(21,819	)
Accrued compensation	(27,861	)
Accrued other	(13,977	)
Deferred revenue	(198,265	)
Other long-term liabilities	(3,572	)
Accrued retirement benefits	(26,758	)
Deferred tax liabilities	(319,612	)
Goodwill	$1,504,261	

(1) Represents approximately 62.5 million new shares (plus cash in lieu of fractional shares) of NetScout common stock issued to the existing common unit holders of Newco based on the July 13, 2015 NetScout common stock closing share price of $36.89 per share.

(2) Represents the value of certain outstanding Danaher equity awards held by Newco Employees for which continuing employees will receive value after the Closing Date. A portion of this amount relates to awards that will continue to vest in Danaher shares after the Closing Date. These future compensation amounts will be settled in shares other than shares of the acquired business. The balance of this amount also represents future compensation expense and relates to a cash award to be paid by NetScout to acquired Newco employees on August 4, 2016. The cash payment by NetScout will be reimbursed by Danaher. These items are further described in the Employee Matters Agreement dated July 14, 2015 by and among NetScout

Systems, Inc., Danaher Corporation and Potomac Holding LLC and have been accounted for separately from the Communications Business Acquisition.

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(3) Represents the fair value attributable to the foreign entities that the Company did not obtain control over on July 14, 2015 due to regulatory and other compliance requirements. The Company expects to gain control over these entities in the next twelve months.

The Transaction is expected to extend the Company's reach into growth-oriented adjacent markets, including cyber security, with a broader range of market-leading products and capabilities, strengthen the Company's go-to-market resources to better support a larger, more diverse and more global customer base, and increase scale and elevate the Company's strategic position within key accounts. Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill of $1.5 billion from the acquisition will be included within the following operating segments: $534.7 million in Arbor Networks, $792.9 million in Tektronix Communications, $57.0 million in VSS, and $119.7 million in FNET. All reporting units resulting from the Transaction will be included in the Company's annual goodwill impairment review.

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

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

	Fair Value	Useful Life (Years)
Developed technology	$221,900	9 - 13
Customer relationships	794,100	13 - 18
Backlog	18,200	1 - 3
Definite lived trademark and tradenames	43,900	3 - 9
Leasehold interest	2,600	4 - 6
	$1,080,700	

The weighted average useful life of identifiable intangible assets acquired in the transaction is 14.7 years. Developed technology is amortized using an accelerated amortization method and has a weighted average useful life of 11.7 years. Customer relationships are amortized using an accelerated amortization method and have a weighted average useful life of 16.3 years. Backlog is amortized using an accelerated amortization method and has a weighted average useful life of 2.0 years. Trademarks and tradenames are amortized using an accelerated amortization method and has a weighted average useful life of 8.5 years. Leasehold interests are amortized on a straight-line basis and has a weighted average useful life of 5.6 years.

The Company incurred approximately $17.9 million of acquisition-related costs related to the transaction which are included in general and administrative expense during the six months ended September 30, 2015.

During the six months ended September 30, 2015, the Company has recorded $168.8 million of revenue and a net loss of $19.5 million directly attributable to the Transaction within its consolidated financial statements.

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The following table presents unaudited pro forma results of the historical Consolidated Statements of Operations of the Company and the Communications Business of Danaher for the three and six months ended September 30, 2015 and 2014, giving effect to the mergers as if they occurred on April 1, 2014 (in thousands, except per share data):

	Three Months Ended September 30, (unaudited)		Six Months Ended September 30, (unaudited)	
	2015	2014	2015	2014
Pro forma revenue	$267,754	$268,897	$538,060	$559,009
Pro forma net income (loss)	$(11,773)	$(18,019)	$(30,683)	$(21,969)
Pro forma income (loss) per share:				
Basic	$(0.12)	$(0.17)	$(0.30)	$(0.21)
Diluted	$(0.12)	$(0.17)	$(0.30)	$(0.21)
Pro forma shares outstanding				
Basic	100,242	103,560	101,750	103,570
Diluted	100,242	103,560	101,750	103,570

The pro forma results for the three and six months ended September 30, 2015 and 2014 primarily include adjustments for amortization of intangibles. This pro forma information does not purport to indicate the results that would have actually been obtained had the acquisitions been completed on the assumed date, or which may be realized in the future.

NOTE 8 – GOODWILL AND INTANGIBLE ASSETS

Goodwill

The Company has five operating segments: (1) legacy NetScout, (2) Arbor Networks, (3) Tektronix Communications, (4) VSS and (5) FNET. At September 30, 2015 and March 31, 2015, goodwill attributable to the legacy NetScout reporting unit was $198.0 million and $197.4 million, respectively. Goodwill attributable to the newly acquired Arbor Networks, Tektronix Communications, VSS and FNET operating segments were $534.7 million, $793.3 million, $57.0 million, and $119.7 million, 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 change in the carrying amount of goodwill for the six months ended September 30, 2015 is due to the acquisition of the Communications Business of Danaher, 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 six months ended September 30, 2015 are as follows (in thousands):

Balance at March 31, 2015	$197,445
Goodwill acquired during period	1,504,261
Foreign currency translation impact for the six months ended September 30, 2015	999
Balance at September 30, 2015	$1,702,705

Intangible Assets

The net carrying amounts of intangible assets were $1.1 billion and $50.2 million at September 30, 2015 and March 31, 2015, 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.

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Intangible assets include the indefinite lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets at September 30, 2015 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	$252,869	$(40,682)	$212,187
Customer relationships	832,628	(25,034)	807,594
Distributor relationships	1,626	(1,626)	—
Definite lived trademark and trade name	43,900	(1,655)	42,245
Core technology	7,162	(4,167)	2,995
Net beneficial leases	336	(336)	—
Non-compete agreements	287	(287)	—
Leasehold interest	2,600	(125)	2,475
Backlog	18,200	(2,028)	16,172
Other	1,095	(646)	449
	$1,160,703	$(76,586)	$1,084,117

Intangible assets include the indefinite lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets at March 31, 2015 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	$30,865	$(25,561)	$5,304
Customer relationships	38,498	(16,935)	21,563
Distributor relationships	1,585	(711)	874
Core technology	7,118	(3,660)	3,458
Non-compete agreements	280	(280)	—
Other	943	(562)	381
	$79,289	$(47,709)	$31,580

Amortization of software and core technology included as cost of product revenue was $14.8 million and $15.6 million for the three and six months ended September 30, 2015, respectively. Amortization of other intangible assets included as operating expense was $9.8 million and $10.7 million for the three and six months ended September 30, 2015, respectively.

Amortization of software and core technology included as cost of product revenue was $923 thousand and $1.9 million for the three and six months ended September 30, 2014, respectively. Amortization of other intangible assets included as operating expense was $856 thousand and $1.7 million for the three and six months ended September 30, 2014, respectively.

The following is the expected future amortization expense at September 30, 2015 for the years ending March 31 (in thousands):

2016 (remaining six months)	$55,306
2017	123,195
2018	109,157
2019	103,629
2020	96,114
Thereafter	596,716
	$1,084,117

The weighted average amortization period of developed technology and core technology is 11.5 years. The weighted average amortization period for customer and distributor relationships is 16.1 years. The weighted average amortization period for trademarks and tradenames is 8.5 years. The weighted average amortization period for leasehold interests is 5.6 years. The weighted average amortization period for backlog is 2.0 years.

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The weighted average amortization period for amortizing all intangible assets is 14.6 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.

The notional amounts and fair values of derivative instruments in the consolidated balance sheets at September 30, 2015 and March 31, 2015 were as follows (in thousands):

	Notional Amounts (a)		Prepaid Expenses and Other Current Assets		Accrued Other	
	September 30, 2015	March 31, 2015	September 30, 2015	March 31, 2015	September 30, 2015	March 31, 2015
Derivatives Designated as Hedging Instruments:						
Forward contracts	$19,159	$20,203	$34	$15	$416	$1,664

(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 September 30, 2015 and 2014 (in thousands):

Derivatives in Cash Flow Hedging Relationships	Effective Portion Gain (Loss) Recognized in OCI on Derivative (a)		Gain (Loss) Reclassified from Accumulated OCI into Income (b)			Ineffective Portion Gain (Loss) Recognized in Income (Amount Excluded from Effectiveness Testing) (c)		
	September 30, 2015	September 30, 2014	Location	September 30, 2015	September 30, 2014	Location	September 30, 2015	September 30, 2014
Forward contracts	$(527)	$ (963)	Research and development	$ 38	$ 11	Research and development	$ 29	$ 38
			Sales and marketing	430	(143)	Sales and marketing	(7)	12
	$(527)	$ (963)		$ 468	$ (132)		$ 22	$ 50

(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 July 14, 2015, the Company entered into a certain credit facility with a syndicate of lenders pursuant to a Credit Agreement (Credit Agreement), dated as of July 14, 2015, by and among: the Company; JPMorgan Chase Bank, N.A. (JPMorgan), as administrative agent and collateral agent; J.P. Morgan Securities LLC, KeyBanc Capital Markets, Merrill Lynch, Pierce, Fenner & Smith Incorporated, RBC Capital Markets and Wells Fargo Securities, LLC, as joint lead arrangers and joint bookrunners; Santander Bank, N.A., SunTrust Bank, N.A. and U.S. Bank National

Association, as co-documentation agents; and the lenders party thereto. The Credit Agreement provides for a five-year $800,000,000 senior secured revolving credit facility, including a letter of credit sub-facility of up to $50,000,000. The Company may elect to use the new credit facility for working capital purposes or repurchase of up to 20 million shares of common stock under the Company's common

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stock repurchase plan. The commitments under the Credit Agreement will expire on July 14, 2020, and any outstanding loans will be due on that date.

Subsequent to entering into the Credit Agreement, the Company drew down $250 million to support general working capital requirements as well as to help finance the repurchase of the Company's common stock under its authorized 20 million share common stock repurchase plan. At September 30, 2015, $250 million was outstanding under this credit facility.

At the Company’s election, revolving loans under the Credit Agreement bear interest at either (a) a Alternate Base Rate per annum equal to the greatest of (1) JPMorgan’s prime rate, (2) 0.50% in excess of the Federal Funds effective rate, or (3) an adjusted LIBO rate plus 1%; or (b) such adjusted LIBO rate (for the interest period selected by the Company), in each case plus an applicable margin. For the initial period until the Company has delivered financial statements for the quarter ended March 31, 2016, the applicable margin will be 1.75% per annum for LIBOR loans and 0.75% per annum for Alternate Base Rate loans, and thereafter the applicable margin will vary depending on the Company’s leverage ratio, ranging from 1.00% per annum for Base Rate loans and 2.00% per annum for LIBOR loans if the Company’s consolidated leverage ratio is greater than 2.50 to 1.00, down to 0.25% per annum for Alternate Base Rate loans and 1.25% per annum for LIBOR loans if the Company’s consolidated leverage ratio is equal to or less than 1.00 to 1.00.

The Company’s consolidated leverage ratio is the ratio of its total funded debt compared to its consolidated adjusted EBITDA. Consolidated adjusted EBITDA includes certain adjustments, including, without limitation, adjustments relating to extraordinary, unusual or non-recurring charges, certain restructuring charges, non-cash charges, certain transaction costs and expenses and certain pro forma adjustments in connection with material acquisitions and dispositions, all as set forth in detail in the definition of Consolidated EBITDA in the Credit Agreement.

Commitment fees will accrue on the daily unused amount of the credit facility. For the initial period until the Company has delivered financial statements for the quarter ended March 31, 2016, the commitment fee will be 0.30% per annum, and thereafter the commitment fee will vary depending on the Company’s consolidated leverage ratio, ranging from 0.35% per annum if the Company’s consolidated leverage ratio is greater than 2.50 to 1.00, down to 0.20% per annum if the Company’s consolidated leverage ratio is equal to or less than 1.00 to 1.00.

Letter of credit participation fees are payable to each lender on the amount of such lender’s letter of credit exposure, during the period from the closing date of the Credit Agreement to but excluding the date which is the later of (i) the date on which such lender’s commitment terminates or (ii) the date on which such lender ceases to have any letter of credit exposure, at a rate per annum equal to the applicable margin for LIBOR loans. Additionally, the Company will pay a fronting fee to each issuing bank in amounts to be agreed to between the Company and the applicable issuing bank.

Interest on Alternate Base Rate loans is payable at the end of each calendar quarter. Interest on LIBOR loans is payable at the end of each interest rate period or at the end of each three-month interval within an interest rate period if the period is longer than three months. The Company may also 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 and other obligations under the credit facility are (a) guaranteed by each of the Company’s wholly-owned material domestic restricted subsidiaries, subject to certain exceptions, and (b) are secured by substantially all of the assets of the Company and the subsidiary guarantors, including a pledge of all the capital stock of material subsidiaries held directly by the Company and the subsidiary guarantors (which pledge, in the case of any foreign subsidiary, is limited to 65% of the voting stock), subject to certain customary exceptions and limitations. The Credit Agreement generally prohibits any other liens on the assets of the Company and its restricted subsidiaries, subject to certain exceptions as described in the Credit Agreement.

The Credit Agreement contains certain covenants applicable to the Company and its restricted subsidiaries, including, without limitation, limitations on additional indebtedness, liens, various fundamental changes, dividends and distributions, investments (including acquisitions), transactions with affiliates, asset sales, including sale-leaseback transactions, speculative hedge agreements, payment of junior financing, 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. These covenants and limitations are more fully described in the Credit Agreement. At September 30, 2015, the Company was in compliance with all of these covenants.

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The Credit Agreement provides that events of default will exist in certain circumstances, including failure to make payment of principal or interest on the loans when required, failure to perform certain obligations under the Credit Agreement and related documents, defaults under certain other indebtedness, certain insolvency events, certain events arising under ERISA, a change of control and certain other events. Upon an event of default, the administrative agent with the consent of, or at the request of, the holders of more than 50% in principal amount of the loans and commitments may terminate the commitments and accelerate the maturity of the loans and enforce certain other remedies under the Credit Agreement and the other loan documents.

In connection with the Company's new revolving credit facility described above, effective as of the Closing Date, the Company terminated its existing term loan and revolving credit facility pursuant to the Credit and Security Agreement, dated as of November 22, 2011, by and among the Company, KeyBank National Association, as joint lead arranger, sole book runner and administrative agent, Wells Fargo Bank, National Association, as joint lead arranger and co-syndication agent, Merrill Lynch, Pierce, Fenner & Smith Incorporated, as joint lead arranger, Bank of America, N.A., as co-syndication agent, and Silicon Valley Bank and Comerica Bank, as co-documentation agents, and the Lenders party thereto.

The Company capitalized $6.6 million of debt issuance costs associated with the origination of the Credit Agreement, which are being amortized over the life of the revolving credit facility. The unamortized balance was $6.4 million as of September 30, 2015. The balance of $1.3 million is included as prepaid expenses and other current assets and a balance of $5.1 million was included as other assets in Company's consolidated balance sheet.

NOTE 11 – COMMITMENTS AND CONTINGENCIES

Acquisition related – The Company has one contingent liability related to the acquisition of Simena, LLC (Simena) in November 2011 for future consideration to be paid to the former seller which had an initial fair value of $8.0 million at the time of acquisition. At September 30, 2015, the present value of the future consideration was $4.5 million.

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.

NOTE 12 – PENSION BENEFIT PLANS

Certain of the Company's non-U.S. employees participate in certain noncontributory defined benefit pension plans acquired in the acquisition. None of the Company's employees in the U.S. participate in any noncontributory defined benefit pension plans. In general, these plans are funded based on considerations relating to legal requirements, underlying asset returns, the plan's funded status, the anticipated deductibility of the contribution, local practices, market conditions, interest rates and other factors.

The following sets forth the components of the Company's net periodic pension cost of the noncontributory defined benefit pension plans for the three and six months ended September 30, 2015 (in thousands):

	Three months ended September 30,		Six months ended September 30,	
	2015	2014	2015	2014
Service cost	$49	$—	$49	$—
Interest cost	75	—	75	—
Amortization of net loss	80	—	80	—
Net periodic pension cost	$204	$—	$204	$—

Expected Contributions

During the six months ended September 30, 2015, the Company did not make any contributions to its defined benefit pension plans. During the fiscal year ending March 31, 2016, the Company's cash contribution requirements for its defined benefit pension plans are expected to be less than $1.0 million. As the participants within the Company's plans are all active employees, the benefit payments are not expected to be material in the foreseeable future.

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Other Matters

Substantially all employees not covered by defined benefit plans are covered by defined contribution plans, which generally provide for company funding based on a percentage of compensation. Expense for all defined benefit pension and defined contribution plans amounted to \$1.5 million and \$2.8 million for the three and six months ended September 30, 2015, respectively.

NOTE 13 – TREASURY STOCK

On April 22, 2014, the Company's board of directors approved a stock repurchase program. This program authorized management to make additional repurchases of NetScout outstanding common stock of up to \$100 million. Through September 30, 2015, the Company had repurchased 824,452 shares totaling \$34.3 million in the open market under this stock repurchase plan. The Company repurchased 67,752 shares for \$2.8 million under this program during the six months ended September 30, 2015. At September 30, 2015, there were no shares of common stock that remained available to be purchased under this plan due to the approval of a new share repurchase program approved on May 19, 2015.

On May 19, 2015, the Company’s board of directors approved a new share repurchase program, conditional upon the completion of the Company's planned acquisition of Danaher Corporation's (Danaher) Communications Business. This new program enables the Company to repurchase up to 20 million shares of its common stock. This plan became effective on July 14, 2015 upon the completion of the Transaction and replaced the Company's previously existing open market stock repurchase program described above. For additional information regarding the acquisition of the Communications Business, see Note 7 above. Through September 30, 2015, the Company has repurchased 4,496,596 shares totaling \$176.3 million in the open market under this stock repurchase plan. At September 30, 2015, 15,503,404 shares of common stock remained available to be purchased under the plan.

In connection with the vesting and release of the restriction on previously vested shares of restricted stock units, the Company withheld 157,771 shares for \$5.9 million related to minimum statutory tax withholding requirements on these restricted stock units during the six months ended September 30, 2015. These withholding 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 September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Numerator:				
Net income (loss)	\$(7,915)	\$11,233	\$(246)	\$22,709
Denominator:				
Denominator for basic net income per share - weighted average common shares outstanding	91,410	41,060	66,232	41,071
Dilutive common equivalent shares:				
Weighted average stock options	—	11	—	14
Weighted average restricted stock units	—	581	—	647
Denominator for diluted net income per share - weighted average shares outstanding	91,410	41,652	66,232	41,732
Net income per share:				
Basic net income (loss) per share	\$(0.09)	\$0.27	\$—	\$0.55
Diluted net income (loss) per share	\$(0.09)	\$0.27	\$—	\$0.54

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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 September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Restricted stock units	557	—	579	—

Basic net income (loss) per share 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 net income (loss) per share 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

The Company's effective income tax rates were 78.1% and 37.9% for the three months ended September 30, 2015 and 2014, respectively. Generally, the effective tax rates differ from statutory rates due to the impact of the domestic production activities deduction, research and development credits if enacted, the impact of state taxes and income generated in jurisdictions that have a different tax rate than the U.S. statutory rate. The effective tax rate for the three months ended September 30, 2015 is higher than the effective rate for the three months ended September 30, 2014 primarily related to a decrease in profit before taxes due to Transaction related expenses recorded in the quarter and a change in the jurisdictional mix of earnings resulting from the Transaction.

Our effective tax rates were 99.0% and 39.6% for the six months ended September 30, 2015 and 2014, respectively. The effective tax rate is higher than the comparable period in the prior year primarily due to the decrease in profit before taxes due to Transaction related expenses recorded in the first six months of Fiscal 2016 and a change in the jurisdictional mix of earnings resulting from the Transaction.

NOTE 16 – SEGMENT AND GEOGRAPHIC INFORMATION

The Company reports revenues and income under five operating segments that aggregate under one reportable segment. The consolidated financial information is used by the chief operating decision maker 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 September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
United States	$195,169	$79,337	$273,442	$165,355
Europe	35,631	11,005	48,238	20,051
Asia	14,180	4,672	17,712	11,389
Rest of the world	16,130	8,585	22,461	14,656
	$261,110	$103,599	$361,853	$211,451

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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NOTE 17 - RELATED PARTY TRANSACTIONS

A member of the Company's Board of Directors also serves as an executive officer (under Section 16 of the Securities Exchange Act of 1934, as amended (the Exchange Act) of Danaher. As part of the split off of Danaher's Communications Business and the Company's subsequent acquisition of that business from Newco's shareholders, NetScout has entered into multiple transactions with Danaher which include: transitions services agreements, lease agreements, closing agreements, and compensation for post combination services provisions within the separation and distribution agreement. The Company has disclosed these transactions parenthetically within the financial statements. A member of the Company's Board of Directors also serves as a member of the board of directors for EMC, Corp. (EMC) and therefore, the Company considers sales to EMC to be a related party transaction. The Company recognized $346 thousand in revenue from EMC during the six months ended September 30, 2015 in the ordinary course of business. Another member of the Company's Board of Directors also serves as a Section 16 officer of State Street Corporation (State Street) and therefore, the Company considers sales to State Street to be a related party transaction. The Company recognized $122 thousand in revenue from State Street during the six months ended September 30, 2015 in the ordinary course of business.

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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, including those referred to in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended March 31, 2015 and elsewhere in this quarterly report. These factors may cause our actual results to differ materially from any forward-looking statement.

Overview

We are an industry leader for real-time service assurance and cyber security solutions that are used in many of the most demanding service provider, enterprise and government networks. Our Adaptive Service Intelligence (ASI) technology continuously monitors the service delivery environment to identify performance issues and provides insight into network-based security threats, helping teams to quickly resolve issues that can cause business disruptions or impact user experience. We manufacture and market these products in integrated hardware and software solutions that are used by customers to help drive ROI on their network and broader IT initiatives while reducing the tangible risks associated with downtime, poor service quality and compromised security. We report revenues and income under five operating segments that aggregate under a single reportable segment. Substantially all of our identifiable assets are located in the United States.

We have been a technology innovator for three-plus decades since our founding in 1984. Our market-leading solutions change how organizations manage and optimize the delivery of business applications and services, assure user experience across global IP networks and help protect networks from unwanted security threats. Through both internal development and acquisitions, we have continually enhanced and expanded our product portfolio to meet the needs of organizations by providing solutions to manage dynamic network and application environments and by improving user experience by providing high-value analytics that help validate and assure service availability, quality and reliability.

Our mission is to enable enterprise and service providers to realize maximum benefit with minimal risk from technology advances, like IP convergence, network function virtualization (NFV), software defined networking (SDN), virtualization, cloud, mobility, bring your own device (BYOD), web, and the evolving Internet by managing the inherent complexity in a cost-effective manner. Our ASI technology, which we have developed in support of this mission, has the potential of not only expanding our leadership in our core markets, but can also serve as a gateway for future intelligence solutions including cyber and business intelligence.

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.

On July 14, 2015, we completed the acquisition of the Communications Business, which included certain assets, liabilities, technology and employees within Tektronix Communications, VSS Monitoring, Arbor Networks and certain portions of the Fluke Networks Enterprise business, which excluded Danaher's data communications cable installation business and its communication service provider business. The Transaction was structured as a Reverse Morris Trust transaction whereby Danaher Corporation contributed its Communications Business to a new subsidiary, Potomac Holding, LLC (Newco). The total equity consideration was $2.3 billion based on issuing approximately 62.5 million new shares of NetScout common stock to the existing common unit holders of Newco, based on the July 13, 2015 NetScout common stock closing share price of $36.89 per share. The Transaction is expected to more than double NetScout's total addressable market to over $8 billion by extending its reach into growth-oriented adjacent markets, including cyber security, with a broader range of market-leading products and capabilities, strengthen its go-to-market resources to better support a larger, more diverse and more global customer base, and increase NetScout's scale and elevate its strategic position within key accounts. For additional information regarding the Transaction, see Note 7 of our Notes to Consolidated Financial Statements.

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Results Overview

NetScout's financial results for the quarter ended September 30, 2015 include approximately two and one-half months of contribution from the Communications Business.

We continue to maintain strong liquidity. At September 30, 2015, we had cash, cash equivalents and marketable securities (current and non-current) of $351.4 million. This represents an increase of $86.5 million from March 31, 2015.

Use of Non-GAAP Financial Measures

We supplement the United States generally accepted accounting principles (GAAP) financial measures we report in quarterly and annual 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, an adjustment for a delayed transfer entity, and the amortization of acquired intangible assets. Non-GAAP net income includes the foregoing adjustments and also removes expenses related to share-based compensation and certain expenses relating to acquisitions including: compensation for post-combination services, business development charges, and depreciation expenses, 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.

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The following table reconciles revenue, net income and net income per share on a GAAP and non-GAAP basis for the three and six months ended September 30, 2015 and 2014 (in thousands, except for per share amounts):

	Three months ended September 30,		Six months ended September 30,	
	2015	2014	2015	2014
GAAP revenue	$261,110	$103,599	$361,853	$211,451
Product deferred revenue fair value adjustment	3,107	—	3,107	18
Service deferred revenue fair value adjustment	14,945	—	14,945	—
Delayed transfer entity adjustment	633	—	633	—
Amortization of acquired intangible assets	2,028	—	2,028	—
Non-GAAP revenue	$281,823	$103,599	$382,566	$211,469
GAAP net income (loss)	$(7,915)	$11,233	$(246)	$22,709
Product deferred revenue fair value adjustment	3,107	—	3,107	18
Service deferred revenue fair value adjustment	14,945	—	14,945	—
Inventory fair value adjustment	12,773	—	12,773	—
Share based compensation expense	7,503	4,495	12,098	7,797
Amortization of acquired intangible assets	26,678	1,779	28,245	3,575
Business development and integration expense	14,544	1,477	17,906	1,477
Compensation for post combination services	21,661	545	21,682	1,081
Restructuring reversals	(104)	—	(104)	—
Loss on extinguishment of debt	55	—	55	—
Acquisition related depreciation expense	1,177	—	1,177	—
Income tax adjustments	(50,868)	(2,908)	(54,420)	(4,818)
Non-GAAP net income	$43,556	$16,621	$57,218	$31,839
GAAP diluted net income (loss) per share	$(0.09)	$0.27	$—	$0.54
Per share impact of non-GAAP adjustments identified above	0.56	0.13	0.86	0.22
Non-GAAP diluted net income per share	$0.47	$0.40	$0.86	$0.76

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, 2015, filed with the Securities and Exchange Commission (SEC) on May 20, 2015, for a description of all of our critical accounting policies.
The critical accounting policies included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2015 have not materially changed, other than the following:
The critical accounting policies entitled "Revenue Recognition" has been updated to reflect the combined policies of NetScout and the Communications Business.

Revenue Recognition
The Company exercises judgment and uses estimates in connection with determining the amounts of product and services revenues to be recognized in each accounting period.
The Company derives revenues primarily from the sale of network management tools and security solutions for carrier and enterprise customers, which include hardware, software and service offerings. The majority of the Company’s product sales consist of hardware products with embedded software that are essential to providing customers the intended functionality of the solutions. The Company also sells stand-alone software solutions to provide customers with enhanced functionality. In addition, the Company sells hardware bundled with a software license. Product revenue is recognized upon shipment, provided that evidence of an arrangement exists, title and risk of loss have passed to the customer, and in the case of software products, when the customer has the rights and ability to access the software, fees are fixed or determinable and collection of the related receivable is reasonably assured. If any significant obligations to the customer remain post delivery, typically involving obligations relating to installation and acceptance by the customer, revenue recognition is deferred until such obligations have been fulfilled. Because many of the Company’s solutions are comprised of both hardware and more than incidental software components, the Company recognizes revenue in accordance with authoritative guidance on both hardware and software revenue recognition.
The Company’s service offerings include installation, integration, extended warranty and maintenance services, post-contract customer support (PCS), and other professional services including consulting and training. The Company generally provides software and/or hardware support as part of product sales. Revenue related to the initial bundled software and hardware support is recognized ratably over the support period. In addition, customers can elect to purchase extended support agreements for periods after the initial software/hardware warranty expiration. Support services generally include rights to unspecified upgrades (when and if available), telephone and internet-based support, updates and bug fixes. Consulting services are recognized upon delivery or completion of performance. Reimbursements of out-of-pocket expenditures incurred in connection with providing consulting services are included in services revenue, with the offsetting expense recorded in cost of service revenue. Training services include on-site and classroom training. Training revenues are recognized upon delivery of the training.
Generally, the Company’s contracts are accounted for individually. However, when contracts are closely interrelated and dependent on each other, it may be necessary to account for two or more contracts as one to reflect the substance of the group of contracts.
Multi-element arrangements are concurrent customer purchases of a combination of the Company’s product and service offerings that may be delivered at various points in time. For multi-element arrangements comprised only of hardware products and related services, the Company allocates the total arrangement consideration to the multiple elements based on each element’s selling price compared to the total relative selling price of all the elements. Each element’s selling price is based on management’s best estimate of selling price (BESP) paid by customers based on the element’s historical pricing when VSOE or third party evidence (TPE) does not exist. The Company has established BESP for product elements as the average or median selling price the element was recently sold for, whether sold alone or sold as part of a multiple element transaction. The Company also considers its overall pricing objectives and practices across different sales channels and geographies, and market conditions. The Company reviews sales of the product elements on a quarterly basis and updates, when appropriate; it’s BESP for such elements to ensure that it reflects recent pricing experience. The Company has established VSOE for a majority of its services related to undelivered elements based on historical stand-alone sales or by the renewal rate offered to the customer. If neither

VSOE nor TPE of selling price exist for a deliverable, the Company uses its BESP for that deliverable.
For multi-element arrangements comprised only of software products and related services, the Company allocates a portion of the total arrangement consideration to the undelivered elements, primarily support agreements and training, using vendor-specific objective evidence of fair value for the undelivered elements. The remaining portion of the total arrangement consideration is allocated to the delivered software, referred to as the residual method. VSOE of fair value of the undelivered

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elements is based on the price customers pay when the element is sold separately. The Company reviews the separate sales of the undelivered elements on a regular basis and updates, when appropriate, its VSOE of fair value for such elements to ensure that it reflects recent pricing experience. If the Company cannot objectively determine the VSOE of the fair value of any undelivered software element, revenue is deferred until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements. However, if the only undelivered element is maintenance and support, the entire arrangement fee is recognized over the service period.

For multi-element arrangements comprised of a combination of hardware and software elements, the total arrangement consideration is bifurcated between the hardware and hardware related deliverables and the software and software related deliverables based on the relative selling prices of all deliverables as a group. Then, arrangement consideration for the hardware and hardware-related services is recognized upon delivery or as the related services are provided outlined above and revenue for the software and software-related services is allocated following the residual method and recognized based upon delivery or as the related services are provided.

The Company’s products are distributed through its direct sales force and indirect distribution channels through alliances with resellers. Revenue arrangements with resellers are recognized on a sell-in basis; that is, when the Company delivers the product to the reseller. The Company records consideration given to a reseller as a reduction of revenue to the extent the Company has recorded revenue from the reseller. With limited exceptions, the Company’s return policy does not allow product returns for a refund. Returns have been insignificant to date. The Company does not offer price protection to its resellers. In addition, the Company has a history of successfully collecting receivables from the resellers.

Three Months Ended September 30, 2015 and 2014

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 September 30, 2015, one direct customer accounted for more than 10% of our total revenue, while no indirect channel partner accounted for more than 10% of our total revenue. During the three months ended September 30, 2014, no direct customer or indirect channel partner accounted for more than 10% of our total revenue.

	Three Months Ended September 30, (Dollars in Thousands)						Change		
	2015			2014					
		% of Revenue			% of Revenue		$	%	
Revenue:									
Product	$174,899	67	%	$57,953	56	%	$116,946	202	%
Service	86,211	33		45,646	44		40,565	89	%
Total revenue	$261,110	100	%	$103,599	100	%	$157,511	152	%

Product. The 202%, or $116.9 million, increase in product revenue compared to the same period last year was primarily due to $131.0 million in additional revenue resulting from the acquisition of the Communications Business and a $2.4 million increase in revenue from our legacy service provider sector. This increase was partially offset by a $16.5 million decrease from our legacy general enterprise sector.

Going forward, we expect that the revenue mix in future quarters will likely be oriented toward service provider customers since the revenue from Tektronix Communications has historically been from the service provider sector. However, the timing and magnitude of certain projects will impact the quarterly revenue mix in any given quarter.

Service. The 89%, or $40.6 million, increase in service revenue compared to the same period last year was primarily related to $37.8 million in incremental service revenue associated with the acquisition of the Communications Business, as well as a $2.9 million increase in revenue from new maintenance contracts in our legacy NetScout business and renewals from a growing support base. We expect continued service revenue growth to be generated by product revenue growth which increases our installed base and therefore our related maintenance contracts.

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Total revenue by geography is as follows:

	Three Months Ended September 30, (Dollars in Thousands)				Change	
	2015		2014			
		% of Revenue		% of Revenue	$	%
United States	$195,169	75 %	$79,337	77 %	$115,832	146 %
International:						
Europe	35,631	14	11,005	11	24,626	224 %
Asia	14,180	5	4,672	4	9,508	204 %
Rest of the world	16,130	6	8,585	8	7,545	88 %
Subtotal international	65,941	25	24,262	23	41,679	172 %
Total revenue	$261,110	100 %	$103,599	100 %	$157,511	152 %

United States revenues increased 146%, or $115.8 million, compared to the same period last year, primarily due to a $120.4 million contribution from entities acquired as part of the Transaction, partially offset by a decrease within the legacy NetScout general enterprise sector in this region. The 172%, or $41.7 million, increase in international revenue compared to the same period last year is primarily due to a $48.3 million contribution from entities acquired as part of the Transaction, partially offset by a decrease across the service provider and general enterprise sectors. We expect revenue from sales to customers outside the United States to continue to account for a significant portion of our total revenue in the future. In accordance with United States export control regulations we do not sell to, or do business with, countries subject to economic sanctions and export controls.

We expect that the combined company will have a more balanced geography mix with approximately one third of our revenue coming from outside of North America.

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.

	Three Months Ended September 30, (Dollars in Thousands)				Change	
	2015		2014			
		% of Revenue		% of Revenue	$	%
Cost of revenue						
Product	$75,421	29 %	$12,939	13 %	$62,482	483 %
Service	24,766	9	8,656	8	16,110	186 %
Total cost of revenue	$100,187	38 %	$21,595	21 %	$78,592	364 %
Gross profit:						
Product $	$99,478	38 %	$45,014	43 %	$54,464	121 %
Product gross profit %	57 %		78 %			
Service $	$61,445	24 %	$36,990	36 %	$24,455	66 %
Service gross profit %	71 %		81 %			