NETSCOUT SYSTEMS INC
Form 10-Q
February 03, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2011

OR

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

For the transition period from to

Commission file number 0000-26251

NETSCOUT SYSTEMS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**04-2837575**
(State or Other Jurisdiction of 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 February 1, 2012 was 41,552,652.

Table of Contents

NETSCOUT SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTER ENDED DECEMBER 31, 2011

TABLE OF CONTENTS

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. Unaudited Financial Statements

NetScout Systems, Inc.

Consolidated Balance Sheets

(In thousands, except share and per share data)

(Unaudited)

	December 31, 2011	March 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 102,762	$ 67,168
Marketable securities	61,167	133,430
Accounts receivable, net of allowance for doubtful accounts of $259 and $346 at December 31, 2011 and March 31, 2011, respectively	49,593	62,801
Inventories	9,414	8,925
Prepaid income taxes	4,413	3,205
Deferred income taxes	3,624	3,383
Prepaid expenses and other current assets	5,692	4,814
Total current assets	**236,665**	**283,726**
Fixed assets, net	15,213	13,467
Goodwill	169,952	128,177
Intangible assets, net	56,390	47,686
Deferred income taxes	21,849	25,167
Long-term marketable securities	28,360	27,880
Other assets	2,463	1,467
Total assets	**$ 530,892**	**$ 527,570**
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 6,585	$ 9,709
Accrued compensation	20,763	21,854
Accrued other	6,932	4,786
Current portion of long-term debt	0	15,000
Current portion of contingent liabilities	3,014	0
Deferred revenue	82,802	85,241
Total current liabilities	**120,096**	**136,590**
Other long-term liabilities	2,170	1,721
Deferred tax liability	1,590	0
Accrued long-term retirement benefits	2,044	1,859
Long-term deferred revenue	12,311	14,735
Long-term debt, net of current portion	62,000	53,106
Contingent liabilities, net of current portion	4,986	0
Total liabilities	**205,197**	**208,011**

Commitments and contingencies (Note 13)		
Stockholders equity:		
Preferred stock, $0.001 par value:		
5,000,000 shares authorized; no shares issued or outstanding at December 31, 2011 and March 31, 2011	0	0
Common stock, $0.001 par value:		
150,000,000 shares authorized; 47,778,373 and 47,441,879 shares issued and 41,534,672 and 42,557,221 shares outstanding at December 31, 2011 and March 31, 2011, respectively	48	47
Additional paid-in capital	232,969	227,201
Accumulated other comprehensive loss	(1,851)	(676)
Treasury stock at cost, 6,243,701 and 4,884,658 shares at December 31, 2011 and March 31, 2011, respectively	(53,376)	(35,437)
Retained earnings	147,905	128,424
Total stockholders equity	**325,695**	**319,559**
Total liabilities and stockholders equity	**$ 530,892**	**$ 527,570**

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

Table of Contents

NetScout Systems, Inc.

Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2011	2010	2011	2010
Revenue:				
Product	$ 46,005	$ 43,016	$ 113,616	$ 114,289
Service	37,292	33,320	105,601	98,271
Total revenue	83,297	76,336	219,217	212,560
Cost of revenue:				
Product	10,731	10,343	27,439	28,002
Service	6,508	5,749	19,273	16,972
Total cost of revenue	17,239	16,092	46,712	44,974
Gross profit	66,058	60,244	172,505	167,586
Operating expenses:				
Research and development	13,593	10,145	36,073	29,734
Sales and marketing	27,518	27,022	81,144	77,832
General and administrative	6,564	6,356	20,135	17,478
Amortization of acquired intangible assets	565	476	1,541	1,430
Restructuring charges	372	0	372	0
Total operating expenses	48,612	43,999	139,265	126,474
Income from operations	17,446	16,245	33,240	41,112
Interest and other expense, net:				
Interest income	104	210	304	587
Interest expense	(472)	(599)	(1,449)	(1,879)
Other expense, net	(150)	(3)	(607)	(2)
Loss on extinguishment of debt	(690)	0	(690)	0
Total interest and other expense, net	(1,208)	(392)	(2,442)	(1,294)
Income before income tax expense	16,238	15,853	30,798	39,818
Income tax expense	6,207	4,752	11,317	13,324
Net income	$ 10,031	$ 11,101	$ 19,481	$ 26,494
Basic net income per share	$ 0.24	$ 0.26	$ 0.46	$ 0.63
Diluted net income per share	$ 0.24	$ 0.26	$ 0.46	$ 0.62
Weighted average common shares outstanding used in computing:				

Net income per share - basic	41,523	42,105	42,126	41,946
Net income per share - diluted	42,303	43,173	42,815	42,836

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

Table of Contents

NetScout Systems, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended December 31, 2011	Nine Months Ended December 31, 2010
Cash flows from operating activities:		
Net income	$ 19,481	$ 26,494
Adjustments to reconcile net income to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	12,191	10,369
Loss on extinguishment of debt	553	0
Loss on disposal of fixed assets	149	91
Share-based compensation expense associated with equity awards	6,117	4,139
Deferred income taxes	3,258	(73)
Other losses (gains)	(35)	0
Changes in assets and liabilities		
Accounts receivable	16,189	8,764
Inventories	(2,285)	(1,115)
Prepaid expenses and other assets	(800)	3,360
Accounts payable	(2,752)	(1,786)
Accrued compensation and other expenses	(1,403)	491
Income taxes payable	0	1,652
Deferred revenue	(6,780)	(7,678)
Net cash provided by operating activities	43,883	44,708
Cash flows from investing activities:		
Purchase of marketable securities	(89,369)	(49,593)
Proceeds from maturity of marketable securities	161,365	69,161
Purchase of fixed assets	(7,852)	(4,182)
Acquisition of businesses, net of cash acquired	(46,721)	0
Net cash provided by investing activities	17,423	15,386
Cash flows from financing activities:		
Proceeds from the exercise of stock options	264	2,163
Treasury stock repurchases	(17,939)	0
Proceeds from issuance of long-term debt, net of issuance costs	60,691	0
Repayment of long-term debt	(68,106)	(7,500)
Excess tax benefit from stock options exercised	(612)	3,403
Net cash used in financing activities	(25,702)	(1,934)
Effect of exchange rate changes on cash and cash equivalents	(10)	0
Net increase in cash and cash equivalents	35,594	58,160

Cash and cash equivalents, beginning of period	67,168	63,322
Cash and cash equivalents, end of period	$ 102,762	$ 121,482
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 1,008	$ 1,614
Cash paid for income taxes	$ 9,648	$ 5,607
Non-cash transactions:		
Transfers of inventory to fixed assets	$ 1,910	$ 1,348
Additions to property, plant and equipment included in accounts payable	$ 184	$ 0
Contingent consideration related to acquisitions, included in contingent liabilities	$ 8,000	$ 0
Debt issuance costs settled through the issuance of additional debt	$ 1,184	$ 0
Interest settled through issuance of additional debt	$ 125	$ 0

The accompanying notes are an integral part of these consolidated financial statements, see Note 1.

Table of Contents

NetScout Systems, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

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 results reported in these consolidated financial statements are not necessarily indicative of results that may be expected for the entire year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2011.

Foreign Currency

NetScout accounts for its reporting of foreign operations in accordance with guidance which establishes guidelines for the determination of the functional currency of foreign subsidiaries. NetScout s foreign subsidiaries are an extension of NetScout s U.S. operations. In accordance with the guidance, NetScout has determined its functional currency for its foreign subsidiaries to be the U.S. dollar, except for recently acquired entity Fox Replay BV (Replay) discussed below. Foreign subsidiary expenses that are denominated in a currency other than the U.S. dollar functional currency are translated at the foreign exchange rate in effect at the time the transaction is recorded.

NetScout will experience currency exchange risk with respect to foreign currency denominated expenses. In order to partially offset the risks associated with the effects of certain foreign currency exposures, NetScout has established a program that utilizes foreign currency forward contracts. Under this program, increases or decreases in foreign currency exposures are partially offset by gains or losses on forward contracts, to mitigate the impact of foreign currency transaction gains or losses. The Company does not use forward contracts to engage in currency speculation. All outstanding foreign currency forward contracts are recorded at fair value at the end of each fiscal period.

The functional currency of recently acquired Replay is the currency of the Netherlands, the Euro. Accordingly, the assets and liabilities of Replay are translated into United States dollars using the period-end exchange rate, and income and expense items are translated using the average exchange rate during the period. Cumulative translation adjustments are reflected as a separate component of stockholders equity. Foreign currency transaction gains and losses are charged to operations.

The Company had foreign currency losses of $153 thousand and $605 thousand for the three and nine months ended December 31, 2011, respectively.

Table of Contents

Revision of previously reported amounts

As previously disclosed, during the three-month interim period ended September 30, 2011, the Company identified errors in the presentation of its Consolidated Statement of Cash Flows for prior fiscal periods. Transfers from inventory to fixed assets were presented as cash outflows within the Purchase of Fixed Assets line and cash inflows within the Inventories line of the Consolidated Statement of Cash Flows. Such items should have been netted down within the Consolidated Statement of Cash Flows and disclosed as a non-cash activity. The Company revised the amounts related to cash provided by operating activities and cash provided by (used in) investing activities in its Consolidated Statement of Cash Flows to correct for these immaterial errors. The Company has detailed the adjustments to prior periods below:

	Year Ended March 31, 2010	Three Months Ended June 30, 2010	Six Months Ended September 30, 2010	Nine Months Ended December 31, 2010	Three Months Ended June 30, 2011
Net cash provided by operating activities:					
As reported	$ 47,224	$ 23,854	$ 31,932	$ 46,056	$ 6,319
As adjusted	45,654	23,138	30,584	44,708	4,755
Change	$ 1,570	$ 716	$ 1,348	$ 1,348	$ 1,564
Net cash provided by (used in) investing activities:					
As reported	$ (61,075)	$ 13,046	$ 22,556	$ 14,038	$ (28,994)
As adjusted	(59,505)	13,762	23,904	15,386	(27,430)
Change	$ 1,570	$ 716	$ 1,348	$ 1,348	$ 1,564

The Company has also revised the Consolidated Statement of Cash Flows for the full year period in the fiscal year ending March 31, 2011. This revision changed cash flows from operating activities and cash flows from investing activities by $1.3 million such that: cash flows from operations decreased from $68.5 million to $67.2 million, and cash out flows from investing activities decreased from $61.3 million to $60.0 million for the full year. The adjustment did not change from the six month period ended September 30, 2010 through the remainder of the fiscal year ended March 31, 2011 as later inventory transfers occurred in the same accounting period in which the items were purchased; as such those transactions were properly netted down within operating cash flows and shown gross in investing cash flows. The Company has concluded that the errors described above were immaterial to all periods presented above and cumulatively as of December 31, 2011. These errors had no effect on net income or net income per share.

2. Concentration of Credit Risk and Significant Customers

Financial instruments, which include cash, cash equivalents, accounts receivable and accounts payable, are stated at cost, plus accrued interest where applicable, which approximates fair value. Debt is recorded at the amount drawn on the revolving credit facility plus interest based on floating rates reflective of changes in the market which approximates fair value.

At December 31, 2011, the Company had two customers each of which accounted for more than 10% of the accounts receivable balance. At March 31, 2011, the Company had one customer which accounted for more than 10% of the accounts receivable balance. During the three and nine months ended December 31, 2011 and 2010, no direct customer or indirect channel partner accounted for more than 10% of total revenue. Historically, the Company has not experienced any significant non-performance by its customers nor does the Company anticipate non-performance by its customers in the future; accordingly, the Company does not require collateral.

3. Share-Based Compensation

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

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2011	**2010**	**2011**	**2010**
Cost of product revenue	$ 49	$ 34	$ 137	$ 85
Cost of service revenue	49	22	161	152
Research and development	600	368	1,702	1,009
Sales and marketing	775	551	2,152	1,623
General and administrative	697	485	1,965	1,270
	$ 2,170	$ 1,460	$ 6,117	$ 4,139

Table of Contents

On September 7, 2011, the Company s stockholders approved an amendment and restatement of the 2007 Equity Incentive Plan (the Amended 2007 Plan) to increase the shares of common stock reserved for issuance by 8,000,000 shares. A total of 13,000,000 shares are reserved for issuance under the Amended 2007 Plan. In addition, any shares not delivered to a participant because an award is exercised through a reduction of shares subject to the award (cashless exercise) will not be available for issuance under the Amended 2007 Plan and any shares reacquired by the Company to cover withholding taxes upon exercise of a stock option or stock appreciation right or as consideration for the exercise of a stock option or stock appreciation right will not become available for issuance under the Amended 2007 Plan. Shares withheld to cover tax liabilities of restricted stock unit grants will be restored to the available reserve on the 2 for 1 amount. Furthermore, the share reserve under the Amended 2007 Plan is reduced one share for each share of common stock issued pursuant to a stock option or stock appreciation right and two shares for each share of common stock issued pursuant to restricted stock, restricted stock units, performance stock awards, or other stock awards granted under the Amended 2007 Plan on or after March 31, 2011.

On September 7, 2011, the Company s shareholders approved the 2011 Employee Stock Purchase Plan (the ESPP), under which 2,500,000 shares of the Company s common stock have been reserved for issuance. The Company plans to implement the ESPP as of March 1, 2012, after which eligible employees may purchase shares of the Company s common stock through regular payroll deductions of up to 20% of their eligible compensation. Under the terms of the offering under the ESPP, the number of shares of the Company s common stock which a participant could purchase during any purchase period is limited to 2,000. In addition, the fair market value of shares purchased by an individual participant in the plan may not exceed $25,000 in any calendar year. The purchase price per share at which shares of common stock are sold on each purchase date during an offering period is determined by the Company s Board of Directors as of the beginning of the offering period, but may not be less than 85% of the lesser of the fair market value per share of common stock on that purchase date or the fair market value per share of common stock on the first day of the offering period.

4. Cash, Cash Equivalents and Marketable Securities

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents and those investments with original maturities greater than three months to be marketable securities. Cash and cash equivalents consisted of money market instruments and cash maintained with various financial institutions at December 31, 2011 and March 31, 2011.

Marketable Securities

The following is a summary of marketable securities held by NetScout at December 31, 2011, 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	$ 22,652	$ 7	$ 22,659
Commercial paper	16,079	1	16,080
Corporate bonds	19,231	(5)	19,226
Certificates of deposit	3,203	(1)	3,202
Total short-term marketable securities	61,165	2	61,167
Auction rate securities	19,253	(2,145)	17,108
U.S. government and municipal obligations	9,415	23	9,438
Corporate bonds	1,813	1	1,814
Total long-term marketable securities	30,481	(2,121)	28,360
Total marketable securities	$ 91,646	$ (2,119)	$ 89,527

8

Table of Contents

The following is a summary of marketable securities held by NetScout at March 31, 2011, 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	$ 86,670	$ (1)	$ 86,669
Commercial paper	24,111	(1)	24,110
Corporate bonds	13,364	17	13,381
Certificates of deposit	5,251	12	5,263
Auction rate securities	4,007	0	4,007
Total short-term marketable securities	133,403	27	133,430
Auction rate securities	19,784	(2,302)	17,482
U.S. government and municipal obligations	8,716	3	8,719
Corporate bonds	1,678	1	1,679
Total long-term marketable securities	30,178	(2,298)	27,880
Total marketable securities	$ 163,581	$ (2,271)	$ 161,310

Contractual maturities of the Company s marketable securities held at December 31, 2011 and March 31, 2011 were as follows (in thousands):

	December 31, 2011	March 31, 2011
Available-for-sale securities:		
Due in 1 year or less	$ 61,167	$ 133,430
Due after 1 year through 5 years	11,252	10,398
Due after 10 years	17,108	17,482
	$ 89,527	$ 161,310

The Company s long-term marketable securities include investments in auction rate securities. Beginning in February 2008 and continuing through December 31, 2011, auctions have failed resulting in a lack of short-term liquidity for these securities, which has caused the Company to classify $17.1 million as long-term on its consolidated balance sheet. As of December 31, 2011, the Company s auction rate securities consisted of three positions issued by municipal agencies with a total par value of $19.3 million and a current estimated market value totaling $17.1 million. As of December 31, 2011, these marketable securities were AAA rated. The securities are collateralized by student loans with underlying support by the federal government through the Federal Family Education Loan Program and by monoline insurance companies.

During the three months ended December 31, 2011, redemptions by the issuers for certain of the Company s auction rate securities totaling $250 thousand were settled at par. During the nine months ended December 31, 2011, redemptions by the issuers for certain of the Company s auction rate securities totaling $4.5 million were settled at par.

At December 31, 2011, the Company valued its outstanding long-term auction rate securities at fair value using a discounted cash flow model. This model estimated future interest income using maximum rate formulas applicable to each of these securities which consider historical spreads for benchmark rates included in these formulas as well as rates for U.S. Treasuries. The model then discounts the estimated future interest income using a risk based discount rate that considers known U.S. Treasury yields as of December 31, 2011, historical spreads in comparison to U.S. Treasuries, and a liquidity risk premium. As these securities have retained investment grade credit ratings, the Company has not applied a credit spread to its discount rate. The valuation also includes assumptions as to when these securities will return to liquidity, of which the weighted average period is estimated at between 48 and 51 months depending on the security being valued. This valuation resulted in a cumulative temporary decline in value of $2.1 million ($1.3 million, net of tax) as of December 31, 2011 recorded within accumulated other comprehensive income (loss) on the balance sheet. To the extent the Company determines that any impairment is other-than-temporary, the Company would record a charge to earnings.

The Company has the ability and intent to hold these securities until a recovery in the auction process or other liquidity event occurs. Based on the Company s current cash position, expected operating cash flows and the Company s other sources of cash, the Company does not believe that it is more likely than not that it will be required

Table of Contents

to sell the securities before a recovery in the auction process or other liquidity event occurs. Additionally, the Company believes that the present value of expected future cash flows consisting of interest payments and the return of principal is sufficient to recover the amortized cost basis of the securities and expects to collect these cash flows. Therefore, the Company does not believe that the decline in value of its auction rate securities is other than temporary, or that any portion of the temporary decline is the result of a credit loss.

5. Fair Value Measurements

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

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

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

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures certain financial assets and liabilities at fair value, including marketable securities and derivative financial instruments.

The Company s Level I 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 II investments are classified as such because fair value is being calculated using data from similar but not identical issues, or a discounted cash flow model using the contractual interest rate as compared to the underlying interest yield curve. The Company s short-term auction rate securities at March 31, 2011 were classified as Level II since the amount which was redeemed in April 2011 was based upon a redemption notice for an inactive market. The Company s derivative financial instruments consist of forward foreign exchange contracts and are classified as Level II because the fair values of these derivatives are determined using models based on market observable inputs, including spot prices for foreign currencies and credit derivatives, as well as an interest rate factor. For further information on the Company s derivative instruments refer to Note 11.

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

Table of Contents

The following table summarizes the valuation of the Company s financial assets and liabilities by the above categories as of December 31, 2011 (in thousands):

	Total Fair Value	Level I	Level II	Level III
ASSETS:				
Cash and cash equivalents	$ 102,762	$ 102,762	$ 0	$ 0
U.S. government and municipal obligations	32,097	32,097	0	0
Commercial paper	16,080	0	16,080	0
Corporate bonds	21,040	21,040	0	0
Certificate of deposits	3,202	0	3,202	0
Auction rate securities	17,108	0	0	17,108
Derivative financial instruments	8	0	8	0
	$ 192,297	$ 155,899	$ 19,290	$ 17,108
LIABILITIES:				
Contingent purchase consideration	$ (8,000)	$ 0	$ 0	$ (8,000)
Contingent contractual non-compliance liability	$ (1,600)	$ 0	$ 0	$ (1,600)
Derivative financial instruments	(540)	0	(540)	0
	$ (10,140)	$ 0	$ (540)	$ (9,600)

The following table sets forth a reconciliation of changes in the fair value of the Company s Level III financial assets for the nine months ended December 31, 2011 (in thousands):

	Auction Rate Securities	Contingent Purchase Consideration	Contingent Contractual Non-compliance Liability
Balance at beginning of period	$ 17,482	$ 00	$ 0
Additions to Level III	0	8,000	1,600
ARSs redeemed by issuers at par	(500)	00	0
Unrealized gains included in accumulated other comprehensive income (loss)	157	00	0
Unrealized gain (loss) included in the statement of operations	(31)	00	0
Balance at end of period	$ 17,108	$ 8,000	$ 1,600

6. Inventories

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

	December 31, 2011	March 31, 2011

Raw materials	$ 4,964	$ 4,548
Work in process	473	27
Finished goods	3,977	4,350
	$ 9,414	$ 8,925

7. Acquisitions

While the Company uses its best estimates and assumptions as part of the purchase price allocation process to value the assets acquired and liabilities assumed on the acquisition date, its estimates and assumptions are subject to refinement. As a result, during the preliminary purchase price allocation period, which may be up to one year from the

Table of Contents

acquisition date, the Company records adjustments to the assets acquired and liabilities assumed with a corresponding offset to goodwill. The Company records adjustments to the assets acquired and liabilities assumed subsequent to the purchase price allocation period in the Company s operating results in the period in which the adjustments were determined.

Simena

On November 18, 2011, the Company completed the acquisition of Simena, LLC (Simena), an established provider of high performance, low-latency IP packet flow-based network monitoring switching technology that enables IT organizations and service providers to aggregate, filter and control network traffic for data, voice, and video monitoring and cybersecurity deployments. Simena s technology is expected to further strengthen the Company s unified service delivery management strategy by extending visibility capabilities. The technology should enable fine-grained packet-flow control for monitoring environments to better leverage critical network monitoring points. The results of Simena s operations have been included in the consolidated financial statements since that date. The goodwill recognized primarily relates to the expected synergies to be achieved with our current product families and the ability to leverage existing sales and marketing capacity and customer base with respect to the acquired Simena technology.

In connection with the acquisition of Simena, the Company paid the sellers $10.1 million at closing and became obligated to pay the seller up to $10.8 million in additional purchase consideration subject to adjustment based on the final determination of certain assets and liabilities. As a result, a majority of the changes to the value of the contingent consideration would be expected to have an offsetting impact on the recorded values of the assets and liabilities assumed as part of the transaction. Additionally, the Company is working with the seller to get additional information on such assets and liabilities. The Company will continue to refine its estimates of fair value related to these items in the next twelve months. Certain information was not available in the reporting period as Simena had not previously created GAAP basis financial statements and the analysis which would underlie estimates thereto.

The total acquisition date fair value of the consideration was estimated at $18.1 million as follows (in thousands):

Initial cash payment	$ 10,086
Estimated fair value of contingent consideration obligation	8,000
Total consideration	$ 18,086

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

Allocation of the purchase consideration:	
Current assets	$ 2,300
Identifiable intangible assets	4,470
Goodwill	14,013
Total assets acquired	20,783
Current liabilities	(338)
Deferred revenue	(759)
Contractual non-compliance liability	(1,600)
Contingent consideration	(8,000)
Fair value of consideration transferred	$ 10,086

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill from the Simena acquisition will be included within the Company s single reporting unit and will be included in the Company s enterprise-level annual review for impairment. The Company expects all of the goodwill and intangible assets acquired as part of this transaction to be deductible for tax purposes.

Table of Contents

The fair values of intangible assets were based on valuations using an income approach, with estimates and assumptions provided by management of Replay and the Company. 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)
Acquired technology	$ 2,740	10
Customer relationships	1,730	10
	$ 4,470	

The weighted average useful life of identifiable intangible assets acquired from Simena is 10 years. Acquired technology is amortized using an accelerated amortization method and customer relationships are amortized using a straight line method.

The Company incurred approximately $160 thousand of acquisition-related costs which are included in general and administrative expense during the nine months ended December 31, 2011.

Replay

On October 3, 2011, the Company completed the acquisition of Fox Replay BV (Replay), a leading provider of session reconstruction and replay technology that enables organizations to perform forensic analysis of end-user actions in support of cyberintelligence, information assurance, lawful intercept and general security practices. Replay was acquired to add critical technology and expertise that is expected to provide an important element of our unified service delivery management product strategy to address growing cybersecurity concerns in our target markets. The results of Replay s operations have been included in the consolidated financial statements since that date. The total purchase price of $20.2 million consisted entirely of cash consideration. The goodwill recognized primarily relates to the value in combining Replay s product with our customer base.

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

Allocation of the purchase consideration:	
Current assets, including cash and cash equivalents of $547	$ 2,310
Fixed assets	85
Identifiable intangible assets	4,950
Goodwill	15,313
Total assets acquired	22,658
Current liabilities	(74)
Deferred revenue	(715)
Deferred income tax liabilities	(1,632)
	$ 20,237

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill from the Replay acquisition will be included within the Company s single reporting unit and will be included in the Company s enterprise-level annual review for impairment. None of the goodwill or identifiable intangibles associated with this transaction will be deductible for tax purposes.

The fair values of intangible assets were based on valuations using an income approach, with estimates and assumptions provided by management of Replay and the Company. 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)
Acquired software	$ 1,100	6
Customer relationships	1,400	10
Core technology	2,100	10
Non-compete agreements	350	3
	$ 4,950	

Table of Contents

The weighted average useful life of identifiable intangible assets acquired from Replay is 8.6 years. Acquired software and core technology are amortized using an accelerated amortization method. Customer relationships and non-compete agreements are amortized on a straight-line basis.

The Company incurred approximately $782 thousand of acquisition-related costs which are included in general and administrative expense during the nine months ended December 31, 2011.

Psytechnics, Ltd.

On April 1, 2011, the Company acquired all of the outstanding equity of Psytechnics, Ltd. (Psytechnics) a supplier of voice video network monitoring software. Psytechnics was acquired to expand NetScout s voice video monitoring capabilities using Psytechnics existing software offering, Experience Manager. The results of Psytechnics operations have been included in the consolidated financial statements since that date. The total purchase price of $17 million consisted entirely of cash consideration. The goodwill recognized primarily relates to the value in combining Psytechnic s product with our customer base.

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

Allocation of the purchase consideration:	
Current assets, including cash and cash equivalents of $69	$ 1,099
Fixed assets	50
Identifiable intangible assets	4,350
Goodwill	13,179
Total assets acquired	18,678
Current liabilities	(1,198)
Deferred revenue	(466)
	$ 17,014

The Company has analyzed the realizability of the deferred tax assets of Psytechnics and has concluded that it is appropriate to provide a valuation allowance against these balances, given the historical objective evidence. The net asset balance reserved is $3.1 million and primarily consists of net operating loss carry forwards and tax basis in intangibles previously amortized for financial reporting purposes attributable to the U.K. operations of the acquired entity. The Company will continue to evaluate additional positive and negative evidence relating to the realizability of these assets within the first year of the transaction; any resulting changes to the valuation allowance attributable to facts existing as of the acquisition date but unknown at the time of the assessment would be recorded against goodwill. Any new facts resulting in changes to the valuation allowance will be recorded as a component of earnings.

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill from the Psytechnics acquisition will be included within the Company s single reporting unit and will be included in the Company s enterprise-level annual review for impairment. No goodwill associated with this transaction will be deductible for tax purposes.

The fair values of intangible assets were based on valuations using an income approach, with estimates and assumptions provided by management of Psytechnics and the Company. 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)
Acquired software	$ 1,200	5
Customer relationships	450	10
Core technology	2,700	10
	$ 4,350	

The weighted average useful life of identifiable intangible assets acquired from Psytechnics is 8.6 years. Acquired software and core technology are amortized using an accelerated amortization method. Customer relationships are amortized on a straight-line basis.

The Company incurred approximately $1.0 million of acquisition-related costs which are included in general and administrative expense.

The following table presents the pro forma results of the historical Consolidated Statements of Operations of the Company and Psytechnics, Replay and Simena for the three and nine months ended December 31, 2011 and 2010, giving effect to the mergers as if they occurred on April 1, 2011 and 2010 (in thousands, except per share data):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2011	2010	2011	2010
Pro forma revenue	$ 85,277	$ 80,728	$ 226,537	$ 222,024
Pro forma net income	$ 10,247	$ 10,733	$ 21,133	$ 26,558
Pro forma income per share:				
Basic	$ 0.25	$ 0.25	$ 0.50	$ 0.63
Diluted	$ 0.24	$ 0.25	$ 0.49	$ 0.62
Pro forma shares outstanding				
Basic	41,523	42,105	42,126	41,946
Diluted	42,303	43,173	42,815	42,836

The pro forma results for the three and nine months ended December 31, 2010 primarily includes adjustments for amortization of intangibles, interest income and interest expense. The pro forma results for the three and nine months ended December 31, 2011 includes adjustments for amortization of intangibles. This pro forma information does not purport to indicate the results that would have actually been obtained had the acquisition been completed on the assumed date, or which may be realized in the future.

Since the date of the acquisitions we have recorded $2.3 million of revenue earned by Psytechnics, Replay and Simena within our consolidated financial statements.

8. Goodwill & Intangible Assets

Goodwill

The carrying amount of goodwill was $170.0 million and $128.2 million as of December 31, 2011 and March 31, 2011. The following table summarizes the changes in the carrying amount of goodwill (in thousands):

	Three Months Ended December 31, 2011	Nine Months Ended December 31, 2011
Balance at beginning of period	$ 141,356	128,177
Goodwill related to the acquisition of Psytechnics	0	13,179
Goodwill related to the acquisition of Replay	15,313	15,313
Goodwill related to the acquisition of Simena	14,013	14,013
Foreign currency translation impact	(730)	(730)
Balance as of December 31, 2011	$ 169,952	169,952

Intangible Assets

The net carrying amounts of intangible assets were $56.4 million and $47.7 million as of December 31, 2011 and March 31, 2011, respectively. Intangible assets acquired in a business combination are recorded under the acquisition method of accounting at their estimated fair values at the date of acquisition. The Company amortizes intangible assets over their estimated useful lives, except for the acquired trade name which resulted from the Network General acquisition, which has an indefinite life and thus is not amortized. The carrying value of the indefinite lived trade name will be evaluated for potential impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired.

Table of Contents

Intangible assets consist of the following as of December 31, 2011 (in thousands):