NETSCOUT SYSTEMS INC
Form 10-Q
August 02, 2016


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 June 30, 2016
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 July 27, 2016 was 91,992,604.

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FOR THE QUARTER ENDED JUNE 30, 2016
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Unless the context suggests otherwise, references in this Quarterly Report on Form 10-Q, or Quarterly Report, to "NetScout," the "Company," "we, " "us," and "our" refer to NetScout Systems, Inc. and, where appropriate, our consolidated subsidiaries.

NetScout, the NetScout logo, Adaptive Service Intelligence and other trademarks or service marks of NetScout appearing in this Quarterly Report are the property of NetScout Systems, Inc. and/or its subsidiaries and/or affiliates in the USA and/or other countries. Any third-party trade names, trademarks and service marks appearing in this Quarterly Report are the property of their respective holders.

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Cautionary Statement Concerning Forward-Looking Statements

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, 2016, and elsewhere in this quarterly report. These factors may cause our actual results to differ materially from any forward-looking statement. We are under no duty to update any of these forward-looking statements after the date of this Quarterly Report or to conform these statements to actual results or revised expectations.

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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)

| | June 30, 2016 (Unaudited) | March 31, 2016 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $210,870 | $210,711 |
| Marketable securities | 108,743 | 128,003 |
| Accounts receivable and unbilled costs, net of allowance for doubtful accounts of $6,212 and $5,069 at June 30, 2016 and March 31, 2016, respectively | 196,227 | 247,199 |
| Inventories and deferred costs | 58,842 | 58,029 |
| Prepaid income taxes | 28,402 | 18,137 |
| Prepaid expenses and other current assets (related party balances of $38,357 and $44,161, respectively) | 65,855 | 78,399 |
| Total current assets | 668,939 | 740,478 |
| Fixed assets, net | 64,058 | 62,033 |
| Goodwill | 1,710,286 | 1,709,369 |
| Intangible assets, net | 1,023,968 | 1,054,040 |
| Deferred income taxes | 5,040 | 6,206 |
| Long-term marketable securities | 15,309 | 13,361 |
| Other assets | 6,858 | 7,356 |
| Total assets | $3,494,458 | $3,592,843 |
| Liabilities and Stockholders’ Equity | | |
| Current liabilities: | | |
| Accounts payable (related party balances of $3,943 and $5,893, respectively) | $45,607 | $43,969 |
| Accrued compensation | 68,748 | 82,303 |
| Accrued other | 28,160 | 32,045 |
| Income taxes payable | 2,091 | 2,091 |
| Deferred revenue and customer deposits | 279,974 | 296,648 |
| Total current liabilities | 424,580 | 457,056 |
| Other long-term liabilities | 2,606 | 2,903 |
| Deferred tax liability | 272,763 | 285,359 |
| Accrued long-term retirement benefits | 31,158 | 31,378 |
| Long-term deferred revenue and customer deposits | 67,025 | 68,129 |
| Long-term debt | 300,000 | 300,000 |
| Contingent liabilities | 4,674 | 4,636 |
| Total liabilities | 1,102,806 | 1,149,461 |
| Commitments and contingencies (Note 12) | | |
| Stockholders’ equity: | | |
| Preferred stock, $0.001 par value: | | |
| 5,000,000 shares authorized; no shares issued or outstanding at June 30, 2016 and March 31, 2016 | — | — |
| Common stock, $0.001 par value: | | |

| | | |
|---|---|---|
| 150,000,000 shares authorized; 114,503,040 and 114,495,614 shares issued and 91,992,604 and 94,088,469 shares outstanding at June 30, 2016 and March 31, 2016, respectively | 114 | 114 |
| Additional paid-in capital | 2,650,315 | 2,642,745 |
| Accumulated other comprehensive loss | (1,735) | (1,501) |
| Treasury stock at cost, 22,510,436 and 20,407,145 shares at June 30, 2016 and March 31, 2016, respectively | (531,434) | (481,366) |
| Retained earnings | 274,392 | 283,390 |
| Total stockholders' equity | 2,391,652 | 2,443,382 |
| Total liabilities and stockholders' equity | $3,494,458 | $3,592,843 |

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 June 30, 2016 | 2015 |
|---|---|---|
| Revenue: | | |
| Product | $164,589 | $53,593 |
| Service | 104,363 | 47,150 |
| Total revenue | 268,952 | 100,743 |
| Cost of revenue: | | |
| Product (related party balances of $4,577 and $0, respectively) | 59,827 | 12,498 |
| Service (related party balances of $190 and $0, respectively) | 27,207 | 8,798 |
| Total cost of revenue | 87,034 | 21,296 |
| Gross profit | 181,918 | 79,447 |
| Operating expenses: | | |
| Research and development (related party balances of $1,026 and $0, respectively) | 60,551 | 18,058 |
| Sales and marketing (related party balances of $1,600 and $0, respectively) | 81,588 | 38,092 |
| General and administrative (related party balances of $1,504 and $0, respectively) | 30,927 | 10,099 |
| Amortization of acquired intangible assets | 17,572 | 809 |
| Restructuring charges | 2,034 | — |
| Total operating expenses | 192,672 | 67,058 |
| Income (loss) from operations | (10,754) | 12,389 |
| Interest and other income (expense), net: | | |
| Interest income | 191 | 158 |
| Interest expense | (2,331) | (192) |
| Other expense, net | (764) | (112) |
| Total interest and other expense, net | (2,904) | (146) |
| Income (loss) before income tax expense (benefit) | (13,658) | 12,243 |
| Income tax expense (benefit) | (4,660) | 4,574 |
| Net income (loss) | $(8,998) | $7,669 |
| Basic net income (loss) per share | $(0.10) | $0.19 |
| Diluted net income (loss) per share | $(0.10) | $0.19 |
| Weighted average common shares outstanding used in computing: | | |
| Net income (loss) per share - basic | 93,344 | 40,776 |
| Net income (loss) per share - diluted | 93,344 | 41,371 |

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

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

| | Three Months Ended June 30, | |
|---|---|---|
| | 2016 | 2015 |
| Net income (loss) | $(8,998) | $7,669 |
| Other comprehensive income (loss): | | |
| Cumulative translation adjustments | (258) | 977 |
| Changes in market value of investments: | | |
| Changes in unrealized gains (losses) | 41 | (59) |
| Total net change in market value of investments | 41 | (59) |
| Changes in market value of derivatives: | | |
| Changes in market value of derivatives, net of (benefits) taxes of ($19), and $4, respectively | (31) | 6 |
| Reclassification adjustment for net gains included in net income (loss), net of taxes of $8, $460, respectively | 14 | 863 |
| Total net change in market value of derivatives | (17) | 869 |
| Other comprehensive income (loss) | (234) | 1,787 |
| Total comprehensive income (loss) | $(9,232) | $9,456 |

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

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

| | Three Months Ended June 30, 2016 | 2015 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income (loss) | $(8,998 ) | $7,669 |
| Adjustments to reconcile net income (loss) to cash provided by operating activities, net of the effects of acquisitions: | | |
| Depreciation and amortization | 40,174 | 4,986 |
| Loss on disposal of fixed assets | 38 | 10 |
| Deal-related compensation expense and accretion charges | 38 | 37 |
| Share-based compensation expense associated with equity awards | 8,132 | 4,595 |
| Deferred income taxes | (11,328 ) | 239 |
| Other losses | (17 ) | 42 |
| Changes in assets and liabilities | | |
| Accounts receivable and unbilled costs | 50,757 | 23,729 |
| Due from related party | (1,984 ) | — |
| Inventories | (3,714 ) | (1,806 ) |
| Prepaid expenses and other assets | (5,429 ) | 6,654 |
| Accounts payable | 4,858 | (1,629 ) |
| Accrued compensation and other expenses | (18,108 ) | (20,955 ) |
| Due to related party | 704 | — |
| Income taxes payable | (5 ) | 40 |
| Deferred revenue | (17,385 ) | (14,321 ) |
| Net cash provided by operating activities | 37,733 | 9,290 |
| Cash flows from investing activities: | | |
| Purchase of marketable securities | (35,806 ) | (32,289 ) |
| Proceeds from maturity of marketable securities | 53,159 | 19,034 |
| Purchase of fixed assets | (9,218 ) | (3,415 ) |
| Purchase of intangible assets | (20 ) | (88 ) |
| Increase in deposits | (62 ) | — |
| Collection of contingently returnable consideration | 5,133 | — |
| Capitalized software development costs | (290 ) | — |
| Net cash provided by (used in) investing activities | 12,896 | (16,758 ) |
| Cash flows from financing activities: | | |
| Treasury stock repurchases | (50,068 ) | (3,167 ) |
| Net cash used in financing activities | (50,068 ) | (3,167 ) |
| Effect of exchange rate changes on cash and cash equivalents | (402 ) | 94 |
| Net increase (decrease) in cash and cash equivalents | 159 | (10,541 ) |
| Cash and cash equivalents, beginning of period | 210,711 | 104,893 |
| Cash and cash equivalents, end of period | $210,870 | $94,352 |
| Supplemental disclosures: | | |
| Non-cash transactions: | | |
| Transfers of inventory to fixed assets | $2,673 | $1,229 |
| Additions to property, plant and equipment included in accounts payable | $374 | $245 |

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 United States 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 GAAP. The results reported in these unaudited interim 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, or the Closing Date, the Company completed the acquisition of Danaher Corporation's (Danaher) Communications Business (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). The Transaction is more fully described in Note 7 below. The Transaction was recorded using the acquisition method of accounting; accordingly, the financial results of the acquisition are included in the accompanying unaudited interim consolidated financial statements for the periods subsequent to the acquisition.

These unaudited interim 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, 2016 filed with the SEC on May 31, 2016.

Recent Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (ASU 2016-09), which simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for the Company beginning April 1, 2017. The Company is currently assessing the potential impact of the adoption of ASU 2016-09 on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) Section A - Leases: Amendments to the FASB Accounting Standards Codification (ASU 2016-02), its new standard on accounting for leases. This update requires the recognition of leased assets and lease obligations by lessees for those leases currently classified as operating leases under existing lease guidance. Short term leases with a term of 12 months or less are not required to be recognized. The update also requires disclosure of key information about leasing arrangements to increase transparency and comparability among organizations. ASU 2016-02 is effective for annual reporting periods beginning after December 31, 2018 and interim periods within those fiscal years, and early adoption is permitted. The Company is currently assessing the potential impact of the adoption of ASU 2016-02 on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: Topic 606 (ASU 2014-09) and issued subsequent amendments to the initial guidance in August 2015, March 2016, April 2016 and May 2016 within ASU 2015-04, 2016-08, ASU 2016-10 and ASU 2016-12, respectively (ASU 2014-09, ASU 2015-04, ASU 2016-08, ASU 2016-10 and ASU 2016-12 collectively, Topic 606). Topic 606 supersedes nearly all existing revenue recognition guidance under GAAP. The core principle of Topic 606 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. Topic 606 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 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, among others. Topic 606 will be effective for the Company in the first quarter of its fiscal year 2019. Early adoption is not permitted. The Company is currently assessing the potential impact of the adoption of ASU 2014-09 on its consolidated financial statements.

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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 June 30, 2016, the Company had one direct customer which 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. At March 31, 2016, the Company had one direct customer which 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 months ended June 30, 2016, 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 June 30, 2015, no direct customer or indirect channel partner accounted for more than 10% of the Company's total revenue.

As disclosed parenthetically within the Company's consolidated balance sheet, the Company has a receivable from Danaher in the amount of $38.4 million and $44.2 million that represents a concentration of credit risk at June 30, 2016 and March 31, 2016, respectively.

Historically, the Company has not experienced any significant failure of its customers' ability 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 June 30, | |
|---|---|---|
| | 2016 | 2015 |
| Cost of product revenue | $195 | $102 |
| Cost of service revenue | 798 | 373 |
| Research and development | 2,633 | 1,490 |
| Sales and marketing | 2,611 | 1,403 |
| General and administrative | 1,895 | 1,227 |
| | $8,132 | $4,595 |

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, 2016. 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 the last day of February each year.

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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 June 30, 2016 and March 31, 2016.

Marketable Securities

The following is a summary of marketable securities held by NetScout at June 30, 2016, classified as short-term and long-term (in thousands):

| | Amortized Cost | Unrealized Gains | Fair Value |
|---|---|---|---|
| Type of security: | | | |
| U.S. government and municipal obligations | $ 82,005 | $ 24 | $ 82,029 |
| Commercial paper | 26,714 | — | 26,714 |
| Total short-term marketable securities | 108,719 | 24 | 108,743 |
| U.S. government and municipal obligations | 15,276 | 33 | 15,309 |
| Total long-term marketable securities | 15,276 | 33 | 15,309 |
| Total marketable securities | $ 123,995 | $ 57 | $ 124,052 |

The following is a summary of marketable securities held by NetScout at March 31, 2016, classified as short-term and long-term (in thousands):

| | Amortized Cost | Unrealized Gains | Fair Value |
|---|---|---|---|
| Type of security: | | | |
| U.S. government and municipal obligations | $ 109,963 | $ 4 | $ 109,967 |
| Commercial paper | 16,172 | — | 16,172 |
| Corporate bonds | 1,864 | — | 1,864 |
| Total short-term marketable securities | 127,999 | 4 | 128,003 |
| U.S. government and municipal obligations | 13,349 | 12 | 13,361 |
| Total long-term marketable securities | 13,349 | 12 | 13,361 |
| Total marketable securities | $ 141,348 | $ 16 | $ 141,364 |

Contractual maturities of the Company’s marketable securities held at June 30, 2016 and March 31, 2016 were as follows (in thousands):

| | June 30, 2016 | March 31, 2016 |
|---|---|---|
| Available-for-sale securities: | | |
| Due in 1 year or less | $ 108,743 | $ 128,003 |
| Due after 1 year through 5 years | 15,309 | 13,361 |
| | $ 124,052 | $ 141,364 |

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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 June 30, 2016 and March 31, 2016 (in thousands):

| | Fair Value Measurements at June 30, 2016 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| ASSETS: | | | | |
| Cash and cash equivalents | $210,870 | $— | $— | $210,870 |
| U.S. government and municipal obligations | 25,611 | 71,727 | — | 97,338 |
| Commercial paper | — | 26,714 | — | 26,714 |
| Derivative financial instruments | — | 116 | — | 116 |
| Contingently returnable consideration | — | — | 8,341 | $8,341 |
| | $236,481 | $98,557 | $8,341 | $343,379 |
| LIABILITIES: | | | | |
| Contingent purchase consideration | $— | $— | $(4,674) | $(4,674) |
| Derivative financial instruments | — | (93) | — | (93) |
| | $— | $(93) | $(4,674) | $(4,767) |

| | Fair Value Measurements at March 31, 2016 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| ASSETS: | | | | |
| Cash and cash equivalents | $210,711 | $— | $— | $210,711 |
| U.S. government and municipal obligations | 41,116 | 82,212 | — | 123,328 |
| Commercial paper | — | 16,172 | — | 16,172 |
| Corporate bonds | 1,864 | — | — | 1,864 |
| Derivative financial instruments | — | 191 | — | 191 |
| Contingently returnable consideration | | | 16,131 | 16,131 |
| | $253,691 | $98,575 | $16,131 | $368,397 |
| LIABILITIES: | | | | |
| Contingent purchase consideration | $— | $— | $(7,293) | $(7,293) |
| Derivative financial instruments | — | (158) | — | (158) |
| | $— | $(158) | $(7,293) | $(7,451) |

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

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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 liabilities 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 transferred to Newco (as defined below) for post-combination services on various dates through August 4, 2016 as part of the Transaction. The contingently returnable consideration is classified as Level 3 because the fair value of the asset was determined using assumptions developed by management in determining the estimated cash awards expected to be paid on August 4, 2016 after applying an assumed forfeiture rate. The contingently returnable consideration of $8.4 million, net of taxes as of June 30, 2016 is included as prepaid expenses and other current assets in the Company's consolidated balance sheet. For additional information, see Note 7 of the Company's Notes to Consolidated Financial Statements. The fair value of contingent purchase consideration of $4.7 million is related to the acquisition of Simena LLC (Simena) in November 2011 for future consideration to be paid to the former seller.

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 three months ended June 30, 2016 (in thousands):

| | Contingent Purchase Consideration | Contingently Returnable Consideration |
|---|---|---|
| Balance at beginning of period | $ (7,293 ) | $ 16,131 |
| Increase in fair value and accretion expense (included within research and development expense) | (38 ) | — |
| Payment received | — | (7,790 ) |
| Payments made | 2,657 | — |
| Balance at end of period | $ (4,674 ) | $ 8,341 |

Deal-related compensation expense and accretion charges related to the contingent consideration for the three months ended June 30, 2016 was $38 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):

| | June 30, 2016 | March 31, 2016 |
|---|---|---|
| Raw materials | $20,497 | $ 18,617 |
| Work in process | 1,315 | 651 |
| Finished goods | 37,030 | 38,761 |
| | $58,842 | $ 58,029 |

NOTE 7 - ACQUISITIONS

On July 14, 2015 (Closing Date), the Company completed the Transaction, which was structured as a Reverse Morris Trust transaction whereby Danaher contributed its Communications Business to a new subsidiary, Potomac Holding LLC (Newco). The total equity consideration was approximately $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. On the Closing Date, the Company did not gain control over certain foreign entities due to regulatory and other compliance requirements (Delayed Close Entities). The Company closed on the acquisition of these Delayed Close Entities on October 7, 2015.

The Transaction was accounted for under the acquisition method of accounting with the operations of the Communications Business included in the Company's operating results from the relevant 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

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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 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. The primary areas of the purchase price allocation that are not yet finalized are related to the valuation of deferred income taxes and residual goodwill.

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.

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 an aggregate of $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 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 tax 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 June 30, 2016, 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 June 30, 2016, the Company has recorded a cash retention award liability of $9.7 million and is included as accrued compensation in Company's consolidated balance sheet. For the three months ended June 30, 2016, $1.7 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 and who continued to be employed by NetScout through December 31, 2015 received a cash incentive bonus payment. The cash incentive bonus liability was accounted for separately from the business combination as the cash incentive bonus is automatically forfeited upon termination of employment. NetScout recorded the liability over the period it was earned as compensation expense for post-combination services. The payment of the cash retention award, which was

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reimbursed by Danaher to NetScout, was accounted for separately from the business combination on the date of the acquisition.

4) Certain Newco Employees received cash retention payments that were 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 was accounted for separately from the business combination as the cash retention payment was automatically forfeited upon termination of employment. NetScout recorded the liability over the period it was earned as compensation expense for post-combination services. The payment of the cash retention award, which was reimbursed by Danaher to NetScout, was accounted for separately from the business combination on the date of the acquisition.

The following table summarizes the allocation of the purchase price for the entities acquired on July 14, 2015 (in thousands):

| | | |
|---|---|---|
| Purchase Price Allocation: | | |
| Total equity consideration | $2,299,911 | (1) |
| Less: Equity consideration for replacement awards | (29,355) | (2) |
| Estimated Purchase Price | 2,270,556 | |
| | | |
| Estimated fair value of assets acquired and liabilities assumed: | | |
| Cash | 27,701 | |
| Accounts receivable | 140,586 | |
| Inventories | 80,719 | |
| Prepaid expenses and other assets | 6,715 | |
| Property, plant and equipment | 36,825 | |
| Deferred income taxes | 13,067 | |
| Intangible assets | 1,080,700 | |
| Other assets | 999 | |
| Accounts payable | (21,311) | |
| Accrued compensation | (24,316) | |
| Accrued other | (12,916) | |
| Deferred revenue | (187,882) | |
| Other long-term liabilities | (3,615) | |
| Accrued retirement benefits | (29,917) | |
| Deferred tax liabilities | (344,646) | |
| Goodwill | $1,507,847 | |

(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, less 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.

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(2) Represents the value of certain outstanding Danaher equity awards held by Newco Employees for which continuing employees received, or 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 cash awards to be paid by NetScout to acquired Newco employees on August 4, 2016. The cash payments 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.

The following table summarizes the allocation of the purchase price for the Delayed Close Entities acquired on October 7, 2015 (in thousands):

| | |
|---|---|
| Purchase Price Allocation: | |
| Total equity consideration | $5,700 (1) |
| Estimated Purchase Price | $5,700 |
| | |
| Estimated fair value of assets acquired and liabilities assumed: | |
| Accounts receivable | $110 |
| Inventories | 78 |
| Prepaid expenses and other assets | 35 |
| Property, plant and equipment | 1,254 |
| Other assets | 281 |
| Accounts payable | (8) |
| Accrued compensation | (824) |
| Accrued other | (176) |
| Deferred revenue | (65) |
| Other long-term liabilities | (126) |
| Goodwill | $5,141 |

(1) Represents the fair value attributable to the Delayed Close Entities that the Company obtained control over on October 7, 2015.

The Transaction was aimed at extending the Company's reach into growth-oriented adjacent markets, including cyber security, with a broader range of market-leading products and capabilities; strengthening the Company's go-to-market resources to better support a larger, more diverse and more global customer base; and increasing scale and elevating 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 was included within the following operating segments: $534.8 million in cybersecurity (Arbor Networks), $794.4 million for the service assurance product lines focused on the service provider market (formerly known as Tektronix Communications), $57.0 million in the network visibility product lines (formerly known as VSS Monitoring), and $125.1 million in the service assurance product lines primarily focused on the enterprise market (formerly known as FNET) as of March 31, 2016. There were no measurement period adjustments during the three months ended June 30, 2016. 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.

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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 trade names | 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 trade names are amortized using an accelerated amortization method and have a weighted average useful life of 8.5 years. Leasehold interests are amortized on a straight-line basis and have a weighted average useful life of 5.6 years.

The Company incurred approximately $0 and $3.4 million of acquisition-related costs related to the Transaction during the three months ended June 30, 2016 and 2015, respectively.

During the three months ended June 30, 2016, the Company has recorded $173.8 million of revenue and a net loss of $3.7 million directly attributable to the entities acquired as part of the Transaction within its consolidated financial statements.

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 months ended June 30, 2015, giving effect to the Transaction as if they occurred on April 1, 2014 (in thousands, except per share data):

| | Three Months Ended June 30, 2015 (unaudited) |
|---|---|
| Pro forma revenue | $ 290,113 |
| Pro forma net loss | $ (4,763 ) |
| Pro forma net loss per share: | |
| Basic | $ (0.05 ) |
| Diluted | $ (0.05 ) |
| Pro forma shares outstanding | |
| Basic | 103,560 |
| Diluted | 103,560 |

The pro forma results for the three months ended June 30, 2015 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.

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NOTE 8 – GOODWILL AND INTANGIBLE ASSETS

Goodwill

The Company has five reporting units: (1) legacy NetScout, (2) cybersecurity (Arbor Networks), (3) service assurance product lines focused on the service provider market (formerly known as Tektronix Communications), (4) network visibility product lines (formerly known as VSS Monitoring) and (5) service assurance product lines primarily focused on the enterprise market (formerly known as FNET). At June 30, 2016, goodwill attributable to the legacy NetScout, cybersecurity, service assurance line focused on the service provider market, network visibility product lines and service assurance product lines focused on the enterprise market reporting units was $197.8 million, $534.9 million, $795.5 million, $57.0 million, and $125.1 million, respectively. At March 31, 2016, goodwill attributable to the legacy NetScout, cybersecurity, service assurance line focused on the service provider market, network visibility product lines and service assurance product lines focused on the enterprise market reporting units was $198.1 million, $534.8 million, $794.4 million, $57.0 million and $125.1 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 three months ended June 30, 2016 is due to 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 three months ended June 30, 2016 are as follows (in thousands):

| | |
|---|---|
| Balance at March 31, 2016 | $1,709,369 |
| Foreign currency translation impact | 917 |
| Balance at June 30, 2016 | $1,710,286 |

Intangible Assets

The net carrying amounts of intangible assets were $1.0 billion and $1.1 billion at June 30, 2016 and March 31, 2016, 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.

Intangible assets include the indefinite-lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets at June 30, 2016 (in thousands):

| | Cost | Accumulated Amortization | Net |
|---|---|---|---|
| Developed technology | $253,036 | $ (79,949 ) | $173,087 |
| Customer relationships | 833,129 | (58,248 ) | $774,881 |